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THE 1973 MIDYEAR REVIEW OF THE ECONOMY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-THIRD CONGRESS

FIRST SESSION

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THE 1973 MIDYEAR REVIEW OF THE ECONOMY

MONDAY, JULY 30, 1973

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

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

Present: Senators Proxmire and Fulbright; and Representatives Reuss and Blackburn.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Jerry J. Jasinowski, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. This morning the Joint Economic Committee is beginning its 1973 midyear review of the economy. This year's midyear review comes at a moment when the United States is confronted with a complex set of extremely grave economic problems. Every major dimension of the economic situation presents problems which appear far more severe today than they did when this committee held its annual hearings just last February.

First among the problems we wish to examine is unemployment. In recent months concern over inflation has tended to distract attention from the fact that unemployment is still almost 5 percent. Unemployment has been continuously above the 4-percent level for nearly 3½ years. During that 3½-year period, failure to fully utilize our labor resources has cost us over $200 billion in lost output.

The future prospects seem little brighter than this past history. I know of few students of the economy who expect any significant reduction in unemployment during the remainder of this year. Indeed, if the pattern of slow growth of output which showed up in the second quarter continues, unemployment will soon start to rise again.

A popular attitude seems to have grown up that somehow unemployment is less serious today, that 5-percent unemployment is "all right." Consider that in the second quarter 4.4 million persons were unemployed, an additional 2.3 million were working only part time because full time was not available, and there were about 800,000 discouraged workers. The statistics thus show a total of 7.5 million workers who could not find full opportunities for employment. Additional uncounted millions could find work only in low-paying jobs which made little use of their education and ability. The problem of unemployment and underemployment is far too serious to be put on the back burner until other problems have been taken care of. Our current performance is not only pitiful compared to virtually every other industrial country, large industrial country, it is not up to our own historical standard.

Inflation, obviously is also a problem, and a dramatic one. The administration has just instituted its complicated new phase IV anti-inflation program. While I welcome this move as a good faith effort to deal with inflation I have many reservations about the design of the program. Even with the best possible program, inflation is going to remain a critical problem for the foreseeable future.

These domestic economic difficulties are matched by the difficulties of the dollar in international markets. The weakness of the dollar abroad is both puzzling and disturbing.

I would like to take one more minute to quote from a newspaper which I think puts the present situation into a helpful perspective. This is an editorial comment:

> Over a wide range of vital commodities, the United States provides traditionally higher prices, particularly in regard to food and oil. But suddenly the world prices are higher than our domestic prices are. Our problem now is not surpluses and low prices, but shortages and high prices. Foreign demand reflecting the rising demand of other nations is no mere passing irritation. It will be permanent and we are going to have to learn to live with it.

Very few in the administration seem to be aware of the dramatic change on which this newspaper comments. All of these questions will be addressed in the course of these hearings. All of them are difficult economic questions.

Our first witness is Prof. F. Gerard Adams, Department of Economics, Wharton School of Finance. In addition to a distinguished academic career, Professor Adams has served on the staff of the Council of Economic Advisers and the Organization for Economic Cooperation and Development in Paris.

The second witness is Prof. Willard W. Cochrane. Department of Agricultural Economics, University of Minnesota. In addition to his academic background, he served at the Agriculture Department during the 1960's. He is the author of "The City Man's Guide to the Farm Problem." We have invited him to discuss the agricultural problem and the outlook for food prices and supplies.

The third witness is Prof. Charles Kindleberger, Department of Economics, Massachusetts Institute of Technology. Professor Kindleberger is a distinguished, highly regarded, international economist. It is a pleasure to welcome him before this committee.

I would like to ask each of you gentlemen to confine your remarks to 10 minutes, if you can, and we will proceed to a discussion. Your entire prepared statements will be printed in full in the record, if you don't have an opportunity to present them orally.

So, Mr. Adams, go right ahead.

STATEMENT OF F. GERARD ADAMS, PROFESSOR, DEPARTMENT OF ECONOMICS, WHARTON SCHOOL OF FINANCE, UNIVERSITY OF PENNSYLVANIA

Mr. Adams. As our vice chairman pointed out, the economic outlook this summer is considerably more uncertain than it has been in a long time, a very long time. We are reminded daily of the continued pressures from high demand, yet there are increasing questions: Will there be a recession in 1974? Can the upsurge of inflation be tamed? What is the appropriate policy mix?

The Wharton Econometric Forecasting group has looked into these questions with care. To summarize our findings: There will be a real slowdown of the economy in 1974. By the standards of past business cycles, the slowdown will be mild. It is a semantic question whether this should be termed a recession or not.

While the current upsurge of prices may go further and last longer than we had expected, it has substantial temporary elements. With appropriate policy the rate of inflation will slow down somewhat, but will remain in the range of 4 percent to 5 percent per year, GNP deflator, during 1974.

Macro demand management policy, either monetary or fiscal, is not sufficient to deal with the current situation. We will have to rely on substantial price-wage control and/or incomes policy to keep inflation in check throughout 1973 and 1974.

Recent policy shifts have complicated the life of the economic forecaster. We have updated our prediction insofar as possible in line with these developments. One of the significant advantages of econometric forecasting is the ability to respond quickly with a consistent picture of the effects of a policy change.

But that means, also, that the model should not be used mechanically; it requires tuning and adjustment to incorporate prospective policy developments. The present forecast is a preliminary response to phase IV, dated July 20, 1973. A control forecast to be prepared in the next few weeks at Wharton will incorporate the second quarter statistics and a review of the policy assumption. Probably it will be different in detail, but not in qualitative evaluation of economic prospects.

The latest Wharton forecasts point to a substantial real slowdown into most of 1974. The growth of real GNP will decline from an annual rate of over 6 percent, in 1973 over 1972, to only approximately 1 percent, 1974 over 1973. While there will not be any quarter when there is real decline of GNP, growth will be negligible over 4 quarters. Capacity utilization, which has been at very high levels, 94 percent by the Wharton index of capacity utilization with many important industries at full capacity, will fall off to 87 percent toward the end of 1974. The unemployment rate will increase gradually to near 6 percent. Profits, which appear to have increased sharply again in the second quarter, can be expected to decline.

The rapid economic expansion we have seen recently cannot be sustained: it is too much to expect that reentry to less pressured situation can be accomplished without such a slowdown. It reflects the continued restraint in Federal Government purchases—an essential element if the economy is to be cooled—decline in residential construction which responds with its normal long time lags to the reduced availability of mortgage money, and to some reduction in inventory accumulation and restraint in real investment in 1974. The consumer may also be increasingly cautious during the coming quarters.

It makes little difference whether you call this a recession or not. There is considerable uncertainty about its dimensions. Strikes in the automobile industry, or severe loss of confidence associated with continued rapid inflation could aggravate the situation. But the important thing to note is the continued underlying strength of demand, the relatively low vacancy rates in housing, and the anticipated further improvement in the real trade balance.

These factors will prevent the slowdown from going too far.

The price situation represents a more serious question mark. Few economists, within and outside the Government, had predicted the upsurge of prices so far in 1973. We have factored into our forecasts the influence of phases III, III½, and IV, but the imponderables are very large. Much depends on the uncertain movement of agricultural prices, on the specifics of price control enforcement, on labor settlements.

Our analysis implies that some of the recent price increase is temporary, the sudden increase in food prices and prices of primary materials on world markets, a catchup from past price controls, and the effect of high capacity utilization. Some of these factors may turn out to be more favorable during the forecast period.

On the other hand, an important determinant of industrial pricing is the unit labor cost. The latter, the cost of producing a unit of product, depends on wage rates, and on productivity. Wages pressures are moderate this year, with compensation increases running a little over 7 percent annually. But in the next phase of the business cycle productivity gains which have offset increases in wages in the past will not be as favorable and this may impose pressures for additional price increase.

After an initial price freeze catchup bulge, the Wharton forecast shows more moderate price increases. Price increase may be running at an annual rate of 6 or more percent for the remainder of 1973, as measured by the broad GNP deflator—other measures of prices may be much, much higher. Into 1974 we see prices increasing somewhat above 4 percent for most of the year. But price forecasts are uncertain and this one presupposes continued restraint on wages and a successful phase IV.

For the policymaker, the present situation presents some most perplexing problems. There is little more that aggregate demand policy can accomplish. The coming slowdown in demand is desirable. It is not clear that additional restraint on aggregate demand would ease the inflationary pressure in the short run. The cost in unused resources and danger of recession exceeds the gains with respect to price stability. We must avoid an extended bout of "stagflation."

For fiscal policy this means continued restraint. Federal expenditures must be held in check as now planned. Reductions in defense expenditures may be turned to civilian purposes, a strategy which is particularly important at a time when needs for public services are growing. But a further cutback in spending or a tax increase will not appreciably cool the economy or reduce inflation in advance of the anticipated slowdown.

The management of monetary policy is even more problematical. Interest rates are at record highs. But the level of interest rates is not a reliable measure of tightness in monetary markets. In view of the rapid rate of inflation, the real interest rate is significantly lower than the nominal rate and in view of changes in regulation Q interest rate ceilings financial availabilities are not as constrained in many sectors as they might be. Money supply has been growing rapidly.

The Federal Reserve has undoubtedly tightened its monetary policy posture, and we have factored such an assumption into our forecast. The predicted slowdown is already a consequence of tighter monetary policy. It is well to keep in mind that the normal channels of monetary policy, through investment and residential construction, involve long lags. Short of a real crunch, a tightening of monetary policy now will have the bulk of its effect next year. Monetary policy will not cool the economy in the short run.

This leaves principally the tools of direct price and wage management. One view is that intervention in the market process is ineffective and leads to inequities, shortages, and aggravated inflationary pressures. There is some validity to this point. The problem at this time is that success of anti-inflationary policy rests on a very fragile limb. Wages have been held in check successfully, but surely wages cannot be held back much longer if prices continue to move rapidly. The risk of a true inflationary spiral is considerable. We must keep a lid on prices, wherever possible, until the economy has had time to cool.

Simulations with the Wharton model have shown that limitations on prices can permit somewhat higher real growth with reduced inflation. Put the other way, failure to limit inflation implies lower real output.

It is difficult, if not impossible, to control prices in agricultural or materials markets, but there is considerable scope for price limitations in manufacturing industry. These industries exercise certain pricing power. Profits have mounted considerably this year. Industry responds to long run price and profit developments. It will not limit investment or hold back production in response to reasonable short-term price limitations.

With phase IV, we once again have the tools to apply price controls until the boom has mad time to cool. The critical issue is how these regulations will be administered and enforced. The controls must be firm; it may be wise to roll back many prices to their level in January, before the spurt of prices and profits in the first half of this year. Many of the increases in costs could well be absorbed. But controls must also be flexible, responsive to the needs of special situations. They require extensive management. They must not be permanent but they must last long enough until price pressures have abated.

The management of inflation rests on a balanced approach, moderation in fiscal and monetary policy, effective limitations on prices, and continued reasonable wage awards.

Thank you.

Senator PROXMIRE. Thank you, Mr. Adams. May I say that without objection, the table attached to your statement will be placed in the record at this point.

Mr. ADAMS. Thank you.

[The table follows:]

WHARTON MARK III QUARTERLY MODEL JULY 20, 1973, SPECIAL RELEASE: 1ST IMPRESSIONS OF PHASE IV

TABLE 1.—SELECTED MAJOR ECONOMIC INDICATORS

Item	Lagged 1973.1	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	Annual 1972	1973	1974
Gross national product	1,237.9	1,268.2	1,292.6	1,315.9	1,332.8	1,349.6	1,367.5	1,388.2	1,415.9	1,151.8	1,278.6	1,359.5
Percent change: Gross national product	15.19	10.15	7.93	7.39	5.25	5.13	5.42	6.19	8.24	9.66	11.01	6.32
Real gross national product	827.3	836.3	840.9	842.1	842.8	844.0	846.4	851.3	859.5	789.5	836.7	846.1
Percent change: Real gross national product	7.97	4.41	2.24	.58	.34	.57	1.12	2.32	3.92	6.45	5.97	1.13
Implicit price deflator, GNP	1.496	1.516	1.537	1.563	1.581	1.599	1.616	1.631	1.647	1.459	1.528	1.607
Percent change: Implicit GNP deflator	6.69	5.50	5.56	6.77	4.90	4.54	4.24	3.78	4.15	3.02	4.76	5.14
Implicit price deflator private GNP	1.429	1.450	1.470	1.495	1.511	1.528	1.544	1.558	1.572	1.395	1.461	1.535
Percent change: Private GNP deflator	6.34	5.90	5.76	7.07	4.23	4.55	4.21	3.77	3.61	2.64	4.75	5.07
Real private output per manhour	6.19	6.23	6.24	6.25	6.26	6.27	6.30	6.36	6.43	6.03	6.23	6.30
Percent change: Real pvt output/man-hour	4.73	2.39	1.17	.23	.47	1.04	2.04	3.34	4.63	3.93	3.23	1.11
Private compensation per man-hour	5.02	5.11	5.21	5.23	5.43	5.53	5.62	5.71	5.82	4.79	5.16	5.57
Percent change: Private compensation/man-hour	11.39	7.28	8.02	8.65	9.17	7.26	6.91	6.50	7.84	6.07	7.86	7.98
Unemployment rate (percent)	5.02	4.93	4.87	4.96	5.15	5.40	5.73	6.07	6.36	5.59	4.94	5.59
Capacity utilization: manufacturing plus mining	.94	.94	.94	.92	.91	.90	.88	.87	.87	.90	.94	.89
Personal savings rate (percent)	6.64	6.65	6.21	5.98	6.49	6.41	6.18	6.21	6.89	6.89	6.37	6.32
Percent change in money supply	4.93	4.77	1.04	6.77	5.04	4.50	4.16	5.53	4.84	6.50	5.60	4.66
4-6 month commercial paper rate	6.28	7.36	8.77	8.87	8.31	7.78	7.29	6.86	6.35	4.73	7.82	7.56
Moody's total corporate bond rate	7.56	7.72	8.00	8.29	8.44	8.53	8.54	8.50	8.41	7.63	7.89	8.50
Corporate profits before tax	113.1	118.6	116.6	118.7	108.4	109.7	109.6	113.2	118.8	94.3	116.7	110.2
Federal surplus, NIA basis	−7.5	−4.8	−.8	−.8	−7.2	−7.8	−6.5	−6.5	−12.7	−18.1	−3.1	−7.0

Senator PROXMIRE. Mr. Cochrane, please proceed.

STATEMENT OF WILLARD W. COCHRANE, PROFESSOR, DEPARTMENT OF AGRICULTURAL ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. COCHRANE. I will try to focus on the food and agriculture situation as it impinges on the United States. If you have questions about more detail of the world food situation, I will be glad to try to answer them.

I think everyone knows the world food and agricultural situation has literally turned upside down in the past year. A year ago we were worrying about grain surpluses and now we are worrying about food prices. What has caused this? Little of the cause is to be found in things that have happened in the United States. This is, in my opinion, a pure case of world development impinging on the United States through the world market.

We have had over the last 10 years, I would say, a notable increase in the demands for meat products in Western Europe, Japan, and a few other places like Hong Kong and so on. We have become one of the principal suppliers of the raw materials to the production of that increased meat production, feed grains, and protein meals.

What I see has happened over this long period is that we have had a slow but steady tightening in these markets—these feed grain and soybean meal markets—with our exports increasing every year and with a modest upward pressure on the prices.

So we had the element of a tightening situation growing out of the basic economic development of Western Europe and Japan and the demand on the part of their consumers to eat like the U.S. consumers. That is the underlying situation as I see it. But then we have several acts of God and acts of man, which are unpredictable that operated to turn the situation around.

The first one, the one we are most familiar with, is the poor grain crop in the Soviet Union in the last year. What many people fail to recognize is that the Soviets have had a poor crop in the past. But years ago they tightened their belt a little and went hungry. There is a decision this time that caught everybody off guard—the decision to go into the world market and buy grain in one of the largest purchases in the history of the world.

Then we had poor crops, poor food grain crops stretching all the way from India to Indonesia and the Philippines, and that did not convert into a real strong demand for grain such as the Soviet deal, but nonetheless, the Philippines and India and other countries were in the market trying to buy little pieces of grain here and there, all of which had a tightening element. Then we had the act of God off the Peruvian coast in which the fish run ceased for reasons I don't know, and an important supply of fish meal to Western Europe dried up over the past year.

So you put these acts of God and acts of man on top of a tightening world grain situation and you go from a surplus situation to a shortage situation. When is this food crisis or food price crisis likely to begin to moderate? Well, I would look at it about this way: These are my "if" conditions.

If we have no bad crops in any of the major wheat producing areas and wheat consuming areas of the world this year, I would think that wheat prices would begin to moderate in the fall of this year. I must confess I expected them to begin to moderate before this, and they are still going up. Some of you may be aware the Chicago Board of Trade closed at $3.44 a bushel on Friday, which I believe is an alltime high.

In any event, if we get average weather around the world, I would expect to see some moderation in wheat prices this fall. If we get average weather and no bad crops in the major feed grain producing areas, I would look to see corn prices, which is the best indicator of feed grain prices, to remain about constant through the coming year, but easily going up some more or easily slacking off a little bit with any little bit of good news or any little bit of bad news.

In other words, I think that the feed grain situation is really touch and go, and it could go either way. The crop of corn that we see coming to harvest this fall should put us in an uneasy balance in which it could go either way. Soybeans: We are going to get a large crop in the United States this year. I would think that soybean prices would begin to ease off this fall, but soybean prices are now between $10 and $11 a bushel. I don't think that we will see them go back to the $3 level of 1970–72 for a long time. I would think soybean prices might well fluctuate between $4 and $8 a bushel for a considerable period of time because soybeans are such an important element in the meat production that is so strong in Western Europe and in Japan.

So I am outlining here a very iffy condition, and that is exactly what I mean to do. There is absolutely no way to predict beyond the current crop year as to what may happen in the future. I wouldn't be surprised to see in 1974–75 some poor crops in major producing areas and prices go still higher, or I wouldn't be surprised to see two or three real good crop years in a row and a surplus grain situation once again—at least in wheat and feed grain, probably not soybeans.

Are the Soviets going to continue to come into the market and try to upgrade the diets of their people? There are indications that they may be. If they do, that will tighten the situation. I don't know what they are going to do.

Are the Chinese going to begin to come into the market? I am not privy to what is going on, but it appears they are making some large purchases in the world. There are acts of God and acts of man that could occur over the next several years and of such magnitude as to influence world grain prices. It is nonsense to try to predict whether the food price situation is going to ease or it is going to get tighter.

These world developments are going to have direct effects back home because we are a major supplier of wheat in world markets, and we are the leading supplier of soybeans and feed grains. If one set of things happens, the demand for these exportable supplies is going to be reduced and our marketable supplies of feed grains and soybeans will increase at home, in which case we could expect meat prices to come down.

On the other hand, if a further tightening occurs, which is a very real possibility, then there is going to be a strong export demand for feed grains and soybean products in our domestic markets, and we can expect prices of these inputs to go up.

Since the demand for meat is inelastic—the demand is about −0.6, this means that with any small increase in the marketable supplies of feed grains, we can expect prices of meats after a lag to decline significantly, or with any small decrease in marketable supplies, for meat prices to shoot upward. We are seeing this right now.

Really, you know, we have had good crops in the United States and we are getting only what I would call a moderate pull on our supplies, and meat prices are zooming upward, going to the roof.

What I would like to suggest to this committee in thinking about policy is that we must recognize that we can't predict more than about a year ahead. We should know what is going to happen to supplies and requirements the year ahead. We have the intelligence, if used properly, in the United States to know what is going to happen a year ahead, but not beyond that.

The world food situation is balanced on a razor's edge, and I am trying to point out that it can easily go either way. This means to me that we need a food and farm policy in the United States which can move quickly and rapidly either way. The cornerstone of this policy, and one of the aspects in which I am disappointed in, in the present farm legislation, should be a major storage program.

This storage program should operate like a giant balancing wheel, coming into the market to acquire stocks when we have surpluses and prices are low. When the prices are rising, it would pour supplies onto the market to moderate the upswing. But even with a giant storage program, I don't believe we can operate a storage program sufficiently large to moderate the kind of price swings that we are likely to have in world markets.

Hence, I believe we must continue to have supply management devices along with that storage program. I believe firmly in the need for production controls in periods of surpluses. And unless we want to let food prices go up and down like a yo-yo in the United States, we are going to have to think about the judicious use of export controls. So I am suggesting we need to think about a very large storage program, larger than we have had in recent years, but perhaps not as large as the stocks that we inadvertently collected in the 1950's. Then we need management devices to go along with the storage program.

I am suggesting continuation of production controls and the judicious use of export controls. If we are going to live in an uncertain world where we cannot know with certainty beyond at least 1 crop year, we need such devices. But most of all, we need a forward-looking export policy.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you, Mr. Cochrane.

[The prepared statement of Mr. Cochrane follows:]

PREPARED STATEMENT OF WILLARD W. COCHRANE

SOME NOTES ON THE WORLD FOOD SITUATION WITH SPECIAL REFERENCE TO THE UNITED STATES IN 1973–74

I. THE SITUATION

A. The world of food and agriculture has turned upside down over the past year.

(1) Grain supplies in world markets have become exceedingly short, and prices have risen significantly.

a. No. 1 Canadian Red Spring wheat at Fort William rose from \$62.45 per metric ton in April 1972 to \$98.59 in April 1973.

b. Rice, 5% broken, f.o.b. Bangkok, rose from $128.96 per metric ton in April 1972 to $204.05 in March 1973.

c. Sorghum grain U.S. No. 2, c.i.f. Rotterdam, rose from $59.05 per metric ton in April 1972 to $81.49 in April 1973.

(2) The general surplus condition of American agriculture has evaporated, and supplies of various food products at retail have become painfully scarce.

(3) U.S. farm prices are soaring; average prices received by farmers in the United States increased between June 15, 1972 and June 15, 1973, as follows:

a. All wheat, per bushel: from $1.33 to $2.43.

b. Corn, per bushel: $1.13 to $1.99.

c. Soybeans, per bushel: $3.32 to $10.00.

d. Hogs, per c.w.t.: $25.60 to $37.20.

e. Broilers, live, per lb.: 14.4 cents to 24.5 cents.

B. As we all know, livestock prices have continued to advance since June 15, 1973. U.S. No. 1 hogs reached the high of $50.00 per c.w.t. in midwest markets on July 20, 1973, and the price of poultry products and beef give every promise of shooting skyward in the fall of 1973. How high, no one really knows. But the Wall Street Journal for July 20, 1973 predicted bacon at $2.00 a pound, broilers at 75 cents to $1.00 per pound, and eggs at $1.00 a dozen at retail within two weeks, with the big kick in beef prices to come in September.

C. Confronted with this situation, what has the Administration done? In general terms, it has pursued an erratic, inconsistent course of action dealing with each crisis as it arose, rather than developing a consistent, rationally planned course of action. More specifically:

(1) It contributed to the tight grain market in the U.S. by underwriting the sale of some 400 million bu. of wheat to the Soviet Union, and by pushing soybean exports in fiscal 1972–73.

(2) It has contributed to uncertainty in the minds of farmer producers and processors, hence to production discontinuities, by alternately controlling and decontrolling retail food prices.

(3) It has tried to increase domestic supplies by

a. easing production controls and bringing more acres into production in 1973, and

b. placing an embargo on the export of 1973 crop soybeans and products.

D. This is what happened in one short, eventful year. The world, and more particularly the U.S., moved from a grain surplus condition to a shortage condition in one peacetime year.

II. HOW DID THIS HAPPEN? WHAT HAPPENED TO CAUSE THIS COMPLETE TURNAROUND IN THE FOOD-AGRICULTURE SITUATION?

A. It is important to recognize first that little of the cause of this turnaround is to be found in developments within the U.S. This is a case of world developments impinging upon the U.S. situation.

B. What then were these world development? There were several in number, and I list them in general order of importance, although I have no way of assigning exact weights to these causes.

(1) The long-run trend in Western Europe, Japan and other areas for the per capita consumption of meat products to increase, with the concomitant increase in the import demand for meat-producing inputs (e.g., protein meals and feed grains) in those areas.

(2) The poor grain crop in the Soviet Union in 1972, and the decision by the Soviets to go into the international market and purchase large quantities of grain to make up for their domestic losses.

(3) The poor food grain crops in South and Southeast Asia in 1972 and the entry of some of those countries into the international grain markets in search of supplies.

(4) The failure of the Peruvian fish catch in 1972, and the loss of that important source of protein meal.

C. The scenario, as I see it, runs as follows—the strong and growing demand for animal products in Western Europe and Japan over the past decade has slowly but steadily tightened the international markets for feed grains and protein feeds. To this important economic development we add three supply restrictions resulting from acts of God: a bad grain crop in the Soviet Union, poor food grain crops in South and Southeast Asia, and a failure of the Peruvian fish catch. Finally, we add two conscious acts of man: the decision by the Soviets to enter the world market to make up their losses and the decision by the U.S. to sell out its reserve stocks of grains and soybeans. From this scenario we get the following:

(1) A general tightening of world grain markets, and a significant strengthening of grain prices in those markets.

(2) A sharp and dramatic increase in farm and food prices in the U.S. as it has run short of the inputs required to produce the high levels of animal products demanded by its consumers.

D. In my judgment, the excellent intelligence-management system of the U.S. Department of Agriculture, which was developed over several decades, has broken down, thus allowing, even abetting, the U.S. to sell supplies of grains and protein products to foreign nations which it required to produce its own supply of animal products at stable prices. As a result of poor government management we oversold in a tight world situation and left ourselves in short supply with regard to the raw materials for producing animal products.

III. WHAT IS LIKELY TO BE THE DURATION OF THE PRESENT FOOD CRISIS IN THE UNITED STATES?

A. If we do not run into bad weather and poor crops in any of the major wheat-producing areas of the world, or in any of the great grain-consuming areas of the world, wheat prices in the U.S. should begin to ease following the harvest of the 1973 crop.

B. If we do not run into bad weather and poor crops in the major feed grain-producing areas of the world, prices of corn and other feed grains in the U.S. should hold at or around present levels through the 1973–74 crop year and begin to ease following the 1974 harvest. But the feed grain situation is exceedingly precarious; prices could rise or fall with any small supply development around the world. It is a "touch and go" situation.

C. If the Peruvian fish catch returns to normal, the price of soybeans and soybean meal in the U.S. sould begin to decline following the large 1973 harvest. But no one expects soybean prices to return to the $3.00 level of 1970–72. The world demand for the meat-producing resource is too strong. But only time will tell whether soybean prices level off at $4.00 per bushel or $8.00.

D. Because of high feed grain prices, retail price ceilings, and uncertainties generated by this Administration, current poultry and hog production is well below capacity, and supplies of these products at the retail level are going to be very short in the fall of 1973 and winter of 1974. Thus prices of these animal products, together with beef, are going to soar in the months ahead. Probably, due to the short production cycle, poultry and egg prices will ease first in the spring of 1974. But the U.S. consumer is going to pay and pay in the winter of 1973–74 for the mismanagement of grain and protein product supplies by this Administration.

E. But what we have said above is dependent upon no unusual policy developments among importing and exporting nations and average, or normal, weather around the world. These are critical assumptions that may or may not be realized in fact. Any one of the following developments could take place over the next several years:

(1) More bad weather and poor grain crops in major producing-consumption areas;

(2) A series of bountiful crops around the world;

(3) A failure of the Peruvian fish catch for many years;

(4) The development of major feed grain-producing areas in Africa and Latin America with significant increases in exportable supplies of feed grains.

(5) The decision on the part of the Soviet Union to upgrade the quality of the diets of its people, and the continued importation of large quantities of inputs for producing animal products (e.g., feed grains, protein meals).

F. Now none of the possible developments listed above can be predicted with any degree of certainty, but depending upon which one, or combination of them, should materialize, the world market for grains will either continue to tighten, or begin to ease off. And these developments may be either sharp and precipitous or long-run and sustained. In short, we cannot predict with any degree of certainty whether the world grain supply situation is going to become tighter, hence more critical, over the next few years, or will ease and possibly move into a surplus situation.

G. The implications for the U.S. are, of course, of critical importance.

(1) Since we are an integral part of the world market,

a. the leading supplier of feed grains and soybeans, and

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b. a major supplier of wheat, the materialization of any one, or combination, of the unpredictable developments outlined above, which have the capacity to tighten or loosen the world market situation, would be translated immediately into a contraction or expansion of export sales by the U.S., and an increase or decrease in the prices of these products in the U.S.—products which are the basic inputs of livestock production.

(2) Further, since the demand for food in the aggregate and meat in the aggregate is highly inelastic, this means that small changes in the marketable supplies of feed grains, protein meals and wheat are going to have important price-generating effects on animal products.

a. A small increase in the marketable supplies of feed grains and protein meals will have an important price-depressing effect on animal products, given the appropriate lag, and

b. A small decrease in the marketable supplies of feed grains and protein meals will have an important price-enhancing effect on animal products, given the appropriate lag.

H. In other words, because of the extreme inelasticity of demand for food by U.S. consumers, it is a fine line between too much and too little. A little too much causes farm prices and food prices to tumble precipitously; and a little too little causes farm prices and food prices to zoom skyward.

(1) Because we have lived in a chronic surplus condition in the U.S. for 20 years in which the government has supported farm prices at a reasonable level and managed the agricultural surplus-producing capacity through production control and stock takeover, consumers, politicians and economists have forgotten the price consequences of a small shortage or a small surplus of food products in a free market situation.

(2) But this Administration has hitched the U.S. agricultural production plant to the world market to the extent that existing laws would permit, and we are reaping the whirlwind.

a. The first tightening of the world grain supply situation (due to unfavorable weather in some faraway places) encountered by this Administration is driving the prices of animal products in the U.S. to record-breaking peacetime levels.

b. A series of bountiful crops around the world could just as quickly result in a world surplus of grains and disastrously low farm prices in the U.S. if this Administration should succeed in dismantling the agricultural supply management programs.

I. Given the nature of the demand for food in the U.S. and the unpredictability of the world supply situation beyond one year in advance, the complete and full integration of the U.S. agricultural production plant into the world market is certain to result in:

(1) A feast or famine situation for U.S. consumers, and

(2) Sharp and wide price fluctuations for U.S. farmers.

J. The question is—do we want these kinds of price-quantity gyrations in the food and agricultural sector, or do we want greater stability?

IV. WHAT KIND OF A FOOD-AGRICULTURE POLICY MUST THE U.S. DEVELOP IF IT IS TO PROVIDE ITS CITIZENS WITH ADEQUATE SUPPLIES OF FOOD AND STABLE FOOD AND FARM PRODUCT PRICES AT REASONABLE LEVELS AND STILL REMAIN A MAJOR SUPPLIER OF GRAINS AND PROTEIN MEALS TO THE INTERNATIONAL MARKET?

A. First, it must be a flexible policy capable of dealing effectively with either a world shortage situation or a world surplus situation.

(1) It must be able to move in either direction.

(2) And it must be able to do so quickly. It must be able to cope with a turnaround situation such as we have witnessed in 1972–73.

B. The central feature of this flexible policy must, in my view, be a major government storage program somewhat along the lines of past CCC storage programs but with broader objectives and a more rational set of operating rules.

(1) The overriding purpose of the program would be to stabilize farm product prices at both the farm and retail levels.

(2) To this end, it would operate like a giant balancing wheel in the agricultural economy, acquiring products in periods of surplus and low prices and disposing of stocks in periods of short supply and rising prices—thus serving to moderate and stabilize the price swings involved.

(3) It might acquire stocks through farm price supporting operations, as in the past, but it should have the authority to acquire stocks in the market even though product prices were above support, or loan, levels; and it should have the authority to sell at any time or to dispose of stocks in other ways (e.g., P.L. 480) so as to contribute to price stability in the U.S. and in world markets.

(4) But, as we know from past experience, a storage program devoid of other mangement devices can run into serious trouble. Thus, this food and agricultural policy must include:

a. Voluntary production control features such as were included in the Agricultural Act of 1965 and in the farm legislation now before Congress.

b. Import and export controls, the former to protect uneconomic production deemed to be in the national interest, the latter to protect domestic supplies in periods of critical world shortages.

c. The arbitrary and excessive reliance on the kinds of controls indicated under (b) above is likely to have an injurious effect on U.S. consumers and on foreign trade relations, but on some occasions their use may be required to avoid painful consumption or production adjustments in the U.S. economy.

(5) Buttressed by the management devices suggested in (4) above, the storage program will have the capacity to achieve its price stabilization objectives; without those devices it is doomed to failure.

C. But the important point of this discussion is not program mechanics. I have discussed mechanics only to illustrate the content of a food and agriculture policy with the capacity to provide consumers with adequate supplies and to stabilize prices in the uncertain and unpredictable world of food and agriculture in which we will be living in the decades ahead. The important point of the discussion is the following:

(1) The world—a world integrated by an international market—is balanced on a razor's edge with respect to food supplies and farm prices.

a. Some bad weather and a poor crop in India, or the Soviet Union, and prices shoot skyward as nations and their trading representatives seek supplies from a limited reserve stock to offset their losses and build stocks.

b. Or a series of bountiful harvests around the world leads to physical surpluses (due to limited storage facilities and programs) and tumbling prices in world markets. With just the right combination of events we could have such a development in late 1974.

(2) But which way the world will fall and when—surplus or shortage condition—*beyond the current crop year* is unpredictable.

(3) And since the U.S. is an integral part of the world market system, as one of its principal suppliers, the movement into a shortage situation, or surplus, is immediately felt in the U.S. domestic farm commodities market—with prices either increasing sharply or decreasing sharply.

(4) We have recently witnessed one side of this phenomenon—the quick conversion of a tight world grain situation into a domestic food price crisis.

(5) And we can expect, as a normal thing, to witness and feel at home these swings from world grain surplus to shortage and back again. But beyond the current crop year we cannot predict the occurrence of these swings.

D. Given the above set of relationships,

(1) It does not make sense to wait for a crisis to develop, even perhaps inadvertently contributing to it, and then take *ad hoc* steps to deal with it.

(2) It makes sense to recognize the kind of food and agriculture world of which we are a part.

(3) To make the best possible use of information and intelligence with regard to food production, distribution and disappearance, and to *know* what to expect with regard to such variables for relevant future periods—periods that run up to a year in duration.

(4) And, on the basis of the above intelligence, to begin to execute the flexible policy discussed above to cope with the unfolding world food situation—surplus or shortage.

E. The effective execution of such a flexible food policy should

(1) Moderate the slide into a world surplus or shortage situation and its adverse price effects, and

(2) Insulate to a tolerable degree the domestic market from the extreme supply and price consequences of the world development.

F. The vigorous execution of a flexible policy of farm product storage and management has much to offer American consumers and farmers in the way of assuring adequate supplies and stabilizing prices. The "bare shelf" policy of this Administration in the context of a free market can only lead to "feast or famine."

Senator PROXMIRE. Mr. Kindleberger, please proceed.

STATEMENT OF CHARLES P. KINDLEBERGER, PROFESSOR, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. KINDLEBERGER. Mr. Vice Chairman, I am pleased to be here. I was invited to come in June to discuss the foreign exchange market, the floating exchange rate. I couldn't come. I think my presence here is originated from that, and I am going, if I may, talk to that issue.

Senator PROXMIRE. Fine.

Mr. KINDLEBERGER. I think it is of interest that Professor Cochrane did not mention in his discussion of the farm prices the fact the farm prices have been kicked off by the extreme depreciation of the dollar.

Senator PROXMIRE. He did imply that, didn't he? He said it wasn't our doing and it was the enormous demand from abroad.

Mr. KINDLEBERGER. It seems to me to be clear in a world of shortage, the prices abroad and in this country are going to be joined through the exchange rates. The rate of exchange is a dynamic factor. In this world if you depreciate the rate, it is very likely the present from abroad would have remained to stay here. If we depreciate the rate, they will be likely to remain steady abroad and appreciate here.

We have compounded our problems, partly, on the exchange rate neglect. I think it is interesting to observe that Mr. Cochrane is bothered by a program of storage. I am bothered by a program of neglect of the exchange rate.

Senator PROXMIRE. The neglect of what?

Mr. KINDLEBERGER. Management of an exchange rate. We are going in more free floating. There has been an indication in July, a meeting, and perhaps we modified that. I haven't followed closely enough to know that we have. But I regard the attitude of our Government as to saying we are going to conduct an independent monetary policy. Mr. Burns said it is going to be made in Washington, not in Europe.

If we are going to neglect the exchange rates, it would be irresponsible in fact, because it so happens our exchange rate is quite connected with what has happened in the interest rates in Europe and here. A part of the weakness of the dollar in December and November came about because of the tight list rates abroad, but we pretended not to notice. We kept trying to hold the interest rate down at that time when they were going up in Europe.

I am inclined to think it was led in a considerable way by the speculation against the dollar by the mortgage more or less going up. We allow our friends in Germany and Japan to depend on it, but we didn't. Since that time we allowed free floating and more or less said anything you did is all right with us. I regard that as irresponible.

I think Congressman Reuss is a strong proponent of floating. I happen to be an opponent on it. I think we need international money to have an international system. Floating means you don't have that. At the moment we have grave difficulty with calculating, say, charter rates on oil tankers. People who have long-run contracts in oil don't know what use money has.

In the hearings you held here in June people indicated that trade was now being more and more invited in foreign exchange. We are beginning to find that we have upset and dislocated international trade much more than people who proposed floating exchange rates believed in.

I am inclined to think that we are in trouble on such things as shipbuilding, on oil, because we don't have a unit of account. We don't have a standard to have deferred payment for contracts. We don't have an international money as a standard of value. Some of the multinational aspects and some in the Middle East have been attacked. But they have to have grounds. Unless they match their income and outgo they have to have some international money in which to hold at times, to borrow, and to sell at times.

It used to be the dollar, but it seems to me to be rather careless and I would assert irresponsible with regard to the dollar. We don't need an international money. We are going to disrupt and the economy is a way which is going to be very awkward indeed.

I am inclined to think, as a matter of fact, that the administration has it exactly backwards, that the administration is going to long-term monetary reform and neglect the short-term notion. I would regard that as exactly backward.

What we should do is try to work out over time, slowly get these floating rates to see if we can make them properly, if we can divide the responsibilities between Europe and ourselves, if we will assert some leadership again instead of throwing ourselves as the market forcers, an intervention of what our allies want to undertake. We should try to work out over time a system of manage floating in which we could ultimately hold open the option areas in an exchange rate, and manage in a better degree international monetary policy, not to pay the view that the value is made in Washington, and screaming all the way of tightening of the rates in Europe and Japan.

More than that, I would think a long-term monetary reform is the will-o'-the-wisp. There isn't any basic agreement, no fundamental convergence here, fixed rates, floating rates. The notion that you are going to write a new constitution and set it down in black and white all of the conditions which will take place, under any circumstances strikes me as being a vane quest.

In fact, we are in a position now in the international monetary field that we are in the Security Council of the United Nations even has a veto. The United States always had a veto. The United States has a veto because we control 23 percent of the vote. Europe has a veto, and now the less developed countries have linked together and they have a veto. Whenever three people have a veto and their minds don't meet, my confident prediction as a student of human affairs is that nothing is going to happen. To put our eggs in one basket, in long-term reform, and neglect the short run strikes me as being a bad mistake.

I would have thought I would like to see an attempt to rid the overhead, an attempt to counter the speculators, an attempt to push the dollar back a little bit, which would, by the way, ease our problem in the price field, ease the inflation pressure, and gradually work out with our allies and friends a system of manage floating, which might even hold up someday, although I am not very optimistic in the short run getting back to the use of international money. In justice and domestic economy, getting back to international money which we need.

Thank you.

Senator PROXMIRE. Thank you, Mr. Kindleberger.

[The prepared statement of Mr. Kindleberger follows:]

PREPARED STATEMENT OF CHARLES P. KINDLEBERGER

Mr. Chairman, I am honored to be here to discuss the Mid-Year Economic Report of the President and the Council of Economic Advisers, and to comment particularly on the international aspects. I was able to be present when the Committee staff invited me to comment upon the present exchange and trade position in hearings held in the second half of June. I happen to feel strongly that the present position is misguided and dangerous. In particular, I am unhappy that the Administration seems to be neglecting the day-to-day position of the dollar, content to let the market and foreign central banks guide the course of our exchange rate, while focusing its attention on long-run monetary reform. In my judgment, long-run monetary reform will not succeed in the present disarray of the international monetary mechanism and disagreement on what to do. And neglect of the day-to-day position of the dollar, whether as a positive policy of benign neglect, or more likely an inability and unwillingness to take a clearcut position, threatens the world and the United States with close to a breakdown internationally and more inflation at home.

The advocates of freely flexible exchange rates claim to be happy. Some of them go as far as to assert that there is never destabilizing speculation, that the market is always right. These doctrinaire views are highly dangerous. It is entirely possible that destabilizing speculation will create the condition it fears. Depreciation of the dollar raises the prices of internationally-traded goods, especially foodstuffs, and this price rise is communicated to other prices and wages throughout the system. I have not studied carefully what portion of the increase rate of price rise since February is due to the accelerated depreciation of the dollar since that time, but it is evidently substantial. It is a mistake to regard the 4 to 5 percent of goods and services which we export (or import) has a measure of the impact of the foreign sector on the economy. In a world of deflation, exchange depreciation will drive down foreign prices; in a world of inflation, as today, depreciation drives up prices at home, not only the prices of the goods we export but of the supply we consume at home. Some economic theorists will argue that this is an internal matter, transfering purchasing power from one group to another, say from consumers to farmers, with no net effect. In my view this is erroneous. The gain of farmers is felt sooner than the loss to consumers, so that net spending increases with inflationary effect, and ultimately other income groups insist on having their money incomes raised to maintain real income. The rise in prices of grain, soybeans, meat, lumber, copper, and many prices is intimately associated with the depreciation. And to the extent we depreciate and then cut off exports, as has been done in grains and soybeans, we are disrupting the international economy in two ways.

The Europeans, and especially Pompidou, has urged that the United States take a hand in halting the slide of the dollar. Our response that if they want to halt it they can do it, is irresponsible in the extreme. The price of the dollar is important to us and to the world. The task of managing the exchange market is something in which we should not only share but take a leading role. I am convinced that destabilizing speculation can exist, has existed at other times and places, and has been a serious factor in the exchange market since the first of the year. By permitting it to go unchecked we are destroying confidence in the dollar and ruining its serviceability as international money. By our attitude, we are communicating to the world, and especially to the European Economic Community and Japan, that we have no interest any longer in the functioning of the world economy. If we do not, why should they? And if no one tries to stabilize the system, can it be stable? I think not. The fallacy of composition takes over when there is no leadership. The whole is less than the sum of its parts because we have an intercommunicating system. If everyone looks after himself, the totality will be worse off, as each gains at the expense of a greater hurt to others.

My concern for the loss of United States leadership is based in part on my study in recent years of the 1929 depression. In a book which has appeared in England and will be published in this country next month. I have concluded that the 1929 depression was so wide, so deep and so drawn out not because the shock to the system was so great, but because the system was unstable. To be stable, the world economy needs a stabilizer, a bank of last resort, so to speak. In 1931, the British could no longer fulfill that rule and the United States refused to do so. Today it is not clear whether the United States and Europe are unable to stabilize the world economy, or merely unwilling. But the attitude implicit in the Administration's view that it does not care what the dollar sells for, and how much pressure its depreciation exerts abroad is loaded with dynamite.

Part of the difficulty, I think, is that Washington has lost touch with markets and market psychology. I speak as one with a bias: for three years from 1936 to 1939, it was my task at the Federal Reserve Bank of New York to write a weekly letter for the signature of a vice-president, describing the state of the foreign-exchange market. The Treasury and the Federal Reserve Board in Washington had their data and their models—though not then computerized, but relied on the Federal Reserve Bank of New York for a feel of the market. In the government securities market today, the analytical-statistical approach is supported by a sense of market psychology before a new issue is priced. While I am thoroughly out of touch with the day-to-day workings of the governmental machinery, it is my strong impression that Washington no longer relies very much on the Federal Reserve Bank of New York for an intuitive appreciation of the position. If the computer has no answers, it folds its hands in its lap and accepts its fate. If this impression is correct, it is a distortion of the lessons of economics.

A program of intervention carries dangers, as a New York Times editorial suggested the other day. So does inaction. It is possible for the interveners to misjudge the strength of a market trend, and to lose money in a vain attempt to stem or reverse it. We have been leaving this sort of risk to foreign central banks, which, in seeking at various levels to hold the dollar up, but failing, have acquired dollars at prices well above current levels. This is not a matter for our disinterest. Rather we should work out immediately a more effective system of sharing the risks. A well-planned attack could reverse the trend, as most economists, bankers, businessmen are convinced that the dolar is undervalued at the moment, even though a further attack against it with no resistance may make it fall further and earn profits for bears. As one who has been studying history rather than day-to-day market performance, I am loath to suggest a particular form of defense, but to indicate something of the nature of what I have in mind let me offer the following: a funding of $25 billions of the overhang, that is the dollars held by foreign central banks, into 7 percent 10-year bonds; the activization of the swap-lines by at least $5 billion and their use in buying dollars aggressively in the foreign exchange market from private holders,—not foreign central banks; plus an arrangement in cooperation with other central banks to sell a substantial amount of gold in the market and reverse speculation there. It may be that some such program is underway as a result of the Basle meeting attended by Governor Daane and Vice President Coombs, of the Washington Board and the New York Bank respectively. I hope so.

My scepticism on the prospects for long-term monetary reform is profound. There is no meeting of minds, and no leadership capable of producing concensus, so fare as I can see. In the International Monetary Fund, the United States has refused on grounds of irritation, to renew the term of the managing director, but Europe and the United States cannot agree on a candidate to replace him. The issuance of SDRs, which some believe is central to the evolving system, is stymied by the instance of the developing countries on using new issues as a means of providing aid to them, aid which appears to be drying up by previously utilized bilateral and multilateral means. In the early days of the IMF, the United States with a quota of about 23 percent had an effective veto over action since 80 percent of the votes were needed to take action, and only the United States had more than 20 percent. Since that time, the Common Market, even with its original six members, has acquired a veto if they vote together, and the less developed countries (LDCs) another, if they form a coalition, as they have done on such matters as the link between SDRs and foreign aid. When all groups have a veto and there is no meeting of minds or leadership capable of producing concensus, there is likely to be little action. Any agreement in words has to be so qualified with exceptions that there is a danger of validating the exceptions more than the rules. This was the basis on which the Congress of the United States rejected the International Trade Organization charter, or rather discouraged the Truman administration from presenting it to it. A similar fate, in my judgement, is in store for an agreement on monetary reform which will emerge from Nairobi or subsequent deliberations of the IMF on recommendations of the Committee of 20.

On the central issue of whether there should be more flexibility of exchange rates, or a system of fixed rates, with one money coming widely into use as international money, I have no doubts. Flexible exchange rates with no management have shown themselves once again to be disturbing because of destabilizing speculation. Managed flexibility will work if one major country such as the United States decides that it does not care what its exchange rate is, and permits each and every other country to choose the rate it wants. This is the system which the United States finally rejected on the ground that it did care—a great deal—about the rate of the dollar in foreign currencies. Where two countries manage their mutual exchange rate together, the vaunted independence which flexible exchange rates are supposed to produce is lost. As the period since February shows, it is not easy to agree on rates mutually, and when the United States is content with a rate for the dollar, other countries may not be. We are repeating almost exactly the experience of 1933 when President Roosevelt repeatedly expressed himself as prospectively satisfied with a lower rate for the dollar than the one existing. James Warkburg's diary in September 1933 records a conversation with the President in which he reminded the latter that in April when the dollar was $3.75, to the pound sterling, he wanted $3.85. In May when it was $3.85, he said he would be satisfied with $4.00. On June 17 when he was offered $4.00, he wanted $4.25. In August when the pound was $4.50, he wanted $5.00.

The advocates of flexible exchange rates focus on the function of money as a medium of exchange, and rightly note that this function can be performed under flexible exchange rates, for individual transactions through the foreign-exchange market. But money has other functions—as a store of value, as a unit of account and as a standard of deferred payment—i.e. for balancing income and outgo in the short run, for calculating whether given transactions are beneficial or not, and for making contracts. None of thees functions is well performed under flexible rates. The proponents of the system trot out the forward exchange market at this stage, and the discussion is apt to get technical, but there is nothing the forward market contributes net to the foreign exchange market on a spot basis, and forward markets cannot be used as a unit of account or a standard of deferred payment because they do not apply to streams of funds of uncertain amount stretching into the uncertain future. The world needs an international money to function well. Without the existence of such money now, there is great uncertainty in shipbuilding, contracts for oil, non-ferrous metals, direct investment and the like. It is impossible in present circumstances to decide whether it is or is not worthwhile for the Volkswagen company to construct or buy an assembly plant in the United States without being able to forecast, within a fairly narrow margin, the price of the dollar for some years ahead. Small business men are surely incapable of forecasting the price levels in two countries, and whether the exchange rate between the two currencies will reflect closely the relative inflation between them. Larger companies and bank research departments can make a try but the success is likely to be limited.

It is said that the system of using the dollar as international money has been proved to be crisis-prone and ineffective. In my judgment, the difficulty was less in the system than in the fact that neither the United States, nor the Common Market countries, well understood it. With North America and Europe joined in a single money and capital market through the Euro-dollar, the United States, and say, Germany tried to run independent monetary policies. It cannot be done. In a single market there is one price, and with one price, there is a single market. The United States would try to lower interest rates, and Germany to raise them, which made dollars flow to the Euro-dollar market from New York, and German borrowers with access to that market to borrow Euro-dollars for paying off expensive loans from German sources. Beginning with the Interest Equalization Tax in 1963, the attempt was made to fragment the market. Neither United States controls on outflows, nor European controls to prevent inflows have worked effectively. The enormous outflows of 1970 and 1971 which touched off the so-called Nixon shock and brought about the Smithsonian agreement with Secretary Conally's hard bargaining had much of their origin in a failure on both side of the Atlantic to understand the law of one price, and to manage their monetary policies in a coordinated way. I argue that this is no more difficult politically than to manage their exchange policies in a coordinated way, and much more beneficial in promoting world trade and investment.

It must be admitted that since 1970 there has been a change in the United States balance of payments on current account, which is not related to this failure of comprehension on the capital account, or at least unrelated in any way that I can see. I refer to the rapid collapse of the surplus on current account and its replacement, with great suddenness I would argue, by a substantial deficit, to an extent well beyond the forecast estimates which relied on existing coefficients for relative prices and incomes. There seems to have been a sudden structural shift, in the direction of deficit. Much of it was the counterpart of recognizable factors, such as the automotive agreement, with Canada, but even after allowances for this there was a great deal more, largely focussed on Japan and Germany.

Many analysts blame this shift on progressive overvaluation of the dollar which had built up during the years of United States passivity with respect to its exchange rates. It is more than that. My hypothesis, in which I do not have great confidence, is that it is a result of some aging process which has taken place in the United States economy, relative especially to Japan, much like the Climacteric in Britain at the end of the 19th century when she was overtaken by Germany and the United States. The innovative process seems to have slowed down, for one thing, with few dynamic new products coming forward to replace the earlier innovations which Japan and Europe have now learned to produce for themselves. A well-known example is the inability of Detroit to meet Environment Protection Agency standards in seasonable fashion, when the Japanese automotive manufacturers appear to have no difficulty, or Mazda's ability to make the Wankel engine work, if it has done so, when General Motors, Chrysler and even Daimler Benz have been unable to use it in a marketable car.

In addition to the slippage in innovation, there is a relative increase in spending which comes from 1) government deficits; 2) a decline in personal saving from over 7 to 5½ percent of disposable income. The devalued dollar is unlikely to increase saving, and at full employment it is unable to stimulate output by much, except for the released farm land, largely offset by flooded fields. The absorption approach to the impact of exchange rates on the balance of payments, emphasizes that the balance of payments on current account is the difference between what a country produces and what it spends. If depreciation expands production more than expenditure, it can improve the current account. If, however, with full employment, production cannot be increased, and depreciation fails to reduce expenditure, the balance of payment on current account will remain unchanged. I see little prospect in the long run of depreciation producing a major improvement in the balance of payments because I fail to see how it will reduced the government deficit or increase personal saving. The likelihood is rather that the system is homogeneous, and more depreciation means more inflation. If we have the exchange rate and double all prices, we have advanced not one whit, and in destroying the international usefulness of the dollar as money, we have regressed.

In the present circumstance, I would advocate a shelving of longrun plans for monetary reform, and an attempt to stabilize exchange markets by reversing the destabilizing speculation. Over the long run, Europe, Japan and the United States can evolve a pattern of exchange rates, and of working together on exchange matters, which will enable us slowly and painfully to coordinate monetary and fiscal policies, so as to sustain the exchange rate. The market in due course, with the permission of the relevant monetary authorities, will fix on one money to use above all others, as it fixed on the pound sterling after 1870, or the dollar after 1924. In making its judgment the market will be influenced by its then-current view of the political sagacity of one and another country and its economic stability and dynamism. The dollar may be a contender, or it may not. The market, as I have said, ultimately decides. For a country to have its currency chosen is not an unqualified blessing, or a license to exploit the rest of the world as many thought after 1945 was implicit in the dollar standard. The country in question will accept some limitations on its policy-making powers, and gain some advantages, but it should take note that there may be some national loss for the international good. Money is a public good which the nations of the world cannot provide privately in dealing with each other.

Implicit in this is the view that the SDR is not a starter. Some analysts take the view that the SDR can serve as international money, each country fixing its exchange rate against the SDR as numeraire, independently without considering cross rates against its major trading partners. I regard this as dream-world stuff. One cares about the exchange rate in terms of the currency relations with other countries, not about a rate on an intellectual construct outside the system. If a world central bank issued SDRs which could be used in payment and bore a competitive rate of interest, this would be something else again. The link problem would vanish, since countries spending SDRs would in effect be borrowing at a competitive rate of interest. More interesting, perhaps, if private holders could choose between holding national currencies or SDRs, the forces of competition would unify interest rates, and monetary policies, in various countries as the rate of interest on SDRs set the rates in national markets. This would represent the system of interdependent monetary policies which the flexible exchange rate was intended to avoid.

In short, we are not ready for monetary reform. We do not appreciate sufficiently the benefits of international money. The costs may be admitted to be substantial, but the benefits are not negligible though they have been neglected. We have not thoroughly understood how the dollar system would have to work to be effective. And we are moving in a direction with respect to SDRs the ultimate end of which we do not perceive, and may not want. But we need to patch up the system as it is, for it is in bad shape. This means working together in the general, as well as the national interest, and putting aside the trigger-happy readiness to veto or insistence on our rights. If we cannot provide the leadership, or if other countries are unwilling to provide fellowership for our leadership, we should follow if some other leadership can be found. The world cannot support every country going a different way, for itself, as in 1931 through 1934.

Senator PROXMIRE. Thank you, gentlemen, very much. We covered a great deal of ground here in a very short time.

Mr. Cochrane, you say that food prices seem to be less predictable than they have been in a long time, virtually unpredictable. It is hard to say what is going to happen on food prices, what is going to happen to demand.

On the other hand, doesn't it seem very likely on the basis of a long-term change in demand in Europe and in Japan, the immense increase in demand for protein products, doesn't it seem likely also in view of the limitation on our increased productivity, which did not increase as rapidly in the last 3 or 4 years as it did before that, doesn't it seem likely that food prices are, in the long term, going to rise more sharply? I call your attention to something that I think many people really miss, even though we sense how much food prices have increased. On page 27 of the Economic Indicators for July you see that farm products literally went off the chart. From late 1972 until June 1973 the increase has been fantastic. I calculated about a 47-percent increase in farm products at wholesale prices, in that less than 1-year period. There is nothing we have had like that at any time in that past that I know anything about. Some of the factors that caused that seem likely to persist.

Mr. COCHRANE. Could I back up just a little bit? I agree with you in looking at your chart: my prepared statement which I wrote on Thursday, is out of date in 3 days. Grain prices and food prices are literally going through the roof and probably your lines could go up about an equal distance since June 15.

In my prepared statement I make a point that we have lived in the United States since 1950 in a basic surplus situation with all prices basically riding on supports—feed grains and food prices. I think farmers, consumers, politicians, and economists, and all, have forgotten how inelastic the demand for food is. I tried to hit on this for many, many years as the reason why we needed farm programs. Every one of us in this room likes to eat three meals a day and eat about the same quantity of the same kind of food every day. If prices go up, we want to continue eating three meals each day. If prices go down, we don't switch to four meals.

What that means is that a little bit too much is too damn much, and a little bit too little is too damn little. It was no accident that farm prices shot up during and following World War II. When you are hungry you will pay any price for food. Now what I am trying to point out to you gentlemen is that we have a situation involving a continued strong economic demand for increased meat consumption in Western Europe, maybe even in the Soviet Union and Japan—this is a very strong demand factor—and we have superimposed upon that certain acts of God and acts of man which have created a shortage of grain out of which to make these animals. It isn't a very big shortage, but it is just large enough to push prices through the ceiling.

Now my best guess is that prices will continue to rise significantly through the end of this year and then food prices will begin to fall back.

Senator PROXMIRE. What you say is that you look at the retail price of food. The fact is that the wholesale prices haven't really been reflected fully as yet by any means in the price that the housewife has to pay at the grocery store. That is where they will go up for quite some time.

When you tell me that that wholesale price rise is going to continue, it would seem to me that rising prices in the food sector, for the rest of this year and right into next year is virtually inevitable.

Mr. COCHRANE. I agree with that. We are going to pay prices for food like we never paid before during the next 6 months.

Senator PROXMIRE. Right. Now I would like to move to Mr. Adams in this respect. Mr. Adams, you talked about how our demand situation, as you say, will be moderated, and I think this is desirable. A slowdown in demand is desirable. You say that at a time when we have nearly 5 percent of our people out of work. You predict that with that moderation in demand and slowdown in the growth of economy we are going to have 6 percent unemployment by the end of next year. I think that is a likelihood.

I just don't see that this slowdown accomplishes anything in terms of the guts of our inflation problem, which is, No. 1, food. The increases in food prices so far have been about 50 percent in the Consumer Price Index and 60 percent in farm produce wholesale prices.

No. 2, a whole list of commodities, which have suffered price rises have done so largely because demand abroad is very great. What does a slowdown in our economy do to moderate demands sufficiently to have any effect on this inflation? Aren't we just going to compound the misery of increased unemployment if you follow that policy?

Mr. ADAMS. One aspect of the economic situation at this time is that while we still have almost 5 percent unemployment, on the other hand there seems to be a very tight utilization situation.

Senator PROXMIRE. Let me interrupt you to say your figures dramatically clash with those of the Federal Reserve Board. You have 94 percent.

Mr. ADAMS. Yes; 94 to 95 percent at this time.

Senator PROXMIRE. The rate of capacity they show is about 10 points below that.

Mr. ADAMS. Theirs is about 82.

Senator PROXMIRE. What is the reason for that difference?

Mr. ADAMS. Well, our calculation is made on rather simple terms. In other words, it is a calculation that looks directly to the volume, the output the industries of the economy have achieved. Past evidence suggests, looking back on the behavior of our index in 1966, 1967, and 1969, we have come far closer in measurement than the Federal Reserve.

Senator PROXMIRE. What has happened is that our capacity, the capability of our factories to turn out goods must have been increased in view of the enormous increases in construction of plant and equipment. In view of the vast input in that area in the last 4 or 5 years, unprecedented at any time in our history, you are telling us on the basis of the past experience, you are convinced we are close to our actual capacity.

Mr. ADAMS. We have had, of course, large expansion of investment, but we also have a large expansion of output. If we look at particular industries, such as petroleum refining, automobiles, steel, rubber, until very recently lumber, we know that these industries are close to a peak output.

Senator PROXMIRE. Oil and refining, you are right. That is a particular kind of situation, and there are many reasons for that. Without exception, have you calculated three shifts, 7 days a week, that kind of calculation?

Mr. ADAMS. I don't think you need that kind of a calculation. Implicit in calculation is the notion of a sort of desired operating rate. Once firms get to the point where they have to start putting on additional third shifts, working Saturdays and Sundays, then there you can always produce more output. I don't think that is a relevant issue.

The relevant issue is where are you relative to normal full operating rates which these industries see as their standard output? The point here is that very many industries are at full utilization by that kind of standard.

Senator PROXMIRE. I think we could take an entire morning to discuss that aspect of it. I would like to have you to state for me whatever you have for the record to document your position and to justify how you can argue that we are close to capacity when the Federal Reserve Board reports such a dramatically different situation. Is it inevitable then that we are going to have to settle between 4½ and 5 percent unemployment as best we can do?

Mr. ADAMS. For the time being.

Senator PROXMIRE. The latest report shows it is 4.8 percent. You say it is going to be up to 6 percent. Maybe 4.8 is too low.

Mr. ADAMS. For the time being I think it is inevitable. In the long run there are certainly other strategies, training programs and education and so on, which will give us a longrun possibillity of making better use of labor force which we have available. At this time I am inclined to say between 4 and 5 percent is certainly the minimum from the point of view of the economy's use of the labor force.

Senator PROXMIRE. My time is up. Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman.

Welcome, gentlemen. I would like to ask perhaps all of you about an ironic problem thaat we are in whereby the dollar, after some years of being overhauled abroad, is now so undervalued that proteins and feed grain importing countries of the world are coming in and buying large amounts of our commodities at discount prices, causing greater anguish for Mr. Cochrane and many others, who say to put on export controls, which I assume Mr. Kindleberger also means.

So I am going to try to articulate a question which will lead to some suggestions for short-term answers.

Mr. Kindleberger, our relation is that of doctor and student. You are the doctor and I am the student, which is a long standing and very profitable thing to me. You are right in saying that we are currently on slightly opposite sides of this fluctuating exchange rate controversy. Certainly it is not desirable that at present the dollar is fluctuating at considerably under what most people think would be a more appropriate exchange rate. You say return to fixed exchange rates.

If you found out you were to be Secretary of the Treasury tomorrow, what set of rates would you plumb for? August 15, 1971, I am sure not. December 1971, the Smithsonian hierarchy. February, March of this year? How much would you crank up the dollar? If you are going to do it at all, you might as well do it right the first time.

Mr. KINDLEBERGER. No, I think I indicated, Congressman Reuss, that I would try to manage for a while and try to edge up on it, try to estimate, to get monetary policy internationally working better. Because I think to pick a set of rates and then to continue to go into independency with monetary policy would be compounding our errors of the past.

Representative REUSS. But at any rate, you do favor pretty massive, multibillion dollar intervention to boost the dollar up?

Mr. KINDLEBERGER. Yes, sir.

Representative REUSS. If it is true, as so many knowledgeable Europeans tell me it is true, that the weakness of the dollar is due mainly to two factors: First, the administration's mismanagement of the economy, and particularly its letting inflation get out of control; and second, the administration's Watergate performance and refusal to level on it, if those are indeed important factors behind the lowly status of the dollar internationally today, why is rigging the market really going to help?

I am not so doctrinaire that I interpose intervention in aid of sensible political and economic policies, but I am darned if I can see that it is up to the central banks to establish a rate that goes counter to the judgment of the market. In this case, for us fluctuating exchange rate buffs, no sooner did we get them than the Republicans loused up the deal by Watergate and had an effect on this inflation policy.

Wouldn't we be much better off going to the causes of our difficulties, political and economic, and to the extent that we apply policies for nudging the dollar up if you really want central bankers to have all of that important a role? I expect it could go up without much nudging.

Mr. KINDLEBERGER. You used words like "rigging" and "nudging."

Representative REUSS. Well, you use a word like "irresponsible."

Mr. KINDLEBERGER. I would have thought that the Watergate does play a role of worry about the paralysis of policy in general. I am not at all sure, I don't know but that one could invert the matter of inflation to say that it was the allowing of the dollar to go down for psychological reasons, a posture of benign neglect, or feeble neglect, which we pursued, if I may say so, from December on which did not add to the inflation. Nobody was minding the store. People were just not worrying about it at all. Any intervention that Europe wanted to do was fine, but we didn't say what the dollar was like.

In those circumstances, that added to inflation, and things get a positive feedback operation. I would have thought that a policy of helping with overhead, dividing responsibilities with Europe, discussing with them—since we all believe in exchange rates—that something could be internationally, not nationally, determined.

I think they have international consequences, that we have a much more positive policy. You may well be right that paralysis means that we can't even develop that kind of policy. I am very much in mind, sir. I have become an economic historian now. One enjoys this kind of perspective and I don't regard myself as being very useful on day-to-day policy.

I am reminded of the psychological theories of the French in 1920. When the Cabinet Ministers would make pronouncements, the exchange rates would fall. This is because a great many French people did have francs which they were prepared to move out rapidly. A psychological theory of the foreign exchange developed.

We have been very close to that foreign exchange, because it may not move to mop up the dollar, nor move to lock in people.

For a while in January, as money would move out, the Federal Reserve would print more. It was trying to get interest rates down when interest rates were being pulled up by speculation against the dollar. It was helping the speculators—aiding the speculators to drive the dollar down.

You know, I regard that as not the way to operate. In my prepared statement, I suggest that Washington seems to have neglected any sense of the market legislation, when the market is oversold. The Treasury would never in the world try to float a bond in New York without talking to the market operators, getting a feel for it, getting a sense of it. Not what the economists say or what the computer tells them, but also what the knowledgeable people find where the market is oversold.

We neglect this entirely in the field of foreign exchange. When I was in the Federal Reserve Bank in New York, we used to have an ear to the ground finding out what the market was like—was it oversold. In this instance, what we have done is to help it by the big speculations of the short position. We pour on more money. I just regard that as funny management.

Representative REUSS. Before I call on Mr. Cochrane, I want to verify an impression I have, which is that you would be opposed to extensive export controls on international trade of American commodities. Instead, try to damp down the inflationary demand by the international raising of the foreign exchange value of the dollar; is that correct?

Mr. KINDLEBERGER. Yes, sir.

Representative REUSS. Mr. Cochrane.

Mr. COCHRANE. I want to make two or three comments. Certainly I agree that the current undervaluation of the dollar had some effect on increasing exports from the United States and contributed to the inflation here at home. But I don't consider that a major element, because the cupboard was bare 9 months ago. I was in the Philippines in January trying to advise the Secretary of Agriculture there to find rice anywhere he could find it. He couldn't find it. The cupboard has been bare for a long time. By a long time, I mean 6 to 8 to 9 months.

Now, I, too, feel like Professor Kindleberger. The Department of Agriculture, which I know well because I worked there at low, intermediate, and high levels has a very great intelligence and policymaking capacity if it had been used. I think this administration was not minding the store. They had enough knowledge to know that the sale of 400 million bushels of wheat to the Soviets was going to tighten the situation here very greatly.

Of course, they claim that they didn't know that the Soviet sale was going to be of that order. That is further evidence of not minding the store. If the sale to the Soviet Union had been perhaps 200 million bushels and wheat had been used much more extensively at home as a feed grain this year, the Soviets might have had to tighten their belt a little more than they did, but also the price effect of meat would have been much less here.

I simply believe that this administration did a very poor job of analyzing the year ahead, and you can do it a year ahead with the intelligence that is available. They were so gung ho to sell wheat, soybeans, and anything else to solve the balance-of-payments problem, that they gave no thought to food price consequences of their acts here at home.

In their zest for foreign sales, they failed to consider how many tons of soybeans and grains we were going to need in the coming year to produce the meat the consumers were going to consume in the United States. Only one thing was missing to them—they could not have known as much as we know now about this fish meal thing off the Peruvian coast. They oversold in an effort to reap the wonderful benefits of large exports and they left us holding the bag in terms of supplies to produce the meat that could have been forecasted within this year. They pursued a bare shelf policy.

The administration, as far as food and agriculture is concerned, didn't make use of the intelligence that was at hand, and they got us in trouble, a lot more trouble than we needed to be in.

Representative REUSS. Thank you very much.

Senator PROXMIRE. Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Vice Chairman.

I want to thank you gentlemen for making your appearances here today. Let me say for my own part that I personally regard the grain sales to the Soviets as one of the greatest economic blunders of this century. I see no political concessions from the Soviet Union, but I see a great expense and great loss to the American taxpayer, as well as the consumer. We realize that that is history.

What should we do right now as far as monetary policy goes? I know that the growth rate of money last month was something approaching 11 percent, when you take into account the checking account, which is on an annual basis. Is that a reasonable policy for us to be pursuing in a time of continuing inflation? A demand-pull inflation, or should there be some reversal of that policy? I would like an expression from you gentlemen.

Mr. ADAMS. Well, perhaps I should say something. I think it is important to note, on the one hand, that we had very rapid growth of money supply, about 11 percent, and that, on the other hand, we have absolutely record interest rates. As I indicated in my statement, the record interest rates don't tell us very much about the true tightness of monetary markets. The record interest rates are rising rapidly. You have to allow for that.

The record interest rates occur at a time when we have had increased flexibility or competitiveness of various kinds of financial institutions. So if you don't get the same strain, the same crunch phenomenon at the high interest rates that we might otherwise have gotten.

On the other hand, it is a difficult problem, one, because the Federal Reserve does not have full control of the money supply. The Federal Reserve is really only in a position of letting out the reserves. On the other hand, because it is quite certain that it would be dangerous if the Federal Reserve held back on reserve in such a way that we had a severe monetary crunch. I would much rather see the more moderate growth in money supply than we have seen here. But I would much rather see the rate of growth of money supply to be higher than we like than to see the opposite phenomenon of a financial crunch, a liquidity crisis, which might shake the economy and might very rapidly put us into a recession.

Representative BLACKBURN. What would you suggest as a rate of growth of money supply? Would you shoot for, say, a 7- or 8-percent rate of growth right now, or would you go down as low as 4 percent? Do you have any thoughts along that line?

Mr. ADAMS. I would shoot high.

Representative BLACKBURN. I think 11 percent right now is high in the present economic situation.

Mr. ADAMS. Surely 11 percent is inadvertent. I think the Federal Reserve had no intention of letting money supplies go so rapidly. I would shoot for 5 or 6 percent. Now we are talking about a growth of GNP in current dollars of perhaps 9 percent. That even a growth of money of 5 or 6 percent represents a tightening, a growth of money supply less than a growth of current dollar GNP.

I would shoot for that, but I would rather have a higher rate of monetary growth than to risk a crunch or a crisis.

Mr. KINDLEBERGER. I would like to associate myself with Professor Adams. There is a school of thought, the monetary school of thought, in this country that says you would pick a thing and go through hell or high water with it. This is an ancient discussion that goes back to England.

In the National Bank Act of 1863 we couldn't have an elasticity in the money supply. So we had a crisis in 1907 that was painful. In these circumstances the British idea is to dish out more money in the short run, but try to get it back in the long run. It is a problem of monetary management. It is very, very tricky.

I am inclined to think we need a trend, a quick trend. The 11 percent seems to be a crisis liquidy problem, owing to the prime rate going up, the mortgage rate going up. This doesn't represent a long-run trend. I don't think people like the notion of easing up in a crisis because they think it is very hard to go back on the trend. They are right to that extent.

Nonetheless, the notion that you lock the door and throw the key away, 6 percent week after week after week, no matter what happens to the demands for money in the market, that isn't to my mind a viable policy. I think I agree completely with Professor Adams. We are nearing a crisis in the credit conditions, that this means we have to let up temporarily. Even though it is not the figure that results, it is one we would be happy with.

I would add one more thing. I am inclined to think we have to have a monetary policy with a view to monetary conditions abroad as well. I think a great deal of our trouble in the past extends to independent monetary policy when they pretend all we need to care about is what monetary policy should be in the United States, when in fact we have been hurting the balance of payments in an extreme way.

Let me just illustrate this. If we were to try to run cheap money in the Atlantic, if the people in New York would borrow to people in the Atlantic and they would lend to New York, you just can't do it when this market is joined. That is to a very considerable extent what has been happening in the United States and Europe market. A low interest rate on the Eurodollar market, Germany tries to put on a high interest rate, they borrow on the Eurodollar market out of the United States. It looks like we are having a big balance of payments on deficits on some of this. The reason is that we should articulate a way to the Federal Reserve Bank to New York to the Atlantic portion.

Representative BLACKBURN. I certainly share your opinion. We cannot isolate ourselves from world market conditions. My own feeling is that the export controls that we have imposed on soybeans and scrap iron may be good short-term politics, but I think as far as long-term economics is concerned, I think we made a mistake because we disrupted some long established markets.

If the price of soybeans keeps going up, I am going to raise them in my windowbox. We will all start raising them. Does anyone care to make any projection about whether or not the supply of foodstuffs this year will be adequate for demand?

I mean, we have a new crop starting to come in now. I understand we have taken off the production quotas. There is no farming in my district so I don't know anything about farm policy, but I understand we are encouraging farmers to grow now. Is that the proper course of action?

Mr. COCHRANE. I have already discussed that, I believe, before you got in, but I will just highlight it for you. Sure we are going to have some big crops of wheat, corn, and soybeans, which are the leading ingredients of meat and livestock in this country.

I think first we should recognize that before those crops materialize, the animals are going to be produced, which in the main, will be the meat we eat this winter. Senator Proxmire and I both agreed that the prices are going to zoom over the next 3 to 6 months in the retail markets. I think we will see prices of livestock products, meat products, such as we have never seen in this country in peace time. But I also indicated that I think it is a reasonable possibility that wheat prices should begin to moderate this fall. I think that the best guess one could make is that feed grain prices should hold about constant, and I think it is a possibility that soybean prices will moderate late this fall. But that is still going to mean some very high animal product prices in the next year.

I also made a major point in my talk that it is impossible to predict the world food situation beyond the current crop year—and it is

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foolish to continue to make projections on the basis of average rainfall around the world. We are linked just like in the money market in an international grain market. If we have some more bad weather in the Soviet Union or some more bad weather stretching from India to Indonesia, we may have higher prices a year from now.

So contrary to you, I think we do have responsibilities in this world and they may well be greater to countries such as Indonesia and India than to France and Germany. As I mentioned, in the case of food it is a fine line between too much and too little. We may need to use export controls from time to time. I don't advocate them as a steady policy or a policy which one uses in a very high-handed and arbitrary fashion.

But we don't know at this time what the crops in India and the Soviet Union are going to be. We could have poor crops for a second year in a row. In this event it could well be that food prices will go higher in 1974–75 than they have in 1973–74. That is, I argue here, unpredictable and——

Representative BLACKBURN. Beyond our control?

Mr. COCHRANE. Beyond our control. If we want to deal with it, we are going to have to deal with it the same way Professor Adams is talking about, by direct control.

On the other hand, it wouldn't surprise me a bit that we will have good crops everywhere this year. I wouldn't be surprised a bit that we have soybeans coming in from South America that we don't know about. So it wouldn't surprise me if prices begin to fall in 1974–75. I just can't predict ahead, and nobody can predict beyond a crop year.

On the other hand, we do have good crop intelligence and we should be able to make wise policy decisions with regard to disposition of supplies within the coming year. In my opinion this administration has not done a good job in this connection.

Representative BLACKBURN. My time has expired.

Senator PROXMIRE. Senator Fulbright.

Senator FULBRIGHT. Thank you, Mr. Vice Chairman.

Mr. Adams, I believe it was your statement that a further cutback in spending or tax increase will not approach our true economic problem or reduce inflation in the event of an anticipated slowdown. Should I conclude that under present conditions we should not contemplate a reduction, for example, in military expenditures which is being currently discussed, and possibly a moderate tax increase?

Mr. ADAMS. I am not certain we should think of it purely in terms of fear of bringing on a recession. The thought behind that sentence was that in the short run the medicine of aggregate demand slowdown does not seem to have much impact on prices.

In the short run, you slow the economy down, you bear a considerable cost in unemployment and unused capacity, you reduce the growth of productivity automatically under those circumstances. On the one hand we ought to think in terms of moderation of alleviating the excess pressure of demand. On the other hand, I think in the short run aggregate demand policy might well remain where it now stands because it will do little to alleviate the price problem.

Senator FULBRIGHT. I confess it is very difficult to translate these economic factors. It is a great mystery to me. The difference of view among Congress is in answer to my own uncertainty. But from a political point of view, there is a feeling among some of the Members of Congress that there is a psychological feeling abroad, as well as here, that the Government is sort of out of control, that we cannot control our own expenditures, we cannot increase taxes. I am not sure on that. We reduced them three times in the last 10 years. If there was a feeling of reasserting control of our economy, that this would have a psychological effect. Perhaps I shouldn't ask an economist about this. Some people's feelings are much more certain of the future.

This adds to the inflation. There is a little bit of sentiment like who is running the bank. Things are all right, but they are going to get a lot worse. Therefore, you should buy all you get ahold of, land, wheat. Besides soybeans and wheat, there is going on in places a program for any land. It is going on in my State, anything tangible. Some have commented that it would be useful, or at least a modest reduction in budgetary expenditures, especially for military and nonproductive things, a modest tax increase. Do you think that makes any sense?

Mr. ADAMS. I am inclined to say that the arguments for a tax increase or expenditure cuts needs to be made independently of the arguments for counterinflationary policy at this time. I think that we could well argue that we ought to cut defense expenditures. I am not sure that there is a strong argument at this time on economic grounds for a tax increase. But I am inclined to say that if we take these arguments, we must recognize that their impact on inflation, of course, in the next four to six quarters is likely to be small.

Senator FULBRIGHT. It wouldn't have much effect?

Mr. ADAMS. Not much.

Senator FULBRIGHT. It might be good on some grounds and bad on other grounds?

Mr. ADAMS. Right.

Senator FULBRIGHT. Do you have any conclusion on the grounds? Do you think it is good or bad?

Mr. KINDLEBERGER. May I contribute to that? I think it would be very helpful from the point of view of the balance of payments.

Senator FULBRIGHT. One reason I am saying this is that I have a group of loan people in my State. They think they are faced with extinction, really, because of the overreliance upon monetary factors in the allowance of the Federal Reserve regulations and so on.

Mr. KINDLEBERGER. I would very much have more use of a fiscal policy, for abroad, too, so that we would rely less on monetary policy or use it a little bit more in connection with our international considerations, as I have mentioned. But I would say this, that the absorption view of the balancing of payments says this: That if nobody has a surplus, then you are going to have excessive spending spill over into an import surplus in the current account. Business has a deficit. Households used to have a big surplus, but they have declined. Government has a deficit. If all three have deficits, the only place you can get a surplus is from having big import surpluses, which would mop up the excess spending.

I would think that the further reduction of the Government deficit would determine the necessity of the balance of payments, the absorption point of view. I think the other point of view is the elasticity point of view. You change price a little bit through decentralization, through adjustment of exchange rates, and the balance of payments will adjust to it readily. Some take the view they have to change people's spending, and it would also help to change spending independently.

It is very important here on the psychological side we have devalued the dollar or allowed it to depreciate further without taking any steps to control spending in the United States, the tax increase, cutting of Government expenditure, too. Decentralization works better with close support by fiscal policy. What we have been doing is allowing decentralization to occur without fiscal policy support. It is, in my judgment, working very badly.

Senator FULBRIGHT. One other question. What is your view about encouraging foreign investment in this country? I believe last fall the Representative of Saudi Arabia made a proposal to our Government that they be allowed to have a deferred position in the market and to invest in, I think it is, downstream operations. We apparently did not respond favorably to that at that time. Do you have any views about that?

Mr. KINDLEBERGER. I would have thought there was very little need in most cases to encourage the many corporations who invested abroad because the dollar was overvalued, and now they find that there is less need for that. Some foreign corporations contemplate making investment in the United States, but there is so much uncertainty about the dollar now. Like the Volkswagen company, as I suggest in my prepared statement, doesn't really know what the dollar is going to be in the next few years, and really, I don't know whether it will be worth while or not. If we assume that the dollar is under equilibrium, really, I would expect a considerable amount of foreign investment. It is enough to have a laissez faire, Senator Fulbright. It is enough to say that they can invest. I certainly hesitate very strongly to subsidize such investment or give them guarantees.

Senator FULBRIGHT. How about putting on inhibition obstacles?

Mr. KINDLEBERGER. The only inhibitions we have are the ones that rise out of the general laws of the United States. In banking, they have to satisfy State authorities. In thinking like the British, they have to satisfy the antitrust. But I would think we would want to continue those general concerns. As far as Saudi Arabia is concerned, they could go by the antitrust problem. I don't think it would be very serious.

The British petroleum thing, the antitrust division, was concerned that they had already bought Sinclair. If they bought the service station of Ohio, in certain parts of Ohio they would be getting more than 40 percent. They divested a few stations and that deal went through.

So I would have thought we ought to welcome, but hardly to take a very positive step to, subsidization. Welcome by all means; yes, sir. A good many States are doing that. I see that in the press that States like South Carolina are touring the world looking for people who might invest.

Senator FULBRIGHT. Thank you very much. My time is up.

Senator PROXMIRE. Mr. Adams, you seem to be easing away a little bit from what I understood you to say in your statement that a slowdown in the economy would be a good thing. Maybe I misinterpreted your position, but as I understand it, the reason for the potential price increases are several. We have already discussed the shortages, especially the food shortage, which is also true of oil and some other areas. We also have a decline in productivity in the past months.

Productivity was sharply lower in the second quarter than in the first quarter, and it is likely to go down further as we move into a situation which I think we are being forced into by the monetary policy, which is going to result in higher interest rates.

What Congressman Blackburn said was very interesting, but if you take the money supply since December, it is a 6-percent increase over the last 6 months. At any rate, higher interest rates are going to be a very big factor in the increases in the cost of living in coming months.

Once again, you put all of these together and it seems to me that is hard to contemplate by any strategies based on the slowdown in the economy. I think if you slow down the economy to 6 percent unemployment by the end of 1974, which we think is likely, you won't have too much effect on inflation. How about it?

Mr. ADAMS. I don't want to give the impression that I am easing away from my earlier position. I am inclined to say essentially this: I thing to the extent that we have excessive demand pressure, there is indeed going to be some slowing of the economy.

Senator PROXMIRE. Let me interrupt to say you still persist in the notion that this is an overall excessive demand rather than spot shortages in the areas that we mentioned, such as food and oil and a couple of others?

Mr. ADAMS. Yes, I think there are indeed areas of the economy where the pressure of demand has made it possible for business firms to raise their prices.

Senator PROXMIRE. Wouldn't you agree strategy based on slowing overall demand is a less effective way?

Mr. ADAMS. I agree.

Senator PROXMIRE. And increased unemployment is the last thing that we need.

Mr. ADAMS. We might also note that one of the problems which has not been mentioned is primary materials in the world market. Mr. Kindleberger may react to this. This current situation is a rather unique one in a sense, because the business upswing is synchronized in the United States and in Western Europe. That has distinctly contributed to the pressure on primary materials and, I think, U.S. exports.

Senator PROXMIRE. Once again you refer to world markets. Any action we take to slow down our economy is going to be weakened, be feeble at least, and have less effect on inflation as we consider the effect of the world market on price. That is another element that also suggests that this policy of pushing toward a 6 percent unemployment figure as the guts of your anti-inflation strategy isn't going to really get the results in slowing down the rising cost of living.

Mr. ADAMS. I would be inclined to say that we should slow the economy, but slow it only very moderately, that the emphasis for the time being at least should be in the direction of policy that is oriented directly toward controlling prices and wages.

Senator PROXMIRE. That data resource forecast is very similar to yours, although they predict an unemployment rate of 5.4 percent next year rather than 6 percent. I still don't see what you do with the unemployed. You argue that you provide manpower training. But if you have 5½ to 6 percent unemployment, this is about as useless and wasteful and cruel as you can get. You train a person and put him through the discipline of training and there is nothing for him, no job.

I think we are in an extraordinarily difficult economic situation. It is very hard to follow consistent policies.

This morning, the Wall Street Journal, an enlightened and conservative paper, suggested, editorially, that we tighten monetary policy, and fiscal policy, and push toward greater unemployment.

Well, let me proceed to something else. One of the few bright spots in the inflation outlook is that wage ceilings in the first half of this year remained fairly reasonable. What do you see as the outlook for upcoming labor negotiations.

Mr. ADAMS. I think most of us are surprised by the fact that the line has been held with regard to wages. One development that we see in the statistical calculations is the following: If you divide the labor market in two and think of the unionized sector and the nonunionized sector, unionized wages don't go up as much as you expect them. They go up more when the situation is soft, and perhaps it is this element, the relative stability of the wage in the unionized sector, which has held down wages.

Senator PROXMIRE. That implies that you expect this other factor, wages, to increase, as well as the local increase in productivity. That is really an aggregate of cost-price push.

Mr. ADAMS. I am very much afraid that the labor unions cannot long hold a posture of moderation in a world where food prices and cost of living is rising rapidly. My feeling is that we are hanging on a very tenuous situation because so long as we can keep the wage down we can tolerate the inflation. But the minute that situation breaks, the minute that the labor demands and receives higher wages for compensation for recent price increases, we have the making of a wage-price spiral. I am very much afraid of that situation.

Senator PROXMIRE. Then you see a very painful political problem for us. It looks as if fiscal policy and monetary policy are not going to get our inflation under control. That suggests that the President's recent statement in which he said he hoped and would work hard to end controls in 1973 is very, very unlikely to be possible on the basis of the analysis. You seem to think the end of controls in the end of 1973 would be a disaster, is that right?

Mr. ADAMS. Yes, and I would say that our forecast presupposes some form of controls throughout the year 1974.

Senator PROXMIRE. You know the law expires on April 30, 1974. There will be a lot of pressure to end them although there would be pressure the other way too, I am sure. You say you feel it has to last through 1974, and I would say, on the basis of your analysis, it has to be a rather comprehensive and substantial control system.

Mr. ADAMS. Yes, I think so. A very basic mistake was the elimination of controls under phase III this year, and I am inclined to say the mistake is being repeated in saying we are going to eliminate controls by 1973.

Senator PROXMIRE. Senator Fulbright was pressing on the notion of cutting spending, increasing taxes. That is a strategy that a lot of people propose. I certainly would enthusiastically favor cutting military spending. I notice Brookings, which is going to testify here tomorrow, argues that it seems quite feasible to do that. But the notion of a tighter fiscal policy under the present circumstances doesn't seem to be the wisest kind of course.

If we really tighten up fiscal policy, it is going to push it towards unemployment quickly. We now have the likelihood of a balanced budget. The administration forecasts that in 1974 the deficit will be $2.7 billion. This represents a great change in the impact of the Government on the economy as compared to what we have had over the past 3 or 4 years, isn't that correct, if this forecast turns out to be accurate?

Mr. ADAMS. I think probably it will. The budget will be closely balanced. I don't see any gain by significantly tighter fiscal policy unless, as Professor Kindleberger suggests, we have some tradeoff between fiscal and monetary policy, for example.

Senator PROXMIRE. My time is up. Congressman Reuss.

Representative REUSS. My colleagues and I are interested in what do we do now? I would like to give, and have you keep in mind, a 30-second critique of why I think we are doing things wrong, what we should be doing, and then you tell me where I am wrong.

Our objective ought to be to get rid of inflation without raising unemployment. We are making a number of mistakes now, I think. One, we are overstimpulating investment in plant and equipment, and thus borrowing from future periods, as the Economic Indicators just issued have suggested: "Private domestic investment rose again in the second quarter, with most of it in nonresidential investment."

We are overstimulating consumer installment purchases, and credit has been zooming upwards.

We have continued a Federal budgetary deficit of several billions of dollars for the upcoming fiscal year, at a time when we could pick up $4 or $5 billion in new revenues very quickly by tightening the minimum tax by which large avoiders of taxes escape their fair share of taxes.

So I find ourselves failing in all these particulars. I would think that we ought to modestly cool off the current plant and equipment boom by scaling down, or even out for a while, the investment tax credit. After all, Germany, which has a similar inflationary problem, far from giving tax credits for business investment, wants to put a 11-percent tax on investment.

I think it would be good sense to reuse something like regulation W, and put limits on the amount of downpayment, and the length of the term for installment credit. This could be very readily removable if needed.

Let us capture about $5 billion in additional revenues by plugging the minimum tax loophole, and you could raise a little bit more on a total or partial repeal of the investment tax tax credit. Let us use half to wipe out the deficit, so as to be in balance for the coming year, and use the other half for a program of public service employment, to see that unemployment rates don't go up.

While such a program speaks only in domestic terms, I think if it makes sense domestically, it would help to undo some of the depreciation of the dollar.

So would you indicate whether this seems to you to be on the right track or the wrong track?

Mr. ADAMS. Maybe I could just say that, of course, it is a moderate program, and while I have not recommended any increase in taxes, I don't see that this would be a proposal that would cause serious difficulty.

Representative REUSS. This just takes money from the gold bricks and fat cats who aren't going to spend it on anything useful anyway.

Mr. ADAMS. I particularly welcome your proposal for a public service employment program along this line. There is a great potential for taking unemployed off the streets and perhaps this specifically could be combined with programs of training along with public service employment in order to reduce the unemployment rate in the young and the people who have had inadequate schooling, and so on.

The macropolicy measures proposed seem to be not unreasonable. On the other hand, I think I ought to stress that the problem of managing inflation is right now not a macropolicy program.

Representative REUSS. I would go along with your direct controls system. I was just talking about fiscal and monetary policy because direct controls don't work if merely superimposed on unsound fiscal and monetary policies.

Mr. COCHRANE. I like your general program on its own merits and I think it is fine, except I don't think it is going to work. It would not deal with the problem we have ahead in the next year in the food and agricultural area. But then let me go on to say, which I think I have already said the decisions have already been made which are going to force most animal product prices up, up, up for the next 3 months, or 4 months. I don't think there is anything we can do about it. That is, we just have to live with it. But for the whole year, it seems to me that the USDA should be taking a careful look at the commercial demand in Western Europe, Japan, the situation in the Soviet Union, all around the world, and it may be that if some of those "if" conditions I outlined are not going to materialize, there would be a need for export controls on feed grains or soybeans during the next year and a half.

If those "if" conditions that I talked about don't materialize and we don't impose export controls, then you will see food prices such as we have never seen before.

Representative REUSS. My proposed program did not directly encompass food, because I agree that we need to know more about it. It would help somewhat, I believe, to relieve the tension between you and Mr. Kindleberger on export controls, because as a sound domestic economic program raises the external value of the dollar, which many of us think is too low now, this would take some of the pressure off excessive demands for our soybeans, feed grains, lumber, and the rest.

Mr. KINDLEBERGER. I welcome the nature of your program, sir, but I have one question which interests me. That is, I wonder whether we haven't really had a fundamental change in the United States with respect to personal savings. You suggest that personal savings functioning simply have the terms and conditions of installment loans. At least I gather that you would have suggested that we have overstimulated consumption, that we could reverse that by reinstituting something like regulation W which, by the way, has to be authorized by Congress.

Representative REUSS. Right now personal savings are less than they should be because people are overbuying because of fear of further inflation. If you leave out those fears, then you might get a more normal pattern.

Mr. KINDLEBERGER. Personal savings have gone down for some years now. I find that quite alarming. I wonder if it is short run. In response to inflation, people are stocking up for it. It is more fundamental and relates to the fact that we have become a more consumer society, much more interested in leisure, in getting our fulfillment not by working hard, and this does not have a big impact on inflation, the balance of payments, and a great many things.

We always have thought that personal savings was a pretty constant norm. It is a fundamental kind of thing to our society.

Representative REUSS. I will admit that my program does not come to grips with many of the psychological factors.

Thank you.

Senator PROXMIRE. Senator Fulbright.

Senator FULBRIGHT. What, if anything, affects this particular situation? You spoke about a proposal that perhaps a modest tax could be put in, a surcharge of a temporary nature. Would that have a beneficial effect, if any? But there has been an inflation and maybe other factors have continued, like what happens to be a rather unusual first half profit that is particularly large, I think 929 large corporations had some 30-percent increase over the last year. What is significant, if anything, in that?

Mr. ADAMS. I think we ought to note, first, that, of course, the profit status is very inexact. All of the evidence doesn't find it to be a very substantial increase in profits. I think there are two elements in that. One element is this pressure of demand situation, the ability of some firms in our economy at least to increase their margins. I understand in a favorable situation with regard to production, with regard to markets, this phase of the situation, the business cycle, this pricing is going to see a big increase in it. I think one element not sufficiently reported on is that the profit numbers had a very substantial inventory profit element. That if you hold your materials and supplies and your finished products over a time when prices are rising, you make an inventory profit. The national accounts, these are subtracted out with inventory evaluation adjustment numbers, which is, I think, a very inexact number which reached $15 million or $20 million in the first two quarters of the year.

So there is a very substantial component of inventory profits included in these reported profit numbers. Certainly one strategy which has been proposed and has been tested is to impose additional taxes on profits. There may be something in that. The thing I would be very careful about is to formulate taxes to profits in such a way that they will not provide incentives for increased cost, that the incentive to minimize cost for efficient production is not impeded by the tax law. But subject to that, certainly a possibility of profit taxes exists.

Senator FULBRIGHT. Would the idea of refundable surcharge or more savings have any beneficial effect here? Under certain conditions, would that have any value at all?

In other words, a surcharge would be refundable in case of a turndown.

Mr. ADAMS. I think that a refundable surcharge, such a policy has been tried, I believe, in Sweden, and to some extent in Canada. I think it is a very interesting weapon of fiscal policy, with great potential. I am not sure that at this point in the business cycle with a slowing down on the horizon that we should turn to that weapon, but in the long run it is a weapon that has considerable potential.

Senator FULBRIGHT. You don't think it would have any effect?

Mr. ADAMS. Not much at the present time; no.

Senator FULBRIGHT. In fact, I haven't heard anything that is going to have any effect on inflation. No one can think of anything to do to control inflation?

Mr. COCHRANE. Yes, sir, Senator. You can go to the price control and the rationing of food, if you want to. I think it is strange that there isn't any talk of it because we may have a food price inflation greater than we have had in any wartime in recent years. But the main reason why I don't even mention it is that with this administration one is wasting his breath in mentioning it.

Further, although I made a major point of not being able to read the future, I believe that if I were forced to guess, I would guess that we will have a feed grain surplus in 2 years, with tumbling prices. But if I had been a member, heaven forbid, of this administration 6 months ago, I would have been talking about price control and rationing in the meats.

Senator FULBRIGHT. Is it too late to do that, do you think?

Mr. COCHRANE. Yes; I think it is. I think it takes you 3 or 4 months to get such a thing in operation, and if you do it wrong, if you do anything wrong in this area, it is a lot worse than nothing at all. I guess I feel these people would do it wrong as they have done in beef in phase IV. I can't imagine why they did what they did with regard to beef unless it is employed just simply to make the cost-of-living index look better than it otherwise would. It can't have any effect except to cause cattlemen to hold back.

Senator PROXMIRE. The explanation that Mr. Shultz gave is that they didn't want everything to go up at one time. They wanted hamburger available at a lower price, even though it might have been a little scarce.

Mr. COCHRANE. All I can say is if you don't do price control and rationing in a consistent fashion and if you talk about getting rid of it in 3 months and so on, I think you are better off doing nothing at all. So I haven't talked price control and rationing because of what I have mentioned in regard to this administration.

Second, if you weren't wasting your breath, I still think it would take you 3 months to put such practice in operation that would be workable and not cause you more discontent than you could live with. It is very easy to create this in this area.

Senator FULBRIGHT. Well, there is certainly nothing without paying of anything. But the alternative you describe seems to me to have a great danger to unlimited increase off the ceiling and continuing so

I can't imagine it. Food and all of these things will continue to go up very dramatically unless we have absolutely perfect weather, if by some miracle we have a late freeze and huge crops. All that is fine. You are taking a big chance that that will happen. My more reasonable guess is that there will probably be an average freeze and an average crop. There is nothing to warrant it to be an unusually great crop that I have heard of.

Mr. COCHRANE. I think we are going to get a very good crop in the United States. That isn't what worries me. What worries me is wheththe Soviets are getting a good crop, and the monsoon in Pakistan and Indonesia. That worries me.

Senator FULBRIGHT. My State, which is not a small producer, we are very high in soybeans and cotton and rice, we had a very late planting season. It was so late that much of the cotton could not be planted and they turned to soybeans because of the floods that affected Mississippi and a good deal of Missouri and Illinois. There is a lot of that country that was waterlogged, and I don't know whether it is going to be an unusually good year or not.

Mr. COCHRANE. We are adding roughly 30 million acres to crop production.

Senator FULBRIGHT. But the best acres were those flooded, the whole Mississippi River Delta.

Mr. COCHRANE. If we know anything, we are going to get good crops.

Senator FULBRIGHT. I hope you are right. I am not sure.

Mr. COCHRANE. In the United States.

Senator FULBRIGHT. I am not sure it is a wise policy to assume, because this administration is extraordinarily inept and almost paralyzed. Congress should not come in and do this, even though we don't. I don't have any higher opinion of this administration than you do. I think Congress ought to do what is right in that.

What I am puzzled about, what is the right thing for the Congress to do at the present time?

Mr. COCHRANE. Senator Fulblright, I spent 6 months in Washington in 1951 trying to help put meat price controls into operation for an administration which wanted to do it, really wanted to do it, and trying to get those controls to work so that you didn't shove meat out into little towns in Nebraska or drive it onto the black market. It was tough to put those controls into operation when you had an administration which believed in it and wanted to do it, and you had administrators who were anxious to try to do a good job.

Since I believe it is so difficult to do, although I believe it could help the meat situation, I believe if you did a poor job of it, it would be worse than nothing. That is the main reason why I don't talk about it.

Senator FULBRIGHT. I am not debating it. You know more about that aspect than I do. But we have just been so desperate to think of something to do while Watergate is mesmerizing the country. We feel, many of us, that we ought to be doing something. That is why I question you on it. I don't have any reason to correct your statement, or to say you were not correct. But if I could summarize by saying all these things that the distinguished Congressman Reuss suggested, most of us thought that that was something that could be done. It doesn't require any administrative genius to do its best. The Congress can do it, is that correct?

Mr. COCHRANE. Well, I did mention, Senator, and I am not sure any of my colleagues go along with me, but after a very careful appraisal of this situation, I think it might be wise to use export controls in the feed grains and soybeans a little longer than this administration is planning on it. I think that is something that should be considered, and if used, it might well contribute to an easing of food prices in the spring of 1974. So that is something that I don't back away from.

I recognize the annoyance it creates among our trading partners. But I think the conditions could be so tight in the food, agriculture, meat area that it should be considered as a way of moderating food prices in the spring and summer of 1974.

Senator FULBRIGHT. One last question. I heard steak was $23 a pound, wasn't it?

Mr. COCHRANE. I heard $12.

Senator FULBRIGHT. Retail is $23 and $12 wholesale.

Mr. KINDLEBERGER. Senator Fulbright, I would like to add to it that we intervene in the foreign exchange markets to correct what I would call a serious inflationary pressure from the undervalued dollar.

Senator FULBRIGHT. My time is up.

Senator PROXMIRE. On that last point, Mr. Cochrane, it seems to me, with the chairman of the Foreign Relations Committee on my right, and Mr. Kindleberger, who is a brilliant international economist, to be such an inward-looking policy, such a selfish policy. After all, we are still the best fed Nation in the world. We spend far less of our incomes on food than other countries.

No. 1, if we are going to follow a policy of restricting our exports, it is a pretty cruel policy. No. 2, it is going to force serious inflation abroad. No. 3, it is going to mean that one big element that would put us into a position of benefiting our balancing of trade and payments over the years is likely to be hurt because we are less reliable as a source of supply.

For all of these reasons, I just wonder, the only alternative may be rationing. In export controls you say the administration is not acting hard enough or long enough.

Mr. COCHRANE. I said they talk about controls that only go on the 1973 crop of beans. That is the way I understand it. Let me try to make your conscience feel just a little bit better than it might with regard to this. The people who these export controls would hit the hardest would be those people in Western Europe and in Japan, who are trying to consume meat like us. I am not talking about export controls on wheat or rice.

Senator PROXMIRE. China, for example, has already bought 135 million bushels of wheat from the United States this year and with a remaining 6 months, and they are looking for more very vigorously. What we are suggesting here is that we might have to have export restrictions on wheat.

Mr. COCHRANE. I didn't mention that up until now. I haven't talked about that.

Senator PROXMIRE. That is a country that cannot be considered affluent. If this is a country hostile to this country, the alternatives are not nice to contemplate.

What we are doing is spending $12 million now in advertising and pushing and promoting the agricultural commodities abroad if it causes such a problem here. I can understand why we have that export licensing, as I said. But I read over the weekend that we are spending $12 million of the taxpayers' money promoting the sales of American agricultural products abroad.

Mr. COCHRANE. I am sure that is correct. I am not here to defend what we are doing now. I would say, though, that over the long run, and I think appropriately, we have sought to expand our agricultural exports primarily in this area of feed grains and soybeans. I think the longrun program of doing that was good. What has changed the situation are these acts of God that I have spoken of. They are going to occur.

Senator PROXMIRE. Since shortly after the beginning of the year, we knew we had a shortage. So that the last half of fiscal 1973 and certainly in 1974 we should not be continuing a food advertising program.

Mr. COCHRANE. Then I suggest you should ask Secretary Butz that question.

Senator PROXMIRE. I heard that farmers were holding a very large share of the current wheat crop off the market, having learned that last summer they could have gotten higher prices by selling later. Is this true? Did this occur on a massive scale?

Mr. COCHRANE. I don't know from first hand knowledge, but that is what we all hear. It has been reported all through the Midwest that farmers are holding back on a massive scale. I can't verify that, but it is the conventional wisdom.

Senator PROXMIRE. This made me very concerned, and we have been doing our best to correct the interpretation of statistics and the competence of the people who handle them, and so forth.

You testified this morning that management should do certain things, and you break this down. What specifically can we do, if anything? We do have the responsibility in that respect? What can we do to stop this or correct it?

Mr. COCHRANE. I would say about three things. First, you should use the prestige of this committee to continue to see that there is an agricultural census collected, because that agriculture census is very important in truing up the annual crops and livestock reports. This administration has been trying to eliminate the agricultural census. Anything this committee can do to see to it that this off-year agriculture census is made is one good thing.

Second, your committee should assist the statistical reporting service in obtaining adequate funds to do its job. In a few commodities SRS had the support of the trade, but in the main no one supports statistics gathering except the Secretary of Agriculture and maybe the Office of Management and Budget. Listen to what the statistical reporting service says they need in the way of money to collect good statistics, I can assure you there are good people down there and they know what they need. But getting money to collect statistics is just like digging out impacted wisdom teeth.

Third, the real breakdown occurred, as I understand it, between the politicians in the administration and the career bureaucrats. You should ask the Secretary of Agriculture whether the political side of the USDA made use of the intelligence that was available last spring, coming in about the spring and summer wheat crop conditions in the Soviet Union. Was it analyzed and used in policy decisionmaking? I think that you can and should chide and ask the Secretary of Agriculture how appropriately they are using the worldwide intelligence and the local intelligence.

One more thing comes to my mind. I have been told, and this is hearsay, that the USDA is cutting back to some degree its intelligence gathering work in the foreign agriculture service. I am not absolutely sure of this, but I have been told that it is true. If it is true, this is the very wrong thing to be doing at this time. It might be wise to check into this and see whether they are cutting back on this intelligence gathering work around the world. If they are, you should combat it.

The point I have been trying to make is that beyond a crop year it is nonsense to say what is going to happen. Within a crop year you can know what is going on. You can appraise stocks. You can know what our requirements are and you can make rational decisions. I am arguing here that this administration has done a poor job of that within the crop year.

Senator PROXMIRE. That is a very, very helpful response. We will certainly follow up on your suggestions.

I just have two other questions I would like to ask. Mr. Adams, could you tell me what you believe will be the performance of the economy in certain respects? What do you foresee for personal consumption?

Mr. ADAMS. Personal consumption probably will be moderate. The savings rate has been low, relative to what it was 2 years ago. The subject came up before. Our impression is that consumers will, in the course of the next few quarters, begin to hold up this consumption. Their consumption is an anticipation, particularly we suspect their purchases of cars is in anticipation of higher prices, in anticipation of a few more antipollution devices that reduce this gas mileage, so it is better to buy now than later.

Senator PROXMIRE. How about investment?

Mr. ADAMS. Investment will not hold up. Business investments in real terms will tend to flatten out. However, we ought to stress the fact that it is really held in check right now more than by supplies shortage.

Senator PROXMIRE. Residential construction?

Mr. ADAMS. Residential construction could be expected to fall off in current dollar terms of approximately $10 billion.

Senator PROXMIRE. Federal Government spending?

Mr. ADAMS. Federal Government spending, we have real terms pretty low. In current dollar terms it grows.

Senator PROXMIRE. State and local government spending?

Mr. ADAMS. In State and local governments it has been rising quite sharply, $5 billion or so. We expect it will continue.

Senator PROXMIRE. You foresee a growth recession?

Mr. ADAMS. That is 1 percent growth in real terms.

Senator PROXMIRE. That could easily slip to a minus one, couldn't it?

Mr. ADAMS. It could, but it could just as easily be 2 percent instead of 1 percent.

Senator PROXMIRE. Now this last question. Last Friday, in Washington, we heard an analysis that real increases in output in the second quarter is 5 rather than 2.6 percent. Is there any reason to doubt the GNP accuracy? Is there any reason to doubt the high competency and honesty, we expect from the Bureau, of economic analysis?

Mr. ADAMS. I do not know whether they were computed this time any differently than they have been computed in the past, so I must work on the assumption that they have not. I can easily see that with the economic situation as much out of hand as it is, unprecedented inflation, an extremely rapid report on the first quarter growth of GNP, some problems with seasonal adjustments, I can easily see where the second quarter number might not be realistic, nor the first quarter number. We find when we average two quarters together and get a 6-month spread, we get a smoother and perhaps more accurate picture of what is going on, rather than taking one target. I do prefer to take the first half of the year as a unit and average out the 5-percent growth. There is evidence of a slowing in the second half of this period. Still, production figures support that. There is some evidence of slowing now coming in.

Senator PROXMIRE. Senator Fulbright.

Senator FULBRIGHT. Now I have a very important question. You have intrigued me as to the accuracy of the corporate reports. You seem to suggest that the first quarter has been overestimated. You didn't put it that way, but I concluded from the question that they weren't accurate. Do you have any question that they were not accurate?

Mr. ADAMS. No, however, I want to stress the fact that the profit numbers are always subject to considerable revision after the fact. In this case that means that there is an uncertainty attached to that number. We have seen a revision a year later of as much as $5 or $7 billion. This revision could be either way. We are dealing with a series that is not precise to begin with. It is a substantial potential of inventory profits in it.

Senator FULBRIGHT. I am just wondering, I recognize the difficulty in the Government reporting. I hadn't thought that it infiltrated into the whole economy, that nobody reports accurately anymore.

Senator PROXMIRE. What is the reason for that big change of $5 billion to $7 billion?

Mr. ADAMS. The basic reason is essentially this: The preliminary profit reports are based on the number that comes out of the corporate balance sheets, the income statements, on a quarterly basis as compiled, because you can go to a current basis and find the GNP account numbers that are desired in the corporate income tax reports. They have corporate income tax reports coming in a year, 1½ years, later. They involved certain different definitions of the accounting. The end result often turns out to be quite different from the preliminary numbers.

Senator PROXMIRE. Thank you, gentlemen, very much. It has been most helpful and informative to us. We appreciate it a great deal.

The committee will stand in recess until tomorrow when we hear from four distinguished witnesses from Brookings. The committee hearing will be here at 10 tomorrow morning.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, July 31, 1973.]

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

RSQE FORECASTING SERVICE

The University of Michigan
Ann Arbor, Michigan 48104

FOR RELEASE: 8/20/73

TO: Members of the Economic Outlook Conference

FROM: Saul H. Hymans and Harold T. Shapiro

The Economic Outlook at Mid-Year

Mid-Year Review and Preview

The sudden and sharp slowdown of an economy which had been expanding at a near record rate naturally generates a considerable amount of uncertainty and confusion. On the basis of preliminary data released by the Department of Commerce the annual rate of growth of real Gross National Product declined from 8.6 percent in the first quarter of 1973 to only 2.6 percent in the second quarter. While it would be wise to regard with some scepticism the magnitude of the slowdown as recorded in the currently available data, there seems to be little question that the rate of expansion has indeed declined. The mere fact of a decline in the growth rate should come as little surprise to those who have been reading our recent forecast releases, but its appearance in the second quarter of this year -- and its apparent magnitude -- are entirely out of line with our earlier expectations. We have given this matter considerable thought and would like to share with you the understanding we have come to on the complex of factors -- some unexpected and others "underexpected" -- which need to be considered in order to place current economic developments in proper perspective.

Over the course of the two year period ending in the first quarter of 1973, real GNP rose at an average annual rate of more than 6.2 percent, productivity in the private nonfarm sector of the economy increased at an average annual rate of nearly 4.4 percent, the number of persons employed increased by almost 4 $\frac{1}{2}$ million, the unemployment rate declined from 6 percent to 5 percent, and the overall price level (as measured by the GNP deflator) rose at an average annual rate of only 3 $\frac{1}{2}$ percent. Over the same span of time personal disposable income -- consumer incomes adjusted for income taxes -- rose at an annual rate of 8.2 percent, while corporate profits (adjusted for inventory valuation) rose at an annual rate of more than 17 percent.

The record of growth from mid-1972 through the first quarter of 1973 is even more striking (see Table 1). Real GNP grew at an annual rate of nearly 7 percent in the second half of 1972 and then accelerated to a growth rate of more than 8 $\frac{1}{2}$ percent in the first quarter of this year. Consumers contributed heavily with solid gains in spending on nondurables and services and enormous rates of increase in the purchase of durable goods, especially automobiles and major household furnishings. The business sector had already launched a major investment campaign to enlarge and modernize capacity with the result that business capital spending (corrected for price inflation) rose at an annual rate of 12 $\frac{1}{2}$ percent in the second half of 1972 and 18 percent in the first quarter of this year. Benefitting both from new capacity and improved utilization of capacity, productivity increased at an annual rate in excess of 5 percent from mid-1972 through the first quarter of 1973. Even with these substantial gains in productivity, employment rose by 1.7 million from the second quarter of 1972 to the first quarter of this year, while the unemployment rate fell from 5.7 percent to 5 percent. At the turn of the year there seemed to be little worry about any resurgence of substantial inflation, and most forecasts were calling for an inflation rate in the range of 2 $\frac{1}{2}$ to 3 $\frac{1}{2}$ percent for 1973.

By late spring of this year it had become apparent that the economy was facing trouble on a number of fronts. The price of farm products (measured by

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Table 1

Summary of Recent Economic Data

	Units	Levels 1972 IV	Levels 1973 I	Levels 1973 II	Annual Rates of Change, % 1972 II -1972 IV	Annual Rates of Change, % 1972 IV -1973 I	Annual Rates of Change, % 1973 I -1973 II
Gross National Product	billions of 1958 $'s	812.3	829.3	834.6	6.9	8.6	2.6
Personal Consumption Expenditures	"	540.5	552.7	553.8	6.6	9.3	0.8
Durables	"	109.2	117.0	116.6	14.8	31.8	-1.4
Nondurables	"	225.8	228.8	228.1	4.7	5.4	-1.2
Services	"	205.4	207.0	209.0	4.6	3.2	3.9
Business Fixed Investment	"	87.5	91.2	91.8	12.5	18.0	2.7
Residential Construction	"	35.3	35.6	35.3	6.5	3.4	-3.3
Change in Business Inventories	"	6.3	3.3	3.9	---	---	---
Net Exports	"	-0.8	2.0	4.9	---	---	---
Federal Government Purchases	"	58.6	58.2	57.5	-13.2	-2.7	-4.7
State and Local Government Purchases	"	85.0	86.2	87.4	9.8	5.8	5.7
GNP Deflator	(1958=100)	147.63	149.81	152.30	3.1	6.0	6.8
Private Nonfarm GNP Deflator	"	139.1	140.5	142.2	2.3	4.1	4.9
Farm Products Deflator	"	151.3	167.6	193.0	26.0	50.6	75.8
Consumption Deflator, Nondurables	"	137.6	140.8	144.6	3.9	9.6	11.2
Aggregate Unemployment Rate	%	5.3	5.0	4.9	---	---	---
Output per Manhour	(1967=100)	114.2	115.6	115.5	5.3	5.0	-0.3
Disposable Income	billions of current $'s	828.7	851.5	870.4	11.3	11.5	9.2
Corporate Profits plus IVA	"	98.8	104.3	108.9	26.1	24.2	18.8

the farm component of the GNP deflator) had risen at an annual rate of 26 percent in the second half of 1972 and that rate nearly doubled to more than 50 percent in the first quarter of this year. The farm sector of the economy, it turned out, was in the midst of a substantial dislocation resulting from the joint influence of a) the Soviet wheat deal, b) enormous growth of domestic and foreign demand combined with poor weather and thin harvests, c) the inadequate production targets inherent in the Administration's acreage allotments, and d) the vagaries resulting from an on-again-off-again price-control program which handled the various stages in the production and distribution of agricultural products with strange inconsistencies. The enormous increase in farm prices which began late last year and accelerated in the first quarter of this year pushed the annual rate of increase of consumer prices for nondurable goods from under 4 percent in the second half of last year to nearly 10 percent in the opening quarter of this year.

The nonfarm price level also accelerated in the first quarter of this year. The Phase III price control program, initiated early this year, may have been intended as part of a smooth transition to the orderly de-control of prices, but as presented by the White House it was interpreted to mean "the lid is off". In combination with a huge spurt in demand and rapidly rising prices for agricultural and other raw materials, industrial prices surged. Combining the results in agriculture, industry, trade and distribution, along with rising government pay scales, the overall annual rate of inflation in the first quarter of 1973 amounted to 6 percent, nearly double the 3.1 percent rate of the previous half-year.

By the second quarter of this year additional trouble-spots arose. The enormous gains in consumer durable and business capital spending simply could not be maintained, and they were not. Continued increases in interest rates --

partly the desire of the Fed to restrain a booming economy -- and a slowdown in the inflow of funds to S & L's succeeded in restraining a three year long housing boom and the volume of residential building activity began to decline in the Spring. Evidence also began to emerge that -- whether in response to rising prices or not -- the rate of growth of consumer purchasing of nondurable goods was also diminishing. The net effect of all this is that the second quarter of 1973 appears to have registered the smallest quarterly gain in real GNP in two years and, simultaneously, the highest quarterly rate of inflation since the Korean War period.

While few observers appear to be questioning whether the economy did in fact slow down in the second quarter of this year, many -- we included -- are expressing strong doubts about the degree of the slowdown as registered in the preliminary Commerce Department estimates of the second quarter. We would not be surprised to find that subsequent revisions peg the second quarter growth rate in the range of 4 to 5 percent rather than the 2.6 percent currently estimated. Our doubts center on the very small volume of inventory investment resulting, in part, from the enormous inventory valuation adjustment estimated for the second quarter, and the estimated decline in the volume of consumer spending on nondurable goods which may reflect inaccuracies both in data collection and in seasonal adjustment procedures.

Magnitude aside, then, the fact of slower growth has to be viewed as the net result of at least the following six factors:

- The dimensions of the recent boom in consumer durables, some of which has to be thought of as borrowing from the future, possibly in anticipation of subsequent price increases

- The maturing of a two year spurt in business expenditures to modernize and expand capacity

- The turn-around of a three year long housing boom, due in part to a general tightening of credit conditions and in some measure to the competitive disadvantage of S & L's at a time of generally rising credit demands

- The failure of the Administration's agricultural policies which have resulted in speculative distortions in the decisions which are vital to the future supply of agricultural products

- The essential abandonment of Administration leadership on the price front which was the operational result of the Phase III program, and

- A major rise in the cost of credit resulting from sharply rising credit demands, the desire of the Fed to restrain the boom, and the renewed expectations of inflation which were generated in no small part by policy failures.

The latter three of these factors are what really count for the near term course of development of the American economy. Consumers have often reacted strongly to sharp price increases and they appear to be doing so again. Credit costs which rise by much more than "normal" have often "clamped the lid" on the purchase of durable goods by consumers and businesses, and such a factor can be of even greater significance following a period of high and rising purchase rates.

We must inevitably feel uncertain about whether a fairly natural slowdown will remain but a brief respite, or whether the balance will be tipped toward recession. We might just as well say it here: we do <u>not</u> forecast that a recession will develop during the coming year and a half. But we do forecast a period of very slow growth from the third quarter of this year through mid-1974, with a pick-up in growth toward the end of 1974. Admittedly, our forecast involves an even-wider-than-usual confidence band. In the succeeding pages we shall try to explain the basis for the continued slow growth which we are forecasting, why we believe a real recession to be relatively unlikely, and where the greatest uncertainties appear to rest.

Inputs to the Forecast

- The Federal Budget input to the RSQE forecast for 1973-74 is summarized in the fourth column of Table 2 which presents our estimates of federal expenditures in the National Income Accounts for fiscal 1974. Our estimated total for federal expenditures is \$275.4 billion. Both the total and its composition are quite close to the official budget estimates either as presented in January or as estimated by the Commerce Department's Bureau of Economic Analysis in June. Compared to fiscal 1973 levels, the projected increase in expenditures is rather modest with fairly substantial increases scheduled only in the categories of non-defense purchases and transfer payments. The small increase in defense purchases includes a January 1974 pay increase amounting to \$1.8 billion (annual rate) and some new military procurement added to a basic pattern dominated by manpower reductions. Grants-in-aid show very little net increase following the end of the period of retroactive payments on revenue sharing. In addition, a federal take-over of a number of welfare programs for the aged and disabled in 1974 results in a reduction in Grants and a corresponding increase in transfer payments of about \$2 billion.
- State and Local Government Purchases of goods and services are projected to rise by about $14 \frac{1}{2}$ percent and $12 \frac{1}{2}$ percent in calendar 1973 and 1974 respectively. The substantial rise for 1973 reflects the already huge accumulation of liquidity resulting from very rapid growth in 1972 and early 1973 and the receipt of retroactive revenue sharing funds from the federal government. State and Local spending will continue to rise significantly in 1974 but at a somewhat slower

Table 2

Federal Government Expenditures in the
National Income Accounts
(Billions of Dollars)

	Fiscal 1973[1/]	Fiscal 1974		
		Official Budget[2/]		RSQE[3/]
		January	June	
Purchases of Goods and Services	104.3	111.5	111.1	111.2
National Defense	73.3	75.9	74.9	76.2
Non Defense	31.0	35.6	36.2	34.9
Transfer Payments	89.4	101.9	101.9	100.5
Domestic	86.9	99.1	99.2	98.1
Foreign	2.5	2.8	2.7	2.4
Grants-In-Aid to State and Local Governments	40.5	41.6	42.1	41.5
Net Interest Paid	14.4	15.8	16.8	17.6
Subsidies less Current Surplus of Government Enterprises	5.9	4.8	4.4	4.6
Total Expenditures (NIA Basis)	254.5	275.5	276.3	275.4

1/ Preliminary, based on Survey of Current Business, July 1973.

2/ "Revised Estimates of Federal Budget" Survey of Current Business, June 1973, p. 3.

3/ Estimated by RSQE.

rate reflecting the less rapid accrual of revenues and fairly high credit costs during at least the early part of the calendar year.

- The Pattern of Monetary Policy takes on special significance in view of the circumstances currently prevailing as the "initial conditions" for our forecast. A number of categories of expenditure -- consumer durables, business fixed investment, homebuilding, capital expenditures by State and Local governments -- are at this point in time likely to be extremely sensitive to the credit environment provided by the monetary authorities. A credit squeeze, or "crunch" could well induce a sharp drop in the actual levels of many such expenditures. It is our view that credit conditions over the next year and a half will continue to have a strong depressing effect on housing expenditures, but will not be so tight as to produce substantial reductions in other components of aggregate demand. In terms of interest rates we project short-term rates to be at or near their peak and would expect short rates to be declining through 1974.
- Farm Prices are projected to continue rising throughout the rest of this year and to close the year at a level some 60 percent above that of the fourth quarter of 1972. For 1974 we are projecting a modest decline in farm prices concentrated especially in the second half of the year.
- The recent sharp rise in import prices can be traced primarily to the successive rounds of dollar devaluation. Over the forecast period we foresee no further dollar devaluations and project import prices to rise at an annual rate of 6 percent reflecting inflationary

conditions abroad. Further, we expect the combination of improved terms of trade and the overall growth in foreign demand to result in a substantial growth in the volume of U. S. exports, averaging 9 $\frac{1}{2}$ percent at annual rates over the next six quarters.

<u>The RSQE Forecast for 1973-74</u>

We forecast that during the coming year and a half the U. S. economy will be characterized by divergent sectoral trends which will result in real GNP growing at an average annual rate of only 2.6 percent. The major components contributing to the <u>slow growth</u> of aggregate demand are

- -- Residential construction expenditures, which we forecast to decline by \$9 $\frac{1}{4}$ billion in constant dollars from 1973.2 to 1974.4. This corresponds to a level of housing starts down to about 1 $\frac{1}{2}$ million (annual rate) by the end of 1974.
- -- Consumer spending on automobiles and parts which we forecast to decline by more than \$3 billion in constant dollars from 1973.2 to 1974.3, and
- -- consumer purchases of nondurable goods which we forecast to grow at an unusually low average annual rate of about 2 percent from the second quarter of 1973 to the second quarter of 1974.

Those components which make strong <u>positive</u> contributions to the growth of real GNP from mid-1973 to mid-1974 are

- -- Business capital expenditures which continue to rise in real terms, though not at the rates of late 1972 and early 1973,
- -- Net exports which reach a level of almost \$7 billion in real terms by the second quarter of 1974,
- -- Consumer spending on services and non-auto durables which continue to rise at an average annual rate in excess of 4 $\frac{1}{2}$ percent,
- -- State and Local government purchases of goods and services, and
- -- Inventory accumulation which rises in mid-1973 and then remains for several quarters in the \$7-9 billion range (1958 dollars).

The 2.6 percent rate of growth of total output is accompanied by a steady rise in the unemployment rate and virtually no growth in productivity. We forecast a full percentage point increase in the unemployment rate to a level of 5.7 percent for the closing quarter of next year.

The pattern of price increases which we expect over the next year and a half is strongly influenced by our judgements regarding the nature and success of the Phase IV program. There can be little doubt that the early months of the prógram will be characterized by a temporary bulge in the rate of inflation. For the second half of 1973 we forecast that the annual rate of price inflation (GNP deflator) will exceed 7 percent. We expect that the Phase IV program will evolve as an overall "guideline" policy with its enforcement apparatus concentrated on highly visible areas of critical importance to the course of overall price behavior. This assumption together with slow growth of aggregate demand and a moderate decline in farm prices implies a progressive slowing of the rate of inflation throughout 1974. We forecast the aggregate rate of inflation to be at about $4\frac{1}{2}$ percent by the end of next year.

Although 1974 as a whole must be characterized as a year of disappointing economic growth, the elements of a renewed expansion can already be seen developing in our forecast of the second half of the year. The following developments are of special interest in this regard.

-- Consumer purchases of automobiles and residential building activity are both forecast to be rising by year-end.

-- The continued growth of real disposable income and more moderate rates of increase in consumer prices are forecast to induce an increasing rate of growth in the purchase of consumer nondurables.

Quarterly detail regarding the forecast summarized above is contained in Tables 3-5 and the computer print-out appended to this report.

Table 3: R.S.Q.E. Forecast
Gross National Product in Current Dollars
(Billions of Current Dollars, Seasonally Adjusted at Annual Rates)

	1973			1974				Calendar Years		% Change	
	II[1/]	III	IV	I	II	III	IV	1973	1974	1972-73	1973-74
Gross National Product	1271.0	1309.81	1341.80	1368.15	1389.94	1412.47	1439.26	1291.28	1402.46	11.8	8.6
Personal Consumption Expenditures	795.1	815.55	834.18	851.59	866.12	881.38	898.72	806.07	874.45	11.0	8.5
Durable Goods	133.1	135.23	136.98	138.23	137.96	139.32	142.73	134.39	139.56	14.5	3.9
Automobiles and Parts	59.9	59.71	60.30	59.62	58.63	58.37	60.33	60.09	59.24	13.8	-1.4
Furniture and Household Equipment	54.5	56.57	57.34	58.90	59.25	60.50	61.64	55.52	60.07	15.4	8.2
Other Durables	18.8	18.95	19.34	19.71	20.07	20.45	20.77	18.78	20.25	14.0	7.8
Nondurable Goods	329.8	340.00	348.75	356.68	363.19	368.79	374.48	335.18	365.79	11.8	9.1
Services	332.2	340.33	348.45	356.67	364.97	373.27	381.51	336.47	369.11	8.8	9.7
Gross Private Domestic Investment	199.2	208.20	213.70	213.71	213.75	213.75	214.78	203.91	214.00	14.3	4.9
Nonresidential	134.4	139.79	145.87	150.83	154.81	157.64	159.69	137.75	155.74	16.5	13.1
Residential Structures	59.5	58.62	55.58	52.08	49.42	48.90	49.94	58.17	50.09	7.7	-13.9
Change in Business Inventories	5.3	9.79	12.25	10.81	9.52	7.21	5.14	7.99	8.17	----	----
Net Exports	1.7	2.36	2.52	3.55	4.68	5.94	6.97	1.64	5.28	----	----
Exports	95.1	98.76	102.50	106.39	110.44	114.63	118.98	96.51	112.61	31.4	16.7
Imports	93.4	96.40	99.98	102.84	105.76	108.69	112.01	94.88	107.33	21.6	13.1
Government Purchases of Goods and Services	275.0	283.70	291.40	299.30	305.40	311.40	318.80	279.65	308.72	9.7	10.4
Federal	106.5	108.20	109.30	113.00	114.10	115.50	117.90	107.37	115.12	2.8	7.2
National Defense	74.5	75.20	75.30	77.20	77.30	77.70	78.10	74.82	77.57	0.6	3.7
Other	32.0	33.00	34.00	35.80	36.80	37.80	39.80	32.55	37.55	8.2	15.4
State and Local	168.5	175.50	182.10	186.30	191.30	195.90	200.90	172.27	193.60	14.4	12.4
Gross National Product Deflator, (1958 = 100)	152.30	155.05	157.79	160.18	162.20	164.16	166.01	153.74	163.14	5.2	6.1
Aggregate Unemployment Rate (%)	4.92	4.68	4.77	4.96	5.23	5.50	5.70	4.85	5.35	---	---

1/ U. S. Department of Commerce, July 1973, preliminary.

Table 4: R.S.Q.E. Forecast
Gross National Product in Constant Dollars
(Billions of 1958 Dollars, Seasonally Adjusted at Annual Rates)

	1973			1974				Calendar Years		% Change	
	II[1]	III	IV	I	II	III	IV	1973	1974	1972-73	1973-74
Gross National Product	834.6	844.77	850.38	854.13	856.94	860.44	866.99	839.76	859.62	6.2	2.4
Personal Consumption Expenditures	553.8	557.57	559.84	564.70	568.20	572.65	578.87	555.98	571.10	5.5	2.7
Durable Goods	116.6	117.47	117.52	117.99	117.16	117.42	119.05	117.14	117.91	12.6	0.7
Automobiles and Parts	53.0	52.47	52.07	51.39	50.46	49.80	50.61	52.92	50.57	12.6	-4.4
Furniture and Household Equipment	48.3	49.66	49.88	50.80	50.70	51.36	51.97	48.95	51.21	12.9	4.6
Other Durables	15.3	15.34	15.57	15.79	16.01	16.25	16.48	15.28	16.13	11.7	5.6
Nondurable Goods	228.1	228.57	228.51	230.48	232.46	234.30	236.53	228.50	233.44	3.4	2.2
Services	209.0	211.53	213.81	216.23	218.58	220.93	223.29	210.34	219.75	4.2	4.5
Gross Private Domestic Investment	131.0	134.71	136.25	134.14	132.03	129.72	128.23	133.02	131.03	8.3	-1.5
Nonresidential	91.8	93.62	95.82	97.48	98.36	98.57	98.42	93.11	98.21	11.2	5.5
Residential Structures	35.3	33.89	31.43	28.71	26.67	25.85	26.03	34.05	26.82	-1.4	-21.2
Change in Business Inventories	3.9	7.20	9.01	7.95	7.00	5.30	3.78	5.85	6.01	----	----
Net Exports	4.9	5.35	5.52	6.22	6.97	7.78	8.44	4.43	7.35	----	----
Exports	65.3	66.80	68.33	69.90	71.51	73.15	74.83	66.42	72.34	17.7	8.9
Imports	60.4	61.45	62.81	63.68	64.54	65.37	66.39	61.99	64.99	6.1	4.8
Government Purchases of Goods and Services	144.9	147.14	148.77	149.07	149.74	150.29	151.46	146.29	150.14	2.3	2.6
Gross National Product Deflator, (1958 = 100)	152.30	155.05	157.79	160.18	162.20	164.16	166.01	153.74	163.14	5.2	6.1
Aggregate Unemployment Rate (%)	4.92	4.68	4.77	4.96	5.23	5.50	5.70	4.85	5.35	---	---

[1] U. S. Department of Commerce, July 1973, preliminary.

Table 5: R.S.Q.E. Forecast
Supplementary Data
(Seasonally Adjusted at Annual Rates where Applicable)

	1973			1974				Calendar Year		% Change	
	II[1/]	III	IV	I	II	III	IV	1973	1974	1972-73	1973-74
Incomes											
Personal Income[2/]	1019.1	1054.43	1081.59	1109.34	1133.06	1158.64	1181.14	1037.93	1145.54	10.5	10.4
Disposable Income[2/]	870.4	892.05	914.02	944.20	963.44	977.26	995.50	881.99	970.10	10.7	10.0
Personal Saving Rate (%)	6.0	5.92	6.07	7.15	7.42	7.10	6.99	5.97	7.17	---	---
Corporate Profits plus IVA[2/]	108.9	111.34	112.82	108.26	103.98	99.39	101.10	109.34	103.18	20.0	-5.6
Prices, Wages, Productivity											
GNP Deflator[3/]	152.30	155.05	157.79	160.18	162.20	164.16	166.01	153.74	163.14	5.2	6.1
Personal Consumption Deflator[3/]	143.6	146.27	149.00	150.80	152.43	153.91	155.25	144.97	153.10	5.2	5.6
Private Nonfarm Sector											
Private Nonfarm GNP Deflator[3/]	142.2	144.20	146.36	148.07	150.04	151.85	153.47	143.32	150.86	3.9	5.3
Compensation per Manhour[4/]	149.9	154.52	157.82	162.40	165.63	169.16	170.80	152.54	167.00	8.3	9.5
Output per Manhour[4/]	115.5	116.09	116.36	116.53	116.68	116.96	117.58	115.89	116.94	3.4	0.9
Unit Labor Cost[4/]	129.7	133.10	135.63	139.37	141.95	144.63	145.26	131.58	142.80	4.7	8.5
Manufacturing Sector											
Industrial Production[4/]	122.8	125.03	125.82	125.94	125.71	125.67	126.59	123.51	125.98	9.2	2.0
Capacity Utilization Rate (%)	82.0	82.32	81.67	80.59	79.31	78.20	77.71	81.85	78.95	5.1	-3.5
Unemployment Rates (%)											
Aggregate	4.92	4.68	4.77	4.96	5.23	5.50	5.70	4.85	5.35	---	---
Male 20 and Over	3.35	3.17	3.34	3.62	3.98	4.34	4.63	3.31	4.14	---	---
Interest Rates and Government Surplus											
90 Day Treasury Bill Rate (%)	6.58	8.25	7.70	7.20	6.70	6.20	5.75	7.06	6.46	---	---
4-6 Month Commercial Paper Rate (%)	7.42	9.00	8.80	8.45	8.00	7.50	7.01	7.88	7.74	---	---
Corporate Aaa Rate (%)	7.31	7.69	7.46	7.44	7.36	7.25	7.11	7.42	7.29	---	---
Consolidated Government Surplus (NIA Basis)[2/]	11.1	16.09	16.22	3.05	-2.22	1.23	-0.17	13.08	0.47	---	---

[1/] U. S. Department of Commerce, U. S. Department of Labor, Federal Reserve Board, July 1973, preliminary.

[2/] Billions of Current Dollars [3/] 1958 = 100 [4/] 1967 = 100

Uncertainties and Alternatives

It seems to us especially important to call attention to four major areas of uncertainty surrounding our forecast.

- Our projection of Federal expenditures (see Table 2) may be a bit conservative. The Administration and the Congress could well choose to respond to rising unemployment by providing greater federal support -- via increased spending -- for such things as mass transit, housing programs, environmental improvement, etc.
- One important aspect of our current forecast is that it contains a personal saving rate of about 7 percent for 1974. This is a full percentage point above the 1973 level. In our model the higher saving rate is produced by rapid inflation and high interest rates. In the current circumstances we feel that the saving rate being produced by the model is at the upper end of the range of likely outcomes. A saving rate one half of a percentage point below that in our forecast would add $5-6 billion to the level of real GNP for the year 1974.
- Our forecast hinges very strongly on the accuracy of our assumptions regarding monetary policy. Should the Federal Reserve react to the Phase IV price bulge by further tightening credit conditions, the effect would be even slower growth, if not an outright recession, in 1974.
- Finally, we can only hope that the Phase IV program will not be accompanied by the damaging inconsistencies or administrative infeasibilities which characterized earlier Phases of the anti-inflation program.

Constant Adjustments in the RSQE Forecast

Twenty-two constant adjustments have been used in generating the forecast of 1973-74.

a) The following represent adjustments for level drift or start-up error.

CON(01)	Private Nonfarm Compensation per Manhour.
CON(03)	Private Nonfarm Deflator.
CON(06)	Personal Consumption Expenditures Deflator, Nondurable Goods.
CON(10)	Residential Construction Expenditures Deflator.
CON(29)	Employment Rate, Males 20 and over.
CON(30)	Aggregate Unemployment Rate.
CON(35)	Personal Consumption Expenditures, Nondurable Goods.
CON(38)	Inventory Investment.
CON(43)	Indirect Business Taxes.
CON(48)	Corporate Dividend Payments.
CON(51)	Imports of Goods and Services.
CON(54)	Corporate Aaa Interest Rate.
CON(55)	Housing Starts.
CON(56)	Residential Construction Expenditures.

b) Other Adjustments

CON(04)	Phase IV price bulge in Private Nonfarm Deflator.
CON(13)	Smoothing of Auto Consumption for Overwithholding Refunds.
CON(25) and CON(60)	Exogenizes Government Purchase Deflator.
CON(33)	Smoothing of Furniture and Household Equipment Consumption for Overwithholding Refunds.
CON(34)	Smoothing of Other Durable Consumption for Overwithholding Refunds.
CON(63)	Exogenizes Treasury Bill Rate.
CON(75)	Choice among alternative price equations.

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

TUESDAY, JULY 31, 1973

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

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

Present: Senators Proxmire and Humphrey; and Representatives Reuss and Carey.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Lucy A. Falcone, Sarah Jackson, Jerry J. Jasinowski, John R. Karlik, Richard F. Kaufman, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. This morning's hearing, while in the context of the Joint Economic Committee's 1973 midyear review of the economy, is also a continuation of the hearings begun in April by the Subcommittee on Priorities and Economy in Government on National Priorities and the Budgetary Process.

One of the major purposes of the Priority Subcommittee's inquiry this year is to determine the feasibility and desirability of the legislative budget cycle. Such a cycle would begin early in the year and continue in the months to follow with an exploration of economic and budgetary problems for the next year.

Thus far, we have fired the opening gun in this year's budget by raising questions about the budget request we are likely to receive from the President next January.

The assumption behind our approach is that Congress must do more advance planning than it has in the past if it is to play a meaningful role in the budgetary process.

One reason that Congress has a difficult time controlling the budget is that we wait too long before starting to work on it. By the time January rolls around, and the budget is transmitted to Congress, the administration has put in months of effort and the document is more or less set in concrete.

There is neither the time nor the opportunity after January, under the present system, for Congress to do much more than make marginal changes in the program requests or tax structure.

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This morning's panel is particularly qualified to speak to these and other issues.

I might point out that Brookings was founded 46 years ago, in 1927, and includes on its board of trustees such statesmen and business leaders as Douglas Dillon, Kermit Gordon, William McChesney Martin, Jr., Robert McNamara, and Gene Black.

Throughout my years in Congress I have known no private, nonpartisan, independent organization which has played a more constructive and creative role than the Brookings Institution.

All of todays panelists have been able to review public policy from the point of view of the executive branch of Government, as well as their present perspective.

Ed Fried was a senior staff member of the National Security Council. Alice Rivlin was Assistant Secretary for Planning and Evaluation in HEW. Charles Schultze was Director of the Bureau of the Budget, and Nancy Teeters was a fiscal economist in the Bureau of the Budget.

I understand Mrs. Teeters has accepted a position as senior specialist in the Library of Congress' legislative research work beginning in September.

Welcome to the legislative branch, Mrs. Teeters. You may be sure I will call on you frequently for your advice and counsel, and I hope you will be able to contribute to the priorities subcommittee's project in the fiscal year 1975 budget once you have moved to the Library of Congress.

You may each proceed in your own way. I understand you have an order of presentation which I guess begins with Mrs. Rivlin.

STATEMENT OF ALICE M. RIVLIN, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mrs. RIVLIN. As you know, my colleagues and I have just completed a study entitled "Setting National Priorities: The 1974 Budget," which is the fourth in a series of studies of national budgetary choices published annually by the Brookings Institution.

Although it is part of a series, the new study is emphatically not a revision or updating of last year's book. It is quite different and we hope it will prove more useful to the Congress.

How does the new book differ from its predecessors?

First, of course, the new study takes off from a different budget, the "radical' administration budget for 1974. The President's budget is remarkable, not only because it proposes deep cuts in ongoing programs, but because, by concentrating these cuts in domestic programs, especially grants to State and local governments for social purposes, it strongly expresses a particular view of Federal priorities and the Federal role.

Compared with previous editions of "Setting National Prorities," far more of our efforts this year, especially on the domestic side, were devoted to examining specific changes proposed in the President's budget, their implications for the future, and alternatives to them.

Second, we have attempted to look at budgetary choices in a new way, focusing primarily on alternative roles of the Federal Government both at home and abroad and their implications for the budget.

[1] The views presented in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution or its officers, trustees, or other staff members.

Third, we have attempted for the first time to lay out and discuss several comprehensive Federal budgets for the next 5 years, illustrating the consequences of major choices about tax reform, national security, and the role of the Federal Government in the domestic arena.

I will speak briefly this morning about our new strategic approach to priorities, especially on the domestic side and Mrs. Teeters will go into some specific examples of alternative domestic strategies. Mr. Fried will then deal briefly with major national security issues and Mr. Schultze will discuss alternative budgets for the next 5 years.

There are several useful ways of cutting through the infinite complexity of the Federal budget so that basic issues can emerge and be debated. The conventional way to organize a discussion of the budget involves separating the discussion of revenue and expenditure issues—who pays and what do they pay for? On the expenditure side, it involves separating issues by major functional areas, such as defense, health or housing. Discussions of priorities then tend to be stated in terms of the relative importance of major functions. How much should be spent on defense or health or housing?

This is a useful way to look at the budget, especially since the executive branch, citizen interest groups and to some extent congressional committees tend to be organized along these same functional lines. Previous versions of "Setting National Priorities" have taken this approach. This year, however, we thought it would be illuminating to look at budgetary choices in a new way: In terms of alternative strategies or roles of the Federal Government. The national security section of the book addresses alternative roles of the United States in world affairs and thir implications for defense spending. The domestic section addresses alternative roles of the Federal Government in dealing with individuals and State and local governments.

In domestic affairs we have identified four so-called strategies, each of which is reflected in the current Federal budget, but could receive substantially more—or less—emphasis in the future. The first two strategies involve relations between the Federal Government and individual citizens: Redistributing cash income through taxes and transfers, such as social security. Veterans' pensions or public assistance; and helping people buy essentials, by means of food stamps, health insurance, college scholarships or tax deductions for housing costs or medical expenses. In using the second strategy the Federal Government not only affects people's incomes, but how they spend their income.

The two other strategies involve the relation between the Federal Government and State and local government: Revenue sharing or redistributing resources among State and local governments with only broad directions about how the money should be spent; and categorical grants for specific purposes, such as support of vocational education, community mental health centers, or urban mass transit.

At present the expenditure side of the domestic budget is dominated by programs to redistribute cash income among individuals. Cash transfers will amount to about $81 billion in fiscal year 1974—not counting military retired pay—or about 45 percent of the domestic expenditures.

Most of this money goes for social security benefits and other programs for aged and disabled people. Cash transfers go mainly to people at the low end of the income distribution; hence the effect of cash transfers is to make the distribution of income somewhat more equal than it would otherwise be.

The same cannot be said of the Federal tax system. The two major Federal taxes—the moderately progressive individual income tax and the regressive payroll tax—largely offset each other. Taken together they have little effect on the distribution of income.

Federal programs to help individuals buy essentials are also substantial. About $27 billion or 15 percent of the domestic budget is expected to be spent in 1974 for medicare, medicaid, food stamps, federally assisted housing, college student aid and similar programs, mostly to assist low-income people to buy essentials.

Tax expenditures for these purposes are also major. Special tax treatment for medical expenses, homeownership, and child care now costs at least $16 billion a year. These tax expenditures, however, are no help to the poor and tend mainly to benefit families in the middle and upper middle income ranges.

General revenue sharing now accounts for only a small fraction of Federal spending—less than $7 billion or under 4 percent of domestic spending is allocated to this purpose in the administration's 1974 budget—but the proportion could grow dramatically in the future if the public and the Congress came to feel that equalizing resources among State and local governments should become an important Federal function.

Categorical grants are considerably larger and devoted to two major purposes. Investments in the physical environment—mostly transportation and air and water pollution abatement—are expected to cost about $15 billion in fiscal year 1974. Grants for social purposes—education, manpower training, community health services and the like—add up to about the same total. Because of the controversial nature of these grants it is easy to forget what a small fraction of the Federal budget they take. In fiscal year 1973 grants to State and local governments for social programs amounted to about $15 billion or 9 percent of the domestic budget. Cuts in commitments proposed by the administration would reduce these grants by about a third to roughly $10 billion, although the magnitude of the cut would not be immediately reflected in expenditures. The number of separate programs would also be sharply reduced.

Each of these strategies has a plausible rationale and each has inherent difficulties that will have to be addressed in designing programs for the future. Choices among strategies reflect deeply held views about the appropriate kind of action for the Federal Government to be taking. Those who favor increased emphasis on cash income redistribution, for example, believe that poverty and inequality of income are basic to many of the Nation's problems and should be reduced. They do not feel, however, that the Federal Government should be telling people how to spend their income. Those who emphasize health insurance or housing allowances, by contrast, give higher priority to insuring everyone access to specific necessities than to equalizing incomes in general.

Those who advocate greater relative emphasis on revenue sharing give higher priority to equalizing public services—or reducing local tax burdens—but have confidence in State and local decisionmaking.

Those who favor expanded categorical grants are also more deeply concerned about improving publicly provided services, but believe steps must be taken to insure that State and local uses of Federal funds reflect national priorities.

We have chosen this framework for discussing national priorities for two reasons. First, we suspect that the major focus of political debate and controversy for the next few years will be over the role of the National Government, not over specific functions. The debate will not be over health versus housing versus education, but over the locus of decisionmaking, in these functional areas.

Second, we believe that certain kinds of budgetary choices are illuminated by this framework. For example, if major emphasis were given to redistributing cash income, say through a generous negative income tax, programs such as food stamps or housing subsidies would seem far less necessary. Alternatively, if a decision were made to adopt a substantial national health insurance plan, many specific grants to State and local governments to support health services would appear obsolete. These types of "trade-offs" should be highlighted and debated in making budgetary choices for the future.

Thank you.

Senator PROXMIRE. Thank you.

Mrs. Teeters, please proceed.

STATEMENT OF NANCY H. TEETERS, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mrs. TEETERS. Mr. Vice Chairman and members of the committee, it is a pleasure to appear before this committee to discuss the national priorities and the budget outlook. Within each of the strategies or ways of doing things that we have identified, we have developed proposals to illustrate how such a strategy could be implemented.

In some cases, the different strategies represent different ways to accomplish similar goals—income redistribution and helping people to buy essentials. In other cases, a similar instrument is used to accomplish disparate goals—grants for social programs and grants for environmental improvement. I would like to discuss briefly a few of the alternates we developed.

REDISTRIBUTION OF INCOME

The distribution of income can be affected by policy changes on either the tax or expenditure side of the Federal budget. In addition to reform of the individual income tax, we have examined two proposals for reform of the payroll tax.

The payroll tax bears more heavily on lower income groups than on upper income families. In fact, for incomes up to about $12,000 a year, a four-person single-earner family pays more payroll tax than income tax. One of the reform proposals examined would remove the ceiling on wages subject to tax, introduce personal exemptions, and a minimum standard deduction as under the income tax.

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[1] The views presented in this statement are those of the author and not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

Such a reform would reduce the tax burden markedly on incomes under $10,000 and would provide some tax relief for incomes up to $20,000. There would be a short-term revenue loss of less than $2 billion and longer term would actually increase revenues.

As an alternative, the wage ceiling could be retained but personal exemptions introduced that phase out as income rises. Such a proposal would reduce the tax burden for a family of four with incomes up to approximately $7,000 at an annual cost of about $3 billion.

On the expenditure side, several ways of improving the cash benefit programs were developed. In each case, the existing transfer programs, except welfare, would be retained and under one alternative, a universal guaranteed income, instituted. Income from other transfer programs would be counted in the minimum guarantee. The costs of such a program depend heavily on the level of the guaranteed income and the rate at which such payments are reduced as income from other sources rises.

For example, a guaranteed income of $3,600 for a family of four in 1976 is estimated to cost $12 billion if the payments are reduced by 67 cents for each dollar of earnings and $22 billion if the payments are reduced by 33 cents for each dollar of earnings.

A $4,800 guarantee and a 67 percent "marginal tax rate" has about the same cost as the $3,600 guarantee and 33 percent tax rate. An alternative to such a program would be one of "filling in the cracks" of the existing income maintenance system; that is, increasing the maximum unemployment benefit, enacting the rest of the changes recommended by the Advisory Council on Social Security, increasing the monthly welfare benefit to aged, blind, and disabled and reforming the remaining welfare programs. If the existing transfer programs were expanded and if a guaranteed income were given to all families with children, the cost of "filling in the cracks" would be approximately the same as a universal income guarantee. If the welfare reform were limited to female-headed families, the costs are lower, especially at the higher levels of guaranteed income.

HELPING PEOPLE BUY ESSENTIALS

Two of the areas analyzed are medical care and housing. By 1978, we estimate that $32 billion will be spent by the Federal Government under medicare and medicaid programs and tax subsidies through the income tax.

One of the alternatives examined is the maximum liability health insurance—MLHI—proposal—that is not as comprehensive as the national health insurance proposal that has been introduced by Senator Kennedy and Representative Griffiths. Under the MLHI proposal, half of the medical expenses of middle and upper income groups in excess of 10 percent but less than 15 percent of income would be paid for by the Government. All expenses is excess of 15 percent of income would be federally financed. Low income groups—$2,400 annual income, for example—would pay 5 percent of the first $720 of medical expenses. Gross costs of the program are estimated to be $43 billion, in 1978 or a net increase of $11 billion over existing programs.

An alternative would be to reform the tax subsidy for medical expenses under the income tax. A tax credit of $1 for each dollar of medical expenses above 10 percent of income would relieve the burden of catastrophic medical expenses. Refunds could be given to taxpayers whose medical credits exceed their tax liability.

Several approaches have been tried to improve the quantity and quality of housing. Among the most successful are those aimed at improving the housing market by improving the mortgage market—Federal National Mortgage Association, Federal Home Loan Banks, Government National Mortgage Administration. There are also sizable subsidies provided home ownership in the income tax code. Most of these programs aid the middle and upper income groups. In the past, efforts to increase housing available to the poor have taken the form of subsidizing the construction of public housing and in recent years the home ownership and rental assistance programs.

The major problems with current programs of housing assistance for the poor is that the supply of assisted housing is not large enough so that people in equal income status have equal access to housing assistance. An alternative is to provide housing allowances to everyone in certain eligible groups, such as the elderly, families with children, or all renters. The cost of such allowances depends on the level of benefits—that is, what the average cost of renting a basic house is—the percentage of income that the family is expected to pay for housing, and the proportion of eligible households that apply for the allowance.

Table 1, attached to my statement, shows our estimates of what various levels of housing allowances would cost for various groups in our population.

[Table 1 follows:]

TABLE 1.—BENEFITS AND NUMBER OF HOUSEHOLDS ASSISTED UNDER 3 HOUSING ALLOWANCES, BY ELIGIBLE GROUPS, 1974 LEVELS [1]

Eligible group	Benefits (billions of dollars)						Number of households receiving benefits (millions)					
	High benefit		Low benefit		Medium benefit with welfare reform		High benefit		Low benefit		Medium benefit with welfare reform	
	No price change	Prices rise 10 percent	No price change	Prices rise 10 percent	No price change	Prices rise 10 percent	No price change	Prices rise 10 percent	No price change	Prices rise 10 percent	No price change	Prices rise 10 percent
All households	12.3	15.5	1.9	2.5	3.7	5.3	20.3	22.7	7.8	9.0	13.3	15.5
All families	9.0	11.6	1.2	1.7	2.4	3.6	13.2	15.0	4.1	5.0	7.9	9.5
Families with children	6.6	8.5	.9	1.2	1.8	2.7	8.5	9.7	2.7	3.2	5.2	6.3
All renters	6.6	8.3	1.1	1.4	2.1	3.0	11.0	12.2	4.3	5.0	7.6	8.8
Nonfarmers	11.4	14.4	1.7	2.3	3.4	4.9	19.2	21.5	7.2	8.4	12.7	14.8
Aged only	2.8	3.6	.4	.6	.9	1.3	6.0	6.5	2.5	2.9	4.2	4.8

[1] High benefit allowance: basic housing benefit (family of 4 with 0 available resources) = \$1,650–\$2,100 a year, depending on location of residence. Available resources = money income, plus ¼ of assets in excess of \$10,000 a year (\$5,000 for households with aged head), less \$300 for each household member working at least 20 hours a week, less social security taxes. The basic allowance is reduced by ¼ of available resources.

Low benefit allowance: basic housing benefit = ½ the level of the high allowance, reduced by ¼ of available resources.

Medium benefit allowance combined with welfare reform: negative income tax rate = 50 percent on earnings above \$720 annually (excluding social security taxes); basic benefit (family of 4) = \$2,400 (benefit varies with household's size—all households are eligible); allowance = ¾ of high allowance for a family with no available resources.

No price change assumes that housing costs are unaffected by the housing allowance.

Prices rise 10 percent assumes that housing costs increase 10 percent because of the housing allowance.

Source: Authors' estimates.

Mrs. Teeters. The high benefit assumes an allowance for a family of four with no available resources of between $137.50 and $175 a month depending on where they live. There would be a 25-percent reduction in the allowance as income rises.

There is time to discuss only a few of the alternative domestic programs that were developed. Any major new domestic program tends to be expensive. We have again done a 5-year projection of receipts and expenditures. Under existing programs, not taking into account the expenditure reductions recommended by the administration, the results of our projection are very similar to last year's projection—$15 to $20 billion deficits, even when revenues are calculated at full employment.

Even with the reductions, the amount of resources available for fiscal 1975 is negligible, as shown in table 2 attached to my statement.

[Table 2 follows:]

TABLE 2.—PROJECTED FULL-EMPLOYMENT REVENUES AND EXPENDITURES, BEFORE AND AFTER BUDGET CUTS BY THE ADMINISTRATION, FISCAL YEARS 1974-78

[In billions of dollars]

	1974	1975	1976	1977	1978
Projection before budget cuts:					
Revenues	268	290	315	342	370
Expenditures	284	311	334	357	378
Existing programs	280	303	325	347	368
New programs	4	8	9	10	10
Deficit	−16	−21	−19	−15	−8
Projections after budget cuts:					
Revenues	268	290	315	342	370
Expenditures	267	288	308	329	348
Surplus	1	2	7	13	22
Administration's June revision:					
Revenues	+5	+6			
Expenditures		+2			
Net adjustment	+5	+4			
New surplus	+6	+6			
ubsequent changes:					
Social security (net)		1.5			
Other	1.0	1.5			
Adjusted FE surplus	4.0	3.0			

Mr. Teeters. By fiscal 1976, only about $7 billion of resources become available for new programs.

In June, the Office of Management and Budget released new estimates of receipts and expenditures for both fiscal 1974 and 1975. Due to the very rapid rate of inflation experienced during the first half of calendar 1973, the estimated full-employment receipts were increased by $5 billion in fiscal 1974 and $6 billion in fiscal 1975, as shown in the lower portion of table 2. Total expenditures of $267.7 billion estimated for fiscal 1974 were not changed and the total for fiscal 1975 was increased by $2 billion from $288 to $290 billion.

Since June, an increase in social security benefits has been legislated to take effect July 1, 1974, having a net cost of $1.7 billion in fiscal

1975—$2.5 billion increase in expenditures less $800 million increase in revenues.

In addition, according to the "Budget Scorekeeping Report," approximately $1 billion of additional outlays for fiscal 1974 have been enacted so far this session. The full-employment surpluses under the current budget posture are not more than $3 to $4 billion and probably less, because there are increases in expenditures that we are not yet aware of—such as the housing subsidy money that the courts have ruled be released from impoundment.

Thank you.

Senator PROXMIRE. Thank you.

Mr. Fried, please proceed.

STATEMENT OF EDWARD R. FRIED, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mr. FRIED. There is a striking contrast this year between the domestic and foreign policy aspects of the budget. Where the domestic budget is designed to bring about substantial change in the role of the Federal Government in society, the defense budget reflects a standpat position on defense policy and military force levels. And where the domestic budget is characterized by an emphasis on expenditure cuts and on eliminating programs judged to be less effective, the defense budget shows very little evidence of initiatives to streamline military programs or achieve significant dollar savings, either this year or in the future.

Indeed, the total cost of defense is scheduled to go up in fiscal 1974, even after allowing for inflation. In total obligational authority, $85 billion has been requested for defense programs, $4 billion more than in fiscal 1973. Adding $3 billion to allow for the reduction in Vietnam costs and deducting $4 billion to allow for projected price and pay increases indicates an increase of $3 billion in the real cost of defense. In other words, this year's peace dividend from closing out the Vietnam war is destined for military rather than civilian use.

Moreover, our projections show that if present defense policies, force levels, and weapon programs are unchanged, the cost of defense, in constant dollars, will rise by about 3 to 4 percent a year over the rest of this decade. In current dollars, that is, allowing for inflation, the defense budget will reach $104 billion by 1978. In these circumstances, there would be little if any margin for a shift in national priorities from military to civilian spending.

Why are defense costs rising at the same time as international tensions are easing?

One major reason is that U.S. defense policy is becoming the prisoner of a high-cost defense structure. In effect, the unit cost of defense is constantly going up, principally because of the pay increases required to make military pay competitive with that in the private sector, because of a higher ratio of support to combat forces, and because of the rising cost of weapons. As a result, the present cost of defense in dollars of constant purchasing power is roughly the same as it was 10 years

[1] The views presented in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution or its officers, trustees, or other staff members.

ago, even though the size of American forces has been substantially reduced.

Another reason is that recent positive developments in international relations have had virtually no effect on our perception of security needs. The world may have become less dangerous, but apparently not to the point of altering the U.S. view of its interests and commitments abroad or of the military forces necessary to back them up.

To encourage examination of the basic assumptions underlying the defense program, we have outlined several alternative defense budgets, largely to illustrate the budgetary consequences of a few key factors. I would like to briefly summarize these alternative approaches to providing for the Nation's security.

The first is the administration's defense posture as reflected in the 1974 budget. It seeks to maintain current force levels, to modernize strategic forces extensively, and to retain U.S. deployments both in Europe and in Asia. These force levels and military programs are believed to be necessary for the near term to sustain U.S. alliances and encourage continuing improvement in East-West relations. Possible reductions in forces or cutbacks in weapon programs, therefore, are approached cautiously so as to avoid alarming allies or giving the wrong signals to potential adversaries. The reasoning is that maintaining strong military forces now is the safest and surest route to having reduced military forces and smaller defense budgets in the future. Disadvantages in this approach stem principally from its high cost. Eventually these cost pressures alone could dictate changes in defense policies, carrying with them the danger that changes made under such pressures will be wasteful in economic terms and harmful in foreign policy terms.

Alternatively, the United States could seek to serve present military purposes, at substantially lower cost. It can be argued that economies promising savings of $10 billion a year by 1978 can be made in defense costs without modifying the current definition of U.S. interests abroad or appreciably affecting present military capabilities to protect or advance those interests. About half the savings would arise from slowing the modernization of strategic forces—the Trident submarine, the new B-1 strategic manned bomber, and others—and cutting back marginal programs such as air defense and the less effective components of the present strategic bomber force. The balance would come from economies in the use of manpower, a pruning of Reserve Forces, reform in the method of determining military pay increases, and rejection of proposals for additional enlistment bonuses or for the recomputation of retired pay.

A second and more drastic alternative, based primarily on a reassessment of U.S. interests in Asia and of U.S. strategy for the defense of Europe, could reduce the defense budget by $25 billion in 1978. In addition to the efficiency-oriented savings of $10 billion discussed above, it would incorporate the following three major changes in defense policy and force levels.

First, in Asia the United States would limit its security interests to Japan and disengage from commitments to the defense of Southeast Asia. This would make possible the closing down of most U.S. military bases in Asia, a reduction in the number of aircraft carrier task groups, and the return and deactivation of a large portion of U.S. forces now stationed in the region. Savings would reach almost $5 billion a year.

Second, U.S. forces for the defense of Europe would be designed to fight a short war rather than, as now, a protracted conflict similar to World War II. This would mean (1) streamlining U.S. forces both in Europe and the United States to bring maximum defensive power to bear in the first stages of a conflict, and (2) substantially reducing those elements of U.S. forces—principally active and Reserve divisions based in the United States and selected naval forces—geared to a long war in Europe. Savings would reach $8 billion a year. Most of these savings, it should be stressed, would come from reducing forces based in the United States rather than from withdrawing U.S. forces in Europe. In fact, on the logic behind this alternative, the possibility for such savings rests on maintaining strong, although moderately reduced, forces in Europe.

Third, further reductions would be made in strategic forces. Land-based missiles would be gradually phased out on the ground that bombers and submarine-launched missiles would provide a sufficiently powerful and flexibile strategic retaliatory capability. Savings would amount to almost $2 billion a year.

These three changes add up to an alternative defense budget which, by fiscal 1978, would be $78 billion, or about $25 billion less than we estimate the present defense program will cost at that time and representing about 4.5 percent of GNP, rather than 6 percent of GNP, which Defense is now projected to absorb in 1978.

Numerous other defense budgets based on the efficiency criteria and foreign policy alternatives analyzed in our book could readily be developed. All of these alternative budgets, including those I have summarized, involve potential costs as well as savings which must be evaluated on their merits. It is worth emphasizing that such an evaluation—that is, the judgments that must be made about how much "defense insurance" the Nation should carry—depend only in part on strictly military considerations. They involve differing views about cost and efficiency factors in the defense budget. And they involve differing political assessments, since in today's international environment, the purposes served by military forces are as much political as military.

This brings me, Mr. Vice Chairman, to the emphasis you have placed in these hearings on the role of the Congress in "encouraging more complete and more timely analysis of next year's budget." So far as defense is concerned, it is evident that cost pressures and the rapidly changing international scene will transform the fundamental character of the debate: The central issue is not whether policies and force levels will change, but how change should be managed.

In considering this issue, our analysis of defense forces suggests that it would be useful for the Congress to have four points in mind:

First, defense costs depend primarily on total force levels, not on the location of forces. The cost of maintaining forces overseas is not much different from the cost of maintaining them at home. From a budget point of view, the debate about how many troops we should keep abroad has much less significance than the debate about how large our forces should be.

Second, the full budgetary effect of moving toward smaller military forces is felt only after a few years. Cutbacks in programs are made gradually and usually involve initial one-time costs; first year savings are relatively small. Hence a multiyear approach to consideration of the defense budget is essential.

Third, in seeking restraints on defense spending, procurement is only one source, and probably the smaller source, of potential savings. Manpower-related expenses and the numerous issues involved in achieving efficient management of military personnel and an effective system of military pay are at least equally important and deserve at least equal attention.

Fourth, a serious reassessment of the defense budget must center on force levels and the foreign policy purposes to which ther are related. A close connection between foreign policy and military appropriations is critical to a systematic determination of how large our forces should be, where they should be stationed, and what kind of weapons they should have.

These considerations argue for a sharper focus on force structure issues and a longer term view of the cost and foreign policy implications of the defense program than the annual congressional debate on our defense budget now provides.

Thank you.

Senator PROXMIRE. Thank you.

Mr. Schultze, please proceed.

STATEMENT OF CHARLES L. SCHULTZE, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mr. SCHULTZE. Mr. Vice Chairman and Congressman Reuss, my colleagues have outlined the highlights of our analysis of the alternative approaches to major policy problems in both the domestic and national security areas. As they noted, we sorted our budgetary programs in terms of the different roles or strategies through which the Federal Government acts, at home and abroad.

Within that framework we examined the advantages and disadvantages of a wide range of Federal programs, both military and civilin, and for each one provided 5-year estimates of budgetary costs.

In the final chapter of this year's "Setting National Priorities" we drew upon all of this material to develop a series of comprehensive alternative budgets, each of which illustrates a very different priority emphasis, in terms of the split between military and civilian programs, the level and structure of Federal taxes, and the strategies chosen to carry out national objectives. This is the first time we have attempted such a comprehensive approach to alternative budget strategies. I would like to summarize our results very briefly.

Before turning to the specific alternatives, however, let me call your attention to one central fact which emerges from the analysis: It is impossible to control the shape of the Federal budget, and therefore the ordering of national priorities in a conscious and deliberate way unless attention is lifted from the budget year immediately ahead, and shifted to an outlook which extends at least several years into the future.

Budget debate and budget decisions which concentrate in what can be done to change the structure of Federal revenues and expenditures

[1] The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

in the coming year inevitably generate the false impression that the budget is uncontrollable.

It is not. This year's budget indeed cannot be changed significantly by this year's decisions. And the reason for this is that its shape and structure were largely determined by decisions made 2, 3, or 5 years ago, most of which are virtually impossible to undo now.

But just as this year's budget priorities were fixed by actions taken several years ago, this year's actions can set budget priorities several years hence, and, if we wish, radically alter the priorities expressed in the current budget.

As an example of this fact, I call your attention to one set of alternatives developed in the final chapter of "Setting national Priorities." Through a combination of moderate tax reforms and modest cuts in the defense budget, together with the revenues yielded by economic growth, some $44 billion could be made available by the fiscal year 1978.

With such a sum, a number of major new initiatives could be undertaken which would yield substantial benefits to American citizens individually and to American society as a whole. But even if the tax reforms and changes in defense budget were put in motion immediately, they would yield only $5 billion in fiscal 1974, a sum, taken by itself, hardly large enough to warrant the political costs of these actions.

Moreover, decisions about how best to use the $44 billion which would eventually become available—what initiatives to start and how to phase them in—could never be made by fixing our gaze principally on the immediate problem of how to use the $5 billion yielded by these actions in 1974.

This fact was driven home to us in preparing the final chapter on alternative 5-year budget strategies. We did not start with the 1974 budget, and then proceed to build up each succeeding year.

Rather we began with an estimate of what various tax reforms and defense policies could yield by way of "free" budget resources in 1978. We then worked out alternative uses of those resources in 1978, and only as a final step phased in the new programs during the intervening years.

The 1975, 1976, and 1977 budgets were thus determined principally by long-range decisions based on a set of targets for 1978. It would have been impossible to reverse the process, and budget for a new set of priorities by working forward year by year.

In short, contrary to what has now become the conventional wisdom, the Federal budget is controllable, and can be altered to meet changing needs, if—but only if—the Executive and the Congress are willing to scrap procedures which focus on the current year and decide budgetary issues in a longer range context.

THE NATURE OF THE ALTERNATIVE BUDGETS

The alternatives which we developed to illustrate different sets of priority choices differ from each other in two dimensions:

First, in terms of the total resources available for domestic programs. This involves two basic kinds of choices—about tax reform, and about the split between the defense and the domestic budget.

Second, within each potential level of resource availability, the alternatives differ in terms of the strategies or roles through which the budgetary resources might be used to meet national objectives.

The table attached to my statement is an attempt to lay out schematically the nature of the choices involved.

[The table follows:]

ALTERNATIVE BUDGET STRATEGIES

[In billions of dollars]

	(I) Current posture			(II) Moderate additional resources			(III) Large additional resources		
	1974	1976	1978	1974	1976	1978	1974	1976	1978
Resources available for domestic programs:									
Economic growth	1	7	22	1	7	22	1	7	22
Tax reform	0	0	0	1	10	12	2	15	30
Defense cuts	0	0	0	3	7	10	6	18	25
Total	1	7	22	5	24	44	9	40	77
Alternative strategies for using resources.	1. Administration approach: Tax cuts, additional, and general revenue sharing. 2. Expenditure increases.			1. Administration approach plus more money: Tax cuts, additional general revenue sharing, and education equalization. 2. Cash income redistribution: Negative income tax, payroll tax reform, and low-income tax relief. 2. Helping people buy essentials: Health insurance, housing, day care and higher education. 4. Social grants.			Strategies 1 through 4, similar to preceding col. II, with larger tax cuts or larger and more varied program initiatives.		

Mr. SCHULTZE. The first bank in the table shows the resources available for domestic programs under three sets of choices about tax reform and defense cuts. The first alternative would be to continue the present budgetary posture: Existing tax laws would remain unchanged; current defense programs and policies would be continued.

In the next 3 years, fiscal 1974 through 1976, revenues would grow only slightly faster than expenditures on current programs, leaving virtually nothing for use in new domestic initiatives.

By 1977 and 1978 some leeway would become available, but the amount would be small relative to the total budget or to the size of the economy. The $22 billion available in 1978 would be about 6 percent of the budget or 1¼ percent of GNP.

We developed two different ways in which this small amount of resources could be used, and these are identified in the second part of the table. The table gives only a brief identification of the alternatives; the book itself, of course, shows the alternative uses of resources in some detail.

One alternative is labeled "Administration approach." Under this approach most of the resources yielded by economic growth would be used for general tax cuts and the remainder for expanding no strings attached general revenue sharing. Smaller government and less government intervention is the theme of this approach.

The other alternative, under the current budgetary posture, with respect to defense and tax structure, would devote the available resources to additional domestic expenditures. We did not develop this alternative extensively on grounds that virtually no funds would be available before 1977, and that nothing of any major significance by way of a change in nataional priorities could be begun before then.

The next major set of alternatives—shown in the second column of the table under II—we labeled "Moderate additional resources." It assumes an important, but not dramatic, restructuring of the tax system, reducing tax preferences to yield additional revenues amounting to $1 billion in 1974 and growing to $12 billion in 1978.

It also incorporates changes in defense policies, which leave the basic roles, missions, and objectives of the Armed Forces unaffected, but through various efficiency measures realize budgetary savings which amount to $3 billion this year and increase to $10 billion in 1978. Combined with economic growth, these actions would yield $44 billion of resources by 1978.

The second part of the table, in column II, shows the four alternative sets of strategies for using these resources. The basic strategies have been described by Mrs. Rivlin and Mrs. Teeters, and I only want to point out here a few characteristics of the four alternatives.

The strategies are arrayed in terms of an increasing degree of Government intervention in how the money is spent. The first strategy, for example, uses half of the $44 billion in resources for a general personal and corporate income tax cut and most of the remainder to increase general revenue sharing and to launch a new program of aid to education.

In both of the latter programs the Federal Government retains virtually no control over the use of the funds once they are distributed. The second alternative heavily stresses redistribution of income to the poor and to lower middle-income working people.

It encompasses among other elements a negative income tax for the poor and the low-paid worker, a reform of the payroll tax which benefits low-income working people, and an income tax cut whose benefits chiefly flow to those earning less than the median income.

This approach is liberal with respect to income distribution but conservative with respect to governmental intervention, since the funds are given out in cash, and the Government has no control over their use.

From a political standpoint, this use of budget funds combines the interests of the poor and the working man. The third alternative strategy emphasizes programs which help people to buy essentials. It includes a national health insurance program which covers all of the medical needs of the poor and provides protection against catastrophic expenses for the middle class.

It also includes funds for housing allowances, for day care vouchers for working mothers and for liberal student aid to purchase higher education. In this strategy the Federal Government specifies what the money is to be used for, but relies on private institutions to furnish the necessary goods and services; it gives people money, earmarked for specific purposes, but within that restriction lets them shop freely in the market to buy where they want.

The fourth and final strategic alternative is the most interventionist. Most of the funds would be used for categorical grants to State and local governments or private institutions, with the Federal Government retaining, through guidelines and regulations, some control over the use of the funds.

Instead of supporting day care, or higher education, or manpower training through earmarked transfers to individuals the Federal Government would provide grants to day care centers, colleges and universities, and publicly controlled manpower training institutions.

In addition, grants to cities for urban development and to local schools for compensatory education would be included.

The final column in the table under III outlines the budgetary results which could be achieved by adopting a much more ambitious set of tax reform proposals and undertaking a more thoroughgoing revision of the defense budget, along the lines described by Mr. Fried in his testimony.

This set of choices would make available, by 1978, some $77 billion in discretionary budget resources. Again, four different alternative uses of those funds were developed in the final chapter of the book, each emphasizing one of the four basic strategies described earlier.

We do not suggest that these are the only alternatives. Other combinations are possible and we attempt in the book to provide building blocks so that the reader can construct a budget reflecting his own preferred set of priorities.

We do believe it is useful to consider alternatives not only in the usual way, by weighing health programs against education or space or pollution control, but also in terms of alternative roles or strategies through which the Federal Government can act. It is the latter set of comparisons which we have stressed.

In one sense the message of this analysis is optimistic. Relatively moderate and quite reasonable changes in the tax structure and in the defense budget can make available fairly sizable sums for use in ways which would substantially improve the lot of the American people.

Existing budgetary procedures in both the Executive and the Congress, however, tend to obscure the possibilities which are open, partly because those procedures focus attention solely upon the current budget year, and partly because, in the case of the Congress, there is now no mechanism through which the Congress can consider the budget as a whole, and particularly the basic composition of the budget.

Even if appropriate procedures were devised, so that major changes in priorities could be acted upon in the context of a longer range outlook, it is not at all clear that it would be politically possible to make substantial changes along any of the lines discussed in "Setting National Priorities."

The fact is, that despite all of the talk in the past 5 years about changing priorities, there has been no public discussion which developed in a comprehensive way just what the options were.

There has been much debate about tax reform, and defense budgets, about health insurance, housing subsidies, welfare reform, and pollution control. But mainly these have been considered in isolation from each other. There has been little or no concrete discussion about alternative futures—about what kind of government doing what kind of things we want to have 5 years from now.

The Congress is not only a body for making legislative decisions, it is also a forum for public education and debate. Whatever the fate of the changes in congressional budget procedures now being developed in various committees of the House and Senate, it would be exceedingly useful, I believe, if means could be found to encourage congressional discussion of alternative budgetary futures even if the discussion were not tied to immediate legislative action.

This is not to say that I believe that those procedures should not be developed, but rather that I believe that the Congress has a basic educational function as well as legislative function.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. I thank all of you for a brilliant contribution. It is most useful.

Let me start the way you ended, Mr. Schultze. You ended by saying the one way we can get control of the budget is to widen or lengthen our perspective and look at it from at least a 5-year standpoint instead of a 1-year standpoint.

It makes a lot of sense. There is no question when we talk about uncontrollable items, we are saying they are uncontrollable for 1 year. Controllability, I think, is a function of time. Certainly there is nothing sacred about a year, 12 months, 365 days, anymore than there would be about a 6-month period, a year-and-a-half period, or a 2-year period.

You appear to be suggesting that if we really want to control the budget we ought to at least have some way of working toward some kind of a 5-year budget. Is that correct?

Mr. SCHULTZE. Yes, sir. I think there are two aspects to it. One is information and the other decisions. Both are relevant. By that I mean first having the kind of information which provides the 5-year consequences of the actions you now take.

Senator PROXMIRE. That information is bound to be, no matter how intelligent or comprehensive or well organized it is, limited tentatively because we can't foresee what is going to happen.

Mr. SCHULTZE. I understand that. However, my own view is that tentative, in some cases questionable, in some cases uncertain information in this area, is substantially better than no information at all, substantially better.

The second recommendation involves, in addition to having the information, devising procedures which allows decisions to be made on the basis of more than just 1 year's appropriation.

Senator PROXMIRE. You seem to back away from the structure which would put us in that position and say that it seems that we might work for the time being at least in the direction of education along those lines first.

I am inclined to think that the best way you can get education is to try and force the issue and say that we ought to lengthen our budget period. That will probably go down to defeat for awhile, but as you discuss the necessity of it, it will gain adherents and eventually make progress.

I think this is really a very pround and helpful, significant suggestion you bring us.

Mr. SCHULTZE. The only thing I would like to make clear is that I don't want to leave the impression that I am suggesting the changes in procedures are not very important. They are. I simply wanted to add that in addition to the straight legislative action, the educational role is also significant.

Senator PROXMIRE. I served on the Budget Review Committee, the 35 members of the House and Senate who considered how we can get into a position where we can establish a ceiling, establish priorities, and come up with a responsible budget within that ceiling, to secure enactment each year in a timely way.

That group of Members of Congress unanimously agreed on the staff's recommendation, and it was a fine staff. Since then that has been partly challenged by other Members of the Congress. Whether it is going to succeed or not, whether it is going to come about in time for the 1975 budget is a question.

During all this discussion and debate, I don't recall any suggestion by any member or by any staff person or by any outside person—as you know, extensive hearings were held on this—that we go to something like a 5-year approach, at least in some way.

I am sure that some reference was made to that and it was recognized that we have to think in these terms if we are going to have a more effective control.

Mrs. RIVLIN. May I get into this? I took a flier the other day and made a proposal in testimony before the Bolling committee, the Select Committee on Committees in the House, along just these lines, that the Congress move to a 3-year budget cycle and require the administration to submit a 3-year budget every year.

Senator PROXMIRE. Kind of a rolling budget?

Mrs. RIVLIN. A rolling budget, right. In any one year the debate focus on priorities would be about the budget 3 years ahead. In other words, right now you would be focusing not on 1974 but on fiscal year 1976. One would also, of course, have to have a procedure for amending those decisions in the light of new information or changes in priorities that the Congress wanted.

Senator PROXMIRE. You have that procedure to some extent with supplementals, in terms of expanding the expenditures. But I suppose we don't have it in terms of reducing expenditures, and it is even less effective in the tax area.

Mrs. RIVLIN. It would seem to me that something like this would focus the major debate about priorities on a forward year, but would also give you a chance to review them with respect to the upcoming year and to make changes that seemed to be necessary in the light of fiscal consideration.

Senator PROXMIRE. Will you make that paper available to the committee for its hearing record?

Mrs. RIVLIN. Certainly. I would be delighted to.

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

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ON

HOUSE COMMITTEE ORGANIZATION AND OPERATION

IMPROVING THE CONGRESSIONAL BUDGET PROCESS

ALICE M. RIVLIN

The Brookings Institution

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IMPROVING THE CONGRESSIONAL BUDGET PROCESS

(By Alice M. Rivlin, The Brookings Institution)[1]

Mr. Chairman, I would like to address myself briefly this morning to three questions. First, what are the major flaws in the way Congress deals with the budget? Second, what would be a better procedure for making budget decisions? Third, to what extent do the recent recommendations of the Joint Study Committee on Budget Control remedy the flaws and move toward a better system and to what extent would they make things worse?

THE CURRENT PROCESS

It seems to me a mistake to think of the current debate on budget procedures primarily as a power struggle between the Executive and the Congress—as though current procedures benefitted the Executive and the main problem for the Congress was to develop a new set of procedures that would redress the balance of power in its favor. The problem is more basic and has only accidentally come to light in the course of a struggle between the Congress and the Executive over a particular set of budget decisions. The fundamental problem is that the process by which budget decisions are now made in Congress wastes tremendous amounts of time and energy, both Executive and Congressional, on relatively unimportant decisions and makes it almost impossible for anyone involved in the process—whether they be members of the administartion, the Congress, the press or the public—to understand what the major budget issues are, to debate them intelligently and make informed decisions about them.

In the executive branch, where I have had first-hand experience with the budget process, the amount of time and effort that goes into budget-making, and budget-defending is nothing short of preposterous. Indeed, top management in many agencies does almost nothing else. Months are devoted to making up the agency's own budget and defending it within the executive branch. Weeks are devoted to hearings before authorizing committees and preparing answers to congressional questions. More weeks are devoted to hearings before appropriations committees and answering another round of questions. Long before the harassed agency head or program manager knows what his budget will be for the current fiscal year, he is already involved in developing and defending his budget for the year to come. The process leaves little time and energy at the top level of many agencies for carrying out programs and making sure they are managed effectively.

It would be gratifying if this tremendous expenditure of executive branch time and attention made it easy for the Congress to grasp and act upon budget issues. But the opposite is the case. Hearings rarely

[1] The views presented in this statement are those of the author and not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

serve to clarify issues. The Executive deluges Congress with data and reports, but they often add up to little real information about how programs work and what they accomplish. Only the real experts on subcommittee have time to dig into this material and absorb much of the detail, and even they have little time to examine alternative approaches to what the Administration is proposing. The average Congressman or Senator has to take a great deal on faith and rely on his own over-worked staff to keep him as informed as possible.

The most serious problem is that there is so little room in this process for discussion or debate about budget priorities. A great deal of time and attention is devoted to details of the budget and almost none to basic questions about the allocation of the total federal effort, Is the relative emphasis on national security and domestic problems the right one? Are old people getting too large a share of the budget and children too little? Could some funds for health or highways or housing be spent more effectively for education or environmental protection. Indeed, there is no convenient way to raise these questions. Budget measures are considered and voted on one at a time. There is no opportunity for comparing them and expressing priorities. There isn't even a mechanism for keeping total spending and revenues in line with appropriate fiscal policy. Nor is there any way to look ahead two and three years and make decisions about the directions the federal government should be moving and what the relative sizes of various parts of the budget should be in the future. Decisions are made one year at a time—often for a year which is already nearly over. In some cases this means appropriating funds that are already so fully committed that they may be considered virtually spent; in other cases it means voting funds that will not be spent for a long time, but will seriously constrain future decisions.

This situation is nobody's fault. The traditions of budget making developed in a simpler era when the federal budget was smaller. There were fewer programs; they had less impact on the economy and less information was available or desired about them. But these procedures are obviously anachronistic now. Changing them would be in the collective interest of the Congress and the Executive—not to mention the public—although change is always difficult because it inevitably threatens someone's power.

WHAT WOULD BE BETTER?

Reform of budget procedures ought to have at least four major objectives. The first objective is to *focus attention on big decisions.* This means reducing the number of stages, hearings, bills, presentations and reducing the time and attention spent on relatively unimportant decisions, so there is some time left over for consideration of major budget issues. Second, more *information in more digestable* form must be made available to all members of Congress so that they can make more informed budget decisions. This means that the Congress must have a highly qualified staff whose function is to analyze budget issues and lay out alternatives clearly and comprehensively. Third, the *timing of the budget cycle must be changed* so that the Congress can look far enough ahead to make major changes in the budget if it wants to. Multi-year budgets are essential. Fourth, a way must be found of expressing priorities, of actually voting on major choices, not just with reference to the upcoming fiscal year but several years in advance.

Congress is unlikely to start from scratch and develop a whole new procedure for making budget decisions, but it may be useful to think about what one would be like. My own view is that Congress should require the administration to submit a *three year budget.* (For some programs three years is not long enough. For long-lead items, such as highway networks and weapons systems, full costs should be given as well as budget estimates for the coming three years.) The major time and attention of the Congress should be devoted to the third year. In other words, if this system were operating now budget decisions would already have been made for fiscal year 1974 and fiscal year 1975 and the Congress would be actively debating the budget for 1976. The Administration would be required to submit, along with its budget proposals for fiscal year 1976, proposed amendments to actions already taken for 1974 and 1975 to take account of new developments. The amendments would be debated and disposed of early in the legislative year—well before the start of the new fiscal year.

The budget format should be improved and simplified so it is easier for the Congress and the public to understand. The Congress should not expect, however, that new ways of presenting the budget can do much to simplify an inherently complex reality. Cutting the number of programs, especially small out-dated programs, would do far more to simplify the budget problem than could possible be done by ingenious ways of arranging items in a program budget.

I would also propose revision of the committee structure to combine the authorizing and appropriating functions. Each house would have a *Budget Committee*, whose functions I will come back to in a minute, and several *program committees*. The program committees (e.g. Education and Labor, Armed Services) would both authorize and appropriate funds for the range of programs under their jurisdiction. The game of shunting liberals on to authorizing committees to vote high authorizations that everyone knows will never be funded would come to an end.

In each legislative session, the Congress would deal first with the Administration's proposed *changes* in the budget for the upcoming fiscal year. This budget was voted two years before and amended in the past year, and its basic decisions would not normally be re-opened. Two kinds of changes would, however, be considered: those necessitated by changes in the fiscal outlook and those necessitated by other new developments, such as new needs arising out of natural disasters or economic setbacks or new information that programs were not working as expected. The Administration would submit its recommended changes to the Budget Committee and defend them. Opposition witnesses would also be called. *The Committee would report out its recommended changes in a document showing the projected deficit or surplus for the upcoming fiscal year as well as spending by categories.* The Committee proposal could be amended on the floor, but any amendments that added or subtracted funds would have to include compensatory changes in spending or an explicit change in the surplus or deficit. This process of amending the budget for the forthcoming fiscal year should be started in January and be over well before June.

In the meantime, hearings will have started on the really important budget proposal, that for the budget three years ahead. The Administration's proposed total for both revenues and expenditures in that year would be discussed and the budget committee in each house would vote on a tentative total for revenues and expenditures to be used as guidance to the program committees on working on parts of the budget. Program committees would normally exercise their authorizing function only every two or three years and in the other years would stick mainly to considerations of appropriation levels. In other words, they would not try to give a full-scale review to all programs in every year but would concentrate their energies on reviewing the basic authorization for a portion of the budget each year.

Recommended budgets (and new authorizations where necessary) would be reported out of program committees and acted on by the full House or Senate at intervals during the year much as is now done. Actions taken on the floor on various parts of the budget, however, would be reconciled at the end of the session. Funds appropriated and revenues voted would be added up. The Budget Committee would recommend changes to bring the totals into line if its view had changed over the year and there would be an opportunity on the floor to take some money out of one program and put it in another or to increase or cut taxes in line with changes in expenditures. These proposed amendments would provide an opportunity for debate on major issues of budget priorities. (Some sort of conference procedure would, of course, be needed to resolve differences between the House and the Senate.)

Both the budget committees and the program committees would be aided in their work by substantially increased staffs charged with analyzing administration budget proposals, developing alternatives, and commissioning studies to evaluate existing programs or develop new proposals. These staffs, especially those attached to the budget committees, would provide analysis and information designed to elucidate budget decisions not only for committee members but for the rest of the Congress as well. The staff positions should carry enough status and pay to attract very able people.

The alternative of an independent staff—a Congressional OMB—seems to me undesirable. To be effective and useful the staff operation has to be part of the decision process; i.e., attached to a committee where decisions are made. Committee staffs, however, would be free to call on outside agencies (certainly including the GAO) for studies and in-depth analysis. They would not normally do research themselves but would concentrate on formulating questions and summarizing data presented.

Shifting to such a system would, it seems to me, accomplish several objectives at once. It would focus the attention of the Congress, the Executive and the public where it belongs: the big decisions that must be made now if budget priorities are to be altered two or three years in the future. It would provide a mechanism for debating questions of future priorities as well as for adjusting short-run taxing and spending policy to the needs of the economy. It would simplify the committee structure and reduce the amount of time consumed in separate hearings and presentations, and it would improve the flow of digestible information to Congressmen and Senators who have to make these decisions both in committee and on the floor.

RECOMMENDATIONS OF THE JOINT STUDY COMMITTEE ON BUDGET CONTROL

The recent report of the Joint Study Committee on Budget Control addresses these same problems and makes some recommendations on which I would like to make some very brief comments. The basic idea of the report seems to me absolutely correct: the Congress must have some mechanism for looking at the budget as a whole, for explicitly considering whether the surplus or deficit to be expected from the joint impact of revenue and spending measures is appropriate to economic conditions, and for considering the desirability of shifting funds from one federal activity to another.

The mechanism suggested by the Joint Study Committee for achieving these ends, however, seems to me to have at least two serious flaws. First, it deals only with the upcoming fiscal year. It suggests procedures for making tentative budget allocations early in the legislative session and for reconciling budget actions at the end of the session—procedures that seem likely to slow down the appropriations process and virtually guarantee that all agencies will be operating on continuing resolutions until well into the fiscal year. It seems to me essential that any mechanism for making decisions on the budget as a whole be accompanied by a shift in the timing of the budget cycle, so that important decisions are made at least a year in advance and preferably more.

Second, the Joint Study Committee's recommendations complicate rather than simplify the existing committee structure by adding a new Budget Committee composed of members drawn from other committees. It leaves both authorizing and appropriating committees with their current functions, but adds a new set of decision-makers. It seems to me essential to reduce, not increase, the current complexity of the process.

Senator PROXMIRE. Mr. Fried.

Mr. FRIED. One additional comment, Mr. Vice Chairman. We have been talking for 2 years now, in the case of defense, about moving toward a 5-year rolling authorization.

Senator PROXMIRE. It is like pulling teeth to get any information from them.

Mr. FRIED. But it is possible. We make our effort, as small as it is, and it may not be too far off the mark in terms of projecting what future costs will be. It is terribly important that we look at least 5 years out in the case of defense expenditures. A rolling 5-year defense authorization, at least, is not that unusual as far as some other countries are concerned. The Germans have a 5-year defense authorization as well as the Japanese.

Senator PROXMIRE. Then are you suggesting that maybe in some of these areas we move to a multiyear authorization? We have multiyear authorization in foreign aid and some other areas, so it is not new ground. That would be with the appropriation remaining on an annual basis.

Mr. FRIED. We could move to begin on an annual basis and eventually try to move toward longer term appropriations. But I recognize that is more difficult.

Senator PROXMIRE. Did you suggest the appropriations go to a 3 year or the authorization, Mrs. Rivlin?

Mrs. RIVLIN. Both.

Senator PROXMIRE. In your priority study you talk of essentially two ways you open up the options. One is to spend less for national defense and the second is to enact revenue-raising tax reform.

You haven't discussed the possibilities of spending less for domestic programs. I can think of some rich candidates, or ripe candidates; public works, where many of the benefit-to-cost ratios are not reasonable on any kind of realistic discount basis, and also in the transportation area, the roadbuilding area, shipping subsidies, airport and airline subsidies, railroad bailouts.

We seem to have a lot of expenditures there that can be challenged. Although I am less certain about the size of the number of people in the Federal Establishment, the fact that there are about 1.5 million people outside of the Pentagon.

That hasn't been very carefully challenged, or at least the figures challenged recently. Another, and this is the one I feel most strongly about, is revenue sharing. Although I know it is a new program, tied in for the next 5 years, there are several reasons why it seems to me that State and local governments is where there is the most opportunity for wise spending reductions. Recently Arthur Burns testified that we had something like this enormous increase in the Government spending in the last 40 years.

In 1929 about 10 percent of national income was paid in State and local taxes. In 1940 it was 20 percent and now it is 35 percent. Of course, if we had passed the revenue sharing program 20 years ago it would have been a good program.

Since then we have had demographic changes. The number of children in school will continue to drop over the next several years. We have a far, far better financed social security program for the aged, more comprehensive.

The aged are better cared for. We have many reasons why the burden on State and local governments in the coming years will be less. This is not a logical time to come forward with a revenue sharing program which enfeebles, it seems to me, the discipline for their cutting their spending to a more efficient approach.

Why did you confine your recommendations at least in the fiscal dividend to national defense on the one hand and revenue raising reform on the other in view of all of these other things?

Mr. SCHULTZE. First, in each of the volumes on "National Priorities," as a matter of fact, we did look into a number of those each year. This year you will find, for example, a fairly substantial discussion of the public works program with some suggestions there, although they don't bulk large in terms of the size of the total budget.

This year, I guess partly as a matter of emphasis, time and realism in terms of where the large sums were available, we concentrated most, though not all, of our efforts in the area of defense and tax reform rather than going back and pulling in a lot of discussion contained in the earlier volumes on individual areas.

You will remember also you are putting this in the context of a Presidential budgetary recommendation which took some, depending upon which year you are talking about, $10 to $15 billion out of domestic programs, as a consequence of which we stressed the presentations of alternative major priorities and did not put the emphasis this year on cutbacks in some of those other domestic areas which we have discussed in the past.

Mrs. TEETERS. We did look into the problem of the State and local governments. Last year and again this year we came to the conclusion that overall State and local governments are in fairly good fiscal position.

There are two problems. One is that although the overall position of the State and local governments is fairly good, it is not well distributed. In other words, there are problems with the poor States and the inner cities. A revenue sharing plan could be designed that would go to specific areas where the revenue base is inadequate.

The other problem we identified last year is that during a period of recession, such as 1969 and 1970, the State and local governments get badly squeezed. I made a proposal one time to have a countercyclical revenue sharing program which would cut off in periods of boom and turn on in periods of recession. That is a different problem in terms of the revenue sharing funds.

One of our proposals is to develop a revenue sharing program which will go more to the poor State and local governments rather than the wealthy ones.

Senator PROXMIRE. Somebody said in the volume, I believe, that you expect a very large increase in revenue sharing over the years. Of course, not during the next 4 years, because that is already fixed.

Mrs. TEETERS. It is one of the alternative ways of using funds, a hands-off sort of policy. You could expand revenue sharing very quickly and it would pass the power and decisionmaking body to the State and local governments.

Mr. SCHULTZE. Just to nail that down, in that part of our book which deals with the forward projections, and contrasted to looking at alternative ways of using funds, we do not project forward large expenditures in revenue sharing as one of the potential ways to use additional funds, though we do lay that out.

Senator PROXMIRE. Congressman Reuss.

Representative REUSS. I join the vice chairman in thanking each one of you for another remarkable job. I am very proud of the work you have done.

May I start, Mr. Schultze, with my sensing that your 1974 budget document, which came out the other day, differs a bit, and understandably so, from your 1973 budget document on the subject of tax reform?

You took a rather agnostic position on tax reform in your 1973 publication. That is to say, you said that package three, containing the largest number of reforms, would raise only $10.2 billion a year.

Here, in the 1974 tax reform sections, you envisage that in the current year tax reform, individual and corporate, would realize almost $28 billion, and by 1978 would realize some $46 billion.

There is nothing in the world wrong, and everything right, with coming to a realization that tax reform is close to being a necessity for fiscal soundness in this country. My question is: Is my hunch right, have you warmed up a little bit over last year to the revenue raising possibilities of tax reform?

Mrs. RIVLIN. It is right in the sense that we have shown rather more substantial tax reform packages this year than we did last year. It is not a question of differing estimates of the yield of those packages.

Last year we were rather conservative about the packages that we illustrated. The largest one, as you say, was a fairly moderate tax reform proposal.

This year, essentially, we took that one as the lower bound and then showed what you might do if you were rather bolder about tax reform and decided to undertake some reforms that would really raise a very substantial amount of revenue.

The difference between the two packages this year is that the lower tax reform package would not cut substantially into any of the tax preferences or privileges that are enjoyed by the average taxpayer. It would raise revenue from increasing the effect of rates on very high income people. The second, however, would affect a large number of taxpayers.

Representative REUSS. Sticking to your package, one would raise immediately more than $12 billion a year, would it not, without in any substantial way affecting the middle range?

Mrs. RIVLIN. Yes. It depends on what you mean by immediately.

Representative REUSS. In the current fiscal year.

Mrs. RIVLIN. If the lower package were enacted immediately, which seems hardly likely, it would raise $7.6 billion in 1974.

Representative REUSS. That is from individuals. Plus $5 billion in corporate taxes.

Mrs. RIVLIN. That is correct.

Representative REUSS. $12 billion would reduce the fiscal swelling a good deal, wouldn't it?

Mrs. RIVLIN. Yes, it would.

Representative REUSS. It would enable us, in 1974, if we had had the forethought to do what is set forth here, to have a balanced budget and have a good many more billions, $8 or $9 more billions, for either tax reduction or necessary high priority programs.

Mrs. RIVLIN. That is right. This is an instance of the general point that Mr. Schultze was making earlier, that if you are going to reform taxes you have to do it quickly because the full revenue effects would not be felt for several years.

Representative REUSS. The revenue effect gets better. In 4 years, as you point out, your modest change in package, one yields in individual and corporate revenues $22.7 bililon.

Mrs. RIVLIN. Yes.

Representative REUSS. It seems to me that you have, by your study, demolished the antitax reform argument that one hears so much of nowadays that: "Well, you can't really raise anything by tax reform without hurting the little guy."

Mrs. RIVLIN. I think that is right. I think these figures dramatize that very much.

Representative REUSS. I have one other question. I know you are all familiar with the current congressional budgetary control program that Senator Proxmire has alluded to.

In your judgment, would not that program be improved if it required including in the ambit of targets not only spending by regular spending methods but so-called tax expenditures?

Mr. SCHULTZE. Yes.

Representative REUSS. Just to take a current example, there are some who want to appropriate directly $300 million a year to the private and parochial schools. There are others who want to achieve the same result by lowering revenues by $300 million through a tax credit to the parents of the children who attend private and parochial schools.

It would seem to me that if you are going to require in any budgetary control procedure an inclusion of direct expenditures, you ought increasingly to require inclusion of so-called tax expenditures as well.

Mr. SCHULTZE. I fully agree. As a matter of fact, although I have not thought this fully through, it seems to me one might even go further and at least for a very defined list of tax preferences subject them literally to the 3-year authorizations or 5-year authorizations.

In the case you described, the two are really exactly parallel in terms of their resource absorption capacity. In addition simply to providing information about tax expenditures it seems to me one could consider a specific list of very specific preferences which should be handled by putting them in the tax code on a 3-year basis, just as you have an expenditure authorization for 3 years. It should be considered.

Mrs. RIVLIN. There are other examples that we have highlighted in the book. In housing, for example, the largest Federal housing program costs about $10 billion and gives a set of tax preferences to homeowners.

Also a substantial amount of funds is spent through medical deductions on the income tax.

Representative REUSS. Thank you.

Senator PROXMIRE. Mr. Fried, how deep a personnel cut in numbers, can you tell us, would result from your short war strategy in Europe?

Mr. FRIED. Just from that alone?

Senator PROXMIRE. Yes.

Mr. FRIED. Let me try to summarize it without too much precision. What we said was that as far as troops in Europe are concerned, the emphasis should be on making those troops more effective than they are now to deal with a short war. The reductions we suggest might be possible and still meet this criteria are reductions of about 50,000 in troops in Europe. These reductions would consist principally of support units.

Senator PROXMIRE. As I understood, what you were saying was the principal saving in reduction would be of reserve units in this country that are designed for a long war in Europe that doesn't make any sense in view of the nuclear power of both this side and the other side.

Mr. FRIED. Forces in Europe would be cut by 50,000.

Senator PROXMIRE. And in addition to that what?

Mr. FRIED. The bulk of additional reductions would come from deactivating the equivalent of three divisions plus associated support units, or a reduction of something on the order of 100,000 in the number of active military personnel. In addition very substantial reductions could be made in reserve forces.

Senator PROXMIRE. In addition to that, you suggested that our Far East strategy be modified to provide effective reductions.

In looking at it overall, how does the Senate Armed Services Committee's 7-percent cut in personnel for the coming year fit into your suggestion? That is only for 1 year.

I take, if they would make a similar cut the next year and the year after, and so forth, they might or might not be ahead of you or behind you. How would you compare that?

Mr. FRIED. The Senate Armed Services Committee cut, of course, was not apportioned to specific forces. As far as the totals are concerned, the return and deactivation of the forces we talk about the Asia alternative would be something over 100,000, plus additional personnel reductions that would be associated with a reduction in the number of carriers.

To put the two together, Mr. Vice Chairman, that alternative as a whole would include reductions of about 100,000 in personnel from, say, the efficiency oriented reductions, and another 400,000 in military personnel by 1978 from reductions in force levels. In all, total military personnel would be about 1.7 million compared to 2.2 million now. That is a dramatic alternative of course, and takes into account total effect of (a) efficiency; (b) a reassessment of interests in Asia; (c) a reorganizaton of forces for Europe.

Senator PROXMIRE. You are talking about cutting military personnel.

Mr. FRIED. Right.

Senator PROXMIRE. There are 956,000 civilian personnel, permanent civilian personnel, in the Department of Defense. The reduction there has been far less, pro rata, than the reduction of military personnel. This is part of the long logistic tale, part of what many critics have argued is a fat Pentagon operation.

Can you give us any guidance on the possibility of reducing that very large number? That represents about 40 percent of all of our Federal civilian personnel, the Pentagon does.

Mr. FRIED. I can give you the numbers that are associated with the alternatives in the book. Roughly, 100,000 civilian personnel would be reduced in that first alternative by changes in support functions, a reduction in the number of B–52 squadrons, those kinds of things, and another 100,000 would be associated with the second alternative. In all, this would mean a reduction in defense civilian personnel from 950,000 to about 750,000.

Senator PROXMIRE. In your functional breakdown, you place defense, space, and foreign affairs in the same category. What is your rationale for putting space with defense, and what is included in foreign affairs in this defense category?

Mr. FRIED. That grouping was shown in the breakdown of the total budget, Mr. Vice Chairman. We did not, and do not in the defense section, analyze the space program.

Senator PROXMIRE. You didn't include space?

Mr. FRIED. No, sir.

Senator PROXMIRE. I am chairman of the subcommittee that handles money for space and they are constantly justifying that on the basis of military justification, especially the shuttle.

You ask them why the shuttle is not in the military budget and they say it couldn't survive, that they would throw it out. It doesn't have enough priority.

In your statement you say defense, space, and foreign affairs is considered together in your book. That is at page 5 of your book.

Mrs. TEETERS. Those are the functional categories in the budget; we just took those three functions and put them together.

Mrs. RIVLIN. But we didn't go into an analysis of the space program.

Mr. FRIED. The defense section dealt only with the Department of Defense appropriation.

Senator PROXMIRE. Yet you exclude veterans programs in the defense categories.

Mrs. TEETERS. They are in the transfer programs.

Senator PROXMIRE. And you don't include interest on the national debt, any part of that, in defense, space, and foreign affairs.

Mrs. TEETERS. No.

Senator PROXMIRE. Why not?

Mr. SCHULTZE. Mr. Vice Chairman, in order not to confuse the reader, we are obviously faced with the problem of using one major set of classification throughout the book. Fairly obviously, if one is asking the question how much do past wars as well as the current Military Establishment cost the budget, then you put the numbers together in a different way.

If at any time we wanted to specifically look at that, or anybody wanted to look at that, I think you are quite right, one would then want to do an analysis of the veterans program and the interest on the debt to see how much those were associated.

But simply in terms of having to settle on one set of classifications, particularly since we wanted to look at veterans pensions in terms of how they related to other kinds of cash transfers, we didn't do it the way you suggest. I quite agree that your suggestion is another rational approach that one can take to budget classification.

Senator PROXMIRE. Trying to get on top of defense spending and reduce it, we do have a lot of emphasis on weapons systems rather than personnel. You make a dramatic point when you say weapons cost only about 15 percent of the defense budget and Congress would be well advised to pay more attention to personnel costs, especially manpower, which is 50 percent of the budget.

Yet, aren't the costs attributed to weapons narrowly defined as acquisition costs? Wouldn't they be much greater if operation, maintenance, constructive facilities, and all other field costs are considered? We recently estimated the life cycle of 115 weapons included in the pipeline.

We concluded that those weapons alone, not including what is already paid for in the inventory, or new weapons that come along in the future, would cost roughly $53 billion a year for each of the next 6 years.

What is your reaction? That was based on a GAO study. What is your reaction to that way of calculating hardware costs?

Mr. FRIED. I think it is absolutely right, Mr. Vice Chairman, that the type of weapons systems we have will inevitably influence personnel. The more complicated the weapons system the larger the number of people needed to maintain it.

So there is a close connection between them and we said so. I think, though, the point that we are making is not that an examination of weapons systems is not important, but that we become, in reviewing the defense budget, too greatly occupied with that problem.

For example, if you look at the issue of the way military pay increases are now calculated, a complicated issue which we tried to lay out with some care in this year's budget book, you get to a calculation something like this: If, in fact, the increase in military pay was equal to the increase in civilian pay, as called for in the criteria of the comparability pay legislation—that is, if the methods were changed so as to make that possible—the saving over the decade would be about $200 million the first year, rising to $1.6 billion in constant dollars by the end of the decade. That means, Mr. Vice Chairman——

Senator PROXMIRE. Let me interrupt to make sure I understand what you are saying. You are saying that if military pay had been held down to an increase in the civilian pay——

Mr. FRIED. No. I am saying that as a result of the Rivers amendment passed in 1968 or 1969; military pay increases are calculated differently from civilian pay increases in the Government sector.

There is nothing wrong with this. It was perhaps understandable when it was passed. But the military pay system is a very complex system, with over 200 categories of pay and allowances. That particular change has, in fact, resulted in military pay increases being about 20 percent more than the criteria under the comparability pay legislation passed by the Congress would call for. I am saying if you look at that, and if, in fact, the increases in the military sector were made comparable to the pay increases called for in the civilian sector, the savings over the rest of this decade would average close to $1 billion a year, or about the same as the savings that might arise from slowing down the modernization of Trident.

Senator PROXMIRE. Some people would argue that might have an adverse effect on recruitment. On the other hand, the people I have talked to on the Armed Services Committee tell me that their hearings suggest that the pay isn't a problem in recruiting personnel anyway.

They say that the problem of recruitment has to do with the attitude toward the military. I think that the issue of whether additional pay incentives is necessary for voluntary service is an arguable question.

Mr. FRIED. Our studies on this would suggest that for the time being we can wait and that by changing or lowering some qualifications standards, permitting greater entry of women into the armed services, and perhaps reducing the total number of military personnel we could

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meet requirements through recruitments on the basis of existing pay scales.

But that is a separate question from the one I was discussing earlier, Mr. Vice Chairman. This is the issue involved in the present system of computing military pay increases.

Senator PROXMIRE. Let me ask one other general question before I yield. Year after year, Brookings and other groups have come before Congress and proposed feasible, realistic methods of reducing Defense spending without endangering national security.

In fact, it would be enhancing it. Yet the absolute costs of defense are going up. Can you suggest ways for enhancing the impact of the Defense budget and of increasing congressional influence over the size and shape of the Defense program? What can we do to make these recommendations effective?

Mr. FRIED. I think more is being done, Mr. Vice Chairman. The actions of the Senate Armed Services Committee that you just cited are examples of a more active and concerned assessment of the Defense budget. The committee's new interest in the field of personnel is particularly important.

I would argue, in addition, that it is essential to somehow move toward a multiyear look at the budget, and that Congress as well as the executive has to provide more attention to manpower and the personnel actions. The issues involved in the military pay system are a notable example.

Mrs. TEETERS. I think the proposed reform of congressional handling of the budget, in which the whole budget is debated at one time, is likely to make it more obvious how large Defense expenditures are. It may do a great deal in making people realize how large they are in comparison to the other programs.

Senator PROXMIRE. As you know, we cut the Defense budget. We cut it last year by about $5 billion, and $5 billion or $6 billion 2 or 3 years before that. But the administration is able to continue spending at the same level because of unobligated balances and because of an enormous backlog of funds that they have available.

One of the suggestions was that we get much better control over previous appropriations than we have had in the past.

Mrs. TEETERS. It would certainly be very helpful.

Senator PROXMIRE. My time is up. I will be back.

Congressman Carey.

Representative CAREY. We hear much in international discussions regarding mutual security and mutual balanced force reduction, plus a system of burden sharing in which our more fortunate partners, in the tense and insecure world, would pick up more of the mutual defense burden from the United States.

That is particularly in the NATO countries and the non-NATO country of France as well as perhaps in Indochina eventually. Is that a realistic hope? Is there some expectation that we can have our European parners, at least, assume a greater share of their own burden of defense?

Why should they not do that? I am somewhat pessimistic in asking the question because at least one trading partner, France, indicated she would not associate the problem of trade reform with our inputs in military security, that they may not be taken up in the same discussion or the same package.

Before we get to the bargaining table we are told that we can't use one of our blue chips. What is the most we can expect in international burden sharing, and how much impact would that have on a 1-year budget and a multiyear review of the budget?

Mr. FRIED. Let me answer that question in three parts, Congressman Carey. First, I think that the European countries should do more. At the same time, I would argue that sometimes we perhaps don't appreciate how much they do. Most of Europe's defense is, in fact, provided by European forces. It, nevertheless, remains true that most European countries spend on the average something like 4 percent or a little less of their GNP on defense, while we are still spending 6 percent of our GNP on defense. I believe they can do more.

Second, I think the specific things that we should be looking at in terms of trying to get them to do more are things that really are not that difficult, but they might involve a change in attitude on our own part in the things we are trying to do and the way we organize our forces to provide for the defense of Europe with our NATO allies.

I am referring first to greater emphasis on, say, joint bases, putting U.S. military forces in NATO bases where they would be with the German forces and others, and where, under those circumstances, we could properly view the host country as having the responsibility for the local costs of operating and maintaining those facilities.

If we did that on an extensive scale, and if, in addition, we relied more than we do now on European logistic systems instead of seeking to maintain an independent U.S. logistic system in Europe, we could reduce by a moderate but significant amount the support forces we have in Europe and reduce some of the local costs of operating U.S. military facilities in Europe. Together, the savings would be in the area of perhaps $½ to $1 billion a year.

Third, the major element of savings, if this is what we are looking for——

Representative CAREY. Let's get that clear on the record. We could save $½ to $1 billion a year by organizational and joint operations in housing and tenancy of bases with our NATO neighbors and perhaps with our non-NATO neighbors in Europe?

Mr. FRIED. I am thinking of our NATO neighbors. I refer to two things: First, moving toward joint bases rather than maintain wholly U.S. military bases, principally in Germany, but also in the United Kingdom, to a much lesser degree in Italy and in the Netherlands.

Then, second, if we try to build and work into European logistics systems and supply lines rather than to seek to maintain a wholly U.S. separate supply line. Possible savings from those changes might be in the range of one-half of a billion dollars and possibly as high as $1 billion a year in real costs, in budget costs.

They also would involve an equivalent saving in foreign exchange costs. But to my mind the critical saving is in budget costs.

Representative CAREY. What mechanism would we need to bring that about? Would it require a realinement of the NATO commitment? Is it administrative?

Mr. FRIED. No; it isn't a matter of NATO commitments. It is a matter of our own outlook and what we can work out with our NATO allies. This is all within the framework of NATO defense principles.

Representative CAREY. As long as we maintain command. General Goodpaster and his command are over there, and he lives by Pentagon standards. I don't mean a personal style, but he lives up to Pentagon defense parameters; a change in that is not likely, is it?

Mr. FRIED. I don't know. I think there is more movement in this direction now. We would be giving up, to some extent, United States control of bases. In military terms that might be viewed as serious. I suspect it is much less significant, militarily, and I think politically it has some advantages.

Representative CAREY. Whatever we lost in PX benefits we might pick up in someone else driving a truck?

Mr. FRIED. That may be. I think we would feel that a wholly U.S. line of communications and support facilities is more reliable in time of any emergency. But I think one can equally take the position that relying and tying into European support systems makes just as much sense, because we are either going to live together or hang together in an emergency. It makes political as well as military sense.

Representative CAREY. I am persuaded by your suggestion that it probably would be more realistic if we were to think in terms of ground combat or skirmishing along what is left of the Iron Curtain. In that case, I should think we would have to rely more on local logistic support and local facilities than on overseas deployment or redeployment from this country of supplies and resources.

Any enemy could deny us those access routes successfully, if we got into combat.

Mr. FRIED. I don't think it is easy, Congressman Carey, but I think it is a fruitful and feasible kind of approach to explore. I hope that the Defense Department is moving more actively in this area now.

I would like to get back to the third point—the largest area of budgetary savings. That lies in rethinking what we have forces for and how those forces would fit into the defense of Europe.

What we tried to outline in this year's book is that greater emphasis and perhaps indeed very modest investments now in improving defensive capabilities of our forces in Europe for the contingency of a short war, as part of a NATO-wide effort, might make it possible for us to reduce to a much greater extent the forces we maintain at home for European contingencies which, in all likelihood, we could not get to Europe in time to affect the kind of conflict that most likely would arise there.

Representative CAREY. What about the other side of the globe? Today we hear that world monetary experts are suggesting that the yen and the mark become reserve currencies with regard to special drawing rights on the basis with the dollar.

We balance that notion against the thought of rearming Japan. Are we in a position now where we should expect Japan, the strongest nation in the Pacific, to pick up more of the tab for the defense in that area?

That is a scare item for most Americans, getting Japan strong again. What about the part she would play in the Pacific?

Mr. FRIED. Well, it scares me, Congressman Carey. I am one of those Americans who get a little scared when we talk about rearming Japan and having Japan assume military burdens that we have been bearing in the Far East.

Representative CAREY. I was thinking more of a monetary burden than a military burden. She enjoys a great versatility in her trade and commerce because she doesn't have the burden of the military budget. In pricing her articles, that is a great gift.

Mr. FRIED. Right. Let me say, first, as far as the military relationship with Japan is concerned, I think our security interests in the Far East lie principally in maintaining and, if anything, building on a secure and confident security relationship with Japan. I believe the world will be a great deal safer if Japan finds it possible to maintain smaller rather than larger military forces.

If our objective is to reexamine the purposes for which we spend money, Defense money, in Asia, then we might rethink the forces we maintain for Southeast Asia. That is a more fruitful area to reconsider U.S. interests in terms of present circumstances.

Finally, to get to your point on the yen, I don't find it disturbing that the yen and the mark will increasingly share with the dollar a reserve role in the world's monetary system. In this area, as well as in all other areas, of international economic policy it is necessary rather than disadvantageous for Western Europe and Japan to share with the United States both the responsibilities and the burdens of managing the international economic system. Japan's contribution to that system, as well as indirectly to American security obligations in the Far East, lies in maintaining a sensible regime of exchange rates, which they have come to do now; to liberalize import restrictions, which, again, they have been doing at a faster pace than any other industrial country; and to increase the obligation they are prepared to assume for foreign aid, both in that area and in the world as a whole. I think they have been moving in these directions. I hope they will do more.

Representative CAREY. Thank you very much. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. I was interested in the publication "Setting National Priorities." I shall study it very carefully. In looking through the index, I was somewhat concerned over the failure of those of you who prepared this to indulge yourselves in some observations on food and fiber.

It is my judgment that one of the highest national priorities of this country is to have an adequate supply of food, both for our domestic and international needs. I see no way in the world that we can have any stability in the international monetary policy if the world is plagued with food shortages.

I see no way that we can control inflation here at home if the country is plagued with food shortages. I see no way we can redress the imbalance of trade when we are unable to fulfill our commitments on exports.

I see no way that we are going to be able to stave off major international tension and catastrophe if we continue to have rising population and inadequate food production. I see no effort being made by brilliant people to come to grips with what is today an entirely different picture than we have been accustomed to for the past 40 to 50 years, a picture that is conditioned by increased affluence in the world that demands animal protein, an increased population, a system of transportation and distribution that is totally inadequate for the movement of commodities on the basis of both domestic international needs. I just don't see any thought being given to this.

This, of course, is shocking to me. It is all the way through our Government and our economists. Most of our economists are so completely oriented toward defense expenditures, social welfare expenditures, and capital improvements, that they have forgotten that what the world is plagued with today is a shortage in two areas, primarily, food and energy.

I haven't looked at the energy aspect, but I know you have given some consideration to that. It won't do any good to have any oil if you are short of food. You won't have much food if you are short of oil. What do you have to say about this?

Mr. SCHULTZE. Yes.

Senator HUMPHREY. Why didn't you give it some attention? I have great respect for you. Everybody is hung up on how much we are going to spend on the Defense Department. So am I. I have been impressed with what you have had to say.

Senator Proxmire is the foremost spokesman in this area and I think he makes a lot of sense. And there is what I have heard you say on manpower. But quite honestly, there is no policy on the part of our Government on food. It is catch-as-catch-can.

What happens next year, for example, if we open up all the idle acres, which means there is no reserve acres, and you still don't have enough? Where are you going to go then?

Mr. FRIED. Senator Humphrey, I think this obviously is a major world problem. I don't happen to think it is a major budgetary problem, which this book deals with, because I think under present circumstances, left to his own devices, the American farmer will do all that is necessary to increase food production in the United States to the maximum extent. Therefore, I believe the issue you raise has less to do with the U.S. budget and much more to do with how the world will recognize agricultural policies and the conditions for agricultural trade.

Perhaps the present shortage and the evidence that the events of last year demonstrated; namely, that the reserves on which the world works are very narrow, may cause other countries—and I might add the United States—to be prepared to move toward new methods of international trade that might both improve the prospects of having adequate world food reserves in the event of emergency, and, at the same time, make sure that the efficient agricultural producing areas of the world have maximum play to produce.

Senator HUMPHREY. There are only about two reserve economies for food. One is the United States and the other is Canada. The rest are minor. You can look at Australia and Argentina and they are limited to certain commodities. The rest is a deficit area.

On this matter of budgetary consideration, I have been advocating for years, and finally I think my time is coming because out of sheer necessity, that we have a stabilized system of consumer and marketing reserves, a system of reserves of wheat, corn, beans, the three primary grains, to protect the consumer on the one hand, and to be able on the other hand to give reliability, at least to an appreciable degree, to our commitments in international trade.

That is going to be a budget item. Most people say: "Well, it is very costly." I am trying to get somebody to evaluate for me what the cost is of the increase of food is in the marketplace as compared to handling a reserve.

I would tend to think it is a factor of about 10 to 1, the amount of money that we would put into a reserve being infinitestimal compared to what the consumer is being hijacked for today. It is just beginning.

The Government lies profusely about what is going to happen to prices. Right in this room, 6 months ago, Bert Stein sat here and told us that food prices were going to level off.

In our meetings that I have had before me, he told me that the inflation rate would be held down to 3 percent. I want to tell you if you don't have any better prediction than that you ought to stay out of any and all forms of games because you are going to lose your shirt.

I don't mind a fellow like this working for bookies, but I don't like to have him working with the Government when it comes down to predictions. I just figured that, if we are going to talk about setting national priorities, despite the fact that this is essentially budget, you have to have something in this book about priorities on food.

I want to urge you to give some serious thought, in addition, in 1975 to it, because, by the time you write that, the prices you are paying for food today will look like a bargain.

I am here to tell you it is going to look like Santa Claus compared to what you are going to pay, because no one today has any comprehension of what the demand is for food. There is no statistical information, no reporting system that gives us any indication of what is going to happen to us.

We are like a blind man in a deadend street with the lights turned off and going through a tunnel. That is a pretty sad situation.

Now, I will give you a question that you can answer. I have been screaming about this for 20 years here in Congress, and I want to say that every time I talk about it everybody says surplus, surplus, as if that was a curse. It was the best deal that the American people ever had in their lives.

The only ones who suffered were the farmers. He was taken through the wringer, but the average consumer got a bargain. All this baloney about how much the Government payments cost was nothing compared to what is going on now.

These Government payments would look like a 3-cent postage stamp compared to what is happening to us at this time. In yesterday's testimony the committee was told, although our economic problems are now quite serious, which is a gross understatement, the economic situation is probably going to get worse in the remaining of 1973 and 1974.

We were told, for example:

One, if inflation was to continue food prices would be the highest we have ever seen. Two, there would be a major economic slowdown in 1974 and unemployment will increase to about 6 percent. Three, credit costs will continue to skyrocket with mortgage rates at 9 percent. I think that is an underestimation. I think they will be higher. And international uneasiness about the dollar will continue.

I want to ask the members of this panel generally, do you agree with this gloomy outlook?

What major recommendations would you make to the Congress to improve the economic outlook that is likely to result from current administration policies? First, do you agree with the gloomy outlook?

Mrs. TEETERS. It is certainly true that the rate of real growth has been slowing down since the third quarter of last year. Part of the problem is that during the first quarter of this year we had a very large boom in automobiles and in agricultural sales. If you adjust the real GNP for those two factors, essentially what happened is that we slowed from an 8 percent rate of real growth in the fourth quarter to about a 6 percent rate of growth in the first quarter to about 4½ percent rate of growth in the second quarter. There is no question that the economy is slowing down, but it didn't fall flat on its face, as the impression you would get from looking at the second quarter figures. A slowing down of the economy, giving the price increases that are now spreading out from the food area is probably desirable. I would hope that they will be able to slow the economy down and to keep it at a 4 percent rate real growth, quarter after quarter, which would bring us off the boom and into a full employment type of operation.

It is very difficult to slow the economy down without tipping it over and I wish them lots of luck. I am not sure that I have any specific recommendations at this point. I do think that it means that there is little economic justification for a tax increase. I think the major part of the boom is behind us.

I don't think that microfiscal policies or macroeconomic policies will affect the food prices. It will help if we bring in the acreage which is now out of production. It would also help if the large amount of acreage which is now in second growth forests were put back into production. In Europe such land would be in production. We have much larger reserves of arable land than are apparent if you just look at the acreage in the land bank.

Senator HUMPHREY. A lot of that land is not very productive. You ought not kid yourself about acreage. Farmers are pretty smart when they take acreage out of production and get Government payments. They don't take out the juicy ones.

Mrs. TEETERS. That is right.

In terms of policy recommendations, I think they are getting the slowdown they want. I certainly wouldn't make the policy any more restrictive at this point in time.

Senator HUMPHREY. Why is it that most of you people in the economic field go along with these incredible high interest rates, but hesitate to talk about a sensible tax increase? I know the average consumer doesn't want a tax increase, but everybody buying a house today is really being shaken down.

If he was robbed at high noon, he couldn't really lose more. The tax increase is much fairer, isn't it, particularly if it is on income, than it is to take a young married couple, age 24, and sock them with these 9 and 10 percent interest rates for 30 years?

Mrs. TEETERS. Tax increase might have been an appropriate policy last year. At that time we did not see a boom coming of the magnitude that actually occurred at the end of 1972 and the beginning of 1973. But now the economy is already slowing down. I think it would be a mistake to go into a big tax increase now. Given that and the problems of timing, both getting it through the Congress and deciding who would actually pay it. You are forced back on monetary policy. Interest rates are quite high. I agree with you.

Senator HUMPHREY. To a midwesterner, they are not only high but usury. They are immoral. I consider them illegal. I just resent the fact that we permit the Federal Reserve System, people who have never been elected to anything but just appointed, to pass among us a tax in the name of interest rate. Everybody lives on credit, with the exception of a handful.

Mrs. TEETERS. If the slowdown continues, I think your interest rate will reverse. Of course, they can reverse much faster than fiscal policy.

Senator HUMPHREY. I sure want to tell you I have never seen those bankers take those rates off very fast. That isn't the way they get rich. My experience is once they get up, they stay up, just like the price of mentholatum in Humphrey's drug store.

Once it gets up, it never goes down. I have seen all these prices go up. They are always talking about food prices. That sort of has your interest from this wall while they are really sticking it to you over here. Everything is going up, everything.

I don't even believe these cost of living index figures we are getting. All I believe is what I see when I go out with people shopping. Just looking around, trying to get your car fixed, get a door repaired, buy some nails in the hardware store, get some fencing for your land. See what has happened.

All this talk in the finance pages about what is happening doesn't relate to where people live. I don't know what these people are talking about. I would like very much some time for somebody to tell me the difference between what you read and see and what I experience.

For example, I just tried to fence some land out home. You would have thought I was buying gold wire. But I read that these prices have come down and fencing has come down, but it hasn't happened where I live. I can't go to Tanzania to pick it up.

Mr. SCHULTZE. All of us have been very much involved in trying to take a look at the problems of social priorities in the next 5 years. I think one of the problems about economic forecasting is that everybody and his brother, that somebody calls a business expert or economist, is prepared to come up here and give you a snap forecast and that is why you get so many lousy ones.

I am not prepared to answer short-term forecasting question at the moment. I don't think you can answer those questions until you spend a lot of time dipping into them.

Maybe if you had fewer people giving you forecasts or the people who did give them to you worked on them longer, it would be better. All of us have been so wrapped up in this long-term priorities question that it is very difficult to get at some of the precise problems you are after.

It is not that food problems are not important, too, but they are not the same ones.

Senator HUMPHREY. This is probably the most helpful document that we get. I don't mean to be critical. I am concerned about those things I asked you about. Hopefully, we can get some of your good people to give it some attention.

Mr. SCHULTZE. You mentioned three things, Senator: Energy, food, and interest rates. Of all the three things in the world, I think they are about the three things in the world that we didn't cover in this book.

Senator HUMPHREY. Those are the ones that bother me.

Mr. SCHULTZE. My apologies.

Senator HUMPHREY. I regret that I must now leave. Thank you very much.

Senator PROXMIRE. The big factor moving the budget toward balance, and it has been moving towards balance—I think they project now a $2.1 billion deficit in 1974—the big factor seems to be inflation, because the big increase has been on the revenue side.

We had an increase in 1973, as I understand, of $7 billion, and an increase in 1974 which they propose will be bigger than that. At the same time, it could be in balance if there weren't some real cuts.

I am talking about in real terms on the expenditure side. Obviously, when the inflation not only benefits your revenues, it also means you have to pay more for what you buy. So spending has been held down rather spectacularly.

Last year people were surprised by the recent revelations in fiscal 1973, ending June 30, that it was held to $246 billion, which was below the $250 billion the President announced.

As I say, the expectation is that we will be able to come in under his $268.7 billion. This suggests there have been some real cuts in domestic programs and less of an increase in defense than perhaps we were talking about.

Would you give us an estimate of how much spending is being cut in real terms, and where the cuts are being made effective?

Mrs. TEETERS. I haven't seen the 1973 results yet. My understanding is that during the second half of the fiscal year there was a slowdown in spending widely spread across most areas. On the revenue side it was not just the inflation, but corporate profits bounced back rather rapidly.

Senator PROXMIRE. That was partly inflation.

Mrs. TEETERS. Partly, yes. It gives you a windfall in the short term. However, by another year the inflation will be affecting the expenditures also. We may find ourselves in a very difficult position, where the rate of inflation is slowing down, the revenues are not growing as rapidly and at the same time, expenditures are rising fairly strongly to compensate for past inflation.

You are building in the potentiality of a deficit a couple of years out.

Senator PROXMIRE. I suppose that might hit us on the corporate profit end, to, inasmuch as the productivity increases seem to be less, with the result that profits will be squeezed.

Mr. SCHULTZE. Mr. Vice Chairman, let me note that the recent release of the 1973 information indicates that spending was about $3.2 billion lower than originally estimated. It is a little early yet, however, if you look at where those cuts came, to assume that they will affect next year also.

There are four major items that account for that $3.2 billion, or practically all of it. One is that the social service grant program, this grant program to State and local governments for social services, where the Federal Government matches 75 percent against 25, came in $800 million lower than the estimate in the budget, despite the fact that 1 year ago the States were putting in estimates so far above the budget that a ceiling was put on. It now turns out the States are coming in under the ceiling.

Senator PROXMIRE. Why is that?

Mr. SCHULTZE. That is what I don't know. I think it is too early to tell yet. It came in at $1.6 billion. It was budgeted for almost $2.5 billion.

Senator PROXMIRE. Congressman Carey suggests that is because of the guidelines that have been put into effect.

Mr. SCHULTZE. That may very well be. Whether that is going to mean, as they get used to the guidelines and how they handle them, expenditures will be more next year, I don't know. There is a propensity to learn how to live with the guidelines.

Another is unemployment compensation. It was lower than anticipated because the economy boomed somewhat more. It is pretty hard to predict what is going to happen to unemployment, but it is quite possible that in the next 12 months the improvement in unemployment may not be as great as anticipated.

Senator PROXMIRE. I take it you don't want to give us any reaction to the Wharton estimate of 6-percent unemployment by the end of 1974 or the data resources estimate of 5.4 percent?

Mr. SCHULTZE. I don't All I am suggesting is you can't count on a continuation of these cuts. You can't look at 1974 and project into 1974 the kinds of cuts you got in 1973.

Senator PROXMIRE. If those very competent groups are right, it would suggest, as Mrs. Teeters said, that we ought to be very, very careful about further restraint in fiscal policy.

Mr. SCHULTZE. I would agree with that with the preface that it comes a little bit out of ignorance in the sense that I haven't studied it as carefully as the forecasters to whom you were referring.

Senator PROXMIRE. To get back to your book, one proposal for improving legislative control of the budget is the legislative request made to OMB in the fall budget cycle be transmitted simultaneously to appropriate committees in Congress.

The assumption is the committees ought to know what the agencies are requesting in addition to the final decision of the Executive so we can move to evaluate it when the budget is transmitted in January.

It seems to me that would greatly improve the functioning of the congressional operation. You are a former Budget Director. I know you understand it fully from the President's standpoint, the Executive standpoint. If we put our staff to work on those in the authorizing committees, we would be in a strong position to understand it.

Mr. SCHULTZE. I want to argue against the proposal and then offer a substitute. Even from the standpoint of the Congress, I think I would not want to support that proposal because what I think it is going to mean is that eventually you are going to begin getting pro forma requests where the real decisions have been before those requests come in.

What you are doing is asking the President: "Why don't you tell me where you disagree with your major advisers on matters of supreme political importance?" No President is about to set up a system where that happens.

Senator PROXMIRE. The main thing is that we find that out anyway. I usually get what the agency has requested from OMB, and what the OMB cut them.

Mr. SCHULTZE. But there is an advantage in a number of things like that being done informally. I am afraid that a formal system would end up not giving you the kind of information you really want and transfer some of this to the back room.

Senator PROXMIRE. How about pressing that a little further. In Wisconsin, Oregon, and many, many other States, they have open executive hearings on the budget. The Governor comes in in the late fall and he has his hearings and the press covers them.

The legislative leaders are privy to everything that goes on. Then the Governor decides what his budget is going to be after these open public hearings. It works very well in those States. I don't know of anybody who has said this handicapped the Governor.

You have a much better understanding of what the problems are. Why can't something like that be done here instead of having the whole thing done secretly and then have the huge budget come down all at once? When the newspapers cover it as one huge story, the New York Times will print several pages, but it is far too little to have a grasp of this vital national priority document.

We could have it over a period of 2 months, when Congress is not doing much anyway, in November and December, so that the public and the Congress could be much better informed with debate back and forth in the hearings.

Wouldn't this be a constructive advance to have the Congress and the public in a much better position to understand it all?

Mr. SCHULTZE. Let me first propose an alternative which won't give you just what you are asking for, but which might be very useful. It seems to me it would fit in better with the separation of powers.

That is that each agency should be required to give you at a specified time before the budget comes up, and I don't want to suggest a specific date, but perhaps some time in November, what really accounts for 90 to 95 percent of their budget, to wit, a projection in detail of what the budget would be without any policy changes.

Then what you get from the President's budget really are the policy decisions he has made. You would have the basis then not only for having a lot of information beforehand——

Senator PROXMIRE. That is a very good suggestion. Maybe that is the best we can do. But I still don't understand why the President is any different than the Governors. Governors can operate efficiently and effectively. They are not hamstrung. Their policies are not compromised by public discussion. What are we afraid of?

Mr. SCHULTZE. Maybe some of my colleagues ought to react. Maybe I am reacting too much as an ex-Budget Director. In critical areas where you are debating some very sensitive alternative policy decisions, to have someone on the line in public within the executive arguing for a particular proposal, formally and in public and then the President decides against it and goes the other way, would reduce the likelihood of getting those advisers' really heartfelt advice.

If you have a system where every decision is made at the White House, what the heck. But if you are running a system where the Cabinet plays a role, I am not sure that this wouldn't lead to a very difficult problem in those sessions leading to pro forma advice and not real argumentation.

I may be reacting from an experience that is not a typical experience.

Senator PROXMIRE. Let me ask about something else. Everybody argues that the Congress ought to have a mechanism for weighing the relative merits of the programs. Mrs. Teeters was pointing out that we have a better evaluation of the defense budget when we have to consider it in the light of other demands and try to have a comprehensive, overall ceiling and establish our priorities within that ceiling.

We have been told by a budget expert that such a mechanism does not exist, nor is it employed in a rational way in the executive department. We were told that in April the big tradeoffs are not made by analysis but are value judgments, gut value judgments.

I wonder if you can shed any further light on that problem, based on your experience in the Bureau of the Budget. When and how in the budgetary cycle are the big tradeoffs made between defense spending and other spending? Who makes the ultimate decision?

Mr. SCHULTZE. There are a lot of elements to that question. One, is the mechanism within the executive such that the ultimate decision-maker, in terms of what is proposed to the Congress, namely, the President, that he has in front of him when he makes key decisions a long-range set of alternatives so he explicitly has a good view of what he is giving up in one area to get something in another, so that he knows when he is making a proposal with respect to defense that this is going to cost him something over here, that——

Senator PROXMIRE. Since you left the Budget Bureau the President moved to a different position. I don't think President Johnson did it quite this way.

Mr. SCHULTZE. I am saying that such long-run alternative presentations aren't done.

Senator PROXMIRE. He has established a ceiling so far based on what he calls a full employment budget. Since he has that ceiling, it seems to me that he should have far greater opportunity to consider these tradeoffs.

With President Johnson, I presume, when you were Director of the Bureau of the Budget, he would simply say: "We have to have so much for defense and that is it. We have to have so much in these other areas." Then they would perhaps adjust the tax system a little or simply come in with a deficit or a surplus. But I don't think you had that same system, did you?

Mr. SCHULTZE. It was a simultaneous operation. You looked at the parts and set a tentative total and you modify the total as you look at the parts more carefully. It was a simultaneous operation.

What I was pointing out before is that to the best of my knowledge, and I could be wrong since I am obviously not privy to the innermost councils of this administration, I don't think there is a good mechanism even within the executive for taking a look at long-range alternatives so that the President has in front of him a fairly explicit set of choices.

I do know there was one exercise this administration went through in 1969 where this was explicitly done, but beyond that I don't think it has been. I am therefore suggesting that even within the executive the concept of looking at fairly comprehensive alternatives from the point of view of the President formally making some initial decisions along the line is not done enough and it would be desirable to do it.

I think if one hopes for a system whereby there is some "scientific" means to make an explicit evaluation of benefits against cost so that one can choose, I don't think that can be done.

That is not to say that competent, logical, effective analysis in terms of advantages and disadvantages of programs is not useful. I think it is done, but I think it could be done even more effectively and even in greater depth.

Mrs. RIVLIN. On a simplistic level, the President does, in fact, make up a budget. There is a moment at which he has to address these trade-offs at some level of consciousness. He is submitting a document which covers the entire range of Government programs.

There is no moment at which the Congress does that. I think that is a significant lack in the current system.

Senator PROXMIRE. You see, what we are talking about is whether the President has a rational basis on which he makes his decision. For instance, on what basis does he determine that defense must keep growing while you have some domestic cutbacks?

Mrs. RIVLIN. Any President has a mass of information submitted to him. Part of it is analytical; it tells him what will happen if he does this or that. Part of it represents the value judgments of his staff.

He makes the final decision in the light of all these things. The Congress would have to, too. But at the moment you are not even addressing those decisions.

Senator PROXMIRE. Congressman Carey.

Representative CAREY. I hope at some point in the future, on the basis of a thorough study of this proposal, it would be possible for us to do more exact correlative comparisons of accepting the present revenue system and accepting the President's 1974, 1975, and 1976 through 1977 budgets and demonstrate to the American people what changes on both sides could produce.

That would be either tax reform package one or tax reform package two, with some modification thereof, and a change in their lives that they could expect from some assistance in paying for essentials and some help in cash benefits where needed, and some more systematic method of negative income tax whenever you are carrying on these social functions.

The problem is that if we go the way of this budgeted ceiling, which is being thrust on Congress, and Congress is about prepared to accept it, and we concentrate on that side of the budget and constitute this committee, which on the House side would be essentially those most senior and those most unlined to accept the old pattern, there is very little chance that we would get to what I would consider the informative versus what you call the Nixon radical budget, and the results therefrom.

Unless we can draw some kind of a careful matter that would show what a good sound reform program would produce in terms of changes in the quality of life for America, there is no likelihood that we will get anything, except the budget and the self-imposed congressional ceiling which, in all instances, corresponds to that budget.

So while we may hope that something is going to change, Congress seems to be moving in exactly the opposite way that you would recommend. Isn't that correct?

Mrs. TEETERS. If I may comment on that, the original proposal as to who was going to be on the committee did result in a very conservative committee. My understanding is that one of the modifications being proposed is that the committee members on the budget committees would be drawn from each House as a whole. They would not be dominated by the Appropriations, House Ways and Means, and Senate Finance Committees. I think that is a good change in the original proposal.

Representative CAREY. Let me interrupt. The emphasis will still be on the $268 billion ceiling and whatever it may be and how to maintain the sanctity of the ceiling, not how to change within that ceiling.

Mrs. TEETERS. But within the ceiling you are to set subtotals in rather broad areas. As I understand the reform proposal, it has to be brought to the floor of each House and is debated at that point. It seems to me that is the point at which you set the priorities. You will have a recorded vote as how much for defense, social security, and so forth.

Representative CAREY. But it will still be on the basis of the budget submitted by the President. In a sense, the administration has two budgets, one the recommended budget they send to Congress and then on the committee that you are talking about you have the input, you have the membership of the minority side, which, again, represents the President, and after that input which cannot be ignored from the conservative side of at least the House, and you add up to a revalidation of the President's budget. That is all you will get.

Mrs. TEETERS. I rather disagree with that. I think if the Congress looks at the budget in total, whatever ceiling they set, and they look at the individual pieces in broad brush, you suddenly realize that enormous amounts are going into defense versus pollution control, for example. It seems to me that the forum for setting national priorities is the Congress.

We don't know how these proposed procedures are going to work, or whether they are even going to pass, but it certainly is a step in the right direction. There is certainly nothing that says you have to accept the President's ceiling. You could put on a lower one and reduce taxes, or you could set a higher one and find the financing for it. It is up to Congress to take the initiative at this point.

Senator PROXMIRE. I think what Congressman Carey is talking about, what is most likely to happen, is that these committees, and I am on the Appropriations Committee and I served on the Budget Review Committee and I may have a chance to serve on this one, the way this might develop is that the Senate and House committees might recommend something close to what the President proposes, given the makeup that Congressman Carey has accurately described.

I just don't know enough about the House. I have never served in it. I can't understand it. But the House seems to ratify, by and large, what their committees do. They have limitations on amendments, and so forth.

The Senate is much more a wide-open operation. The Senate might very well, in my view, modify rather dramatically what the committee recommends. But when you go to conference, the people in conference who would control what you come out with are the committees and the ranking members of those committees. They would be very likely to come in pretty much once again with revalidation of the President's budget.

Mrs. TEETERS. The composition of the committees is very crucial at this point.

Representative CAREY. In a sense, it would represent the House as a whole. If it does that, you won't override the President's budget in any form, unless you have the votes to do it. We have only done that once out of five tries. Why would we do better in a committee with more senior members? Even though there would be some representation of less senior members, by and large, the power blocks in the House will remain as constituted.

What I am pointing to is unless you have revenue alternatives to pursue at the same time, then that committee will walk into its closed conference room or its open conference room under the clear reminder and restriction, and more than that, the clear caution from the President that:

Unless you accept my budget or your alternative thereto, modestly revised, then you better come out of that room with a recommendation for a tax increase as well.

You, yourselves, have said that a tax increase is not in prospect because there is the present economic deceleration. Here we are in a tax fix, trying to set a budget that doesn't answer America's needs and, which in your own terms, means vast and radical cutbacks in domestic programs.

That is another element of gloom that I have. That is about the way it looks to me, unless we get them with the revised estimates into the same room with the revised budget ceiling, we will come out with a little less than when we went in.

Mrs. TEETERS. But that will be included, as I understand. You will have revenue alternatives to be presented at the same time.

Representative CAREY. That is the difficulty. This group is not constituted to consider revenue alternatives.

Thank you.

Senator PROXMIRE. I have two or three more questions. I realize the hour is late. I understand the Government Operations Subcommittee considering proposals for changing congressional budgetary oversight recently approved a bill which, among other things, moved back the date of issuing the budget from January to the preceding November.

Could you give us your reaction to this proposal? Indicate whether you approve the budget review system and would you also give us your opinions generally on the numerous recommendations made thus far, including the Joint Study on Budget Control?

Mrs. RIVLIN. I think anything that gives you more time to look at the budget helps. Moving from January to November doesn't help very much. Another alternative is shifting the fiscal year to a calendar year, which would give you an additional 6 months.

I just want to go back to the point I made earlier that you really can't get control of the budget unless you shift your time schedule much more than that and really give serious consideration to budget priorities at least 2 years in advance.

Senator PROXMIRE. So you want at least a 3-year budget?

Mrs. RIVLIN. Yes.

Mr. SCHULTZE. Let me add to that. We are going back a little bit to Congressman Carey's point. It seems to me that there is an undercurrent, among many liberals that the power structure of the Congress is such that any of these tight budget control bills, fundamentally, is going to take away the possibility of significantly progressive legislation.

It is just the way the nature of the beast operates. Once you say: "If I want health insurance I have to give up some defense," health insurance is in dire trouble. If you push health insurance and cut other items through simple pro rata cuts, many liberals believe that progressive measures will fare better.

Senator PROXMIRE. You are saying, by and large, the status quo projects will survive, but the new staff, the innovations, the new approaches are likely to suffer?

Mr. SCHULTZE. The way they get in the budget now is to get the camel's nose under the tent and wedge it in further as the years go by.

Senator PROXMIRE. Do you mean if they have to recognize the 5-year cost?

Mr. SCHULTZE. I think there is a fear of that. I want to answer some of that fear, if I can. One, I think the point Mrs. Rivlin makes is very correct. Even in a political sense it is very correct. If you are just going to look at the current year only, the status quo looms so terribly large that it is very difficult to propose anything and get it in under the tent which is going to have any major advantage to potential politically important beneficiaries.

Again, if I go back to our own experience, if you are trying to lay out some of these alternatives by way of a low-income oriented tax cut, by way of a health insurance program, by way of something in the day care area, whatever it is that might be fairly attractive if responsibly financed and everything else, you can't show it when you look at 1 year.

You have to look out beyond 1 year to see what the real trade offs are. I would suggest while it is no panacea, the point of having a budget procedure which concentrates several years out gives you a chance then to propose programs which have some political attractiveness.

Second, I don't think procedures alone will do it. By that I mean I personally think that what is needed along with the new procedures are informal budget proposals from various groups, for example, from the democratic study group; comprehensive alternatives, so people have something to shoot at, something within a framework in which to operate in the Congress saying: "Here is an attractive package."

You can't do it by complex legislative procedures alone. I think there needs to be developed, to go along with the procedures, a public dialogue and a public debate about some of the real alternatives.

Why cut defense? If you are going to cut defense solely because you are trying to get rid of waste, that is fine and picks up some votes. But when you can show that there are some attractive, useful, highly needed programs which will go along with those cuts, which benefit a large number of the American people, I would then suggest the chances of making changes are greater.

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But if you just consider it in terms of cutting defense alone, some guy will scratch his head and say: "Brother Joe on Long Island will lose his job in an aircraft factory." By looking out for several years, though, you can show the benefits of programs which will expand as defense recedes.

If you have the dialogue on alternatives, it may be possible not to look at changes in procedures as something which will inhibit progressive change, but as something that would make progressive change possible.

I can't predict that, but I think the fears of budget reform, in part, stem from looking at institutional changes just in terms of how in God's name do we stay under this year's budget ceiling. If that is all it is, then I think it is true—changes in procedures will essentially limit progressive change. But it shouldn't be just that.

Senator PROXMIRE. Let me ask you about the honesty problem. We are all very sensitive now, of course, with the Watergate tragedy. We are also aware of the lying and deliberate, calculated, planned, premeditated lying in the Cambodian situation, where a procedure was developed to falsify records, and a couple hundred military people involved in falsifying records on the basis of orders.

We are also aware of the controversy, at least, over the patently partisan interpretation of economic statistics by various statistical experts in the Government.

I would like to ask you in the light of that, in appendix B of your study you discuss the expenditure reductions claimed by the administration in the 1974 budget. In table B-1 you take the $16.9 billion payment in the budget in fiscal year 1974 and adjust it by $4.7 billion to arrive at a more realistic or honest saving of $12.2 billion.

Earlier this year the staff of the Joint Economic Committee did a similar calculation and concluded that of the $16.9 billion claimed, $8.5 billion would be more realistic.

In a paper by Professor Weidenbaum, he classified $7.4 billion as doubtful cuts in items inadequately justified, or items which probably should have been excluded, leaving $9.5 billion as the more honest figure. Clearly, reasonable people differ on the exact value of the real savings proposed in the 1974 budget, but everyone seems to agree with your statement that some of the proposals do not truly represent reduction in the level of Federal programs.

It seems that we are all faced with the problem of getting an honest budget document to work with. In the present situation, before we can decide on the merits of budget proposals, we have have to determine what is really being done. Can you suggest any way to improve the situation?

Mrs. TEETERS. As you know, Senator, President Johnson appointed a commission to study budget concepts, out of which developed the unified budget concept.

Many of the gimmicks used previously were eliminated at that time. As I have watched the unified budget over the years, I have come to the conclusion that there is no budget that you can't fudge if you just put your mind to it. I think what you probably need is to have a Budget Concept Commission meet every 3 or 4 years.

Senator PROXMIRE. You say there is no budget you can't fudge if you really put your mind to it. That is really appalling. I know you are being as honest as you can be in telling us that.

Is there really a calculated effort to fudge the budget and confuse us? Why is that? Why don't they just tell us?

Mrs. TEETERS. Usually because the amount they want to spend adds up to more than is feasible.

Senator PROXMIRE. I understand that. I just don't think that people are very concerned when you get over $1 billion. It is very hard to explain to people that $1 billion is more than $1 million.

I have had far more success with the people in my State in fighting limousines that people ride around in that cost a few thousand dollars than fighting any kind of big spending program that costs billions.

I think the administration's thinking that this is of great significant importance, that the budget is $260 billion or $280 billion, that it has a real political impact is nonsense. To falsify a situation and say you have savings in it that are phoney seems to me is really stupid.

Mrs. TEETERS. They always get caught.

Senator PROXMIRE. We get caught to some extent. As I pointed out, different critics have different notions of how dishonest they are being. We all know they are dishonest.

Mrs. TEETERS. May I go back to my other point? I think a Presidential or Congressional-Presidential Commission to review budget concepts and to evaluate the various gimmicks that develop should meet on a regular basis, like the Advisory Council on Social Security that meets every 5 years. You could clean up gimmickery at least every 5 years and start over again. I think that would be most useful in terms of trying to get honest figures and an honest estimate.

Mr. SCHULTZE. There are two aspects to the budget in this respect. One is not what the totals are, but what the administration claims by way of achievements in, say, cutting.

The administration, when it is in a cutting mood and wants to show how much it has cut, will put the best possible face on it. It defines as a cut, a lot of items that are questioned. That is one thing I don't know what you do about it, except the Congress keeping a very good eye on it as you, yourself, did this year by publishing very quickly thereafter your own evaluation of it. That is one part of it.

Senator PROXMIRE. We don't get as much attention as the President.

Mr. SCHULTZE. I understand that. I don't have any magic answer. It is not so much a question of lying. It is a matter of questionable judgment as to what you claim credit for in accomplishments.

There is a second item that will sound like a pet refrain. Part of the reason for doing things just to make the total look good in an accounting sense is again this excessive preoccupation with the current budget.

Some of that is obviously inevitable. But if more budget debate were on things that really counted, taking action on things that really mean something, there would be less temptation to put this tremendous effort into rigging the total, to make the total look better.

Again, it is no panacea, but I really think that 2- and 3-year budget outlooks would remove some of the temptation for this, though not all of it.

Senator PROXMIRE. I want to thank you people for your appearance so much. This has been a very helpful hearing this morning.

The committee will stand in recess until tomorrow morning at 10 o'clock.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, August 1, 1973.]

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, AUGUST 1, 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, Javits, and Schweiker; and Representatives Reuss and Brown.

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

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

Other members of the committee are coming a little late this morning.

This morning we welcome the members of the President's Council of Economic Advisers before the committee for the purpose of presenting their midyear assessment of the economic situation and outlook.

We have just completed 2 days of testimony from private experts. They have painted an extremely gloomy picture, First, the growth of real output is slowing down and may be heading toward a slowdown next year, not to a healthy sustainable rate but to a near-recession rate of no more than 1 or 2 percent. This means, on the basis of their projections, that unemployment, which is already far too high, will again begin to rise and, according to their estimates, go to 6 percent next year.

Second, there appears little real prospect of bringing inflation under control any time soon. A further sharp rise in food prices during the next few months is inevitable. This in itself is bad enough, but even more serious is the impact which these food price increases may have on pending wage settlements. When and if wage settlements during the remainder of this year rise to reflect these food price increases, this may start the economy on a new inflationary spiral of alarming dimensions.

Third, interest rates are reaching new peaks daily, and the home building industry is threatened with massive collapse due to the shortage of mortgage credit.

Fourth, the weakness of the economy domestically is being reflected in the weakness of the dollar on the foreign exchanges.

Of course, one can point to the fact that real income has continued to improve, but over the past 100 years, real income of the American people has improved about 80 percent of the time, so that is hardly news. One could also contend that employment has continued to rise and that it is at an all time peak, but this has been the rule, with occasional exceptions, year in and year out for 100 years, too.

When we make more meaningful comparisons of our economic position, our shortcomings are startling. As James Reston noted in the New York Times this morning, in 1950 the United States accounted for half the world's gross national product; by 1970 our share was down to 30 percent. In 1950, the United States produced 76 percent of the world's automobiles; in 1971, 30 percent. In 1950, the United States produced 46 percent of the world's steel; now it is producing about 20 percent.

Our unemployment is two to five times that of the Common Market countries and Japan. In 1950, this country held about half of the world's monetary reserves. In 1950, the European nine held 6 percent and we held 40 percent. So 20 years ago, they held less than one-seventh of the reserves we held. Today they hold three and one-half times as much in monetary reserves. And Japan that had almost no monetary reserves 20 years ago now holds nearly twice as much as we do. Also, for the first time in this century, our balance of trade became negative in 1971. By comparison with our competitors, we are doing very badly indeed.

So much for the long-term perspective. How about the immediate economic outlook?

Mr. Stein, the economy is in far worse shape now than it was when you appeared before us last February, and the forecasts are far more pessimistic than they were at that time. It is hard to understand how things could have gotten so bad so fast.

We do not have a complete explanation, nor do I contend that every unfavorable development in the economy could be traced to failures of the administration policy. I do think, however, that there is one consistent thread through administration policy which has made the situation consistently worse than it would otherwise have been, and that thread is lack of foresight and lack of candor.

This administration has viewed the economy through rose-colored glasses ever since it first took office in 1969. Let me review the record. The long period of high unemployment and high inflation that we experienced in 1970 and 1971 was not foreseen. Instead of an accurate forecast of that situation, we had the famous—or infamous—$1,065 billion GNP forecast presented in the Council's 1971 annual report.

Consistently, year after year, we have been presented with budget estimates. In January of 1972, we were told that the budget deficit for the fiscal year 1972 would be $39 billion. Six months later, we learned that the actual deficit was $23 billion. That is a projection for just 6 months ahead containing a mammoth error of $16 billion.

These examples of poor forecasting are ancient history. I would not bring them up if there was any evidence that the administration had learned from this unhappy experience. But I find no such evidence. Look at the recent record.

Last January's GNP had already been revised by $16 billion. January estimate of fiscal year 1973 budget deficit was off by $10 billion. The prediction of prices as measured by the GNP deflator will measure 73 percent higher in 1973 than in 1972, and now will be realized only if prices declined during the second half of this year. And I know of no one—anyone—who feels that prices are going to go down in the second half of this year.

Mr. Stein, influencing the gigantic and complex economy is a difficult task, but it is made immeasurably more difficult by the persistent refusal to face facts. Unless we know where we are, unless we are all made fully aware of the difficulties ahead, we have no basis for developing the policies necessary to deal with the situation.

I hope that this morning we can take off the rose-colored glasses and have a candid discussion of the facts and the problems.

Mr. Stein, we are happy to have you proceed, and say that your entire statement, including the attachments, will be printed in full in the record, and you may proceed as you wish.

Mr. STEIN. Thank you, Mr. Vice Chairman.

We are happy to appear here once more.

Senator PROXMIRE. May I just take a minute to welcome Mr. Seevers, because this is his first appearance before this committee. He appeared before the Banking Committee, of which I am a member, for his confirmation, and we are just delighted to have Mr. Seevers on the Council of Economic Advisers.

He is extraordinarily well qualified, and I think his appointment is most timely, because, as I understand it, he is particularly an expert in the agricultural area, the food area, where, of course, our problems are so immediate and severe.

We welcome you, Mr. Seevers. We are delighted to have you here, and we know you will have a distinguished career on the Council.

Mr. SEEVERS. Thank you, Senator.

STATEMENT OF HON. HERBERT STEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY MARINA v.N. WHITMAN AND GARY L. SEEVERS, MEMBERS

Mr. STEIN. Thank you very much, Senator.

We are all very pleased to have Mr. Seevers with us. Although agriculture has been his specialty, there are many other subjects in which he is very well grounded.

We would like to present our view of the state of the economy and a little bit about its future, candidly and with the intention to inform this committee and the public, because we realize, of course, that the appropriate development of public policy and the appropriate development of private economic behavior depends on a realistic understanding of what is going on in the economy.

And of course, we would not pretend—there is an old saying, you know—would that mine enemy had written a book. We have by now written four of them, which puts us at a certain disadvantage with respect to our critics, although I understand you are about to write one, or have done so.

Senator PROXMIRE. I have written more than one. I write them on other subjects, like exercise and diet.

Mr. STEIN. Well, those are subjects where the validity of a statement is not so promptly tested by the statistics. But in any case, we do come under that disability of saying a lot of things which can soon be verified.

However, you have invited us, I am sure, to give you our best opinion of what the present situation is, and that is what we intend to do.

Now, the big economic problem, and therefore the big economic news, in the first half of 1973 was the surge of inflation.

Senator PROXMIRE. Mr. Stein, would you pull your mike a little closer? For some reason, we cannot turn it up much more.

Mr. STEIN. Most of our statement is devoted to that subject, to the causes of the inflation and to the way in which it can be checked. However, the inflation is not the only thing that has been happening. To concentrate entirely on the inflation is to miss some of the most important aspects of the economic performance of 1973 so far. In the interest of balance, therefore, we shall start with some subjects other than inflation.

Probably the key thing to say is that the real per capita incomes of the American people, after allowing for inflation, rose substantially from the fourth quarter of 1972 to the second quarter of 1973 and were much higher than ever before. This is the fundamental measure of the performance of the economic system.

Now, you have pointed out that it is the characteristic of the American economy that real income, real output, rise on the average over time. And because this is a common characteristic, it is not news. However, I am not here to write a day's newspaper headline, and it is important, even if not new, that the economy is improving in these fundamental respects.

Moreover, I do have the feeling that this fact that the incomes of the American people have been rising in the past year and in the past half year is news, would be news to a great many American people. At least, I find that when I say this to people, they are incredulous, surprised, and in many cases, infuriated to be told that their incomes have been rising in the past year. And I can give you quite a long collection of newspaper and radio editorials in which I have been criticized as being utterly out of touch with the real world for saying that this point, which you and I agree that real incomes have been rising, is an important fact, and that it is a fact at all.

So I think it is often important to reemphasize this, because failure to recognize it, I think, gives a quite unbalanced view of what our problem is. But, as I say, we are going to talk mainly about the inflation problem.

We are interested in the inflation problem almost entirely in relation to behavior of real income, which is the end result of the whole economic process. Thus, people are interested in whether the inflation is changing the distribution of income in a way that they regard as adverse. We are interested in whether the inflation threatens to bring the growth of real income to an end.

There is little evidence of an adverse effect on the distribution of income, although that, of course, depends very much on the point of view—the point of view of the chicken farmer being very much different from that of the consumer. Continuation of inflation at the rate of early 1973 would, we are sure, have been dangerous to the future stability of the economy, but there is little to show that the inflation actually experienced so far had weakened the economy. In a word, the evils of the first half of 1973 were largely uncertain and prospective. That is, they related to what the people thought would happen subsequently. The good of the economy, the high rise in real income, was present and indisputable.

There are a number of possible ways of measuring the change in real per capita income. We show several of them in table 1, attached to this statement, which compares the second quarter of 1973 with the fourth quarter of 1972, with the second quarter of 1972, and with the second quarter of 1963. The 10-year comparison is included for the benefit of those who believe that somewhere in the past there was an economic paradise which we have never since regained.

[Table 1 follows:]

TABLE 1.—PERCENT CHANGES IN REAL PER CAPITA OUTPUT AND INCOME, 1963 II TO 1973 II

[Seasonally adjusted]

Item	Percent change, seasonally adjusted		
	1963 II to 1973 II	1972 II to 1973 II	1972 IV to 1973 II, annual rate
Real per capita:			
Gross national product	37.4	5.4	4.9
Personal income	46.5	4.5	1.7
Earned personal income [1]	43.2	4.4	3.1
Disposable personal income	44.1	5.3	3.1
Consumption	41.8	5.0	4.2
Real compensation per labor force member	39.1	3.6	2.6
Real compensation per employed person	38.1	2.8	1.9
Real OASI average monthly benefit per retired worker	58.9	18.7	−2.3
Real compensation per man-hour, private sector	31.5	1.7	1.0
Real net farm income per farm	58.7	14.1	11.9

[1] Personal income plus personal contributions for social insurance less transfer payments.

Note: Price deflators used: gross national product, implicit deflator; compensation per man-hour, consumer price index; net farm income, index of prices paid by farmers for family living items; all other, implicit deflator for personal consumption expenditures.

Sources: Department of Agriculture, Department of Commerce, Department of Health, Education, and Welfare, and Department of Labor.

Mr. STEIN. What these figures show is a substantial increase in economic well-being over the past 10 years and over the past year, and a rise, although slower, in the past half year. This latest advance seems to have been well shared.

Skeptics often greet statements about economic progress in America with the question of whether the common man, usually identified as the workingman, is sharing it. The evidence is clear that he is. In fact, compensation of employees seems to have been a larger share of the national income in the first half of this year than in any year from 1950 through 1969, and only a little below the peak share reached in 1970. And that is shown in table 2 attached to this statement.

[Table 2 follows:]

TABLE 2.—COMPENSATION OF EMPLOYEES AS PERCENT OF NATIONAL INCOME, 1950–73

Period	Percent
1950	64.1
1951	65.0
1952	67.0
1953	68.6
1954	68.6
1955	67.8
1956	69.3
1957	69.9
1958	70.1
1959	69.8
1960	71.0
1961	70.8
1962	70.7
1963	70.8
1964	70.6
1965	69.8
1966	70.2
1967	71.5
1968	72.4
1969	73.9
1970	75.4
1971	74.9
1972	75.1
1973, 1st half [1]	74.8

[1] Preliminary estimate by Council of Economic Advisers; based on seasonally adjusted data.

Source: Department of Commerce, Bureau of Economic Analysis (except as noted).

Mr. STEIN. During a period of inflation, concern is naturally felt about its impact on older people. However, benefits under social security seem to have kept up well with the cost of living. In the past year real benefits for retired workers have increased by 18.7 percent—that is real benefits per retired worker. Much of that rise is coming in one step in the fourth quarter of 1972.

In the recent past, farm incomes have been rising faster than nonfarm incomes, and there has been a shift of income from the nonfarm community to farmers as a result of the relative rise of farm prices. However, total farm income is so much smaller than total nonfarm income that a shift which is quite consequential for farmers is not large for the rest of the country.

And, as table 1 shows, real net income—real net farm income—per farm in the past year increased by 14.1 percent.

American real incomes per capita rose in the first half of 1973 because American real output per capita rose. So that is, of course, where the real income comes from. The rise of real output per capita may be divided into two parts—the rise of output per hour of work, and the rise of hours of work per capita of population. Both of these factors contributed in the first half of the year. Output per hour of work in the entire economy exclusive of the Armed Forces rose at an annual rate of 20 percent from the fourth quarter of 1972 to the second quarter of 1973.

One of the outstanding developments of the first half of 1973 was the large rise of employment, not only absolutely but also relative to the population. Total employment, civilian plus military, rose from the fourth quarter of 1972 to the second quarter of 1973 by 1.6 million, or at an annual rate of 3.8 percent, while total population rose at an annual rate of 0.7 percent. In the second quarter of 1973, an extraordinarily high proportion of the total population, and of the population of working age—over 16 years—was employed, and that is shown in table 3 attached to this statement.

[Table 3 follows:]

TABLE 3.—EMPLOYMENT RATES, 1950–73

Period	Employment rates (percent)	
	Total [1]	Civilian [2]
1950	56.8	56.1
1951	58.5	57.3
1952	58.7	57.3
1953	58.5	57.2
1954	56.8	55.5
1955	57.9	56.7
1956	58.6	57.5
1957	58.1	57.1
1958	56.4	55.4
1959	57.0	56.0
1960	57.0	56.1
1961	56.3	55.4
1962	56.5	55.5
1963	56.3	55.4
1964	56.6	55.7
1965	57.1	56.2
1966	58.0	56.9
1967	58.4	57.3
1968	58.7	57.5
1969	59.1	58.0
1970	58.4	57.4
1971	57.5	56.6
1972	57.7	57.0
Seasonally adjusted:		
1972:		
I	57.5	56.8
II	57.7	57.0
III	57.8	57.1
IV	57.9	57.2
1973:		
I	58.1	57.4
II	58.5	57.8

[1] Total employment (civilian plus Armed Forces) as percent of total noninstitutional population.
[2] Civilian employment as percent of civilian population.

Note: Data relates to persons 16 years of age and over.
Source: Department of Labor, Bureau of Labor Statistics.

Mr. STEIN. In a few words, the American people had high real incomes per capita in the first half of 1973 because their productivity was high and because the proportion of the population employed was high. Per capita real incomes rose substantially in the first half of 1973, mainly because employment rose strongly and secondarily because productivity rose.

Now let us turn to topic A, which is inflation and why we had so much of it in the first half of 1973. We shall discuss that question in terms of the deflator for the gross national product, which is a measure of the average price of the total national output, not only that sold to consumers but also that sold to government and business and exported.

We recognize that the GNP deflator is not the most common, or possibly even the most interesting, measure of prices. However, there is information about the GNP deflator which is not available for other price measures, and it is possible to explain the behavior of the GNP deflator in a way that throws a great deal of light on the Consumer Price Index and other measures of inflation.

The difference between the rise of the GNP deflator and the rise of the Consumer Price Index in the period under review was not great. From the fourth quarter of 1972 to the second quarter of 1973, the GNP deflator rose at an annual rate of 6.4 percent and the Consumer Price Index rose at an annual rate of 7.2 percent. Two factors account for most of this difference. The GNP deflator is a measure of the price of goods and services produced in this country, whereas the CPI measures the price of goods and services consumed in this country. Since the price of our imports rose more than the price of our exports, the price of things produced here rose less than the price of things consumed here. In fact, on a GNP basis, the price of things purchased here rose at an annual rate of 7.0 percent from fourth quarter 1972 to second quarter 1973. The remaining difference can be accounted for by the greater weight of farm prices in the CPI than in the GNP deflator.

The question to which we address ourselves is why the GNP deflator rose at an annual rate of 6.4 percent from fourth quarter 1972 to second quarter 1973. In the previous two quarters it had risen at a rate of only 3.1 percent, which was generally considered a satisfactory performance. Why did the rate of increase more than double?

The answer to this question is not simple. There is no single cause. We can identify the most important factors at work, but no one can claim to know just how the pieces of the mosaic fit together.

One way to restate the problem is this: From second quarter 1972 to fourth quarter 1972, expenditures for the purchase of goods and services rose at an annual rate of 10.2 percent, while real output rose at a rate of 6.9 percent, and prices rose at a rate of 3.1 percent. From the fourth quarter 1972 to the second quarter 1973, expenditures rose at an annual rate of 12.3 percent, while real output rose at an annual rate of 5.6 percent, and prices rose at a rate of 6.4 percent. Why did expenditures rise 2.1 percentage points more, and output 1.3 percentage points less, in the latter period than in the earlier one?

The answer would have to take into account the following points.

First, monetary policy. The year 1972 was a year of rapid monetary expansion, and the expansion was more rapid than in the second half of 1971, as shown in table 4 attached to this statement. This would ordinarily be expected to generate some step-up in the rise of expenditures. In fact, by some models of the relation between money and GNP, the monetary expansion of 1972 was sufficient to generate the GNP expansion of 1973, given the stage of the business cycle and the course of interest rates.

[Table 4 follows:]

TABLE 4.—PERCENT CHANGES IN THE MONEY SUPPLY AND BANK CREDIT, 1971 II TO 1973 II

[Percent change; seasonally adjusted annual rates]

Item	1971 II to 1971 IV	1971 IV to 1972 II	1972 II to 1972 IV	1972 IV to 1973 II*
M_1	4.7	7.1	7.8	5.8
M_2	8.1	11.0	10.3	8.0
Bank credit	10.9	14.1	14.3	16.5

*Preliminary.

Note: M_1 consists of currency outside banks plus demand deposits; M_2 consists of M_1 plus time and savings deposits averages of daily figures for quarter). Bank credit consists of loans and investments at all commercial banks (quarterly averages of end of month data).

Source: Board of Governors of the Federal Reserve System.

Mr. STEIN. However, such models are very uncertain, and we would make a more cautious statement. We would say that the money stock at the beginning of 1973 was conducive to some acceleration of money GNP and beyond that was permissive to a further acceleration if a stimulus to that came from some other source. Specifically, the economy was sufficiently liquid at the beginning of the year so that if there were independent tendencies for costs and prices to rise, these tendencies would not run into strong resistance from the inadequacy of liquidity.

Second, fiscal policy. Although the general trend of Federal fiscal policy since early 1972 has been to moderate the rate of economic expansion, there was a potentially disturbing departure from that trend in the fourth quarter of 1972 when a large increase in social security payments, including retroactive payments, was made.

Third, the worldwide boom. A worldwide boom of extraordinary proportions has been going on. As a recent report of the OECD stated:

> The Secretariat's forecasts for GNP growth to mid-1974 suggest that the boom at present underway may be the strongest witnessed by the area as a whole since the early 1950's.[1]

And the "area as a whole" refers especially to non-Communist advanced countries.

This boom has affected the American economy in two ways: (1) It has increased the demand for American output, in the form of exports; (2) it has raised the prices of internationally traded commodities which the United States imports and exports.

Fourth, the decline in the value of the dollar. From the beginning of 1973 to midyear the value of the U.S. dollar declined, relative to the currencies of other countries, by 10 percent, when each foreign currency is weighted by U.S. trade with it. This fall in the value of the dollar, when added to the fall which preceded it, affected the U.S. inflation in the same two ways as the worldwide boom—by increasing demand for U.S. output and by increasing the dollar prices of internationally traded commodities.

U.S. net exports of goods and services rose by $2.2 billion from the second quarter of 1972 to the fourth quarter of 1972 and by $5.2 billion from the fourth quarter of 1972 to the second quarter of 1973. This larger increase of net exports accounted for about 20 percent of the acceleration of GNP between the two periods. During the first half of 1973 the price of U.S. imports rose at an annual rate in excess of 25 percent and the price of exports at an annual rate of almost 19 percent. In the same period prices of imported commodities included in the wholesale price index rose at an annual rate of almost 40 percent.

The fact that prices of imports and exports are rising rapidly does not automatically generate rapid inflation in the United States. If total demand is under tight restraint, the rise in international prices will divert expenditure from other things and hold down their prices.

But where liquidity is ample, where the supply of credit responds easily to the demand for it, and where people are very sensitive to the expectation of inflation, rising prices of imports and exports can have multipled effects. Profit margins will be added to the imports of prices, prices of competing goods will follow, heightened expectations of inflation will affect prices not directly touched by international trade, and the whole movement will be financed by more credit expansion and more rapid velocity of money. Thus, there is no mechanical way to assess the total contribution of rising international prices to the U.S. inflation. However, conditions in the first half of 1973 were such as to make the influence of these prices quite powerful.

Fifth, agricultural production and prices. One of the outstanding facts of the American economy in the past year has been the decline of farm output. In the second half of 1972, real farm output—

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[1] The area includes 23 industrialized countries of Western Europe, North America, Japan, Australia, and New Zealand.

value added originating on farms—declined at an annual rate of more than 8 percent, and in the first half of 1973, the decline was at a rate of 14 percent. This drastic fall in output was mainly due to adverse growing conditions. Because of the decline of supply, and because of a very strong foreign demand, farm prices rose dramatically. During the second half of 1972 the GNP deflator for farm products rose at a rate of 26 percent, and in the first half of 1973, the rate was over 60 percent. Even though farm output constitutes only about 3 percent of the GNP, it contributed about 25 percent of the rise of the deflator in the first half of the year. In the case of the Consumer Price Index, where food is much more important, food prices contributed about 60 percent of the rise during that period.

Sixth, nonfarm production. Total nonfarm output rose at an annual rate of 7.4 percent in the second half of 1972 and of 6.2 percent in the first half of 1973. The 1973 rate was still high by historical standards. Nevertheless, the slowdown contributed significantly to the rise of the inflation rate. The slowdown, in turn, resulted from a less rapid rise of productivity. In the second half of 1972 output per hour of work in the private nonfarm sector rose at an annual rate of 5.2 percent. In the first half of 1973 the rate of increase was only 2.3 percent.

This slowdown of output and productivity, when demand—measured by money GNP—was rising faster, suggests that the rate of production was getting fairly close to capacity. This is not to suggest that an increase of output was impossible, or even that future increases of output after the middle of 1973 could only come as fast as the normal growth of potential. However, it does suggest that further increases of output would only come at increasing cost.

There is evidence that a number of basic industries were operating at or near capacity in the first half of the year—including steel, aluminum, paper, and petroleum products. We have already referred to the fact that an exceptionally large fraction of the population was employed in the second quarter of 1973. It is true that the unemployment rate was still 4.3 percent in June, and that the unemployment rate had been below that level about 50 percent of the time in the past 25 years. Still, it is worth noting that the unemployment rate of men 25 to 54 years old was 2.5 percent, and that rate had been lower only about 30 percent of the time in the past 25 years. The unemployment rate of married men was 2.3 percent, and that rate had been lower only about 20 percent of the time in the past 18 years. which is as far back as the statistics go.

Another indication of the difficulty of sustaining a rapid rate of productivity growth is given by the composition of the increase of employment during the first half of 1973. Total employment increased by 1.9 percent. Employment of males 20 years of age and over increased by 0.8 percent, employment of females 20 years and over by 3.2 percent, and employment of teenagers by 4.9 percent. It is no comment on the inherent capabilities of women but may only be a reflection of discrimination—and I mean discrimination in the Labor Department and not any other—to point out that they are typically employed in occupations where their productivity is less than that of men. Another factor contributing to the slowdown of productivity growth was the fact that the 1973 labor force included an exceptionally large proportion of new entrants.

One consequence of the slowdown of productivity growth was an acceleration of unit labor costs. In the second half of 1972, labor costs per unit of output in the private nonfarm economy rose at the rate of 1.4 percent a year, whereas in the first half of 1973, the rate of increase was 5.8 percent.

Seventh—and this is my last factor—price and wage controls. A shift of the price and wage control system, to phase III, was made on January 10, 1973. This seems to have little direct effect on accelerating the inflation. The standards of phase III were very similar to those of phase II. While compliance with those standards was voluntary for most of the economy, subsequent investigation showed compliance to have been extremely good.

There may, however, have been some indirect contribution to the inflation from the common public view of phase III as a looser and less reliable control system. Also, repeated suggestions that the Government might impose a freeze may have caused some price increases that would not otherwise have occurred.

In summary, the inflation of the first half of 1973 seems to have been a classical inflation of moderate proportions, arising from the stage of the cycle we were in and the monetary expansion, to which were added a number of extraordinary features which gave the inflation its exceptional sharpness. These features were the worldwide boom, the devaluation of the dollar, and the decline in agricultural production. These extraordinary features were enabled to have the inflationary effects they did by the abundance of liquidity and by the general sensitivity to the expectation of more inflation.

Let me now turn briefly to a review of international developments.

Most components of the U.S. balance of payments showed a significant improvement in the first half of 1973. The deficit in the U.S. merchandise trade balance declined from $1.7 billion in the fourth quarter of 1972 to $1 billion in the first quarter of 1973 and virtually to zero in the second quarter of 1973. The balance on goods and services improved from a deficit of $870 million in the fourth quarter of 1972 to a balanced position in the first quarter of 1973, and is likely to show a significant surplus for the second quarter of 1973.

This significant decline in net imports of goods and services is due to several factors. First, the cumulative decline in the value of the dollar in terms of foreign currencies has significantly increased the cost of imports to U.S. consumers and reduced the cost of U.S. exports to foreign consumers. While a fall in the foreign exchange value of the dollar initially has an adverse impact on the balance of payments, it is probable that the net effect of all changes in the value of the dollar since 1971 has been to reduce the deficit in the U.S. trade balance.

Second, major crop failures abroad have led to a very large increase in the volume, as well as in the price, of agricultural exports.

Third, the worldwide boom may well have had a larger impact on the foreign demand for U.S. goods than it has had on U.S. demand for foreign goods.

Net flows of long-term capital moved from an inflow of $195 million in the fourth quarter of 1972 to an outflow of $464 million in the first quarter of 1973. This increase in the long-term capital account deficit was more than offset by the decline in the current account deficit, so that the deficit in the balance on current and long-term capital transactions fell from $1.6 billion in the fourth quarter of 1972 to $1.2 billion in the first quarter of 1973. No figures are yet available for the second quarter.

The short-term capital account, including errors and omissions, recorded a deficit of about $100 million in the fourth quarter of 1972, and a deficit of about $9 billion in the first quarter of 1973. The official reserve transactions balance, which reflects short-term captial flows as well as long-term capital flows and current account transactions, recorded a deficit of about $1.5 billion in the fourth quarter of 1972, and a deficit of about $10.5 billion in the first quarter of 1973. The large increase in net short-term capital outflows in the first quarter was the result of heavy speculation against the official exchange rates that had been agreed vis-a-vis the dollar. It was made possible by the willingness of foreign central banks to accumulate dollars, in defense of established parities.

The outflow of dollars led in February to a 10-percent devaluation of the dollar and, when that step failed to stem the outflow, the major countries decided in March to float their currencies relative to the dollar. In the intervening period, the dollar has dropped another 10 percent relative to the major European currencies that are floating jointly. This further fall in the value of the dollar has been due in part to the continuing deficit in the balance of payments on current and long-term capital accounts. But the magnitude of the dollar's drop indicates that, in addition, there has been a decline in the attractiveness of the dollar as an asset in the eyes of governments and private individuals abroad, who together hold some $90 billion.

POLICY FOR ECONOMIC STABILITY

On June 13 the President imposed a price freeze to bring the surge of inflation to a halt and to permit the strengthening of the Government's anti-inflation policy. The new policy was announced on July 18 and consisted of three main elements.

First, a further step in the direction of fiscal restraint, reflected in the goal of balancing the budget for the present fiscal year.

Second, a renewed dedication to moderation in monetary policy.

Third, a tougher, but also selective and temporary, price and wage control program.

The new policy reflects a belief that the conditions which gave rise to inflation on the scale experienced in the first half of 1973 were temporary and not part of the normal state of the American economy.

We do not expect agricutlural output to be declining continuously, but expect it to resume its growth.

We do not expect the exchange value of the dollar to decline, but expect it to rise.

We do not expect the inflationary boom in the rest of the world to go on at its recent pace. Major countries are taking strong steps to slow it down.

We do not expect private output per hour in the nonfarm economy to continue rising at only 2.3 percent per annum.

We do not expect a continuation of the rate of monetary expansion we have had in the past 18 months.

We believe that if we follow prudent fiscal and monetary policies we will reach a situation of reasonable price stability without price and wage controls. Moreover, we believe that long-continued controls will do great harm to the economy, a fact of which there is increasing awareness.

Nevertheless there is a gap between where we now are and this condition of reasonable stability which we seek and expect to reach. Some of the cost and demand pressures built up during the first part of 1973 were kept from passing through into higher prices by the freeze. Other pressures are accumulating during the freeze itself. When the freeze ends we will still be feeling the effects of unusually low food supplies, unusually high foreign prices and the preceding expansionary forces. So we have before us a period of a strong tendency to higher prices. The exact duration and dimension of this tendency we do not know. We have tried to make it clear to the American people that it would be neither possible nor desirable to repress all of these prospective price increases. Nevertheless, we think it is feasible and desirable to slow them down and reduce somewhat their ultimate dimension. That is what phase IV is designed to do.

We shall not try to describe the phase IV controls system here, for reasons of time. We attach to this statement a number of documents of general explanation,[1] and will be happy to answer questions about it insofar as we are able. Obviously, a system designed to control something as complex as the American price system itself inevitably acquires a complexity which is understood only by specialists. That seems to surprise many people, but should not.

Given the economic policy on which we are now embarked, we expect a gradual slowdown from the rate of increase of real output experienced in the first half of 1973. That increase was at an annual rate of 5.6 percent. The increase as reported was most unevenly divided between the first and second quarters. Whether this preliminary estimate was wrong in this respect we do not know. In any case we look for a rate of real expansion declining below the 5.6-percent figure. This would be consistent with a further decline of the unemployment rate below 4.8 percent, the point reached in June.

Our goal is to reach a situation, probably in 1974, where real output is rising at a rate in the neighborhood of our normal growth rate, which is about 4 to 4½ percent per annum. We do not see anything in the present state of the economy which would prevent that transition to a lower, sustainable growth rate from being made smoothly, aside from the random variations always present in economic behavior. However, we recognize that so smooth a transition would be unusual in economic history and that we must be alert to adapt policy to avoid serious departures from the desired path.

Thank you very much.

We will be happy to answer any questions.

Senator PROXMIRE. Thank you, Mr. Stein.

[The following documents were attached to Mr. Stein's statement:]

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[1] See documents, beginning on p. 124.

OFFICE OF THE WHITE HOUSE PRESS SECRETARY,
Embargoed for Release Until 4:30 p.m., EDT, *July 18, 1973.*

THE WHITE HOUSE

STATEMENT BY THE PRESIDENT

The American people now face a profoundly important decision. We have a freeze on prices which is holding back a surge of inflation that would break out if the controls were removed. At the same time the freeze is holding down production and creating shortages which threaten to get worse, and cause still higher prices, as the freeze and controls continue.

In this situation we are offered two extreme kinds of advice.

One suggestion is that we should accept price and wage controls as a permanent feature of the American economy. We are told to forget the idea of regaining a free economy and set about developing the regulations and bureaucracy for a permanent system of controls.

The other suggestion is to make the move for freedom now, abolishing all controls immediately.

While these suggestions are well meant, and in many cases reflect deep conviction, neither can be accepted. Our wise course today is not to choose one of these extremes but to seek the best possible reconciliation of our interests in slowing down the rate of inflation on the one hand, and preserving American production and efficiency on the other.

The main elements in the policy we need are these:

First, the control system must be *tough*. It has to hold back and phase in gradually a large part of the built-in pressure for higher prices which already exists in the economy.

Second, the system must be *selective*. It must permit relaxation of those restraints which interfere most with production, and it must not waste effort on sectors of the economy where stability of prices exists. The control system should also be designed to accommodate the special problems of various sectors of the economy under the strains of high use of capacity.

Third, the system must contain sufficient assurance of its *termination* at an appropriate time to preserve incentives for investment and production and guard against tendencies for controls to be perpetuated.

Fourth, the control system must be backed up by firm steps to *balance the budget*, so that excess demand does not regenerate inflationary pressures which make it difficult either to live with the controls or to live without them.

We have had in 1973 an extraordinary combination of circumstances making for rapid inflation. There was a decline of domestic food supplies. The domestic economy boomed at an exceptional pace, generating powerful demand for goods and services. The boom in other countries and the devaluation of the dollar, while desirable from most points of view, raised the prices of things we export or import.

These forces caused a sharp rise of prices in early 1973. The index of consumer prices rose at an annual rate of about 8 percent from December 1972 to May 1973. The freeze imposed on June 13 put a halt to this rapid rise of prices. But many of the cost increases and demand pressures working to raise prices in the early part of the year had not yet resulted in higher prices by the time the freeze was imposed. Thus a certain built-in pressure for a bulge of price increases awaits the end of the freeze. Moreover, aside from this undigested bulge left over by the freeze, the circumstances causing the sharp price increase in early 1973 will still be present, although not on so large a scale. The demand for goods and services will be rising less rapidly than in the first half of the year. The supply of food will be rising, although not fast enough. Our position in international trade is improving and this will lend strength to the dollar.

All in all, the tendency for prices to rise in the remainder of 1973, a tendency which will either come out in higher prices or be repressed by controls, will be less than in the first half of the year but greater than anyone would like. Particularly, there is no way, with or without controls to prevent a substantial rise of food prices. However, by 1974, we should be able to achieve a much more moderate rate of inflation. By that time, the good feed crops in prospect for this year should have produced a much larger supply of food, and total demand should be rising less rapidly than in 1973.

This more satisfactory situation on the inflation front will be reached if three conditions are met:

First, we do not allow the temporary inflationary forces now confronting us to generate a new wage-price spiral which will continue to run after these temporary forces have passed. To do this we must hold down the expression of those forces in prices and wages.

Second, we do not allow the present controls to damp down 1974 production excessively, a problem that is most obvious in the case of meats and poultry.

Third, we do not permit a continuation or revival of excess demand that will generate new inflationary forces. That is why control of the Federal budget is an essential part of the whole effort.

The steps I am announcing or recommending today are designed to create these conditions.

The Phase IV Controls Program

Our decisions about the new control program have been reached after consulting with all sectors of the American society in over 30 meetings and after studying hundreds of written communications. The advice we received was most helpful and I want to thank all those who provided it.

The Cost of Living Council will describe the Phase IV controls program in detail in statements and regulations. These will take effect at various times between now and September 12. They will include special regulations dealing with the petroleum industry, published for comment. Here I will only review the general features of the program, to indicate its basic firmness and the efforts that have been made to assure that production continues and shortages are avoided.

The controls will be mandatory. The success of the program, however, will depend upon a high degree of voluntary compliance. We have had that in the past. Study of the reports on business behavior during Phase III shows that voluntary compliance was almost universal. Nevertheless, the rules we are now proposing are stricter, and it is only fair to those who will comply voluntarily to assure that there is compulsion for the others.

Except for foods, the freeze on prices will remain in effect until August 12. However, modifications of the freeze rules will be made to relieve its most serious inequities.

The fundamental pricing rule of Phase IV is that prices are permitted to rise as much as costs rise, in dollars per unit of output, without any profit margin on the additional costs. Cost increases will be counted from the end of 1972; cost increases which occurred earlier but had not been reflected in prices may not be passed on. In addition to the cost rule, there remains the previous limitation on profit margins.

Large firms, those with annual sales in excess of $100,000,000, will be required to notify the Cost of Living Council of intended price increases and may not put them into effect for 30 days. During that period, the Council may deny or suspend the proposed increase.

The wage standards of Phase II and Phase III will remain in force. Notification of wage increases will continue to be required for large employment units.

These are, we recognize, tough rules, in some respects tougher than during Phase II. But the situation is also in many ways more difficult than during Phase II. So long as the system is regarded as temporary, however, we believe that business can continue to prosper, industrial peace can be maintained, and production continue to expand under these rules. Machinery will be established in the Cost of Living Council to consider the need for exceptions from these rules where they may be causing serious injury to the economy. And we will be prepared to consider modification of the rules themselves when that seems necessary or possible.

The Special Case of Food

Nowhere have the dilemmas of price control been clearer than in the case of food. In the early part of this year, rising food prices were the largest part of the inflation problem, statistically and psychologically. If price restraint was needed anywhere, it was needed for food. But since the ceilings were placed on meat prices on March 29, and especially since the freeze was imposed on June 13, food has given the clearest evidence of the harm that controls do to supplies. We have seen baby chicks drowned, pregnant sows and cows, bearing next year's food, slaughtered, and packing plants closed down. This dilemma is no coincidence. It is because food prices were rising most rapidly that the freeze held prices most below their natural level and therefore had the worst effect on supplies.

We must pick our way carefully between a food price policy so rigid as to cut production sharply and to make shortages inevitable within a few months and a food price policy so loose as to give us an unnecessary and intolerable bulge. On this basis we have decided on the following special rules for food:

1. Effective immedately processors and distributors of food, except beef, may increase their prices, on a cents-per-unit basis, to the extent of the increase of costs of raw agricultural products since the freeze base period (June 1–8).
2. Beef prices remain under present ceilings.
3. The foregoing special rules expire on September 12, after which time the same rules that apply to other products will apply to foods.
4. Raw agricultural products remain exempt from price control.

To relieve the extreme high prices of feeds, which have an important effect on prices of meat, poultry, eggs, and dairy products, we have placed limitations on the export of soybeans and related products until the new crop comes into the market. These limitations will remain in effect for that period. But permanent control of exports is not the policy of this Government, and we do not intend at this time to broaden the controls beyond those now in force. To a considerable degree, export controls are self-defeating as an anti-inflation measure. Limiting our exports reduces our foreign earnings, depresses the value of the dollar, and increases the cost of things we import, which also enter into the cost of living of the American family. Moreover, limiting our agricultural exports runs counter to our basic policy of building up our agricultural markets abroad. Unless present crop expectations are seriously disappointed, or foreign demands are extremely large, export controls will not be needed. However, reports of export orders for agricultural commodities will continue to be required. Our policy must always be guided by the fundamental importance of maintaining adequate supplies of food at home.

The stability of the American economy in the months and years ahead demands maximum farm output. I call upon the American farmer to produce as much as he can. There have been reports that farmers have been reluctant to raise livestock because they are uncertain whether Government regulations will permit them a fair return on their investment, and perhaps also because they resent the imposition of ceilings on food prices. I hope that these reports are untrue. In the past year *real* net income per farm increased 14 percent, a truly remarkable rise. I can assure the American farmer that there is no intention of the Government to discriminate against him. The rules we are setting forth today should give the farmer confidence that the Government will not keep him from earning a fair return on his investment in providing food.

The Secretary of Agriculture will be offering more specific advice on increasing food production and will be taking several steps to assist, in particular he has decided that there will be no Government set-aside of land in 1974 for feed grains, wheat and cotton.

I am today initiating steps to increase the import of dried skim milk.

When I announced the freeze, I said that special attention would be given, in the post-freeze period, to stabilizing the price of food. That remains a primary objective. But stabilizing the price of food would not be accomplished by low price ceilings and empty shelves, even if the ceilings could be enforced when the shelves are empty. Neither can stabilization be concerned only with a week or a month. The evidence is becoming overwhelming that only if a rise of food prices is permitted now can we avoid shortages and still higher prices later. I hope that the American people will understand this and not be deluded by the idea that we can produce low-priced food out of Acts of Congress or Executive Orders. The American people will continue to be well-fed, at prices which are reasonable relative to their incomes. But they cannot now escape a period in which food prices are higher relative to incomes than we have been accustomed to.

The Process of Decontrol

There is no need for me to reiterate my desire to end controls and return to the free market. I believe that a large proportion of the American people, when faced with a rounded picture of the options, share that desire. Our experience with the freeze has dramatized the essential difficulties of a controlled system—its interference with production, its inequities, its distortions, its evasions, and the obstacles it places in the way of good international relations.

And yet, I must urge a policy of patience. The move to freedom now would most likely turn into a detour, back into a swamp or even more lasting controls. I am impressed by the unanimous recommendation of the leaders of labor and business who constitute the Labor-Management Advisory Committee that the controls should be terminated by the end of 1973. I hope it will be possible to do so and I will do everything in my power to achieve that goal. However, I do not consider it wise to commit ourselves to a specific date for ending all controls at this time.

We shall have to work our way and feel our way out of controls. That is, we shall have to create conditions in which the controls can be terminated without disrupting the economy, and we shall have to move in successive stages to withdraw the controls in parts of the economy where that can be safely done or where the controls are most harmful.

To work our way out of controls means basically to eliminate the excessive growth of total demand which pulls prices up faster and faster. The main lesson of that is to control the budget, and I shall return to that critical subject below.

But while we are working our way to that ultimate condition in which controls are no longer useful, we must be alert to identify those parts of the economy that can be safely decontrolled. Removing the controls in those sectors will not only be a step towards efficiency and freedom there. It will also reduce the burden of administration, permit administrative resources to be concentrated where most needed, and provide an incentive for other firms and industries to reach a similar condition.

During Phase II firms with 60 employees or fewer were exempt from controls. That exemption is now repeated. We are today exempting most regulated public utilities, the lumber industry (where prices are falling), and the price of coal sold under long-term contract. The Cost of Living Council will be studying other sectors for possible decontrol. It will also receive applications from firms or industries that can give assurance of reasonably non-inflationary behavior without controls. In all cases, of course, the Cost of Living Council will retain authority to reimpose controls.

Balancing the Budget

The key to success of our anti-inflation effort is the budget. If Federal spending soars and the deficit mounts, the control system will not be able to resist the pressure of demand. The most common cause of the breakdown of control systems has been failure to keep fiscal and monetary policy under restraint. We must not let that happen to us.

I am assured that the Federal Reserve will cooperate in the anti-inflation effort by slowing down the expansion of money and credit. But monetary policy should not, and cannot, be expected to exercise the needed restraint alone. A further contribution from the budget is needed.

I propose that we should now take a balanced budget as our goal for the present fiscal year. In the past I have suggested as a standard for the Federal budget that expenditures should not exceed the revenues that would be collected at full employment. We are meeting that standard. But in today's circumstances, that is only a minimum standard of fiscal prudence. When inflationary pressure is strong, when we are forced to emergency controls to resist that pressure, when confidence in our management of our fiscal affairs is low, at home and abroad, we cannot afford to live by that minimum standard. We must take as our goal the more ambitious one of balancing the actual budget.

Achieving that goal will be difficult, more difficult than it seems at first. My original expenditure budget for fiscal 1974 was $268.7 billion. Since that budget was submitted economic expansion, inflation and other factors have raised the estimated revenues to about the level of the original expenditure estimate. However, while that was happening the probable expenditures have also been rising as a result of higher interest rates, new legislation enacted, failure of Congress to act on some of my recommendations, and Congressional action already far advanced but not completed.

It is clear that several billion dollars will have to be cut from the expenditures that are already probable if we are to balance the budget. That will be hard, because my original budget was tight. However, I regard it as essential and pledge myself to work for it.

We should remember that a little over a year ago I set a goal for fiscal year 1973 to hold expenditures within a total of $250 billion. There was much skepticism about that at the time, and suggestions that the number was for political consumption only, to be forgotten after the election. But I meant it, the people endorsed it and the Congress cooperated. I am able to report today that the goal was achieved, and total expenditures for Fiscal Year 1973 were below $249 billion.

I will take those steps that I can take administratively to reach the goal of a balanced budget for Fiscal Year 1974. I shall start by ordering that the number of Federal civilian personnel at the end of Fiscal Year 1974 total below the number now budgeted. The Office of Management and Budget will work with the agencies on this and other reductions. I urge the Congress to assist in this effort. Without its cooperation achievement of the goal cannot be realistically expected.

Despite the difficult conditions and choices we now confront, the American economy is strong. Total production is about 6½ percent above a year ago, employment has risen by 3 million, real incomes are higher than ever. There is every prospect for further increases of output, employment and incomes. Even in the field of inflation our performance is better than in most of the world. So we should not despair of our plight. But we have problems, and they are serious in part because we and the rest of the world expect the highest performance from the American economy. We can do better. And we will, with mutual understanding and the support of the American people.

OFFICE OF THE WHITE HOUSE PRESS SECRETARY,
Embargoed for 4:30 p.m. EDT, *July 18, 1973.*

THE WHITE HOUSE

FACT SHEET SUMMARY

ECONOMIC STABILIZATION PROGRAM

PHASE IV

Objective

To moderate the rate of inflation existing during first six months of 1973 with minimum adverse effect on supply.

Design

- Phase IV is mandatory, covers most sectors of the economy, requires prenotification and restricts price increases to dollar-for-dollar pass-through of costs.
- Freeze prices remain in effect until August 12 in all sectors, except food and health which have special rules effective immediately.
- Proposed rules for non-food sectors will be effective August 12 and are being issued for comment. Comments required by July 31.
- Continues wage and benefit guidelines in effect during Phase II and III.
- Exempts on August 12 small businesses (60 employees or fewer), public utility rates, interest rates and rents, wages and prices in lumber and plywood.
- Establishes procedures to consider decontrol industry by industry.

Food Sector

- Phase IV price regulations on food are divided into two stages, Stage A and Stage B.

  Stage A (effective immediately)

  —Ceiling prices on beef continued.

  —All other food prices may be increased only to reflect raw agricultural cost increases since June 8 on dollar-for-dollar basis.

  Stage B (effective September 12)

  —Ceiling prices on beef terminated.

  —Manufacturers and processors allowed to pass through all cost increases on a dollar-for-dollar basis.

  —Other aspects of food regulations to be similar to controls for industrial, service, wholesale and retail sectors.

Industrial and Service Sector

- Prices remain frozen until August 12 at which time Phase IV regulations become effective.
- Regulations to be issued July 19 for public comment. These regulations will:

  —Require companies with annual sales of more than $100 million to give the Cost of Living Council 30 days prenotification before price increases may go into effect.

  —Require companies with sales over $50 million to file quarterly reports.

  —Require companies with sales of less than $50 million but over 60 employees to file an annual report.

  —Establish a new base period for price increases and cost justification—the last fiscal quarter ending before January 11, 1973. Costs incurred prior to the new Phase IV base period are not allowed as justification for higher prices.

  —Permit costs to be passed through only on a dollar-for-dollar basis.

  —Continue the profit margin limitations.

Non-Food Retail and Wholesale Sector

- Prices remain frozen until August 12 at which time Phase IV regulations become effective.
- Regulations to be issued July 19 for public comment. These regulations will require:
  - —Preapproval by the Cost of Living Council of pricing plans based on merchandise categories for companies with sales over $50 million.
  - —Gross margin controls on these categories.
  - —Continuation of profit margin limitation.

Petroleum Sector

- Prices remain frozen until August 12 at which time Phase IV regulations become effective.
- Regulations to be issued July 19 for public comment. These regulations will provide:
  - —Price ceilings for gasoline, heating oil and diesel fuel. The ceiling price is computed as the seller's actual cost of the product plus the dollar and cents markup applied to a retail sale of the same product on January 10, 1973.
  - —A ceiling price for crude oil.
  - —Increased crude production and equivalent amount of old oil to be exempted.
  - —Ceiling prices and octane ratings to be posted on each gasoline pump.

Regulations for Special Sectors

- The health service industry is to be removed from the freeze immediately and returned to the mandatory Phase III controls.
- Proposed regulations for the insurance industry to be issued on July 19 for public comment. The new regulations will go into effect August 12. Until then the freeze remains in effect.

Wages

- The general wage and benefit standards of Phase II and Phase III will be retained. More detailed information for reporting wage and benefit increases will be required.
- Notification of wage and benefit increases by the largest bargaining units will be continued to be required. Prenotification will be required in individual cases.
- A new organizational component of the Cost of Living Council has been established to review wage and salary and benefit increases in the state and local government sector.

For additional information call the Cost of Living Council Public Affairs Office, 202-254-8830, or Cost of Living Council Operations Center, 202-254-7880 or 202-254-8520.

Comparison of phases II, III, and IV

	Phase II	Phase III	Phase IV
		INDUSTRIAL SECTOR	
Price Adjustments:			
Cost passthrough	Full, profit margin maintenance.	Same as phase II	Dollar passthrough only no margin maintenance.
Cost reachback	Last price increase or Jan. 1, 1971.	Last price increase prior to Jan. 11, 1973.	Base cost period (last fiscal quarter before Jan. 11, 1973).
Profit margin	Best 2 of 3 fiscal years before Aug. 15, 1971.	Best 2 of fiscal years completed after Aug. 15, 1968.	Same as Phase III.
Base price	Highest price above which 10 percent of the units were charged from 30 days prior to Aug. 16, 1971, to Nov. 13, 1971.	Same as phase II	Average price for last fiscal quarter before Jan. 11, 1973.
Procedures and Coverage:			
Prenotification	Required of all firms over $100 million annual sales; 30 days before implementation; approval required.	After May 2, 1973, required of all firms over $250 million annual sales which had implemented price increases which resulted in WAPI exceeding 1.5 percent; 30 days before implementation.	Required of all firms over $100 million 30 days before implementation; may be effected unless CLC suspends, denies, or cuts back. Right reserved to reexamine price increases placed into effect.
Exceptions criteria	Gross hardship or inequity	Self-executing based on phase II regulations.	Gross hardship or inequity with consideration for economic disruption.
Reporting	Quarterly for firms over $50 million annual sales.	Quarterly for firms with annual sales or revenues of $250 million or more.	Quarterly for firms over $50 million; annual for nonexempt firms less than $50 million.
Small-firm exemption.	60 employees or fewer	Same as phase II	Same as phase II, with updated computation.
		OTHER SECTORS	
Food	General standard	Special regulations	New special regulations—2-stage implementation.
Petroleum	do	do	New special regulations.
Insurance	Special regulations	Subject to general price standard.	Revised special regulations.
Public utilities	Mandatory certification of regulatory bodies.	Special criteria	Exempt.
Health	Special regulations	Special regulations	Same as phase III until HAC develops revisions.
Rent	do	Exempt	Exempt.

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THE WHITE HOUSE

FACT SHEET

ECONOMIC STABILIZATION PROGRAM

PHASE IV

Background

On June 18th, the President announced a Freeze on prices to last a maximum of sixty days. At that time, he indicated that the freeze period would be used to develop a new and more effective system of controls to follow the freeze. He specifically directed the Cost of Living Council to develop a Phase IV that would stabilize retail prices of both food and gasoline.

The President cautioned, however, that Phase IV would not be designed to get the U.S. permanently into a controlled economy. He promised to avoid action that would lead to rationing, black markets or a recession that would mean more unemployment. Finally, he emphasized that the real key to curbing food prices lies in increasing supplies rather than controls.

During the last month, Secretary Shultz, Chairman of the Cost of Living Council, other members of the Council, and Senior Staff officials of the Cost of Living Council have engaged in extensive consultations with consumers, businessmen, farmers, Congressional leaders, and government officials in all parts of the country. More than 30 meetings with over 400 individuals were conducted. In addition, the Cost of Living Council made available a list of 34 specific questions about the design of Phase IV. Businessmen, farmers and consumers were invited to submit written recommendations to the Cost of Living Council on the nature of Phase IV. More than 200 such proposals were received and fully reviewed. The recommendations ranged from complete elimination of controls to establishment of a permanent system of ceiling prices, rationing and a 250,000 man enforcement agency.

Although the freeze was keeping prices stable at the retail levels, it was causing business shutdowns and unemployment, resulting in supply shortages in some sectors.

Among the problems created by the freeze were situations where the cost of producing or distributing goods was above the freeze price. Confectioners, processed grain millers, poultry and egg producers, margarine and vegetable oil processors, and potato chip manufacturers faced costs greater than the price they could charge for their products. In some cases, low market prices prevailing during the base period, and in other cases freeze prices based on last year's crop, caused fresh fruit and vegetable farmers to incur losses and to change their normal patterns of distribution of items such as tomatoes, potatoes and celery.

Objectives of Economic Stabilization Program

- To moderate the rate of inflation which has existed in the United States during the first six months of 1973 and to do so with a minimum adverse effect on supply.
- To continue expansion of U.S. economy to fulfill its potential with further increases in employment.
- To strengthen the international position of the dollar.
- To build confidence of business, industry, agriculture, the Congress, and consumers necessary

to promote an increase in capacity and supply and to reduce long run inflationary forces.

- To work with business, industry, agriculture, and the public to terminate controls as soon as possible in a manner which will avoid unacceptable rates of inflation after Phase IV.

Features of Phase IV

- A sector-by-sector approach with controls tailored around particular economic conditions of each sector.
- Phased implementation of the program between now and September 12. (Implementation calendar attached.)
- Publication of major parts of the program for public comment before their effective date of August 12, 1973 so that the constructive national dialogue begun during the consultations may be continued. In particular, proposed regulations for the industrial and service, retail and wholesale, petroleum and insurance sectors to be published on July 19.
- More flexible exceptions policy to permit relief in cases of real hardship or to permit necessary supply increases.
- Establishment of a senior committee of government officials to hear appeals and to continually assess exceptions and exemptions policy.
- A request that Congress expedite action on anti-inflation legislative proposals, including authority for temporary export controls, authority to reduce tariffs temporarily in selected cases, authority for disposal of excess materials from the National Stockpile, authority for construction of the Alaska Pipeline, and farm legislation to permit farmers to earn higher income through greater production rather than higher prices.

Food

- "Stage A" of the regulations for food become effective immediately.
  - —The system of ceilings on beef prices established on March 29, will continue until September 12.
  - —Price ceilings on all other agricultural products have been lifted to permit pass-through of only raw agricultural product cost increases incurred since June 8th by processors, distributors and retailers on a dollar-for-dollar basis. No cost other than raw material cost increases may be passed through. Decreases in raw agricultural costs must also be passed through. This system of controls on food products except beef will continue until September 12th at which time Stage B of the food controls go into effect.
- "Stage B" of the food controls program will terminate the meat ceilings and permit pass-through of other cost increases on a dollar-for-dollar basis. This second stage of the food controls program will place the food sector under control rules similar to the rules for the industrial service, retail and wholesale sectors.
- The Tariff Commission has been asked to review temporary suspension of import quotas on non-fat dry milk. In the meantime, an immediate increase of 80 million pounds for non-fat dry milk has been ordered on an emergency basis.
- All remaining set aside acres are to be brought back into production in 1974.
- Limitations on the export of soybeans and related products will be continued through the remainder of the current crop year. An export reporting system for agricultural commodities will be continued to provide information on the volume of planned export shipments.

Industrial and service sector

- Prices in the industrial and service sector will continue to be frozen until August 12th at which time the Phase IV regulations for this sector go into effect.
- Mandatory regulations to take effect on August 12th will be issued tomorrow by the Cost of Living Council for public comment. These proposed regulations will:
  - —Require prenotification by all firms with annual sales of more than $100 million, quarterly reporting by firms with annual sales or revenues of over $50 million, and annual reporting by non-exempt firms with annual sales less than $50 million and over 60 employees.
  - —Establish a new base period for both prices and costs of the last fiscal quarter before January 11, 1973. The base price has already been calculated for CLC-2 forms used in Phase III.
  - —Prohibit use of costs incurred prior to the new Phase IV base period as justification for price increases.

—Permit costs to be passed-through only on a dollar-for-dollar basis.

—Permit prices raised legally during Phase III to remain in effect; however, further price increases may be made only to cover cost increases incurred since the new base period.

—Continue profit margin restraints in addition to other requirements to provide that profit margins may not be increased above the average for the best two out of a firm's last five fiscal years.

—Reinstate the Phase II small business exemption (60 employees or fewer).

—Permit price increases, which are prenotified to the Cost of Living Council after August 12, to be placed into effect after thirty days if the Cost of Living Council has taken no action to suspend, deny or cut back the price increase. The thirty-day period can be extended by the Cost of Living Council if necessary to obtain additional data justifying the proposed increase. The right is reserved to re-examine price increases after they are placed into effect.

—Provide for exceptions to the new regulations only when necessary to relieve gross hardship or inequity or to provide for increased supplies and capacity.

Non-Food Wholesale and Retail Sector

- Prices remain frozen until August 12 at which time Phase IV regulations become effective.
- Regulations to be issued July 19 for public comment. These regulations will require:

—Preapproval by the Cost of Living Council of pricing plans based on merchandise categories for companies with sales over $50 million.

—Gross realized margin controls on these categories (sales minus cost of goods sold divided by sales).

—Continuation of profit margin limitation.

Gasoline and Other Petroleum Products

- Proposed mandatory regulations controlling petroleum prices will be issued Thursday, July 19 by the Cost of Living Council for comment. These regulations, taking into account public comment, will go into effect on August 12.
- The proposed regulations will provide two price ceilings: one on prices for gasoline, heating oil, and diesel fuel; and, one on prices for domestic crude oil. Both ceilings will be reviewed and adjusted as appropriate.
- Ceiling prices and octane ratings must be posted on each gasoline pump.
- Increased crude production (new crude petroleum beyond corresponding 1972 levels) from each producing property and an equal amount of current production (old crude petroleum) will be exempt from the ceiling.
- The price at which a wholesaler or retailer will be allowed to resell products (other than gasoline, heating oil and diesel fuel) is his cost of product plus his actual dollar-for-dollar markup applied to that product on January 10, 1973.
- A manufacturer may not charge a price which exceeds his May 15, 1973 price without prenotification, except to reflect increased cost of imports subsequent to May 15, 1973 and to reflect increased costs of domestic crude petroleum excepted from the ceiling.
- Lease agreements between a gasoline manufacturer and gasoline retailer will be held to the terms and conditions as of May, 1973.

Health

- On July 19, providers of health services will be removed from the freeze, although they continue to be subject to the mandatory Phase III controls.
- This action is effective retroactively to July 1, 1973 for the purpose of determining price increases under cost reimbursement contracts.
- The Health Industry Advisory Committee has been directed to develop detailed recommendations to the Cost of Living Council so that revised controls for hospitals and nursing homes can become effective no later than October 1st. The objectives of the modifications in the control rules in this sector are:

—To reduce the inflationary rate of increase in the cost of hospital stay.

—To moderate the proliferation of new services and selectively control capital expenditures.

—To provide economic incentives for the substitution of less expensive ambulatory care in place of in-patient hospital care where possible.

—To provide for the development of state—not Federal—administration of health care controls.

—To maximize internal flexibility and incentives for health care managers to improve productivity.

—To be responsive to cost saving innovations, such as health maintenance organizations and prospective reimbursement plans.

—The Cost of Living Council will also consider revisions in the controls for doctors, dentists and other non-institutional providers of health care.

Insurance

- Proposed mandatory regulations for the insurance industry will be published by the Cost of Living Council for public comment on July 19. These regulations will become effective, taking into account public comment, on August 12th.
- Health, property-liability, and credit life insurance will be subject to mandatory controls on premium increases. Prenotification of significant rate increases by the largest insurers will be required, and smaller insurers will be required to report periodically to the Cost of Living Council.
- Formulas for calculating rate changes used in Phase II will be modified to reflect experience gained during the controls program.
- As in Phase II, state insurance commissioners will be called on to make determinations as to whether the Cost of Living Council should approved proposed rate changes.

Construction

- On July 19, mandatory regulations for prices in the construction industry will be issued, to become effective on August 12. These regulations will be similar to those issued near the end of Phase III.
- The regulations will establish special rules applicable to prices charged for construction operations, reaffirm profit margin limitations and provide a procedure for renegotiation of fixed price construction contracts where wages have been reduced.

Wages

- The general wage and benefit standards of Phase II and Phase III will be retained. More detailed information for reporting wage and benefit increases will be required.
- Notification of wage and benefit increases by the largest bargaining units will be continued to be required. Prenotification will be regulated in individual cases.
- A new organizational component of the Cost of Living Council has been established to review wage and salary and benefit increases in the state and local government sector.

Enforcement and Penalties for Violation

- The staff of the Cost of Living Council and the IRS is being substantially augmented to administer and enforce the new Phase IV controls.
- Administrative sanctions will be imposed for violation of the price or wage standards and for failure to comply with prenotification and reporting requirements. In addition, judicially imposed civil penalties will be sought where appropriate.

Phase Out of Controls

- The Labor-Management Advisory Committee of the Cost of Living Council will be requested to advise further on the orderly phase out of mandatory controls.
- The Cost of Living Council will work directly with representatives of specific economic sectors to develop plans and commitments for sufficient supply expansion to ensure reasonable prices, as part of a plan to terminate mandatory controls for those sectors.
- Rate increases by public utilities, as defined during Phase III, have been exempted from direct Phase IV controls although the Cost of Living Council reserves the right to reimpose mandatory controls on this sector if necessary to achieve the objectives of the program. Almost all public utility rates are already controlled by federal, state or local regulatory bodies. Duplication of price controls on this sector would be unnecessary to ensure that utility rate increases are non-inflationary and provide for adequate service, necessary expansion and minimum rates of return.
- Wages and prices in the lumber and plywood industry have also been exempted from Phase IV controls. Price decreases in this sector have been common in recent months, and competitive forces are expected to exert continued restraint on price levels throughout the remainder of the year.
- Long-term contracts for production coal mines have also been exempted to provide an incentive for increased supplies of coal to mitigate the energy crisis.

CALENDAR OF PHASE IV ACTIONS

Program Announcement	
—Stage A of Food Regulations	July 18
• Ceilings on Beef Continued	
• Dollar-for-Dollar Passthrough of Other Raw Agricultural Costs Permitted	
—Freeze on Industrial Prices Continued	
Proposed Non-Food Regulations Issued for Comment	
—Industrial Regulations	July 19
—Insurance Regulations	July 19
—Petroleum Regulations	July 19
Non-Food Regulations Become Effective	
—Health Regulations	July 19
—Construction Regulations	August 12
—Industrial Regulations	August 12
—Petroleum Regulations	August 12
—Insurance Regulations	August 12
Stage B of Food Regulations	
—Beef Ceilings Terminated; All Food Prices Subject to Cost-Passthrough Regulations	September 12

Senator PROXMIRE. Mr. Stein, you are a fine economist. You are also an extraordinary selector of statistics.

Let me say what I mean by that. In your statement you say:

Real per capita income is the fundamental measure of the performance of the economic system.

Now, if this is the fundamental measure, that is a measure you have not been stressing in past presentations. You select it for presentation here. One thing you have discussed in the past is real spendable earnings. I do not find that series in table 1 attached to your statement.

Now, what has happened to earnings?

Let's take a look at them. I think that is a key to why people have expressed outrage when you have told them that real income is up. They are right. Real gross average hourly earnings from December 1972 to June 1973, the most recent 6-month period for which we have statistics, declined. They did not go up; they declined 0.68 percent. Real hourly earnings index declined 1.11 percent. Real average—gross weekly—earnings declined 0.15 percent; real spendable average declined 1.31 percent.

Now, another problem with table 1 is where you use figures for compensation per man-hour, you failed to point out, as the Bureau of Labor Statistics press release did, that gains in hourly compensation in the first part of 1973 were unusually high due to the increased social security tax; that is, the amount of tax paid by employers on behalf of employees.

Now, this problem carries over into table 2 attached to your statement. You show that with the large increase in the social security tax included as part of compensation in the first half of 1973, we managed to get compensation as a percent of national income almost up to its 1970 level.

Now, social security is fine for retirement. But this form of compensation will not help a working man pay his grocery bill.

So it is understandable why people express outrage about claims that real income has gone up. It is true that overall it has gone up, and you reconcile these two differences because more people are working. We still have very, very heavy unemployment, but more people are working. Nevertheless, for the average personal real income is not up in the past 6 months; it is down.

And of course, the outlook is understandable, because all of the talk is about slowing down the economy. With unemployment still close to 5 percent—4.8 percent—the talk is that we are going to have a monetary and fiscal policy to slow the economy further.

Further in your statement you say:

Part of the advance in real income per capita was due to increased productivity, 2 percent in the first half of 1973.

And am I correct in thinking productivity declined in the second quarter? Those figures seem to indicate it did decline. You say: "Productivity was high in the first half." I wonder by what standard? The productivity gain was 1 percent below the long-term growth trend of 3 percent; so the productivity increase in the first 6 months was less than what we have been able to achieve.

You point out that total employment rose at an annual rate of 3.8 percent in the first half of 1973. The labor force also rose 3.8 percent over that same period, and you seem to have omitted that figure.

Now, coming to a question, in your statement you say: "The American people had high real incomes per capita in the first half of 1973 because their productivity was high." Then in your statement you say that "the slowdown on nonfarm output resulted from less rapid rise of productivity. For the first half of 1973, our rate of increase was only 2.3 percent."

So what is your story, Mr. Stein? Was productivity low or high?

Mr. STEIN. Well, Senator, I tried to make a distinction which I believe is quite explicit in the document between the level of productivity and the rate of change. The level of productivity at present is high; it has been rising in the first half of the year at a rate which is below its average rate. It is a fact that nobody can deny; it has followed a period in which it rose at much more than the average rate.

I am making two statements about income here which are quite clearly distinguishable. One is that absolute level of real income of the American people is high, and it is high for two reasons. First, because the absolute level of productivity is high, and second, because the absolute rate of employment is high.

I said, in the second place, that the increase in real incomes in the first half of the year has been strong. And there, if you will read the statement carefully, you will see it says primarily because of increased employment, and secondarily, because productivity rose. The increase in productivity is a secondary factor because productivity did not rise as rapidly as employment.

In this whole statement, I have used comparisons of the fourth quarter of 1972 with the second quarter of 1973. As you know, the figures which have been recorded show a very big increase in output, and all other measures of the real economy, in the first quarter, a very small increase in the second quarter. And we do not know whether that division between the first and second quarter is accurate or not.

It seems more sensible to me to move from the fourth quarter to the second quarter and not to get hung up on the question of whether the first quarter was 8 percent and the second quarter 2.6, or the first quarter 7 percent, and the second quarter, 3.6 and so on. We do not know from preliminary figures. I did not think that was useful to do.

Senator PROXMIRE. Now, Mr. Stein, are you not using half-year figures to conceal a trend; the trend in what happened during this 6 months?

Mr. STEIN. No; I am not.

Senator PROXMIRE. Is the trend not adverse?

Mr. STEIN. The statement does not deny that the rate of expansion in the economy has slowed down. We want the rate of expansion in the economy to slow down. But I think it is unwise to focus on these items of preliminary figures for the second quarter and the difference between them and the first quarter to draw a trend of economy. That is, these statistics are quite variable; the economy is quite variable. And I hope you will not draw a trend from one-quarter's behavior.

I would like to comment on what you said about the social security tax and its inclusion as part of workers' compensation. Now, Congress enacts these taxes, and they enact them, presumably, on the theory that they are a way of providing benefits, of paying for benefits for workers. And there would be no more reason to exclude them from the benefits of workers than to exclude what might be deducted from your income or mine for——

Senator PROXMIRE. No; we should not exclude them. All I am arguing is, as far as the average worker is concerned, he cannot understand why he does not get it. He does not get it for maybe 20, 30, 40 years, and it is perfectly proper to include it. But I think it should be explained when it is included, why it is not a present source of income, why he cannot use it.

Mr. STEIN. Well, let's try to educate him about this and not cater to his ignorance.

Senator PROXMIRE. Now, further in your statement you say:

> Although the general trend of Federal fiscal policy since early 1972 has been to moderate the rate of economic expansion, there was a potentially disturbing departure from that trend in the fourth quarter of 1972 when a large increase in social security payments, including retroactive payments, was made.

Now, that one sentence is all you have to say in your statement about fiscal policy as the cause of recent inflation. You strongly imply that increased social security payments have been an important cause of inflation. I think that is just a fantastic statement.

Let me point out the following facts about fiscal policy in 1972. First, the deficit was at a $16.4 billion rate in the first half and a $15.4 billion rate in the second half; it was on an NIA basis. That is almost no change at all, certainly no dramatic move toward restraint.

Second, Federal defense purchases jumped about $5 billion in the fourth quarter of 1971 to the first quarter of 1972. That is not restraint.

Third, an extra retroactive dividend sharing payment was distributed in the fourth quarter of 1972, and that affected the fourth quarter deficit just as much as social security.

Fourth, unemployment was still around 6 percent at the beginning of 1972; 1972 was an election year. The administration was strongly committed to spending money, getting the economy moving, and reducing unemployment.

As I pointed out in my opening statement, in January 1972, you were aiming at a $39 billion deficit. Now, you try to revise history and talk and moderating the rate of economic expansion.

Do you really, seriously, contend that social security payments produced the inflation we have had this year, or was the principal fiscal element in doing so?

Mr. STEIN. Mr. Vice Chairman, I have tried to make clear that I think that the causes of the rapid inflation in the first half of this year are numerous, complex, and interrelated. And certainly, I am not attributing the whole inflation—nor by implication any large part of it—to the social security change.

I would like to remind you of this, if I may: That when we were here a year ago, the prevailing testimony of economists from outside the Government, and I think the prevailing tendency of opinion on this committee, was that we were in danger of stepping on the brakes too hard; we were about to bring the expansion to a sudden halt and produce a recession.

Our policy changed in 1972. We started, at the beginning of the year—the latter part of 1971, the early part of 1972—with an effort to stimulate the economy rapidly. About May or June—I think you can see all our statements to this effect—we decided that the economy was beginning to rise and that the rate of expansion was getting very high, we were approaching a very high level, and that fiscal policy should turn.

As you remember, it was about that time that the President began very vigorously to talk about, first, the $246.6 billion expenditure ceiling, and then, since the various acts made that an infeasible target, a $250 billion expenditure ceiling. He went through great travail and agony and much skepticism of the outside world to hold the budget down to $250 billion. He did that; he succeeded in doing more than that.

I think you misquote me. I do not say that we had a drastically restrictive fiscal policy. I say the general trend has been to moderate the rate of economic expansion. Now, that is a very modest, cautious statement.

If you look at the rate of growth of expenditures quarter by quarter, you will see that it is moderate, except for that big lump we got in the fourth quarter of 1972, which is mainly due to the big increase in social security payments.

We are not claiming total innocence, but we do not like to be blamed for things that we are not on the record for.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Thank you very much.

First, Mr. Vice Chairman, I would like to express to the Council of Economic Advisers my appreciation for sharing their expertise with us. Though it is a requirement for you to come before us, we appreciate your availability in debate to enable us to shape our views.

Now, Mr. Stein, you are probably the leading figure in the administration who is constantly assuring the world that all of these price and wage controls are very temporary and that we are essentially dedicated to getting very quickly to a situation without price and wage control.

What good do you think that does to the economy, which is complaining bitterly about stop/go policies, that is, phase II, phase III, phase IV, all within a period of months? Many business leaders and labor leaders feel this uncertainty is simply upsetting everybody.

Why would it not be wiser to say, we have the controls; we will have them while we need them, and when we do not need them, we will take them off?

Why these promises that it is just very temporary?

Mr. STEIN. Well, I am flattered by your description of me as the leading figure in the administration taking that position. I think that role is held first by the President, and then possibly by some others before me.

And I think to a considerable extent again, we are victims of our history, because I think if you look at what we are saying and what we have been saying about phase IV, we are being much more cautious. We are not promising anything about the time or the termination of these controls.

But I would like to read what the President said. He said:

> Our experience with the freeze has demonstrated the essential difficulties of a controlled system, its interference with production, its inequities, its distortions, its evasions and the obstacles it places in the way of international relations.
>
> And yet, I must urge a policy of patience. The move to freedom now would most

likely to turn into a detour, back into a swamp or even more lasting controls. I'm impressed by the unanimous recommendations of the leaders of labor and business who constitute the Labor-Management Advisory Committee that the controls should be terminated by the end of 1973. I hope it will be possible to do so, and I will do everything in my power to achieve that goal. However, I do not consider it wise to commit ourselves to a specific date for ending all controls at this time.

We shall have to work our way and feel our way out of the controls. That is, we shall have to create conditions in which controls can be terminated without disrupting the economy, and we shall have to move in successive stages to withdraw the controls in parts of the economy where that can be safely done or where the controls are most harmful.

Well, I think that is saying what you said yourself.

Senator JAVITS. Well, Mr. Stein let us say, to use a lawyer's adage, because I happen to be a lawyer. It is never what the facts are, it is what the judge thinks they are that counts. And the general impression which I have and the business community shares is that the administration is promising an earlier end to controls than perhaps is desirable in terms of the economy, simply on the doctrinaire basis that we have got to get off controls.

Now, I gather you deny that, that is not true?

Mr. STEIN. I deny that, yes.

Senator JAVITS. OK. That's what I wanted from you because I notice even in your statement you say:

We believe that if we follow prudent fiscal and monetary policies we will reach a situation of reasonable price stability without price and wage controls. Moreover, we believe that long-continued controls will do great harm to the economy, a fact of which there is increasing awareness.

What interested me is there is nothing about that that is operative. I am questioning who is helped by that statement, what is gained except leading business into a state of complete uncertainty. Nobody is helped by it. Nobody is reassured. You yourself just denied it.

Mr. STEIN. I have denied that we are about to make a dash for freedom, or that we are about to make this move in a situation in which its results would be disruptive. I think there are several reasons for making this kind of a statement.

First, it is to impress people that it is imperative to follow a very fundamental policy which will create conditions in which it is possible to get rid of the controls, because it is not desirable to live with the controls. I think we have to recognize that things have to be done.

Furthermore, I do think that the business community needs assurance that they will not live with this business forever. I agree with you, they would not like to think that we are going to turn them off in November and put them back in February and so on, and that the precise date of their termination is not essential to them.

But I think for businessmen making plans for investment to pay off 5 years, 10 years from now, it is important for them to know that they are going to get back to a free market, or that there is a reasonable expectation that they will, and that is what we are trying to say.

Of course today we are besieged by cattlemen; they do not find our promise even that we are going to relieve them on September 12 particularly reassuring. So there is a problem to create an accurate picture of what the probabilities are.

Senator JAVITS. Well, Mr. Stein, I want to come to the cattlemen in a minute. I would like to ask you this just to finish off this line of questioning.

Could we agree that the administration ought to emphasize both elements of its policy equally; that is, that it will keep controls so long as controls are economically required by the situation, and that it will take them off when they are no longer required; but not this constant dinning which seems to take place.

Again, it is my feeling, and that of many others, well, do not worry about it; we will get through to free action without wage and price controls pretty fast now. Can we at least agree that both elements should be emphasized so that there is a section of the community, like workers, who will take comfort from the first, and a section of the community, like long term investors, who may take comfort from the second? But at least, shouldn't they be evenly put to the power?

Mr. STEIN. I think they should. I think the President's statement on that is very well-balanced.

Senator JAVITS. OK.

Now, let's get to the cattlemen. This is a big struggle between consumers and producers, because here is where consumers have to show some disciplines, otherwise prices will really run away. And the question I would like to ask you is to what extent is the President of the United States and the Department of Agriculture throwing itself behind advice to the consumer?

The consumer right now is going to go after the Government, and all of us, hammer and tongs, to take the freeze off beef. Now, it is very unwise economically to insist on that, but publicly it is going to go like wildfire.

My question: Why isn't our Government, our President under your advice, a leader in advising the consumer what is really at stake? Why the Government believes they should stay on, or why as many distinguished newspapers say, there's really no reason for it for another month, because all it's going to do is dam up the supply, and the situation is going to be the same on September 12, as it is today. So why fuss with it?

Now, could you answer us that?

Mr. STEIN. Well, I thought you were going to ask me a different question which is why aren't the consumers in here in the same numbers and forces as the cattlemen. I wonder why.

But it is my impression, of course, maybe I've watched these things more closely than some others, that the Secretary of Agriculture has said a great deal about this; perhaps we should say more. I think that the situation has reached a state of confusion where some clarification would be desirable, and I hope we will do that.

We spend so much time meeting with the cattlemen, we never get a chance to write anything, but I agree with your position; it needs clarification.

We are meeting with a large number this afternoon. I believe that we will soon issue some settling statement about it.

Senator JAVITS. Well, what do you think we ought to do, Mr. Stein? Do you think we ought to leave the freeze on or take it off, or what is your advice?

Mr. STEIN. Well, my advice is to leave it on.

Senator JAVITS. To leave it on until September 12?

Mr. STEIN. Yes.

Senator JAVITS. And what is your reason? This is the way to get it for the country, too. I'm not cross-examining you. I'm examining you.

Mr. STEIN. Yes.

Well, you have to go backaways, of course. We embarked upon the freeze. We first embarked upon the control of meat prices in the atmosphere of new hysteria in the country about what was happening to meat prices, what was happening to food prices. When we considered how we would disengage from the freeze, we thought that it was desirable to move out in phases; that is, not to have an enormous bulge in prices all at once, but recognizing that there would be a considerable increase in food prices to accept some of this earlier, and some of this a little later.

We decided that in the beef case, it was really possible to retain the controls for a little longer than in the case of poultry. And I really shouldn't be talking about this because Mr. Seevers is the expert. But let me just say a few things and I'll turn it over to him.

We decided to retain the controls on beef, but to remove the controls on poultry and hogs, because there we already had some considerable evidence that the freeze was causing a reduction in the breeding stocks, which would have an adverse, long-term effect on the supply; whereas, we were quite confident that retaining the controls on beef would not affect the long-term supply, but would only move some of the supply from before September 12 to after September 12.

So that all of the cattle that is not being brought to market now will come to market after September 12. There's nothing else to do with it, and there is no evidence that cattle people are reducing their long-range plans for the breeding and development of cattle.

We recognize there are going to be difficulties. The system is fraught with difficulties. We believe it will give us a somewhat smaller rise of prices. It will give us a somewhat more gradual rise in prices. We will get some reduction of prices. We will get considerable expansion of the supply of beef after September 12, which will moderate the beef prices which might otherwise occur then.

But I'd like Mr. Seevers to——

Senator JAVITS. The Chair has given me permission to let Mr. Seevers answer, too.

Mr. SEEVERS. I think Mr. Stein has covered it quite well. There is, first, the objective of spreading out the food price bulge that we knew was going to ensue as the freeze was relaxed.

It was obvious there were some areas like broilers, pork, and eggs where we needed to relax the freeze very soon. Fresh fruits and vegetables was another case, and the dairy sector was another case. So it looked as if it would be desirable to relax the freeze in broad areas of the food sector, but we said, well, if we do this all at once, we think the bubble will be so very large that it would have undesirable consequences.

So as a result, we kept the freeze on the margins for the full food industry, and we said that beef is a large component of retail food prices, and it does not look as if the freeze is going to do as much damage to the beef sector as it is in the other sectors, in the long run sense. No substantial number of breeding cows or calves were being slaughtered. And it just did not look as if the beef industry was going through a contraction like we obviously have gone through in broilers, and some others.

Then, as Mr. Stein said in the short run, we were aware that we might have some shortages, some withholding. We were also aware that consumers might accelerate their buying a little bit. And these two things could operate to create a certain degree of shortages. We did not know how severe those shortages would be, but we were aware that they could occur.

Senator JAVITS. Do I gather, if I may just finish the colloquy, that what the administration was urging the consumer to do was to show some discipline now, and do you feel it will help him in prices later? Is that a fair statement?

Mr. SEEVERS. I would concur with that.

Senator JAVITS. Thank you very much.

Senator PROXMIRE. Senator Sparkman.

Senator SPARKMAN. Well, how is the consumer going to show discipline? I can understand it in some respects. Someone told me the other day he saw a lady at the market who had bought $250 worth of meat, because she felt there was going to be a shortage. And I can understand that that it is not exercising much discipline.

But the consumer, the average family, has to buy sufficient food to live on. And by the way, I do practically all of the grocery shopping in my family, and I don't know any better place to measure inflation from a practical standpoint then right there in the grocery store.

Now, how can I exercise any restraint? I buy pretty much the same thing day after day after day. What discipline can I exercise? Buy less?

Mr. SEEVERS. No. I think in saying that we would like to have consumers exercise restraint, we would like to have them avoid panic buying or hoarding or spending $250 on meat in one day, in one trip to the grocery stores.

Senator SPARKMAN. I just heard that. I didn't see it. But when I go to the grocery stores, I see what the tab is when I go out with groceries. I just think the average consumer is faced with that situation, and I don't see where you get much room for discipline.

Mr. SEEVERS. Well, when you talk about the tab on food prices, you are measuring that as the main indicator of inflation in the country. We have become painfully aware that a lot of people do seem to measure inflation by how much it costs for their food, and indeed, that is one of the reasons why we said what we need to be concerned about, as we move out of the freeze, is trying to spread the bubble out, not have it all hit the consumer at once. Now, as we have seen, there is a good sized bubble, the consumer——

Senator SPARKMAN. You know, it disturbs me when I see pictures, or on TV pictures of cattle, livestock, generally, being held off the market, because I see they can't feed their stocks and sell them for the price that is allowed. I saw these little chickens being killed—one or two day old chicks—because they said they just couldn't afford to feed them. Eggs being broken and being thrown away.

I remember way back in the days when we killed little pigs and ploughed under every third row of cotton, that's always been a shocker to me or anything that smacks of that. I just wonder how we will get away from that.

Mr. STEIN. Well, Senator, of course, if they couldn't afford to feed the cattle, they would sell them. To keep them because they couldn't afford to feed them does not make sense. But to make a more general statement, we are faced and the country is faced——

Senator SPARKMAN. It's faced with what?

Mr. STEIN. The country is faced with a choice between—at this moment—the evils of inflation and the evils of controls, and there are evils on both sides of this thing. And we are trying to pick our way between those evils in a way which will minimize the harm.

We don't like this. We don't like to see the cattle held back, but we also do not like to see another surge right now in the price of beef. The beef, as we say, will come forward. There's no evidence whatever that we're losing the total supply of beef. We've taken steps which will prevent the drowning of chickens and the slaughter of the pregnant sows, and all those horrors with which we were confronted earlier.

And at a reasonable time—that is, on September 12—this, too, shall pass away, and all these cattle will come to market and the cattlemen can be assured that they will get the price that will compensate them. But that is a basic point that we have to tell the American people, that we cannot guarantee them any particular price level of food or even a price level of food that they are used to. They are going to have to pay the price for food which will make it attractive for that farmer to get out there in the hog lot, or wherever he does his work, and I understand it's not very attractive work. He has to be paid well for it.

The economy is thriving. He has lots of other opportunities and the city people are going to have to pay him to do that. It's a situation which we have hoped for over 30 years, 40 years to bring about. It came about rather in a rush which was uncomfortable to many people.

But I think that we would be kidding the American people if we told them we could issue some order here which would give them cheap chickens and so on and so on. As I said in a briefing the other day, if government orders could provide abundant low-cost food, the Russians and the Chinese would be feeding us rather than the reverse. But government orders cannot do this, and that is why we made the steps we have made, and we intend to make another step with respect to beef.

Senator SPARKMAN. I recognize it is a complicated problem, and I am not trying to be critical. But I am trying to think through as best I can the reaction of the ordinary consumer. We tell the consumer to be patient and to be moderate, to work this thing out; it is a difficult problem for the ordinary consumer to do it.

Now, I believe I saw it on TV recently, Secretary Butz testifying before some congressional committee, and I remember he made one statement that ran something like this; I can assure you we are going to continue to have beef.

The next day, I read in the paper that one of the leading beef restaurants here in Washington, which had a big business, was rationing 20 roasts a day, and that's all they could give.

Now, let me get to something else. I have been very much interested in the control program and the freeze. Of course, as you know, the Stabilization Act is under the jurisdiction of the committee to which both Senator Proxmire and I belong, the Banking, Housing, and Urban Affairs Committee.

I went along wholeheartedly with the original freeze, and phase II, and certainly I subscribed to the philosophy that we ought to get into a free market as soon as we reasonably can. But now looking back, do you not feel that we moved away from phase II too soon?

Mr. STEIN. Well, I would say yes, I think we did.

Senator SPARKMAN. What was that?

Mr. STEIN. Yes, I think we did.

Senator SPARKMAN. Of course, I know it's easier on hindsight, but I think that most of our committee rather felt, at the time, that we were moving away too soon.

Mr. STEIN. Well, I could explain at some length why we did it, but I would like to explain the sense in which I think the answer is yes, that we moved away too soon. I don't think that our movement away made any significant contribution to the speedup of inflation in the first half of 1973.

The forces that caused that inflation were not subject to control by phase II, and phase III is not that different from phase II. What we did in a way by moving away from phase II at a time when the economy was about to experience a rapid inflation, more or less inevitably, was to give decontrol a bad name. We gave ourselves a bad name. That was an unfortunate thing to do, and we gave the stability of economic policy a bad name.

So that in retrospect, I would think we would have been better advised to make some more gradual changes in the control system at that moment without saying we are now in phase III. But as you say, I hope we have learned from that.

Senator SPARKMAN. Well, are you satisfied with phase IV?

Mr. STEIN. Well, Senator, you always have to start from where you are, and given where we were on July 18, when we announced phase IV, I'm satisfied with phase IV.

Senator SPARKMAN. Well, I certainly hope it works, and I'm sure we all do. There are other matters I'd like to ask you about, but my time is up.

I would like to ask you, for instance, about this money crunch. It may not be for the whole country, but certain segments of it; housing is in a desperate situation, savings and loan associations are frightened to death almost. I wish I had time to discuss that. Maybe I will on the next round.

Thank you very much.

Senator PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman.

I particularly welcome Mr. Seevers to our exercises here, and say farewell to Mrs. Whitman, who is leaving for the university in a few days, I understand. You will remain ever green in my mind for the great job you did in helping close the gold window on August 15, 1971; a good piece of work. You are Mrs. Phase II as far as I am concerned.

That was one time when controls were well administered, so may the angels sing when you go back. We really appreciated you and your work so much.

Senator JAVITS. To which we all say amen.

Senator SPARKMAN. May the angels sing while we are weeping.

Representative REUSS. Well, you have added something.

Senator PROXMIRE. In case you missed that, Senator Sparkman said may the angels sing while we are weeping. We may not have economists on this committee but we have poets. [Laughter.]

Representative REUSS. Mr. Stein, back in January, when we had our hearings, you forecast that the unemployment rate by the end of 1973 would be in the neighborhood of 4.5 percent, and getting better. Do you still hold that?

Mr. STEIN. Well, yes I do, We're at 4.8 and I expect that we will see some decline from this point.

Representative REUSS. In other words, you disagree with Wharton which says 5 percent at the end of 1973, and 6 percent at the end of 1974; and with Data Research Institute which forecasts 4.8 at the end of 1973, and 5.3 at the end of 1974. You think they are too gloomy?

Mr. STEIN. Yes; particularly Wharton. I think Wharton is pretty much out at one end of the spectrum of forecasters at this moment.

Representative REUSS. You point out in your statement that the GNP deflator and the Consumer Price Index have moved fairly closely together. It is my own view that while the GNP deflator may now increase at a considerably slower rate, the Consumer Price Index is going to continue to rise more steeply throughout 1973.

Do you disagree?

Mr. STEIN. No; I don't. I would expect that the Consumer Price Index would rise more rapidly than the GNP deflator because of the much heavier weight given to food in the Consumer Price Index.

Representative REUSS. Speaking of food and of poultry, which you were discussing a moment ago, as of last January, poultry was reasonably priced. It was one of the few bright spots in the market basket, and production had been increased nicely by poultry farmers over the year before. Whereupon, Secretary Butz and the Department of Agriculture issued a very curious market letter to all of the poultry growers of this country urging them to cut down on their production of poultry, which unfortunately the poultry growers did. They heeded the advice, and cut production down on a year-to-year basis, very considerably, every month starting in February.

The fiasco in poultry that we now have is well known. Do you think the administration's January action was wise?

Mr. STEIN. You mean that marketing——

Representative REUSS. Incidentally, Mr. Vice Chairman, I ask unanimous consent that it be included in the record at this point—the January 1973 marketing letter on poultry by the Department of Agriculture. Also I ask unanimous consent that my newsletter of July 25, 1973, be included in the record at this point.

Senator PROXMIRE. Yes; without objection.

[The material referred to follows:]

[Published January 1973]

SECOND QUARTER, 1973, BROILER MARKETING GUIDE

(By the U.S. Department of Agriculture, Agricultural Marketing Service, Washington, D.C., PMG-30)

INTRODUCTION

This Broiler Marketing Guide is one of a series of guides issued by the Agricultural Marketing Service of the U.S. Department of Agriculture at the request of the broiler industry. The guide is intended for use by the industry in planning production to meet prospective demand. The guide, if followed, should help all segments of the industry develop realistic production and marketing schedules.

The production and marketing of an adequate supply of broilers at reasonable prices benefits both producers and consumers. The marketing guide for second quarter 1973 recommends a level of chick placements for broilers to be marketed and the number of pullets to be added to the hatchery supply flock to adequately meet prospective demand.

SUMMARY AND RECOMMENDATION

A higher level of economic activity, rising employment, larger social security payments, and unusually large tax refunds will boost consumer incomes to new record levels in the first half of 1973. Continued strong demand will likely result in somewhat higher average beef prices. Pork prices may also average above a year earlier. Broilers will continue to benefit from the strength in red meat prices.

Costs of producing, processing, and marketing in the second quarter of 1973 will be above year-earlier levels. A continuation of the higher feed ingredient prices could result in sharply higher broiler production costs.

Considering the prospective demand for broilers and expected sharply higher production costs, it is recommended that broiler meat production in the second quarter 1973 be reduced 5 percent from the high level of a year earlier. It is recommended that a further reduction of 10 percent be made in placements for marketing during Easter week to adjust for the usual seasonal drop in demand.

Longer term prospects are for broilers to face increasing competition from beef, pork, and turkey. As supplies of these meats—particularly pork—increase adjustments in broiler output will be necessary. It is, therefore, recommended that placements of pullet chicks for the hatchery supply flock be held to a level that will provide the same number of broiler chicks as a year earlier when they come into the laying flock.

NEWS FROM THE OFFICE OF CONGRESSMAN HENRY S. REUSS, JULY 25, 1973

BUTZ' SCARCITY POLICY IS CAUSING SKYROCKETING POULTRY PRICES

Rep. Henry S. Reuss (D-Wis.) said today that the 10 cent to 25 cents per pound increases in chicken prices that grocery stores are beginning to charge this week are a result of Agriculture Secretary Earl L. Butz' price-boosting efforts last January. The Agricuture Department in its "Broiler Marketing Guide" advised producers:

Considering the prospective demand for broilers and expected sharply higher production costs, it is recommended that broiler meat production in the second quarter 1973 be reduced 5 percent from the high level of a year earlier. It is recommended that a further reduction of 10 percent be made in placements for marketing during Easter week to adjust for the usual seasonal drop in demand.

Longer term prospects are for broilers to face incerasing competition from beef, pork, and turkey. As supplies of these meats—particularly pork—increase, adjustments in broiler output will be necessary. It is, therefore, recommended that placements of pullet chicks for the hatchery supply flock be held to a level that will provide the same number of broiler chicks as a year earlier when they come into the laying flock.

Following this recommendation, farmers decreased their broiler supplies steadily. Production—1972 compared to 1973—went down from 596 million to 556 million pounds in February, 653 million to 621 million in March, 624 million to 594 million in April, 715 million to 712 million in May, and 650 million to 583 million in June.

Retail poultry prices, which were about the only food prices which didn't rise dramatically in 1972, zomed because of the production cut. Chicken breasts, which sold for 75.4 cents per pound nationwide in 1972, were $1.00 per pound by April, 1973, and are shooting up to $1.10 to $1.25 per pound this week.

William E. Cathcart, poultry expert in USDA's Commodity Economics Division, told Reuss's office that the full impact of the production drop will not be felt until this September, when consumers can expect another ten cent increase in chicken prices.

According to Cathcart, USDA is still not encouraging increased production of poultry.

"The Soviet Union's Secretary of Agriculture caused high food prices last January, and has been sent to Siberia," Reuss said. "Our Secretary of Agriculture has been rewarded by President Nixon with new titles and honors. Questions, anyone?"

Mr. STEIN. No; I don't think it was wise, and I think we have established a system under which such actions, which come out of an enormous bureaucracy, as you know, will be exposed more to the anti-inflationary considerations. That was one of the reasons we set up the Food Committee of the Cost of Living Council, so that all of these actions could be reviewed from that standpoint.

In January we did that. I don't think you will find a more recent example. I hope not anyway.

Representative REUSS. Let me ask a question on international money of Mrs. Whitman, or you, or anyone.

We are in the unhappy position now where the dollar by everyone's account, including that of our Treasury is considerably undervalued. Foreign financial people and writers attribute this largely to two causes: One, the political efferts of the Watergate, and two, the economic policies which have been pursued here in the last few months leading to the inflationary movements which we have seen and a general lack of confidence.

The fact that we don't seem to be able to push the dollar up to its value—the value which the Treasury thinks proper, despite some attempts at rigging the market through intervention by the Fed—indicates that we are going to have a continuing problem of foreigners being unable to buy our soybeans, our proteins, our scrap, our lumber, our what-not at discount prices.

As they buy up our world-traded scarce supplies at discount prices, that tempts us, and we have succumbed to the temptation, to put on export controls which further generate loss of confidence in the dollar.

How do we get out of it? I would think that the only way to get out is to attack the two fundamentals that are bothering the holders of dollars throughout the world; namely, come clean on the Watergate—put an end ot that—and adopt different, more sensible domestic economic policies, and particularly through fiscal and monetary means show a determination to bring an end to inflation.

But I would welcome anybody's view on that. I think we are in a bad political-economic dilemma.

Mr. STEIN. I have never heard the question stated with quite so much objectivity, Mr. Congressman. But I would make a few remarks, and perhaps Mrs. Whitman would like to add something.

I believe there is some degree of uncertainty created in the outside world by the spectacle of what is going on here in the Watergate. We certainly hope that will come to an early and satisfactory end.

With respect to our domestic economic policies, I think we have been following policies which are conducive to a solution of our international problems. For one thing, of course, we have been achieving this great improvement in our balance of trade, as far as we see in our current accounts in the last three quarters.

Representative REUSS. I rejoice at our improved balance of payments position. But that makes it the more ironic that the holders of dollars do not want to hold them, and it adds to the evidence that what is really at the bottom of this sickness is one part Watergate and one part domestic inflationary policies.

Mr. STEIN. Well, I think all you can really say is that there is obviously an unwillingness to hold dollars. Whether the cause of this relates to Watergate or to feelings about our domestic policy, I do not think anybody is in a position to say.

What I was going to say is that I believe that the evidence of continued improvement of the U.S. balance of payments will convince people—after all, the improvement is fairly new—that the dollar will strengthen.

What is required is that this belief which most of us share, that the dollar has been undervalued, should become much more firmly held than it is now so that people are much more willing to bet on it. We are taking strong fiscal measures; we are taking strong monetary measures.

I think that the extent to which interest rates have been permitted to rise in this country has been helpful from the standpoint of our balance of payments, although it does expose us to a good deal of criticism at home, not least from the Congress; and that we have a more forceful anti-inflation policy from the control character that any of the countries to which currency is flowing.

I think this will all become clear. One of the reasons why we are so determined to follow a monetary policy of restraint, a fiscal policy of restraint, and a tough control policy is to disabuse people of the idea that the U.S. inflation is out of control and will run at a more rapid rate than inflation in other countries. As a matter of fact, our inflation is not running at a higher rate than most other countries; and I do not think people who have studied these matters expect that it will.

Obviously, we suffer from a considerable lack of confidence. As I pointed out in the President's message, we do not think we can deal with that very much by talking about it. We think we can deal with it, as you suggest, by sound domestic policies.

We believe they are valid policies, and perhaps Mrs. Whitman would like to say something.

Mrs. WHITMAN. I think Mr. Stein covered it fairly thoroughly. There is one, perhaps, slightly technical point which I would like to make, and that is, when we are in a situation where countries, or at least many countries are not intervening in the exchange markets—that is, when the rates are floating as they are now—as long as we have a deficit in our basic transactions, even if that deficit is shrinking as it is, as long as a deficit exists at all, the value of the dollar will tend to decline unless something else happens to offset that.

So I think that is part of the situation.

Now, I think it is also true the dollar has declined somewhat more than would be explained by this phenomenon alone; and I think that that is probably due to countries trying to reshuffle their assets; that is, some effort, some—you could call it loss of confidence, what you will. The dollar is regarded not as attractive an asset as it was; and I think there are many factors involved in that. You have mentioned some of them.

I also suspect that the rather rapid rate of change and transition in the international monetary system, necessary and I think ultimately beneficial though it is, is probably also one of them, simply because people do not like that uncertainty.

But the fact still remains that it is not until and unless we get some combination of an actual surplus in our basic accounts, which I think we are moving toward but we are not there yet, and/or an actual inflow of capital, short term capital, that we will see a reversal in the decline of the dollar.

Representative REUSS. Thank you.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Mr. Stein, I would like to get into the food problem, but I want to get into it in a little different way than other members have. We do not seem to have any kind of a long term strategy on our food problem, I am referirng to the international food problem particularly. It is understandable why we have not been able to adjust very rapidly to it.

For years—this is adressed to both you and Mr. Seevers—this country had, by and large, surpluses of food production; we had more than we could use. For years our problem was low farm prices, and now all of a sudden we have a dramatically different situation. I think that we simply have not developed an appreciation of how unique the situation is now and how long term it is.

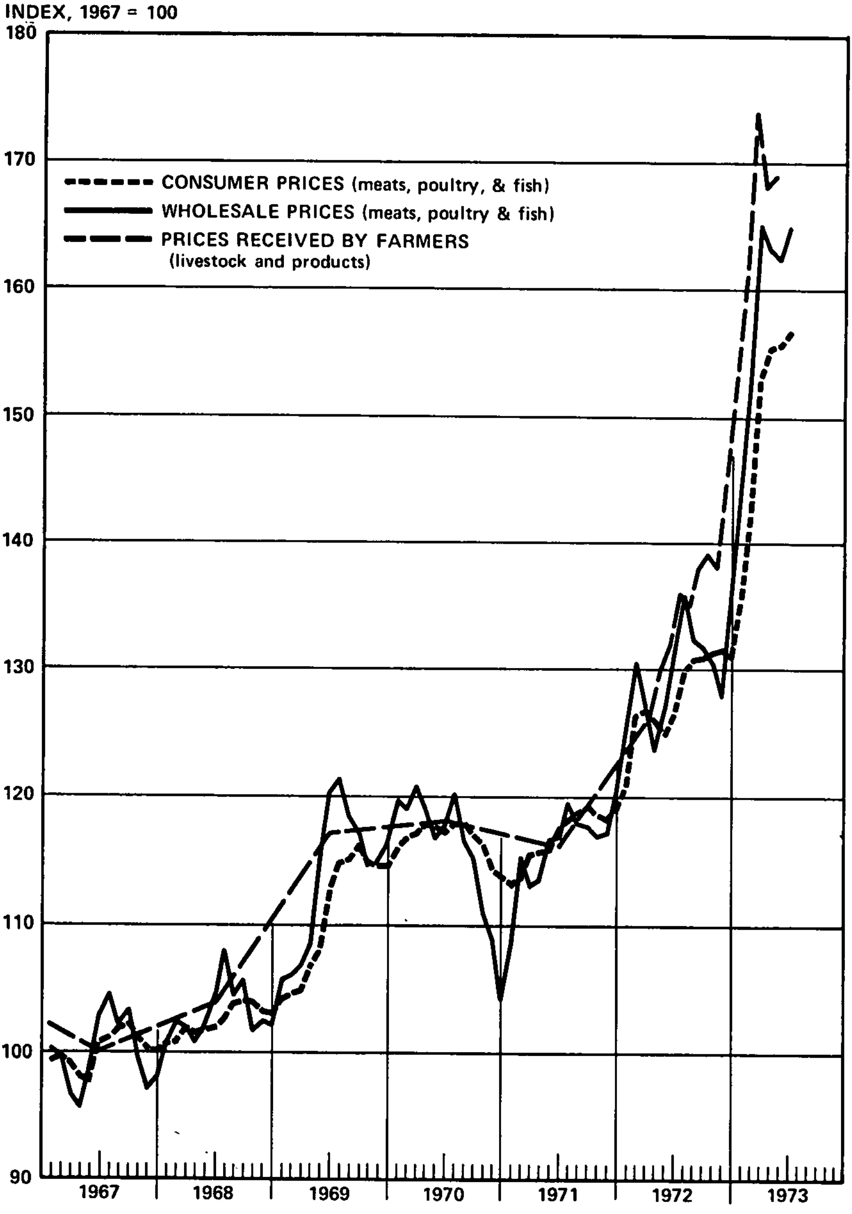
Mr. Seevers did a fine job when he appeared before our Banking Committee; but at that time I got the impression that he felt—and perhaps he can correct me—the situation now was something similar to what it was at various times in the sixties. I think in 1967 and 1969 he felt we had a fairly similar situation.

I am going to show you some charts here, because I think they dramatize clearly what has happened. The first chart is a chart of meat protein prices; it indicates how sharply they have gone up in the last 6 months of 1973. The second chart is a chart of U.S. exports of wheat, corn, and soybeans; it indicates how sharply they have gone up at the beginning of 1972.

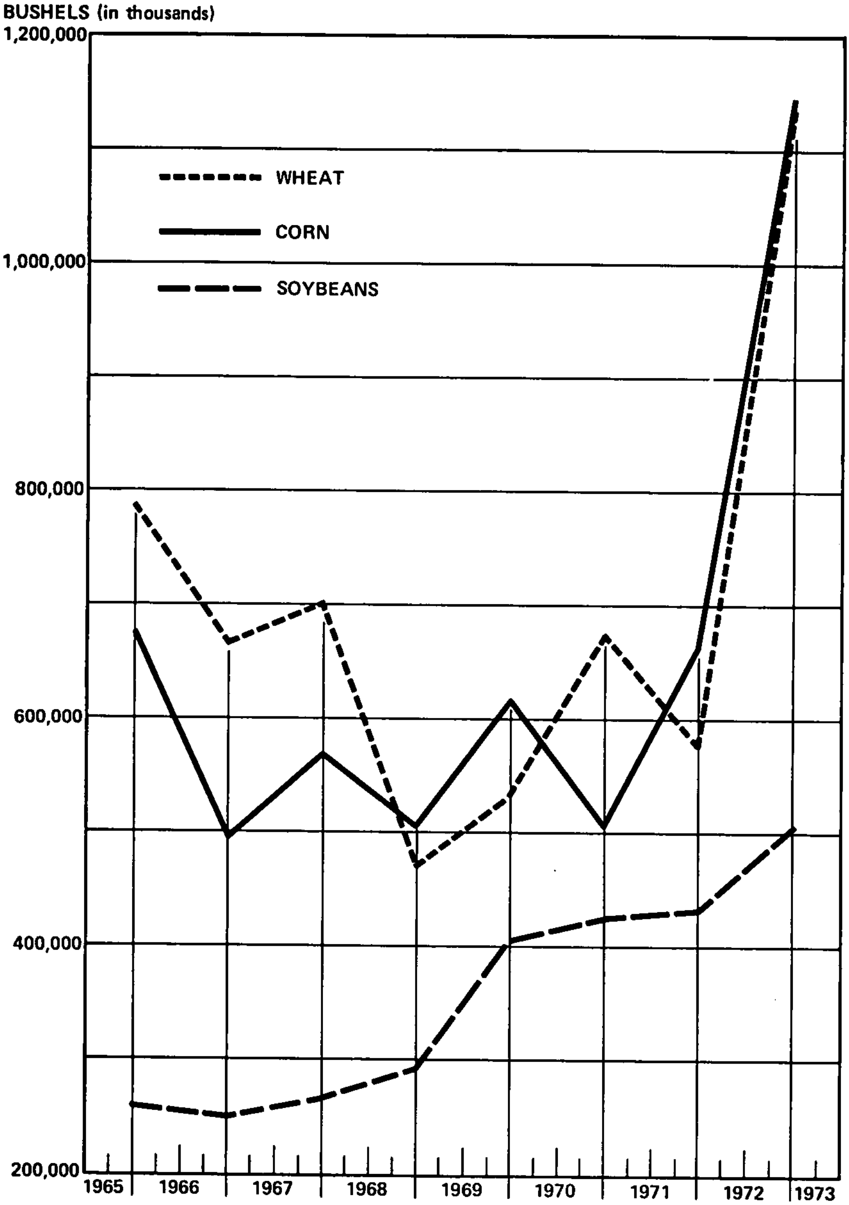
Without objection, the charts will be placed in the record at this point.

[The charts referred to follow:]

MEAT PROTEIN PRICES



U.S. EXPORTS


BUSHELS (in thousands)
1,200,000
1,000,000
800,000
600,000
400,000
200,000
WHEAT
CORN
SOYBEANS
1965
1966
1967
1968
1969
1970
1971
1972
1973

Senator PROXMIRE. Now, there just is nothing like this that have ever happened in our history before. I have here the President's Economic Report that goes back to 1929. I am sure if it went back 100 years we could not find anything of the kind that we have here.

We have a remarkable increase in meat protein prices. This is consumer prices for meat, poultry, and fish; wholesale prices for meat, poultry, and fish; and prices received by farmers uniformly up, and uniformly up so much more sharply than ever before as to dwarf what happened in 1967 or in 1969 or in any previous period; and so as to dwarf anything that had happened in prior years.

We had a big increase, of course, right after World War II, nothing like this. We had an increase of 16 percent one year, 17 percent another year; but this is an increase of more than 40 percent in the last year. Of course, this has not been reflected as yet in the price the consumers are paying, but it is going to be reflected and going to be reflected very emphatically.

What concerns me is we do not seem to have adjusted our policies to account for this. As Hobart Rowen pointed out last Sunday, we are still spending $12 million a year, as I understand it, to promote the sale of our agricultural products abroad. Now, what sense does that make?

And what other policies do we have to recognize the fact that in Europe and in Japan there is not just a this-year increase in demand for our products, but there is obviously a permanent, long-term, almost quantum jump in demand for protein. Because the United States is the only big producer of agricultural products, especially protein products, that we export in a big way—Canada to some extent, but this country primarily—we better have a policy to adapt to this. And I do not see anything like that emerging.

Mr. SEEVERS. Well, I think there are really two dimensions to your question. First, I think that as far as what is going on within the United States, or the factors underlying those price charts, we are responding. We have done a great deal to encourage protein production in this country. You may know that soybean production, if yields are normal, will be up 24 percent this year; and that is a pretty good sized response.

Senator PROXMIRE. Let me interrupt right there. No. 1, it is true that soybean production is up, but is it not also true that that increase in production is likely to be limited in the future because of the fact that we have such a large proportion of our acreage already planted in soybeans. No. 2, from a technological standpoint we have not made any breakthrough in the soybean area where we are able to get higher yield per acre.

We have worked hard on it, but there is no indication that we are going to be able to get much increase in production of soybeans.

Mr. SEEVERS. Well, I think at some price we could get a lot of additional soybean acreage. One possibility is that it might come out of acreages of something else that we also need. So it is not as if we have reached a fixed upper limit on the amount of soybean acreage, but we are approaching pretty much full utilization of our acres. However, we have not reached it yet.

As the Department of Agriculture has already announced, we are going to have zero acres set aside for 1974, so we are really, I think, responding to the maximum extent we can to try to bring all available acres into production.

It is true that the yields of soybeans are fairly static, and we do need a technological breakthrough there. Maybe we should be spending more for R. & D. in that area. It is a tough research problem.

Senator PROXMIRE. Let me shift you over to the foreign demand though. Why is it that we are spending the sum promoting the sale of agricultural products abroad?

Mr. SEEVERS. Could you tell me what the sum is?

Senator PROXMIRE. $12 million.

Mr. SEEVERS. $12 million. Well, ever since World War II we have been in the position of trying to expand our markets abroad. I think this has been in the interest in the country.

Senator PROXMIRE. Well, it has been up until now, but certainly in the last 6 months it has not been; and that should have been brought home to the administration long before August 1973.

Mr. SEEVERS. Well, I expect that $12 million was for fiscal 1973. That was probably budgeted over 1 year ago, and probably was spent on missions that were planned maybe as much as 1 year ago, missions and activities abroad.

Senator PROXMIRE. It is my understanding that there has been no change in that budget.

Let me point out the other serious aspect of this—the attitude that our customers for U.S. food are likely to have toward our recent policies. That indicates how exports have soared beyond anything in the past for wheat, corn, and soybeans. Soybeans is a smaller increase, as you know. Wheat and corn has gone up through the roof—a billion bushels, a fantastic increase.

Now, in addition to that, we have commitments for the rest of this year which are very large; in wheat, 915 million bushels; corn, 841 million bushels; soybeans, 474 million; and we are only 1 month really into the fiscal year, into the 1973–74 year. So it would seem that our exports are likely to be much higher than that.

The trouble is the administration has stressed that they see no need for export controls once the new crop is in this fall, and this is contrary to the advice we have gotten from other agricultural experts, other than yourself. Mr. Seevers, who have come before this committee and the Banking Committee to argue that this is a long-term situation, and there is every reason to expect that the one reliance we are going to have if we are going to hold down food prices in this country is a rather strict and painful and even cruel export controls well into 1974.

Mr. SEEVERS. There is a great inconsistency, I believe, in what you say. If this is really a long-term problem, I do not think we want export controls, because we are going to have to adjust to international markets, or we will have insulated ourselves from the rest of the world. As Congressman Reuss points out, that has implications for other parts of——

Senator PROXMIRE. Yes, but adjustment is a matter of doing it, I would think, with some recognition of the effect on consumers. If we are going to have a situation where we are going to export such a tremendous increase in our exports, diminish these for the supply available, because we cannot increase our production anything like to meet the demand in Europe, we are going to have to have rationing or enormously high prices, which is a different kind of rationing.

Is that not right?

Mr. SEEVERS. Well, you referred to the President's statement. I think that is the first and last word on the subject. I could read it, but in short it says unless we are seriously disappointed on domestic production of these crops, which are all expected to increase; or unless foreign demand is unusually large, which means probably substantially above last year's exports, we would not intend to go to export controls. But it does not rule them out altogether under any kinds of circumstances.

Senator PROXMIRE. You are an extraordinarily able agricultural economist. Are you satisfied with the kind of intelligence we are getting on the nature of the demand in Europe and Japan and elsewhere in the world for our protein produtcion and on the capability that we have to expand our production?

We have been able to expand it at times in the past, but the information that I get seems to be different from the information that you get. We get it from very competent economists who have served in other administrations, who tell us in their view we are very likely to get a situation where the long-term demand is going to expand with great rapidity, and that we do not have the capacity to meet it—world demand, international demand.

Mr. SEEVERS. Well, I think they are using the same basic information as is available to us. They are simply drawing somewhat different policy conclusions.

But in response to your specific question, I am not satisfied with the intelligence we get, the basic information we have on foreign demand. That is currently a very open question. We have estimates that range from 950 million bushels of exports of wheat without controls, which is 200 million bushels less than we exported this last year, ranging up to 1.4 billion bushels of exports. So that is such a wide range that it does mean that there is an enormous amount of uncertainty as to what domestic prices will be, because that much difference in exports makes a huge difference in domestic prices.

Senator PROXMIRE. You indicated that it would be inconsistent for us to have export controls if this is a long-range problem; and I understand that. I think that is an excellent point, but that means you have to have some other strategy; you have to be prepared to ration perhaps under some circumstances. You have got to be prepared to go to something or accept a very sharp and painful increase in prices for the American consumer, do you not—under the assumption that we are going to have an increase in demand that exceeds our capability of meeting it.

Mr. SEEVERS. Yes.

Senator PROXMIRE. Which is certainly a possibility, if not a probability. Mr. Cochran indicated he thought that was at least a 50–50 shot.

Mr. SEEVERS. Let us assume that we are in for 5 years of very high export demand for our grains and soybeans. There are various options. One is to control exports. My judgment would be that that would not be good over an extended period. Another is to have some form of internal control system, or rationing; I guess that would have to be complemental with export controls. Another possibility would be to go through a price adjustment. Prices do ration; even in agricultural products, they do ration.

I think a strong case could be made under this hypothetical circumstance that allowing prices to go up so that we are consistent with the prices in the rest of the world would be the appropriate policy on a long-term basis.

Senator PROXMIRE. You are the first administration representative and spokesman who has indicated that as a distinct possibility. And I think it is honest, and I think it is right. I do not think the policy is necessarily right, but I think that is right to say that that is a possibility. I think the consumer ought to be prepared for the significance of that—a long-term sharp rise in the price of food for the American consumer—so this is not something that they can expect necessarily to be terminated in 1973. It is something that could go on to 1974, 1975, and find instead of spending 16, 17 percent of their income on food, they may be spending 20 percent, which would be a very very painful adjustment with a terrific amount of protest; a great deal of difficulty, seems to me, on the part of the administration, the Congress, and others, and a real battle.

Mr. SEEVERS. I think it is very easy to overstate the potential dimensions of this problem, because I think it is easy to understate the production response in this country. With the kind of prices we have for soybeans and feed grains now, I think farmers are inventive enough to figure out ways to expand production. I think there is, at least at these current price levels, a lot of scope for expanding domestic production, which would subsequently bring prices down below their current level.

Senator PROXMIRE. My time is up. I certainly hope you are right. I hope and pray you are right. I think there is this other possibility: That we should be prapared for and ought to consider options other than this option, that is going to have a terrific political repercussion as well as economic repercussions as a kind of increase in food prices.

Would you like to comment, Mr. Stein?

Mr. STEIN. I would like to speak of the schedule this morning, because all this talk reminds me of my luncheon appointment, and what is your thought——

Senator PROXMIRE. I think we could go on for another half hour, unless you have an imperative appointment that you have to——

Mr. STEIN. No. That is fine. Thank you. I just wanted something certain.

Senator PROXMIRE. Maybe a little bit longer than that. I hope not. Senator Sparkman.

Senator SPARKMAN. Thank you, Mr. Vice Chairman. I will do my best to cut it short, but I do want to ask some questions for Senator Javits who had to leave. Here is one particularly he wanted to ask, and I want to hear the answer to it, too.

These are Senator Javits' words:

> NBC this morning gave an account of the effect which beef price freeze is having on U.S. meatpackers. Apparently, a large amount of beef which formerly would have gone to U.S. packers is now being bought up by Canadian packers, who in turn export the cut meat back to the United States.

And he adds a note:

> Imported beef is exempt from the freeze. The news accounts said that Canadian packers are making 23 cents a pound off the U.S. beef. What are you doing about this?

Mr. STEIN. Well, this point was brought to our attention on Monday afternoon when Secretary Butz and I met with a number of people from the industry and were invited in by Senator Curtis; and we are looking into it. Of course, if it is significant, steps can be taken to stop it.

I think the thing that has to be pointed out is that although the imported beef is itself exempt from control, it is at succeeding stages of distribution under control. That is, the freeze on the retail price of beef remains, so that if some New York supermarket buys beef routed through Canada and pays 23 cents or something over the Omaha ceiling price, he cannot pass that on; he must absorb it. And the exemption does not extend to the retail price, or if it is a restaurant, as I suppose it may be, to the restaurant price.

We are looking into this. We do not know its magnitude. But it should be stopped, I am sure.

Senator SPARKMAN. Thank you very much on that.

Now, let me ask you some very brief questions with reference to the present monetary situation. Of course, you know that we have had a great drop in the production of housing. Last year we produced 2,378,500, according to the index; that includes farm housing as well as urban housing.

I do not see anything here that would indicate what the annual projection would be, but I saw a projection the other day. I believe it was 1,700,000. Whatever it was, we are certainly far below our average production; and there is great concern with reference to housing at the present time. Mortgages, interest rates on mortgages are almost prohibitive; and, in fact, as you know, some of our housing programs have been eliminated, some of them are frozen.

Personally, I am very much concerned; and I know that a great many people throughout the country are greatly concerned about the housing situation.

Now, let me just say this. In the 1966 and 1967 money crunch, housing was hit terribly hard. Governor Mizell, testifying before our committee, made a statement something like this:

> That even though the building industry constituted only a very small part of the GNP—my recollection is that it is around 2½ to 3 percent; I will not vouch for that—that housing took 70 percent of the impact of that money crunch.

Now, we had another in 1969 and 1970. Housing fared better in that one, but still it was perhaps the heaviest hit of any part of our industry.

Are we going to continue to do that, and what is coming out of this present money crunch? I think it is fair to call it that.

Mr. STEIN. Well, let me say several things first about the facts. The decline in housing starts so far has been quite small. Housing starts by June were 2.1 million at an annual rate; the average for the second quarter was 2.2 million; and those are rates which are far above the average for the past 10 years or any amounts of moderate length. They are only down a little. The most we had was 2.5 million in 1 month in early 1972, so we have not yet had a very substantial slide in housing starts.

And furthermore, we do not foresee a decline to a number such as you suggest; 1.7 million I believe you said. We do foresee some decline from our present rate. We think that the rates which we have been experiencing were exceptionally high, and that in a period when it is important to bring about some slowdown in the rate of economic expansion some part of this will inevitably by borne by housing.

As you suggested in 1969 and 1970, the tightness of money did not bear on housing to the extent that it had earlier. We do not think in a future period of tightness the pressure, downward pressure on housing, would be as great as in the past for several reasons. Partly because we have greatly strengthened the access of housing or of mortgages to the credit markets through the mortgage banks, through Fannie May, Jennie May, and through the ability of the Home Loan Bank Board to borrow and to put money in the savings and loan and so on.

Of course, since you were the author of most of this legislation, you know we have an enormous array of new instruments to shelter housing somewhat from the blast of monetary tightness. We do not foresee what you call a crunch. We are having a period of high-interest rates. We expect this will go on. Of course, high-interest rates are also relative to the high rates of inflation. When you have a 6-percent rate of inflation and a 9-percent interest rate, it is not such a terribly high interest rate.

But we do regard this as a sensitive factor for the behavior of the economy of the next year. As I said at the very conclusion of the statement, we do recognize that we have to be alert to the possibility that things will not follow the path we would most desire. And we feel this particularly about the housing thing, so we do have room for people who are involved in either watching, or financing, or having something to do with housing; who are observing this with the thought that if a problem should attain these very critical dimensions, some further intervention might be necessary. But of course, I do not think you would want to commit the Government to maintaining a rate of housing starts at this absolute peak of 2½ million.

Senator SPARKMAN. You are familiar with the recent action taken by the Federal Reserve Board authorizing as much as 8-percent interest on certificates of deposit for 4 years in units as low as $1,000?

Mr. STEIN. Yes.

Senator SPARKMAN. Has it been called to your attention the great disturbance that has caused the savings and loan associations throughout the country?

Mr. STEIN. It has been called to my attention that the savings and loans are calling to our attention that they are feeling great disturbance. We do not see the evidence of this great disturbance.

The fact is that, of course, the initiation of the certificate was a joint action in which the savings and loans, and the mutual savings banks, and the commercial banks were all permitted to pay more for funds. This was a device which was important to keep funds in a financial institution, including a savings and loan.

The problem of the savings and loans, as I see it, and of those other institutions which finance mortgages, in this period has not been that they have been losing money to banks. They have been losing money to the open market. There is a market out there where you can buy Treasury bills or Treasury notes or a lot of other things at a rate which is freely determined and which has been rising.

So if you keep a lid on the financial institutions, obviously, they are going to lose a lot of funds. But so far, the loss of funds by the financial institutions have been quite moderate and does not seem to take the form of a flow from the savings and loans to the commercial banks.

Senator SPARKMAN. Well, you know that up until this recent action there was a differential in favor of the savings and loan associations over the banks in the interest rates that could be paid on long-term certificates of deposit. Now it seems to be turned around.

The complaint that comes to me—and it comes from savings and loan associations all over the country—has been—the Chairman of the Federal Home Loan Bank Board and one of his Board members came up to talk to me about it when it first came out. And many, many savings and loan associations say they just cannot live under the present——

I will say this. Mr. Burns has definitely promised that he is going to watch it very carefully, and if their threats do become real—in fact, he has modified his position a couple of times, I believe, in relation to this; and he does say he is going to watch it very carefully.

But savings and loan people are scared. Of course, they have portfolios and mortgages; perhaps they vary 5 percent, $5\frac{1}{2}$, 6 percent. I dare say they have very few much more than 6 percent.

Mr. STEIN. Well, I think the average earnings on their portfolios has increased enormously in the past several years. I am sure you know that the number of industries that can come here with the immediate prospect of their going out of business is entirely inconsistent with what happens in the American economy.

Senator SPARKMAN. Well, I do hope you will watch it carefully, because it could be a dangerous thing.

Mr. STEIN. We are.

Senator SPARKMAN. Thank you very much, Mr. Stein.

Senator PROXMIRE. Congressman Brown.

Representative BROWN. Thank you, Mr. Vice Chairman.

I would like to talk to you just a little bit about the agricultural food situation. In your statement you indicate that you do not expect agriculture output to be declining too continuously, but you expect it to resume its growth.

When do you anticipate that improvement in agricultural output? With this year, with next year's harvest; at what stage?

Mr. STEIN. Well, fortunately, Mr. Seevers can answer that.

Mr. SEEVERS. We have gotten to a very low level in the second quarter when beef production was down 10 percent, compared with last year. So our base is at a low level to begin with. I think we will see some improvement during the rest of this year; not as much as we would like, but some improvement; it will probably be some time in 1974.

Senator PROXMIRE. Would the Congressman yield just for a minute? I am terribly sorry to interrupt, but that is a rollcall, and Senator Sparkman and I have to go to the floor.

I will be back because I do have some questions I would like to ask; and I am going to turn the committee over to Congressman Brown while I am gone. But I do hope you will remain.

Representative BROWN. Mr. Vice Chairman, I appreciate that. Do not count on my being here when you get back, because I have to walk clear back over to the House side as I usually do when we have these hearings. We may have a quorum call. So if the witnesses are here alone, it is because we are having the meetings continuously on this side of the Capitol.

Senator PROXMIRE. Well, if the witnesses would remain, I will be back.

Representative BROWN [presiding]. To which I might say House members have objected without any relief; but please go ahead.

Mr. SEEVERS. I was stating that I think it will be some time in 1974 before we really see a substantial response in the domestic food supplies due to the higher prices. There are lags in the food production system, and it takes a while; so I would not promise improvement too soon.

Representative BROWN. You are anticipating what, 1974 harvest or 1973 harvest, as an upturn area?

Mr. SEEVERS. We will have an upturn in production in the 1973 harvest. It will be 1974 before those good harvests get translated into increased supplies of milk, broilers, eggs, red meats, and so forth.

Representative BROWN. In my part of the country a lot of farmers do not believe that that is likely to last; that the prices are likely to last very long at the levels that they are. Or they are feeling conversely that their costs are so high, particularly in the areas of grain costs, or any feeding of meat, poultry, or that sort of things; and they do not trust the managed economy now because they feel that somebody in Washington may slap some kind of controls on them. So a lot of them just are not taking advantage of the high prices that they might otherwise receive for their products, and they are not planning to expand their production.

Now, the question I guess I am really asking is, are you finding that agriculture responds well to a managed economy or not?

Mr. STEIN. Well, I think they respond well in the sense that they respond efficiently and gradually; but we are not great defenders of a managed economy. We know we have put the agricultural economy through several unnecessary loops by this policy.

We have felt that—as I have said earlier, before you came—we have been balancing two considerations; one, the great anxiety, amounting almost to hysteria in the country about food prices. To a considerable degree, if I may say so—this anxiety and this hysteria has been evinced by the Congress. The second consideration has been our desire to insure an adequate food supply.

So we, throughout the first year and a half of the price controls, resisted control on nonprocessed agricultural products, despite repeated demands that we impose such controls, because we thought it was counterproductive from the standpoint of supply and ultimately from the standpoint of price.

Finally we found ourselves unable to withstand that. We felt it necessary to do something about the great anxiety in the country, and we have done something. But I think that our fears about the consequences of controls applied to basic agriculture have been justified; and we are withdrawing from that area.

We are preparing to tell the American people, or we have been telling the American people, that they will get food by paying for it, the price that is necessary to the production; and that no orders by us will get them food in any other way.

We hope to withdraw to that position in an orderly manner; but that is where we are going.

Representative BROWN. Well, now does that infer—my next question was going to be what do you think you could do that you have not already done to stimulate increased food production.

Is there anything else that could be done at this point?

Mr. STEIN. Well, we had a little discussion of this earlier. Also, of course, the Secretary of Agriculture has announced there will be no set-aside of acreage from production. The announcement followed a very substantial expansion of acreage available for production by action taken earlier. But now the Secretary said there will be no further set-asides for the 1974 crop.

But one of the most important things we could do would be to get agricultural legislation which did not constantly confront us with the choice between holding back agricultural production and running huge expenditures for agriculture in the budget.

That is a matter that Congress deals with all the time, of course.

Representative BROWN. You are talking about the escalator clause in the proposed agriculture legislation?

Mr. STEIN. Well, I am talking about any legislation which sets a floor to agricultural prices and——

Representative BROWN. Well, I understand the administration has agreed to that, to the compromise that has been reached on that and included a further escalator.

Is that correct?

Mr. STEIN. Well, whether the administration has agreed, I am not sure; but as we have said, this is an open administration. We have not all agreed with the same degree of enthusiasm. And, of course, we agreed because we could not get our preferred solution.

Mr. Seevers was talking earlier about the possible need to promote more research and development in certain aspects of agriculture; but we do think the agricultural economy is very responsive to relative prices. That we have seen all the time. And the price system, if allowed to work, will generate great expansion of output here. Also, of course, it is generating expansion of output in the whole world; and this is a world problem.

We are now seeing, of course in percentage terms, the enormous increase in the output of soybeans in Brazil. It is not only the American farmer who responds to prices.

So I do not despair of the ability of a society to produce food at a reasonable price.

Representative BROWN. I am going to ask you a bit easier question. Could you tell us now what your feelings are concerning the type of fiscal policy that the country should pursue over the next four quarters, the next year?

Mr. STEIN. Well, we have set forth a goal of balancing the budget—some people call it the actual budget as distinguished from the full employment budget—in fiscal year 1974.

Representative BROWN. Now, does this represent a retreat from the full employment budget principle?

Mr. STEIN. No. I cannot say it is an advance.

Representative BROWN. Well, do you want to explain the distinction?

Mr. STEIN. Of course the President has never described a full-employment budget principle in any other way except to say that the expenditures should not exceed the revenues that would be realized in full employment. He has never said that the expenditures should equal or that the expenditures should not be below revenues that would be received at full employment; because he has never ruled out the possibility of surpluses in the budget on other than the full-employment basis.

Representative BROWN. Does that square with Keynesian economics?

Mr. STEIN. Well, it has been a long time, and I just do not know, because that is a concept that did not exist at the time. The concept of a full-employment budget barely existed, and I do not think he knew about it.

Representative BROWN. Well, if I may, I was under the impression that Keynesian economics had this sort of an unknown part about how it would be nice to pay off your debt when you have the money; but you hear so little about it, I guess it has been lost in history.

Mr. STEIN. Well, Keynesian economics I suppose, to use that term, implies that the proper size of a deficit or a surplus is a variable which depends on the state of the economy. And what we are saying is, in accordance with that we are now at a state of the economy where we ought to have a balance in the budget as ordinarily defined. We ought to have a surplus in the full-employment budget for two reasons, one real and one psychological, and that is becoming a very fine distinction. First, we do want to exercise some restraint on the rate of expansion of the economy. Second, as we were saying earlier, we do suffer from a lack of confidence in our policy, perhaps from a failure to understand our policy; and the idea of balancing the budget does have a certain intuitive appeal to a great many people as an indicator of soundness in economic policy, and we want to do that, especially given the fact that it is a circumstance in which even a Keynesian would call for a balanced budget.

Representative BROWN. Could you give me some projection of what those figures ought to be over the next four quarters, either in terms of surplus or achievement of balance, or hopefully even full figures—the income and outgo at the Federal level.

Mr. STEIN. Now, I cannot give you quarterly figures about that.

Representative BROWN. How about a target figure, or a figure based on a full year?

Mr. STEIN. We have said that we think that the receipts, or reasonable estimates of receipts should be in the neighborhood of $268 to $269 billion; that we would like the goal to be to hold expenditures to about that level. The President's initial proposal was for a budget of $268.7 billion for fiscal year 1974; that was in January. Since then a number of things have happened which would tend to make the outcome higher by several millions of dollars.

So what is involved in balancing the budget is cutting several billions of dollars. I guess I cannot be very much more precise than that, about what would probably happen if we do not make this determined effort.

Representative BROWN. But you cannot put your finger on any particular figure, is that what you are telling me?

Mr. STEIN. With respect to total expenditures I would say that what we are looking for is to get the total down to something like $269 billion.

Representative BROWN. What do you anticipate revenues will be?

Mr. STEIN. We anticipate the revenues would be about that. That is why we are looking for that expenditure figure in order to balance the budget.

Representative BROWN. Does that cover the fact that, in your estimate, revenues have generally been running ahead of predictions?

Mr. STEIN. This is a considerable rise in the revenue estimate, apart from what is based on the fact that in the first half of the year the revenues were running ahead. So we have taken that into account.

Representative BROWN. What about monetary policy, Mr. Stein? What would you ask if you had your choice of monetary policy?

Mr. STEIN. We have been having a rate of monetary expansion over recent months—let's say 3 or 4 months—which I would think is excessive. From the table that is in our statement, we show from about the fourth quarter of 1972 to the second quarter of 1973, money supply in its narrow definition increased at an annual rate of 5.8 percent. It seems to me that that would be a fairly satisfactory rate at which to level out. We have been going a good deal faster in the last few months.

Representative BROWN. You would like to have it stabilized at about 5.8 percent or 6 percent for the next year?

Mr. STEIN. I guess 5.8 percent is the number here. I cannot identify it with such precision, and we do not know it very well. But I would say that the neighborhood of 6 percent would probably be a minimal target.

Representative BROWN. Thank you, Mr. Stein.

Senator PROXMIRE [presiding]. Mr. Stein, I hope you will take another good, hard look at the housing starts for next year. I think you are being much too optimistic. Everything that I have been has indicated that we are going to have a serious housing recession, and there are a couple of reasons for that.

For one, we have got a suspension of approvals for subsidized housing, representing a very large part of the housing market. When we had the last credit crunch, housing was insulated, in part, because the subsidized housing continued and, in fact, expanded at a rather rapid rate. Conventional housing went way down. That was in 1969 and 1970.

Now we have a situation where subsidized housing is suspended, and it is not going to be resumed for quite sometime, as you know.

In addition, regardless of all the protections we have trying to keep money in the savings institutions, the institutions that finance housing, you still have this very sharp increase that we have already suffered in interest rates for mortgages, and every indication that it is going to go up.

And all of our past experience has indicated that as mortgage rates rise, we price more and more people out of the market. With every 1-percent increase, we price another several million people out of the housing market. They have gone up—well, since 1970—in the last year almost a half of 1 percent, according to this, and this is not up to date. It has gone up more than a half of 1 percent within the last year; and every indication, as I say, that they are going to go higher.

Now, let me ask you if you will give us a quick résumé. Could you give us briefly what you foresee as the relatively strong and relatively weak sectors of the economy during the months ahead?

Let me run down each of them and you give me your reaction. What do you foresee for personal consumption?

Mr. STEIN. I would expect personal consumption to be rising at a rate higher than was reported for the second quarter, but less than the average in the first half.

Senator PROXMIRE. Business investment.

Mr. STEIN. Business investment will be rising quite strongly for the remainder of this year and into 1974.

Senator PROXMIRE. Business inventory.

Mr. STEIN. We would expect a somewhat more rapid rate of expanded business inventories than we have been having, although we do not see a big inventory boom ahead of us.

Senator PROXMIRE. Residential construction.

Mr. STEIN. We think that this maybe is going to be tapering off.

Senator PROXMIRE. Federal Government spending.

Mr. STEIN. We think that will be rising at a fairly steady rate.

Senator PROXMIRE. State and local government spending.

Mr. STEIN. Well, it will probably accelerate somewhat.

Senator PROXMIRE. Net exports.

Mr. STEIN. We think that will be rising.

Senator PROXMIRE. Well, all in all, trying to put this together, would you say we are headed for a situation in which we are likely to have a growth at a rate of about 4 percent, real terms?

Mr. STEIN. Yes. I think that in 1974 it will be higher than in the second half of this year.

Senator PROXMIRE. Do you see a further reduction in unemployment.

Mr. STEIN. Yes.

Senator PROXMIRE. To what level?

Mr. STEIN. Well, I would think we would get down to the neighborhood of 4½ percent as we have said in our economic report. I think I will stay with that. It is possible to get below there, but that depends a great deal on what happens in the private sector.

Senator PROXMIRE. What do you foresee happening to unemployment in calendar year 1974?

Mr. STEIN. I think unless there is some change in the patterns of behavior, I would expect that we would about level out.

Senator PROXMIRE. Do you think that is about as good as we can do, 4½ percent unemployment, without more serious inflation?

Mr. STEIN. I guess I just do not understand what "we" is.

Senator PROXMIRE. You do not understand what? I am sorry. I missed that.

Mr. STEIN. Who do you mean by "we"?

Senator PROXMIRE. That you can do, this administration can. I was thinking of the "we" being the administration and the Congress, but if you want to put it on the basis of what the administration can do, let's put it that way.

Mr. STEIN. I would say that given the present composition of the labor force and attitudes, I would just have to say the answer to that question is very uncertain. I think it may be possible. I do not distinguish between this administration or any other administration. It is a question of what can be done by public policy and what cannot be done by public policy.

I do not think it is all clear that public policy by itself can get us down much below this 4½ percent number. I think that if people became more eager to accept jobs, if periods of search that they were willing to undergo declined, then we would have a low rate of unemployment. This would not necessarily be a better situation. But we do know that an extremely large proportion of all the unemployment that we now have is the unemployment of people who have left a job, who have just entered the labor force, or who have reentered the labor force and who are looking around.

We know that there have been very large increases of job opportunities, as evidenced by the fact that this big increase of population has been sucked into the labor force and has been sucked into employment.

Nevertheless, the unemployment rate has not declined very much, so I think there is something out there in the response of the individuals in the private sector which tempers the possibility of reducing the unemployment rate.

Senator PROXMIRE. Well, it is discouraging. I will not be much longer. You will be free in a couple of minutes.

It is discouraging to hear you say that this is not a matter of public policy. The only agency that can act in our society in concert in an organized way is the Government.

But if you feel this is an attitude of unwillingness to work at jobs which are unattractive or something of that kind, perhaps there is something that the Government should try to do; or do you think this is something you just have to hope will change the attitude of people throughout the country?

Mr. STEIN. No. I think there are things we can try to do, and we do try to do. We have quite large manpower training programs, and we are concerned, for example, very much with the problem of youth unemployment and are trying to find ways in which we can—we have an interagency committee which I chair—prepare young people better for employment, and reduce the time that they have to spend in search for work.

But I think the thing we have to say is that the mere ability of the Government to set a target is not any assurance that the Government can deliver on that target. We cannot deliver 29-cent-per-pound chickens.

Senator PROXMIRE. You seem to feel there is something defective in the American character, at least I got the notion. Where do you get the notion that there are increased job possibilities now? The job vacancy rate has been declining for several months. Those are the only statistics we have available, unless you have something else. Employment in manufacturing is below 1969 when our population was less than it is.

Mr. STEIN. Well, actually if you look at employment in manufacturing, we know that employment has increased 3 million in the past year; so there are 3 million additional jobs that were provided, or that came into existence and were filled. And they were filled by people.

Senator PROXMIRE. Yes, but the work force expanded that much, so we still have unemployment close to the same level.

Mr. STEIN. Of course, of course. But why did not the people who are unemployed get those jobs instead of people who had not been in the job market?

Senator PROXMIRE. Come on. If the people who were unemployed got those jobs, as long as the work force was growing, you would still have the same number of unemployed; and as far as you know, they did.

Is that not right?

Mr. STEIN. But the average unemployment in this country is rather low. If they were not willing to accept this process of looking for work, they could have entered those jobs.

Senator PROXMIRE. What I cannot understand is what there is in the American character that differs from the character of the English, the Italian, the French, the German, the Japanese, where unemployment is consistently a great deal lower; and in Germany, for example, it is one-fifth of what it is here, and it has been consistently for the last 10 years.

Mr. STEIN. Well, I do not think it is a deficiency in the American character. It may not be a deficiency in the American system at all, as people there are a number of differences. But people in the United States where average incomes are higher are better able to accept a period of search for work without being employed.

But we do have other characteristics of our economy which I think help to explain the differences in the unemployment rate. I think a lot of it is at the youth end. I think we have a much more heterogeneous labor force in its quality, which would itself tend to generate a high rate of unemployment.

Senator PROXMIRE. Will you give me your expectation of what is going to happen to prices the rest of this year? The initial expectation, as I understand, was what we would have inflation by the end of the year of about 2½ percent.

Is that correct? And is it still the forecast?

Mr. STEIN. We did not set that as a goal. I would not expect it any more. We have not set forth a new goal. We are operating, I would say, in this interim period when the controls are being gradually phased out, and we are very uncertain about how much underlying cost pressure there is in the economy to push prices up.

While we are very uncertain about the prospect for prices, we think we have adopted a course which is most likely to bring us to a situation of reasonableness.

Senator PROXMIRE. Yes, but we have no goal now. The President has indicated that he would like very much to have controls end by the end of 1973. He did not say they would. He said he would like very much to have that happen.

Is there any level at which the President would be able to make the decision that the controls should stop?

Would the inflation at that time have to be 4 percent, 3 percent, 2 percent, or 5 percent?

What level would you indicate?

Mr. STEIN. We have not made any determination of that.

Senator PROXMIRE. What do you expect to happen to food prices the rest of this year?

Mr. STEIN. They are going to go up very fast.

Senator PROXMIRE. What does that mean? How fast?

Mr. STEIN. Well, this is small comfort, I suppose—I do not think they will go up as fast as the first half of the year, but I think they will go up pretty fast.

Senator PROXMIRE. One more question.

Recently President Nixon appointed two men to be in very significant and authoritative positions with respect to economic statistics, Mr. Failer and Mr. Barraba. Mr. Barraba, the head of the Census Bureau, and Mr. Failer to be his boss and be in charge of all statistics in the Commerce Department.

Those appointments were vigorously opposed by the American Statistical Society; unanimously opposed by every single member of the executive committee of the American Economic Association; opposed by the American Sociological Association unanimously at the convention they had. Every professional group that took a position, opposed these appointments.

Were you consulted in these appointments?

Mr. STEIN. No, I was not.

Senator PROXMIRE. Do you not think you should have been?

Mr. STEIN. Yes. I think I should have been.

Senator PROXMIRE. Why were you not consulted? You are the President's principal economic adviser. It would seem to me that the quality of our appointments in this technical-professional area would be greatly improved if the President had input from his principal economic adviser. I do not know who he consulted in making this kind of appointment.

Mr. STEIN. Well, I do not either. It is a big organization, and procedural mistakes are sometimes made. Those of us who have primary responsibility have expressed our dissatisfaction in the way in which this was handled; but it has been done.

We were consulted in the appointment of the Assistant Secretary of Commerce for Economic Affairs, who is at a level above both of these people.

Senator PROXMIRE. Yes. That was a good appointment.

Mr. STEIN. Sidney Jones. He was formerly the Assistant to the Chairman of the Council of Economic Advisers, and I am very pleased about that. We are very pleased with the appointment to the Bureau of Labor Statistics. We have recently established as a committee, or are establishing under Mr. Seevers' chairmanship, an interagency Committee on Economic Statistics, which will be a subcommittee of the Committee on Economic Policies, to maintain a closer interaction among the Government users and suppliers of statistics, which we hope will contribute to their usefulness and quality.

I really cannot say any more about that.

Senator PROXMIRE. Will you be sure that the Council of Economic Advisers gets consulted in appointments of this kind in the future?

Mr. STEIN. I believe that they will be consulted about such appointments in the future; and I do not really understand this because they have been consulted about other economic type appointments.

I first learned about that from the newspaper.

Senator PROXMIRE. I am very sorry to hear that. That is most unfortunate. The President has made some very fine appointments, particularly his appointments to the Securities and Exchange Commission. The Chairman is a brilliant man who will be a fine Commissioner.

But in this case I think he made two very serious mistakes.

Thank you very much.

The committee will stand in recess until tomorrow at 10 a.m., when we will hear from Mr. Shultz, the Secretary of the Treasury.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, August 2, 1973.]

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, AUGUST 2, 1973

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

The committee met, pursuant to recess, at 10 a.m., in room 1114, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee), presiding.

Present: Senators Proxmire, Humphrey, Javits, and Percy; and Representatives Reuss and Griffiths.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; William A. Cox, Lucy A. Falcone, Jerry J. Jasinowski, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; 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.

This morning we welcome Secretary of the Treasury, Mr. George P. Shultz, and the Undersecretary, Mr. Paul A. Volcker, and the Internal Revenue Commissioner, Mr. Don Alexander. We are delighted to have such a distinguished panel.

This is the fourth day of our hearings reviewing the state of the economy at midyear.

Already in these hearings we have uncovered significant disagreement on one vital aspect of the economic outlook. The forecasts we have been given for the rate of growth of real output and for the level of unemployment differ markedly. The new Wharton forecast, one of the most respected of private forecasts, shows the rate of real growth declining to about 1 percent—virtually a recession, with unemployment rising to 6 percent. The only other forecast we could get was from Data Resources which also forecasts a slowdown in economic growth to about 2 percent, with unemployment at a level of about 5.4 percent at the end of next year.

On the other hand, Mr. Stein told us yesterday that the Council expects the growth rate to hold at about 4 percent and unemployment to decline to about 4½ percent. Obviously the policy implications of these forecasts are quite different.

One important question we wish to explore with you this morning, Secretary Shultz, is the policy measures which can be adopted if the more pessimistic outlook now predicted by Wharton and the Data Resources and others materialize. Certainly the last thing this country needs is another round of 6 percent unemployment. If this is truly the prospect, steps must be taken now to head it off.

On another aspect of the outlook, there is less disagreement. All of our witnesses have agreed that we are in for further sharp price increases during the remainder of this year. It is important to be honest about this, and let the public know what is in store, unpleasant though the news may be. It is also important that we examine carefully the new phase IV program to be sure that we are at least doing everything that it is sensible to do to keep prices as low as possible.

Of course, we also want to discuss with Secretary Shultz and Mr. Volcker the international economic situation, the position of the dollar in world markets, and the prospects for international monetary reform. These are certainly interrelated. So there is a lot of ground to be covered this morning.

Secretary Shultz, you have a very concise statement. Mr. Volcker, do you have a statement?

Mr. Volker. No, sir.

Senator Proxmire. Do you have a statement, Mr. Alexander?

Mr. Alexander. No, sir.

Senator Proxmire. I appreciate so much you gentlemen appearing. Secretary Shultz, please go ahead.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF THE TREASURY, ACCOMPANIED BY PAUL VOLCKER, UNDER SECRETARY OF THE TREASURY, AND DON ALEXANDER, COMMISSIONER, INTERNAL REVENUE SERVICE

Secretary Shultz. Thank you, Mr. Vice Chairman. I appreciate your opening comments highlighting I think very well the key issues that face us in economic policy.

I might say that Congressman Reuss was kind enough to write to me and say that he intended to pursue a line of questioning here involving matters with the Internal Revenue Service. It is for that reason that I have asked Commissioner Alexander to be with me.

It is a pleasure to be here today to participate in your midyear review of the economy. I recognize that the members of the Council of Economic Advisers participated in an extensive and detailed review with you here yesterday, so I shall limit my opening remarks to a few basic points.

In the first half of the year, the economy moved very rapidly toward full employment of its manpower and productive facilities. The pace of domestic economic expansion exceeded expectations and there were unusually large gains in production and employment.

Some other developments were far less welcome. The dollar declined in value both in terms of foreign currencies and in terms of purchasing power for U.S. goods and services. It was necessary to resort again to a temporary freeze on domestic prices. These developments testify to the need for policies that will guide the economy on to a much less inflationary path of expansion.

There is no mystery as to the correct direction for policies during such a period of intense inflationary pressure. Fiscal and monetary policies must exert a restraining influence. No wage-price control program, however well designed, can achieve its objectives if total spending is pressing hard against productive capacity. In the present situation, there can be no ducking the need for restraint in fiscal and monetary policies if more serious inflationary risks are to be avoided.

It is clear that continued control of Federal spending takes on a new urgency. As I stressed in my appearance before your committee earlier this year, it is critical that the Congress and the executive branch cooperate closely in this important effort.

This committee was instrumental in the successful efforts to hold Federal spending below $250 billion during fiscal year 1973. Certainly there have been many differences between the Congress and the administration over specific Federal program cutbacks and spending reductions, but the important point is that our spending goal was achieved.

Together, we now have an even more challenging problem. Inflation has emerged as our number one economic problem and we must insure that our financial policies are adequately combatting rising prices. Phase IV of the economic stabilization program can help to moderate inflation. The main weapon against inflation, however, remains our financial policies, supplemented by special measures to encourage increased supplies of goods and services.

I would like to emphasize our judgment that fiscal restraint is imperative, and the operational necessity for exerting that restraint on expenditures. We have estimated that fiscal 1974 revenues will approximate the outlay level proposed by the President last January. With the help of the Congress, expenditures can be held to that level, and we can then look forward to a balanced budget. This budget will make available an additional $20 billion for Federal spending over last year's levels, but it will still require a major effort by both the Congress and the administration to live within that spending total.

Nonetheless, such restraint must be exercised if we are to avoid an unacceptable rate of inflation or higher taxes—or both.

The rate of advance in real output during the first half of the year was impressive. However, price performance during the first half of the year was most unsatisfactory. For example, the GNP deflator rose at nearly a 6½ percent annual rate in contrast to about a 3 percent annual rate in the last half of 1972. Consumer prices rose at an 8 percent annual rate in contrast to less than a 4 percent annual rate in the last half of 1972. Rates of advance in certain components of the wholesale price index, especially for agricultural products and other raw materials, were rapid in the first half of the year.

A number of factors combined to trigger this burst of inflation. They include the pressure of rising worldwide demand for basic materials, crop failures abroad, bad weather at home, and repeated threats of price freezes and rollbacks.

By late spring and early summer, it became clear that further policy actions would be needed to contain inflation. As you know, President Nixon announced on June 13 the reimposition of a temporary price freeze of up to 60 days' duration. Subsequently, on July 18, we announced the phase IV controls program which will take effect in stages.

Phase IV is a tough program. It is designed to spread the inevitable bulge of postfreeze price increases over a period of some months and to minimize the impact of inflationary pressures thereafter. The program is designed to fit the special circumstances of certain industries, and some industries will be exempted from price controls based on their own favorable pricing track record.

A wide range of important actions have been taken to increase agricultural supplies and will be yielding their benefits later this year and next. In all the circumstances, wage pressures have been moderate and can continue to be if price rises are restrained. Given the essential support of restrictive fiscal and monetary policies, the economy will work its way through to much lower rates of inflation.

Since I appeared before you in February, international payments trends have moved toward equilibrium; interim arrangements for exchange market operations have been established; and important steps taken toward international economic reform.

The exchange rate changes over the past 2 years have laid the foundation for restoring international, and specifically, U.S. balance of payments equilibrium. That foundation would be undermined if recent rates of inflation were allowed to continue. I am confident we can keep that from happening.

Our trade accounts have improved more than might have been expected in a time of rapid growth in this country. Our trade deficit, which was nearly $7 billion in 1972, was only $1¼ billion in the first half of 1973. The large expansion of agricultural exports has been the most important factor improving our trade balance. Agricultural exports have probably reached a peak. But they will remain at a high level while our industrial trade balance improves.

After some turmoil in the foreign exchange markets in February and early March, members of the Group of Ten and the European Community agreed on interim monetary arrangements until an improved payments equilibrium could be achieved and monetary reform negotiations completed. These interim arrangements reflect recognition of the unusual strains and speculative forces during this period of basic adjustment. Rather than a rigid defense of fixed parities, they permit elasticity in exchange rates in response to market forces.

Since that time the currencies of the European Community which are jointly floating have appreciated significantly in relation to the dollar. Indeed, this movement has extended beyond the changes that we and others have felt is necessary to meet the requirements of longer term equilibrium. At the same time the dollar has remained quite stable in relation to the currencies of Canada, Japan, the developing countries, the United Kingdom, and Italy—countries which account in total for three-quarters of our trade. We and others are prepared to intervene in exchange markets when necessary and desirable, to maintain orderly conditions. I am convinced—and this view is shared by most of my colleagues abroad—that the transitional arrangements in place are the best available response to current circumstances.

Meanwhile, we are tackling the problem of establishing a permanent system with a strong sense of urgency. Two days ago the Committee of Twenty Ministerial Committee on International Monetary Reform completed its third meeting. We had a very useful give and take discussion on some of the key issues, and I believe we can begin to see the outline of workable solutions in important areas. Significant differences certainly remain, but it is clear to me that there is a general will to keep the ball rolling toward an agreed reform. I am particularly encouraged that there appears to be an increasing acceptance of certain elements we have felt extremely important, including the need for symmetry in adjustment pressures between deficit and surplus countries and the necessity of backbone in the provisions to assure adjustment in the new system. As had been agreed in advance the meeting was a working session with no communique.

I might say that was a welcome innovation because when there is going to be a communique it seems you spend the whole meeting arguing over the words, over it, and none of the meeting talking about the substance of what is at issue. So we were able to talk about the substance without the burden of a communique.

I expect that the committee will be able to summarize in more concrete terms the progress it has made at the annual meeting of the International Monetary Fund in Nairobi at the end of September and that we can proceed thereafter to hammering out a detailed agreement.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you, Secretary Schultz.

Secretary Shultz, as you know I very enthusiastically applaud your strenuous and consistent efforts ever since you have been in office to eliminate waste and hold down spending in every way you can. I think this has been commendable and a very wholesome and constructive influence, and I certainly hope that we can continue to follow that policy.

Nevertheless, I do not see that this will get at the heart of our present inflationary problem. In other words, budgetary restraint, monetary restraint do not seem to me to be calculated to achieve the kind of slowdown in prices that we want. This is because in view of the fact that about 60 percent of the rise in the cost of living this year has been in food, according to the data given to us by Mr. Dunlop, and specifically in the prices paid for raw agricultural products, and as a result there has been an enormous increase in food exports. Most of the rest of the inflation appears to be bottomed in the wholesale industrial area, specifically, chemicals, paper, steel, oil, et cetera.

Inflation for the rest of 1973 is sure to come from the passthough of increased wholesale food and industrial wholesale prices. Since we are operating well below capacity and more than 4 million Americans are out of work, it would seem to me that a tight budget and a monetary policy that is in restraint is calculated to cause a 1970-type recession. In other words, increased unemployment, with a continued rise in prices, a credit crunch that will severely hurt housing and will give us the worst of all possible worlds.

Now, how about that?

Secretary SHULTZ. Well, I am not quite sure where you are heading, Mr. Vice Chairman. Are you urging a policy of no restraint, because it seems to me that we have a problem? We are, I believe, pressing capacity very widely in the economy not only in our physical plants and facilities.

Senator PROXMIRE. Well, the data doesn't show that.

Secretary SHULTZ. But I think it does.

Senator PROXMIRE. The Federal Reserve data shows that we are operating at 82 percent of capacity.

Secretary SHULTZ. The calculations on what genuine capacity we have been living with, I think, are open to serious challenge in light of what we see around us. We know many industries that are operating at full capacity right now and cannot increase their production any further, including some in that list that you read.

So I think that we are operating very close to our capacity, and it seems to me that a policy of balanced restraint is what is called for and a balanced budget at this point in time seems to me about the right fiscal policy because, as you say, and I agree with this, we must do everything we can about the problem of inflation. But let us not forget about 6, 8, 12 months from now and be so drastic in our cure that we create another problem which we do not want. And I think a balanced budget is a reasonable answer.

Senator PROXMIRE. As I say, it is vital that we do all we can to increase supply and increase production in any way we can.

Secretary SHULTZ. Right.

Senator PROXMIRE. But at the same time it would seem that if we follow a policy of the kind of restraint that you are talking about, that in view of the slowdown in economic growth we had in the second quarter of this year, the most recent quarter, that we will be very likely to have a situation in which unemployment would begin to rise again. What do we do about that?

Secretary SHULTZ. Well, we follow a fiscal policy of a balanced budget that is appropriate for the present time. It fits in with the full-employment concept in which we would have a slight surplus at full employment under a balanced budget right now, and that seems like the appropriate policy.

Now, other countries are also experiencing the same difficulties. In fact, having spent a fair amount of the time earlier this week with my fellow finance ministers, I would say they are finding these problems even more so. So that the inflation——

Senator PROXMIRE. They are not suffering the unemployment problems we are, by and large, are they?

Secretary SHULTZ. I think it is fair to say that our labor markets, while never satisfactory as long as there are people who want a job and who are willing to look for one and take one that is reasonably in their capacity, whenever we have that our labor market situation is not satisfactory. But in terms of the sort of general state of demand in the labor market, we are operating very full by our standards.

Senator PROXMIRE. Well, would you agree or disagree that a restraint in monetary and fiscal policy will do very little or nothing about food inflation?

Secretary SHULTZ. Well, I think it is an important component of the total picture. It is necessary but not a sufficient condition in the mathematical tradition for restraint of inflation.

Now, we have to do other things, and we are doing other things, and I agree with you that all actions that we can think of to increase supplies in these areas where prices are going up are essential. And this includes doing everything we can to expand the output of food products. It includes everything we can to improve the supply of energy sources here in the United States. It includes the rearrangement of our oil import program which we managed to do finally earlier this year, to put it onto a different footing where we can import so that we increase our supplies, and so on. Everything we can think of to increase our supplies we should do.

We would hope that Congress would pass the stockpile bill that we have asked for. We would hope that Congress would give the authority to reduce tariffs in these areas where we are importing and prices are rising and so on. We hope that the Alaska pipeline bill goes through.

I agree with you completely that actions to improve supply that are specific in particular areas are essential.

Senator PROXMIRE. I'm concerned about this aspect, too. There are at least two inflationary consequences of slowing down the economy. It goes against the conventional wisdom that there should be any inflationary pressures in a slow economy, but I think we found out last time.

One is the likelihood, based on past performances, that labor is more likely to press for higher settlements with a slowed economy than with an economy in which there is more overtime, in which work is more assured. Certainly this was the pattern in 1970 and 1971, as contrasted with a more recent period when there was certainly a very constructive attitude on the part of labor, and the settlements were much more reasonable than most of us had any right to expect.

Then there is a second aspect, that as sure as the sun will rise tomorrow, that if the economy slows down productivity increases are reduced and may even become negative. And that means, of course, that any wage increase is likely to be translated into a price increase. We went through that very recently, of course, in the 1970 and 1971 period.

Now, are not these aspects to be considered as we consider the full consequence of slowing the economy down?

Secretary SHULTZ. They are, and let me comment on both of them, if I may.

First of all, I think we ought to recognize that it is impossible for the economy to expand at the rate of the fourth and first quarter simply because, as we are now quite close to capacity, the sort of definitional limits to a real expansion is on the order of 4 percent or a little more and, therefore, we simply cannot expand at the 8.6 rate that I believe was statistically shown for the first quarter.

So we must bring ourselves out at somewhere near that growth rate and that is not a slowing down of the economy in any sense of leading to unused resources. That is just getting ourselves and our expansion attuned to the natural rate of growth. I think the problem is, having had an expansion that was faster than the natural rate of growth, how do you slow down to it without sort of going through the growth rate that you want to rest on?

Senator PROXMIRE. Well, we may have already done that because, as I understand it, the real growth rate in the first quarter was around 5 percent, 5.2 percent.

Secretary SHULTZ. 8.6 percent.

Senator PROXMIRE. I beg your pardon. I gave you the first half. The second quarter was around 2.6 percent.

Secretary SHULTZ. 2.6 percent, according to the same calculations.

Senator PROXMIRE. So the first half was around 5, 5½ percent, something like that, but the trend is downward. The second quarter was a slowdown below the long-term rate of growth that we have enjoyed in the economy over the years and below our capacity. In other words, if we had grown at the rate of 3 to 4 percent we would have been on target. We went below that.

Secretary SHULTZ. I do not think it is likely we will just sort of hit, quarter after quarter, a 4-percent growth rate. The statistics will jump around, in my judgment anyway. In looking at those statistics, and this is not meant in any sense as a criticism of the compilation of the statistics which I know has been done with great skill and according to established methods and so forth, but it does seem to me not a sensible result to think that the economy changed its rate of growth that much in that short a space of time. The economy is so big and it lumbers along and it just doesn't change that fast, but nevertheless, I think there was a significant easing off from the extraordinary growth rates of the fourth and first quarters, and just where to put it statistically I do not know. So, anyway, that in terms of real growth is the objective we seek.

I think your point about productivity is absolutely right and undeniable. As we move to slower rates of real growth we will move to slower rates of productivity gain, although presumably, if we were able to get on a sustained path of 4 percent real growth, we would get on a sustained path of something like 3-percent productivity growth. So that would have to be, then, balanced against wage increases to see the kind of impact on labor costs that you get. But I think your point is—I certainly agree with it, and it is one reason why I think too great a slowdown, even leaving aside the undesirable consequences of unemployment and so forth, is not desirable from the standpoint of fighting inflation. So I agree with that part.

On the question of the labor settlements, here I do not agree with the way you set that problem up. It seems to me that we did have a right to expect reasonable settlements in the first half of the year and that the contrast between this year and the previous 6 years in which we ran through two 3-year cycles of wage increases was that the workers coming into bargaining this year came in off of contracts where their real earnings rose during the life of the contract for the first time in this 6-year period. In both previous wage cycles, in each one of the major industries' bargaining—trucking, railroad, automobile, steel, and so forth—the average rate of wage increase for the economy as a whole for production workers exceeded, in the year before their bargaining, the rate of increase in that industry. So their wages were falling behind in real terms and falling behind in relative terms and, I think, that is what jacked up the collective bargaining picture in the earlier years. But that influence wasn't present this year.

Now, our danger is that if we are not able to get control of the price side of this equation, we will recreate that situation and that will put tremendous pressure on the wage situation next year and the year after.

Senator PROXMIRE. Well, when I say those elements are reasonable too, I was referring to the fact that during this period we had a very, very sharp rise in food prices to which everybody is more sensitive than perhaps anything else.

Secretary SHULTZ. Right.

Senator PROXMIRE. And the annual rate of inflation of around 7 percent, which made those 7 percent settlements mean not much of an increase in real wages.

One other question before I yield to Congressman Reuss.

The administration's $268.7 billion ceiling on spending was announced as a full-employment budget, that 4 percent unemployment is a full-employment target and with the budget balanced at that level. But unemployment is now 4.8 percent and, in view of the growth slowdown in the second quarter, unemployment might be expected to stay at or near that level. And yet the budget is expected to be, as officially estimated, just about balanced for 1974. In fact, a $2.7 billion deficit is officially forecast. Since we had a $14.4 billion deficit for the past year, we are moving very close to a balance.

What happened to the full-employment concept? Why have calculations on the relations between budgetary policy and full employment been so far off? Why has there been no announcement or a public discussion of adjustments that should be made in these estimates?

Do you mean the administration is now assuming the 4.8 percent is about the best we can do in unemployment? We cannot get lower than that?

Secretary SHULTZ. The full-employment concept is fully alive and operative as a basic guide in our policy thinking. The fundamental rule that the President laid down some years ago when he first spoke on the subject was that we should not permit expenditures to rise above the level of full-employment revenue.

Now, we have managed to stay with that concept all the way through. He did not say that we should never have a surplus at full employment, and we think that under the present circumstances a small surplus in full employment, which is implied by an actually balanced unified budget in fiscal 1974, is about the right policy.

The full-employment revenues have risen as a result of the fact that we have had a higher rate of inflation than we anticipated.

Senator PROXMIRE. I would like to follow that up, but my time is up.

Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman.

Secretary Shultz, 10 days ago, on July 23, I wrote you a letter [1] concerning certain allegations which have brought quite seriously into question the integrity of the Internal Revenue Service.

I specifically requested that you conduct an investigation of those allegations, and I listed at least four of them.

One, that the Finance Commitee to Re-elect the President, under the direction of former Commerce Secretary Stans, former White House counsel Dean, and former CREEP counsel Gordon Liddy, and with the apparent complicity of the IRS, has been allowed to escape capital gains taxes on some $20 million worth of appreciated contributed securities.

I was distressed yesterday to find that the Treasury held a press conference in which it publicly announced that CREEP was being forgiven their tax on the huge amounts it made by selling securities before October 3, 1972. True, the announcement said that thereafter the IRS intended to fell tax evasion, but that's locking the stable after the horses are gone, because almost all the sales of appreciated securities were made before October 3.

[1] See letter of July 23, 1973, beginning on p. 182.

A second allegation concerns the ruling of the Internal Revenue Service in June 1972 attempting to legalize the $3,000 gift tax exclusion for gifts to multiple campaign committees supporting the same candidate and set up for the express purpose of avoiding taxes. The testimony there is that the June ruling was procured by political officers in the Treasury over the objection of career people in the IRS.

A third allegation—the source of this is former IRS Commissioner Randolph Thrower—is that the White House forced the IRS in 1970 to set up a special unit in the IRS to audit the tax returns of people whom the White House thought were radicals.

And a fourth allegation is that the White House persuaded the IRS to audit returns of Nixon enemies and to call off audits on returns on Nixon friends. This allegation was made by Mr. Dean before the Ervin committee.

All of these things distress me very much and I think it is quite important that the Watergate spirit not seep into and corrupt other agencies of the Government. Particularly, I think, the Treasury should be beyond reproach. There are some 80 million taxpayers in this country who pay their taxes and are not the least bit amused by the Treasury yesterday telling CREEP that it can escape scot-free with a tax liability estimated at $5 million or more.

Further, the dollar, as surely the Treasury knows, is in disgraceful condition overseas because people overseas lack confidence in the integrity of the U.S. Government. I think it is of vital importance, as I said in my letter and as I repeat today, that you, Secretary Shultz, conduct a thorough, in-depth investigation of these and other allegations of lack of integrity in the Treasury's Internal Revenue Service.

May I have your assurance that you will conduct such an investigation?

Secretary SHULTZ. Well, first of all, Congressman, let me say that I resent the phraseology that you have used.

Representative REUSS. Well, what part of it do you resent?

Secretary SHULTZ. In suggesting that there is some sort of complicity in part and so on, because there isn't.

I believe that the IRS, as various charges are investigated, will look very good.

Representative REUSS. Have you made an investigation?

Secretary SHULTZ. We are in the process of making one. There is an investigation being conducted by the Joint Committee with which we are cooperating fully and, as a matter of fact, our only complaint about the investigation is that it is not going fast enough and we think that with all these charges floating around about the IRS we deserve to have the facts brought out, and we want them brought out and we want them brought out as promptly as possible so that these charges don't lay around on the table unchallenged.

Now there is an investigation being conducted by the joint committee.

Representative REUSS. By that you mean the Joint Committee on Internal Revenue Taxation?

Secretary SHULTZ. Right, and they have seen these charges and they have undertaken an investigation. That is going on and we are cooperating fully with it and we believe that our proper stance is to cooperate with that investigation. Of course, we are making our own investigation but in the meantime to let that investigation go forward and we will see what the results of it are. We would like to see it go forward rapidly, as I say, and meet these questions that you have raised of whether or not there is this or that or the other wrongdoing occurring. We think the IRS is going to look very, very good from what we know about it.

Insofar as the June 1972 ruling is concerned, the allegation that you made has been made by common cause and there is a court case I guess you would call it. We do not agree that that is the case. And that is in the courts and presumably that is where that should be adjudicated, so I will not comment further other than saying what our position is, and that is in the courts. We again hope for a speedy resolution, and we believe that the IRS has handled itself properly.

Now, insofar as the subject of the tax status of political parties and of various increments of income are concerned. The Commissioner issued a statement yesterday on that, and he is here and will be glad to explain it or answer questions about it. I would say, from my own standpoint as a newcomer to the subject of political campaigns and their financing as I have discovered the subject, so to speak, and looking at it from the tax point of view, it does appear to me to be in a very confused state.

On the one hand, there are many private rulings looking in one direction. There's a record, a long record, of inaction. I must say, from the standpoint of an oldtime arbitrator, you can't help but feel that the law is what is enforced, and if political parties were or have not been subject to taxation and that has existed over a long period of time, presumably Congress could have corrected it if they wanted to. So there is that. But we have issued a formal opinion yesterday, the IRS has, Commissioner Alexander, that political parties are subject to taxation, but, as I did in my testimony, as Mr. Griffiths will remember, on April 30 before the Ways and Means Committee and as we again do in this ruling, we urge the Congress to give us some guidance because this is a confused subject and practices have varied a great deal. We have heard a lot of talk in the last few months about the use of power by the executive branch and so we say to you, here is something that is not very clear, here is what we think, here is what we intend to do if Congress doesn't take some action sometime reasonably soon. But we would prefer to have the Congress say what it thinks about these very delicate issues that Commissioner Alexander's ruling addresses.

Representative REUSS. Mr. Secretary, you have testified that you are making your investigation of these allegations but that your investigation is not yet completed. But you have also said that the Treasury and the IRS have done nothing wrong.

How can you make that assertion when you have not yet completed your investigation?

Secretary SHULTZ. I said I think that the IRS will look very good when the investigation is completed.

Representative REUSS. How do you know if it has not been completed?

Secretary SHULTZ. That is on the basis of what I have seen so far and on the basis of my knowledge of the individuals involved and the way they have conducted themselves as we have worked together.

Now, the investigations are not completed, so I did not say what you stated me as saying. I said we still wait for the investigation to be completed and my belief is that when it is completed we will all be proud of the IRS.

Representative REUSS. Will you cooperate with the arm of Congress—the Comptroller General—in the investigation of possible wrongdoing by the Internal Revenue Service?

Secretary SHULTZ. We are at a loss to know how many people we should cooperate with. We believe that our congressional committee that we are supposed to work with is the Joint Committee and that is the committee we are working with. If the Joint Committee wants us to work with somebody else, then we will work with somebody else. They are, so to speak, our bosses on this issue and that is where the investigation is being conducted.

I understand that Mr. Cox is now proceeding with an investigation of the IRS. If the GAO wants to join the crowd, I suppose that's all right, but we will have to come to you for a budget request.

Representative REUSS. You will cooperate with Mr. Cox and/or with the GAO should they ask your cooperation?

Secretary SHULTZ. We will check with the Joint Committee and they will let us know. We have a pattern with respect to the GAO and the IRS of working with the Joint Committee on a wide range of things, and I think we have worked out a reasonably cooperative arrangement. That is our congressional reference point.

Representative REUSS. Well, let me get this very straight.

The Congress has set the General Accounting Office as its arm in eliciting information concerning wrongdoing in the executive branch. The Congress has also set up various other agencies in a nonexclusive way, including the Joint Committee on Internal Revenue Taxation.

Is it your testimony that you will now cooperate with the General Accounting Office in the study and investigation of executive wrongdoing?

Secretary SHULTZ. No, I did not say that. I said we have worked, not only on this issue but on other issues, with the GAO and the Joint Committee, and I believe have set up a pattern of work that has been satisfactory. And that is the way, it seems to me, it is reasonable to proceed.

I might say that I hadn't conceived in the years that I have associated with the GAO that its purpose was to find wrongdoing. I thought its purpose was to produce better government, to look into things that were going on, and to make constructive suggestions. And I think this atmosphere that we have now here in Washington and around the country that everything is a question of wrongdoing is very bad. People can make mistakes and there is nothing wrong with it. Or there can be differences in judgment and there is nothing wrong with that. And we can argue about how to do things better and do it in a constructive way and we will get better government out of that. But it is not—and there can be wrongdoing, I do not deny that, but I do not think that is our main problem.

Representative REUSS. I repeat my question. If the GAO asks for your cooperation in their investigation of the Internal Revenue Service, will you cooperate or will you not?

Secretary SHULTZ. We will cooperate via the Joint Committee, or we will discuss it.

Representative REUSS. Now, what does that mean?

Secretary SHULTZ. It means that we will do what we have done before, which has worked satisfactory in working with the Joint Committee on this.

Now, I think that there is a real problem here that everybody might as well face up to. If everybody and his brother around this Congress and around the Government can come in and say, I want to see income tax returns of anybody at any time, that is not a good idea at all. There has to be some orderly systematic way of conducting this and I think that if you do not trust the Joint Committee to make a reasonable investigation, tell them so and charge some other committee. But my experience, it is a knowledgeable committee, fair committee and thorough and systematic and it knows something about the tax system.

Representative REUSS. That isn't the question, and I wish you would give me a straightforward answer.

Will you, Mr. Secretary, or will you not cooperate with the General Accounting Office if it requests your cooperation in the investigation of the Internal Revenue Service?

Secretary SHULTZ. Of course I'll cooperate with them.

Mr. ALEXANDER. Could I comment on that?

Congressman Reuss, we are under legal disabilities by reason of three provisions of law, two in the Internal Revenue Code and one in title XVIII, Criminal Acts. In the matter that you have raised, under the Internal Revenue Code under chapter 92, the Joint Committee on Internal Revenue Taxation is given the specific right and the specific duty of legislative oversight into and over the operations of the Internal Revenue Service. Under sections 6103 and 7213 of the Internal Revenue Code it is a crime for an Internal Revenue Service employee to divulge tax information submitted by taxpayers in the belief that it will be held confidential to others than those specifically permitted by law to receive that information. The GAO is not within the group permitted to receive that information under present law.

Representative REUSS. I would not for the world ask that the GAO even consider violating that law.

What the GAO, however, might be requested to do is to find out whether the Treasury and the IRS have been administering the tax laws honestly, efficiently, and economically, because if they don't, it means that revenues escape and other taxpayers have to pay just that much more.

Now, subject to the law you have described, perhaps I shall ask you, you being present, would you cooperate with the General Accounting Office in the investigation of the IRS?

Mr. ALEXANDER. Subject to those laws the IRS has been cooperative in the past. GAO has acted as the agent of the Joint Committee in reviewing IRS collection activities. It has acted as the agent of the Joint Committee in a review now beginning of IRS audit activities and IRS taxpayer service activities. And the IRS will cooperate fully with the GAO acting under the legal restrictions that I have mentioned.

Representative REUSS. You had a few words in there that bothered me—acting as the agent of the Joint Committee on Internal Revenue.

That is not what I asked. There may be cases when the Joint Committee wants to use the GAO as an agent. That is fine, that is their privilege. But suppose the GAO, not as the agent of the Joint Committee on Internal Revenue Taxation but in its own name and style and right, but consistently with the statutes, asks for your cooperation? Will you give it?

Mr. ALEXANDER. Consistently with the statutes we will give it, sir.

Representative REUSS. Is there in your mind some lurking idea that there is a statute which says that unless the Joint Committee on Internal Revenue Taxation says, "Yes, go ahead," the GAO is powerless?

Mr. ALEXANDER. I don't think the GAO will be powerless to inquire into matters that are not subject to these legal restrictions, Congressman Reuss, and the GAO has not been powerless in the past to inquire into such matters. The GAO has people stationed in the IRS building on a full-time basis to look into the activities of the IRS.

Representative REUSS. Very simply, because I hate to prolong this: If the GAO requests the cooperation of the Internal Revenue Service in an investigation which does not involve looking into tax returns or anything that is prohibited by statue to the GAO, will you cooperate or will you say to Mr. Staats, "Come back with a passport from the Joint Committee on Internal Revenue Taxation, or we won't cooperate?" What would your attitude be?

Mr. ALEXANDER. My attitude would be at that time and under those circumstances to find out whether that investigation, indeed, involved the violation of my legal duty not to reveal taxpayer information. If it did not, I will surely cooperate.

Representative REUSS. Thank you.

Mr. Vice Chairman, I have used my time. I would like to place my letter to Secretary Shultz of July 23, 1973, in the record at this point along with a number of specific questions for the Secretary and Mr. Alexander, which under the rules, without objection, I would like to present for an answer.

Senator PROXMIRE. Without objection, it will be done.

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

JULY 23, 1973.

Hon. GEORGE P. SHULTZ,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: The Internal Revenue Service is under the jurisdiction and direction of the Secretary of the Treasury, 26 U.S. Code Section 7802: 22 Op. Atty. Gen. 570 (1899); Boske v. Comingare, 177 U.S. 461. The Secretary's responsibility, thus, is to see that the nation's tax laws are faithfully executed. As the Joint Economic Committee has repeatedly pointed out, inequitable execution of the tax laws is a primary cause of fiscal instability.

I request that you promptly see to it that the Internal Revenue Service faithfully executes the income tax laws with respect to the 1972 income of the Committee to Re-Elect the President, its subsidiaries, and all other campaign committees who are currently evading, with the assistance of the Internal Revenue Service, many millions of dollars of 1972 capital gains tax liability on the sale of appreciated securities donated to them. In a nutshell:

1. *Campaign committees are clearly liable for income taxes on the sale of appreciated securities.* A political party or committee is as much a taxpayer as anybody else:

Matter of Sen. Joseph J. Clark (Internal Revenue Service, Office of the Chief Counsel, Interpretation Division, I-571, 1965), on tax due on the gain realized by a campaign committee on the sale of contributed appreciated property.

IRS ruling, *Democratic League of San Francisco*, (G.C.M. 32991, A–618266, March 19, 1965), in which IRS stated that "unless a political party has received some sort of tax dispensation, the operative presumption must be that its income is subject to taxation. Such a dispensation would have to be spelled out in either the Constitution, an Amendment to the Constitution, a provision of some Federal statute or an accepted judicial interpretation of one of the foregoing authorities. Research discloses no evidence of the existence of any such grant of immunity."

Communist Party of the U.S.A. v. Commissioner, (373 F. 2d 682, C.C.A. 6th, 1967), in which the government took the position that "Political parties are simply not exempt from income tax by statute, regulation or by ruling—public or private, published or unpublished."

IRS Rev. Proc. 68–19 (1968), in which IRS said: "If an unexpended balance of political funds is set aside in a separate bank account, the political candidate, committee, or organization holding such funds may report any income credited to the account on a U.S. Fiduciary Income Tax Return, Form 1041 . . . and pay any tax shown by such return to be payable."

Letter from IRS to Rep. Frank E. Evans (May 8, 1972) citing Rev. Proc. 68–19 in response to Rep. Evans' question whether tax was due on interest earned on campaign funds.

Letter from IRS to Sen. Gaylord Nelson (March 22, 1973) stating: "The Service has ruled consistent with Section 4.02 of the Revenue Procedure [68–19] that political candidates should report the income earned through the investment of such funds of a U.S. fiduciary income tax return, form 1041, and pay any tax shown by such return to be due." The letter stated further that this directive "would also extend to income earned on funds invested in some other manner", and that "may" means "shall".

The IRS has accepted tax payments on capital gains income from campaign committees.

2. *In early 1972 the Committee to Re-Elect the President, the White House, and IRS officials combined to permit evasion of the capital gains tax laws by the Committee to Re-Elect the President.*

Deposition of John D. Dean III, former Counsel to the President, in *Common Cause et al. v. Finance Committee to Re-Elect the President et al.* (see Washington *Post*, p. 7, June 3, 1973), in which Dean stated that he had "discussions" with Maurice H. Stans, Chairman of the Finance Committee to Re-Elect the President, about gift tax multiple exemptions and Stans' interest in getting a gift tax ruling.

Testimony of Hugh W. Sloan, Jr., before the Ervin investigatory committee (June 7, 1973), in which Sloan said that there had been "conversations" between the Committee to Re-Elect the President and other administration officials concerning tax liability of campaign committees.

Memo from Fred F. Fielding, aide to Counsel Dean, to Maurice Stans (Feb. 25, 1972) enclosing White House version of IRS opinion of gift tax exemption, and promising future memo on appreciated securities. Roy Kinsey, another aide to Dean, after consultations with IRS officials, drafted a memo on appreciated securities, which may or may not have been sent to Stans.

Letter in early 1972 from Thomas P. Pike, chief Nixon California fund-raiser, to potential contributors. The letter stated that "The simplest and most painless way [to raise funds] is by giving appreciated low cost securities to several committees (whose names I can supply) in amounts of $3,000 to each committee. In this way neither gift tax nor capital gains tax liability is incurred, and I can easily explain to you the mechanics of doing it."

G. Gordon Liddy, Counsel, Finance Committee to Re-Elect the President, advised on the sale of the appreciated securities, and other details of the scheme to evade.

Through various Washington brokerage houses, the Finance Committee to Re-Elect the President, and its subsidiaries, throughout 1972 sold some $20 million worth of securities that had been donated.

Through capital gains taxes in large amounts were due the IRS by April 15, 1973, none has been paid, and the IRS has made no effort to collect.

3. *When the scheme to allow the Committee to Re-Elect the President to evade its capital gains taxes was revealed in an investigation news story on September 27, 1972, the IRS quickly contrived a cover-up.*

A September 27, 1972, Wall Street *Journal* front-page story by Jerry Landauer described the scheme to evade taxes by having the IRS fail to enforce the capital gains law against the Committee to Re-Elect the President.

Apparently panicking, the IRS six days later, on October 3, 1972, issued a press release (IRS-1257) alleging that the IRS was in doubt about whether a political committee had to pay its income tax, and stating that "It is a matter of history that the Internal Revenue Service has never required the filing of income tax returns by political parties as such." (A demonstrably false statement, see 1 above)

On October 18, 1972 an IRS notice in the Federal Register (pp. 22427–22428) repeated the "matter of history" falsehood, and stated that public hearings on the matter of tax liability would be held after the November election.

Some eight months later, after more than 20 statements had been submitted to the IRS, and after a public hearing had been held in March, 1973, the IRS had neither collected the capital gains taxes due from the Committee to-Re-Elect the President, nor explained why it neglected to collect them. Accordingly, on June 8, 1973, I wrote Internal Revenue Service Commissioner Donald C. Alexander, requesting that the IRS enforce the law and collect the taxes, saying, "The persons involved—in the White House, the Treasury, and the IRS—need to make full disclosure of what looks like an effort to enable a large part of the 1972 campaign, particularly the Nixon campaign, to be conducted at the taxpayers' expense through IRS's failure to enforce the federal capital gains tax laws. Both the revenues and the Revenue Service need to be rehabilitated. I shall appreciate your prompt reply." I have not had a reply from Commissioner Alexander, but I received a letter dated June 20, 1973 from James F. Dring, Director, Legislation and Regulations Division, IRS, stating that the hearing record was still open and that the subject matter was currently being considered by the IRS.

4. *Disturbing evidence has been revealed during the last few weeks of White House attempts to tamper with the IRS for political purposes, either directly or through Treasury intermediaries.*

Memos released by John W. Dean III to Ervin investigatory committee (see: Evening *Star-News*, p. 7, June 28, 1973) showing White House attempt to have IRS audit political enemies and attempt to have IRS call off audits on Nixon friends.

Interview with former IRS Commissioner Randolph W. Thrower (See Washington Post, pp. 1 and 10, June 28, 1973), who claims White House pressure on IRS to hire Mr. Caulfield and Mr. Liddy.

Deposition from Peter Weidenbruch, former Assistant IRS Commissioner (Technical) in Ralph Nader et al v. IRS et al. (see Washington *Post*, p. 7, June 3, 1973) indicating political pressure on IRS to produce Rev. Ruling 72–355 (June 21, 1972), permitting gift tax exemptions for contributions to multiple campaign committees.

5. *Meanwhile, the Committee to Re-Elect the President is starting to dissipate its approximately $4.5 million in assets, thus jeopardizing the assets to which the IRS will need to look when it assesses capital gains taxes owed.*

On July 7, 1973, it was revealed that American Airlines had admitted giving $55,000 in corporate funds to the Committee to Re-Elect the President, and that the Committee was giving indications that it was contemplating turning over the $55,000 to American Airlines, thus dissipating its assets. On July 9 I requested by telegram IRS Commissioner Alexander to make immediate jeopardy assessment against the Committee for the probable amount of capital gains taxes owed, and to require a bond for payment. I have received no acknowledgment or reply to my July 9 telegram. On July 11 the Committee returned the $55,000 to American Airlines.

The dissipation of assets continues. On July 16, 1973, Ashland Oil, Inc. all in one day admitted it had given an illegal $100,000 of corporate funds to the Committee, requested a refund of the Committee, and got it.

* * * * * * *

On this record, I request you, as the cabinet official having jurisdiction over the IRS, to promptly

(1) assess the capital gains taxes due against the Committee, its subsidiaries, and other campaign committees;

(2) take steps to protect the government by preventing a further dissipation of the Committee's assets;

(3) take such remedial steps as are necessary to restore public confidence that the Treasury and the IRS are administering the nation's tax laws without fear or favor.

I shall appreciate an indication from you that you have received this letter. It goes without saying that you can rely on my fullest cooperation in your responsive efforts. If after your initial response, your encounter difficulties, they can readily be the subject of inquiry in your August 2 appearance before the Joint Economic Committee.

Sincerely,

HENRY S. REUSS,
Member of Congress.

RESPONSE OF HON. GEORGE P. SHULTZ AND MR. DON ALEXANDER TO REPRESENTATIVE REUSS' REQUEST OF AUGUST 2, 1973, FOR AN ANSWER TO QUESTIONS STEMMING FROM REPRESENTATIVE REUSS' LETTER OF JULY 23, 1973

This is in response to your request of August 2, 1973, for an answer to the questions listed below, stemming from your letter of July 23, 1973. We have attempted to answer your questions as fully and as completely as possible.

"1. Please indicate any statement by IRS' Chief Counsel during the period 1957–1965 that political parties were exempt from Federal taxes, as stated by IRS Commissioner Alexander on August 1, 1973."

Commissioner Alexander was referring to a legal memorandum from the Chief Counsel to the Assistant Commissioner (Technical), dated December 6, 1957, which concluded that political parties were constitutionally exempt from taxation on the theory that they are essential instruments in maintaining our republican form of Government and the principles upon which it is founded. The memorandum also argued that there had been no indication that Congress intended to tax political parties and that the long administrative practice of not taxing them should control in determining the intent of Congress. However, in 1965 the position expressed in that memorandum was rejected by the Chief Counsel.

"2. Verify and comment on the data set forth in '1. Campaign committees are clearly liable for income tax on the sale of appreciated securities' in my July 23 letter—specifically Clark, San Francisco, Communist Party, IRS 1968, Evans, Nelson, acceptance of payments."

The law with respect to the taxability of political parties has been unclear for many years.

Over a period of a number of years, the Internal Revenue Service has internally taken the position that political parties and campaign committees are taxable entities although, as indicated in the previous answer, the position within the Service from 1957 to 1965 was that political parties were not taxable entities.

The references to "Clark," "San Francisco," "Evans," and "Nelson" are to private rulings issued by the Internal Revenue Service. It is true that private rulings were from time to time issued on the assumption that political parties and committees were taxable entities. However, private rulings are applicable only to the particular taxpayer to whom issued, do not constitute a formal position on which other taxpayers may rely, and are treated, like tax returns, as confidential documents. Thus we are unable to comment further on these rulings.

The only published ruling dealing with the question was Revenue Procedure 68–19. The Internal Revenue Service is on public record in the Communist Party case as contending that political parties are taxable entities. However, after the case was remanded to the Tax Court, a settlement agreement was reached by the parties and the case was dismissed pursuant to the stipulation of the parties with the result that the court decision does not provide a precedent either way.

In 1947, the then Commissioner advised the District Director in Philadelphia in a letter subsequently circulated to the field offices that while political organizations were not exempt from tax, the Internal Revenue Service would not require them to file tax returns.

Thus, while the Service internally took the position that political parties were taxable entities, the only clear indication of the Service's position, except for the inconclusive Communist Party case, available to the general public was the fact that no political party was ever required to file a tax return. Acceptance of tax payments from political parties or committees does not necessarily mean that the Service agrees that the tax is due.

Revenue Procedure 68–19 added to the confusion by indicating that campaign committees "may" report interest income on the tax forms designed for trusts. However, the Revenue Procedure was directed principally at funds maintained for individual candidates and did not provide definitive guidelines with reference to political parties and the many varied political committees presently in existence. Also, it dealt only with the reporting of interest income and did not mention income derived from the sale of contributed property.

Following the notice of October 19, 1972, briefs were submitted by both the Republican and the Democratic Parties. The brief for the Republican Party contended that political parties were not taxable as a matter of law. The brief for the Democratic Party contended that political parties were taxable; that they should be taxable as corporations rather than as trusts; and that, in any event, the state of the law and IRS position in the past were sufficiently unclear that any rule subjecting parties to taxation should be made prospective only.

On August 1, 1973, the Commissioner of Internal Revenue issued a policy statement outlining the policy which the Internal Revenue Service proposed to follow in the future regarding the tax treatment of political parties. A copy of that policy statement is attached. It represents the first clear, official public statement by the Internal Revenue Service's position on this subject.

"3. List all contacts, orally or in writing, on the subject of liability of campaign committees for Federal income tax, including capital gains tax, between the Treasury/IRS on the one hand, and on the other hand John W. Dean III, Hugh W. Sloan, Jr., Maurice H. Stans, G. Gordon Liddy, Fred F. Fielding, Roy Kinsey, Thomas P. Pike."

We have inquired of those persons, presently in the National Office of the Internal Revenue Service and in the Office of the Secretary of the Treasury, having responsibilities that would have placed them in a position to receive such contacts, and none of them has any recollection of receiving contacts on that subject. We have also checked the relevant files and found no written evidence of any such contacts.

Mr. Roy E. Kinsey, Jr., in a deposition in a civil suit (*Nader v. Internal Revenue Service*, Civil No. 1851–72 (D. D.C.)) indicated that he had discussed the tax consequences of contributions of appreciated stock to political committees with Mr. Roger V. Barth of the Internal Revenue Service. Mr. Barth has no specific recollection of any conversation with Mr. Kinsey on this subject matter.

"4. Furnish records of oral conversations or written memoranda within Treasury/IRS concerning and immediately following the September 27, 1972, Wall Street Journal story by Jerry Landauer describing the scheme to evade capital gains taxes."

"5. Furnish records of oral conversations or written memoranda within Treasury/IRS concerning the October 3, 1972, press release alleging that the IRS was in doubt whether a political committee was required to pay any income tax."

Intra-agency memoranda are generally exempt from disclosure to the public under the Freedom of Information Act, and such documents have historically not been supplied on a blanket basis to Congress. Confidentiality of internal memoranda is essential if our personnel are to feel free to record, candidly and in detail, their analyses and opinions for future reference and for the use of policy makers.

"6. According to press accounts, IRS Commissioner Alexander at the August 1, 1973, Treasury news conference 'cautioned fund raisers from dissipating money on hand so as to avoid paying taxes'. Why does not the Treasury/IRS place a jeopardy assessment on Finance Committee to Reelect the President and any other organization similarly situated, as I have repeatedly suggested?"

In the August 1, 1973, Policy Statement Concerning the Tax Treatment of Political Committees and Parties and Contributions of Appreciated Property, Commissioner Alexander stated that the Internal Revenue Service intends to take such steps as may be required to see that major funds under the control of political parties and committees will not be dissipated without regard to potential tax liabilities, and hopes that such result may be achieved through voluntary arrangements with the organizations involved without the necessity of resorting to jeopardy assessments. The Internal Revenue Service is currently in the process of implementing the policy prescribed in the August 1, 1973, statement. Accordingly, at the present time, circumstances do not warrant the immediate utilization of jeopardy assessments to insure the payment of any taxes which may be assessed if Congress should decide not to act.

Attachment.

PART V. ADMINISTRATIVE, PROCEDURAL, AND MISCELLANEOUS MATTERS

INTERNAL REVENUE SERVICE POLICY STATEMENT CONCERNING TAX TREATMENT OF POLITICAL COMMITTEES AND PARTIES AND CONTRIBUTIONS OF APPRECIATED PROPERTY

(Announcement 73–84)

On October 19, 1972, the Internal Revenue Service published in the Federal Register a notice of its concern about the tax treatment of political committees and parties and about transactions involving donations of appreciated property to political committees or parties and sales of such property by such organizations. The Service invited public comments upon these and related issues. Twenty-seven submissions were received by the Service in response to this public invitation, and a public hearing was held March 1. 1973.

Conclusions with respect to the status of the law

Based upon its consideration of the submission received from the public and its further study of the issues, the Service proposes to adopt the following course:

1. Although it has been the long-standing practice of the Internal Revenue Service not to require political parties and committees to file tax returns, the Service does not find any specific provision in the Internal Revenue Code to such effect. Therefore, unless the Internal Revenue Code is changed to relieve political parties and committees from the duty of filing tax returns, the Service will require such entities to file appropriate tax returns.

2. Unincorporated political parties or committees may be treated for tax purposes as associations taxable as corporations or as trusts (or possibly partnerships) depending upon the application to the specific facts and circumtance of the standards developed for the classification of unincorporated organizations.

3. The gross income of political parties or committees shall include interest and dividends from investments, income from any ancillary commercial activities and gains from sales by the committees or parties of appreciated property. Donations received by such committees or parties shall not be considered as income, and expenditures for political purposes shall not be considered as deductions. Deductions shall be allowed, however, to the extent attributable to income of the political parties or committees, in accordance with regular rules of the Service in analogous situations.

4. Gains on the sale of appreciated property, net of any losses, shall be included in income of political parties or committees to the extent provided in the Internal Revenue Code.

Implications of legal conclusions

The legal conclusions above set forth are consistent with positions taken in a number of rulings which were issued privately over several decades, but never made public by the Service. They are also consistent with Rev. Proc. 68–19, 1968–1 C.B. 810, which dealt primarily with candidates' committees (as distinguished from parties or party committees) and stated that interest received on unexpended funds of such committees "may" be reported by the committee on Form 1041.

On the other hand, both the legal conclusions and the above rulings are inconsistent with the historical practices of the Service not to require the filing of returns by political parties and organizations. That policy of not requiring returns was communicated to the field offices of the Service more than 25 years ago, but it, too, was never made public.

These past policies of the Service are logically inconsistent, but they are a historical fact.

We are now faced with the question of determining the fairest way in which to commence general enforcement of the legal rules. Most importantly we must determine whether those rules should be retroactively applied.

Both the Democratic and Republican national committees argued in their legal submissions that the rules should be applied prospectively only. It appears from published reports that both major parties engaged in the practice of encouraging contributions of appreciated property. Thus, if the rules regarding gains on sales of appreciated property are to be retroactively applied to 1972 and prior years, it appears probable that unforeseen and substantial tax liabilities may exist for the national and other committees of both parties.

If such rules were retroactively applied, the hardships of an aggressive and evenhanded collection policy might fall as heavily on those entities which have no funds as upon those which do. Comprehensive collection enforcement might, for example, require placing entities with insufficient funds in bankruptcy, asserting liens on funds raised in the future by such entities and their successors, and asserting transferee liabilities.

The Service agrees with the Democratic and Republican national committees that the retroactive enforcement of rules regarding gains on the sale of appreciated property, now publicly announced for the first time, would create major inequities, and has concluded that it will not seek to apply such rules to sales prior to the Service's statement of its concern with the problem on October 3, 1972. Also, the Service will not require political committees and parties to file tax returns for years prior to 1972. Subject to these limitations upon retroactivity, the above legal conclusions are applicable, but the Service will not seek to enforce them until it appears that Congress has had an opportunity to consider the problem specifically. Congress has already taken a first step, as the Ways and Means Committee January notice of tax reform hearing listed the tax status of political organizations as a major subject to be considered. In his testimony before the Ways and Means Committee on April 30, 1973, the Secretary of the Treasury called for Congressional action in this difficult area.

The Service is beginning investigations to determine the potential liabilities of political parties and committees, and develop promptly the standards and guidelines for the application and enforcement of its new rules if Congress should determine to leave them in place. It intends to take such steps as may be required to see that major funds under the control of such entities will not be dissipated without regard to potential tax liabilities, and hopes that such result may be achieved through voluntary arrangements with the organizations involved without the necessity of resorting to jeopardy assessments.

Other Tax Aspects of Political Activities

In the meantime, the Service proposes to act in the area where its rules and practices have been clear. Those who deducted from income political contributions (beyond the limited Internal Revenue Code allowances to individuals) should find such deductions disallowed. Those who excluded from income political funds diverted to personal use should find the diverted funds treated as income, and this rule shall be applicable to any political parties or committees which may have diverted funds, contributed for political purposes, to purposes determined judicially to have been illegal. Those who rendered services to political parties and committees in return for compensation must be taxed on such compensation. Gift tax liabilities will be enforced in accordance with Rev. Rul. 72–355, 1972–2, C.B. 532.

Senator PROXMIRE. Senator Percy.

Senator PERCY. Secretary Shultz, I would like to discuss three general subject areas and one question about the GAO, to tie in with Congress Reuss.

Senator PROXMIRE. I just want to interrupt because I understand that Mr. Alexander will have to leave. He came, as I understand, to specifically respond to Congressman Reuss.

Secretary SHULTZ. He doesn't have to leave. He came because Congressman Reuss wanted to ask him questions, but I don't want to let him go if there are going to be more questions.

Senator PROXMIRE. Does anyone else have any questions for the Commissioner of Internal Revenue?

Mr. Alexander, you are dismissed. Thank you very much.

Mr. ALEXANDER. Thank you, Senator Proxmire.

Senator PERCY. My first question will be on GAO. I want to talk about red meat a little bit and then about a balanced budget.

Senator PROXMIRE. Mr. Alexander, I beg your pardon. Congresswoman Griffiths might have a question.

Representative GRIFFITHS. Secretary Shultz might not be able to answer it. He might need Mr. Alexander's help.

Secretary SHULTZ. I need all the help I can get, so you stick around.

Senator PERCY. I happen to think GAO is an immensely helpful arm of the Congress and an invaluable asset. I have introduced legislation that would clarify the intent of Congress that GAO should have access as auditor to the executive branch of Government under the congressional wing. The bill would provide for court action if it could not get access to records. And it would actually cut off funds unless reversed by the Congress for any agency that would not cooperate.

Specifically I was concerned about its inability to get access to Lockheed data that the Treasury Department had in connection with the Lockheed loan which was, after all, a quarter of a billion dollar loan or guarantee. I know the vice chairman and I voted against it. We are very much interested in having adequate data. Let me present my facts and then I will be happy to have your response, Secretary Shultz. As I understand it the GAO had no problem getting data from Lockheed itself. It could not get the data from the loan board. And when finally it went to the Banking Committees of the House and the Senate and through those committees were finally able to get data, it was a period of about 6 weeks before the data was actually produced, which seems an extraordinarily long time to provide data that was readily available and apparently in the files. These facts were stated yesterday by Elmer Staats in the hearings on the legislation that I introduced. I would like to give you an opportunity to respond and tell the Treasury Department's side of it and first of all tell why access was denied and, second, why there was a 6-week delay once the agreement was reached through the Banking Committees that the information was pertinent, the GAO should have access to it, and Treasury should deliver the data.

Secretary SHULTZ. Well, it is my impression and I am surprised that this has come up again, because I spent quite a little time working on this very subject when I first became Secretary of the Treasury and I thought we had worked it out, GAO had been able to get the material they wanted to make the audits and so forth, and that that problem was behind us and it wasn't an issue, that we had resolved that problem.

We had a number of problems between the Treasury and the GAO that I had when I got there but I think we resolved it.

Senator PERCY. There were those of us who were surprised that it would take 6 weeks once a decision had been made before the material was provided. Mr. Staats expressed surprise at the delay, and I want to give you a chance to respond to his testimony.

Secretary SHULTZ. I'm surprised that the bureaucracy could respond that fast. That is pretty good—6 weeks.

Senator PERCY. For material that's in the file? I don't imagine the Ervin committee or the country would sit around for 6 weeks if an order had been issued for material that is in the file.

Secretary SHULTZ. You catch me a little bit at the blind side because I had thought that we had resolved this Lockheed-GAO issue a year ago, and I haven't given it any thought since. I'm surprised that's coming up now.

Senator PERCY. Then in principle the Treasury will cooperate with GAO and not have another incident of this kind so we have to rehash old ground?

Secretary SHULTZ. Well, I testified before the Senate Finance Committee when I was standing for confirmation as Secretary of the Treasury that certainly my policy would be to cooperate with the GAO. I am bound to do that. Now I think there are limits. You can't let the GAO take over the job of Secretary of the Treasury. That is my job to do. And it is up to me to exercise the judgment and so forth that are involved there.

So if they want to audit what we have done that is all right, but if they want to sort of sit with us and engage in a joint decisionmaking process, nothing doing.

Senator PERCY. Now, on the subject of red meat and controls.

Secretary SHULTZ. I feel like the red meat here after you and Congresman Reuss.

Senator PERCY. It is appropriate to follow with this, then.

Yesterday, George Meany, in Chicago, in a press conference following his executive board meetings, urged President Nixon to "Get rid of all of his economic advisers except George Shultz, Treasury Secretary, who has consistently opposed controls."

Now, he is not only a golfing partner of yours but also a great believer in your economic theories, and the AFL-CIO has now come out against all controls on the economy, which I think is a very enlightened position.

Are you able this morning, Secretary Shultz, to testify as to your own personal beliefs as to what now should be done with respect to our controls or will your answers represent the consensus that has been reached by the administration?

Secretary SHULTZ. Well, I think it is up to me as the President's spokesman here to explain policies that he has adopted as best I can.

I have never made any secret of my own personal beliefs. As I have testified before the Congress, I have never been an advocate of wage and price controls. Other people have sometimes been and sometimes not been. I never have been and I haven't seen anything in their operation over the last 2 years that has made me more of a believer, although I think we have gotten some mileage out of the proposals that we have had. I think that if we are determined about it, we can get some mileage out of phase IV.

Senator PERCY. Well, I would like to say for the hearing record that I think there have been very few cabinet officials who have had the responsible posts that you have had, that have survived as well as you have had under extraordinary circumstances, and have had the respect of business, labor, and the Congress. I believe, and we do believe that some of the policies have long been wrong but at this particular time certainly I think the consensus of the Congress will be behind your own beliefs with regard to a free market.

Mr. Vice Chairman, I would like to take just a moment to state what I think our policy ought to be with respect to the meat problem now, and I think it is consistent with positions that I have taken right along on the floor of the Senate and on votes. I intend to vote today for an amendment being offered to remove controls on meat prices immediately. I think our ceilings should be lifted.

The problem that we have experienced, the failure of producers to send beef cattle to market and their holding cattle till the promised lift of the freeze, which is supposed to occur on September 12, is just a disaster. They know that in 6 weeks they will receive much higher prices for their product and they are savy enough to hold them until then. I don't think in a free enterprise system they have anything that will hold them back from doing what they think is in their economic best interest. It is very hard to appeal to their sense of patriotism if they are going to take a shellacking as producers, and they probably cannot use their stockholders' money that way.

A result of the freeze policy and farmers' action is that beef is disappearing from grocery stores and wholesale markets. This morning in the Chicago Tribune it indicates on the front page that a task force of 75 city food inspectors yesterday went out and made spot checks of Chicago stores to prevent the sale of ungraded and black-market meat. We know black markets are existing all over the country that have been created this week right here in Washington. In Chicago the Department of Consumer Sales has started a program now urging all retailers to go into an allocation program of their own.

George Meany yesterday said:

> We're in a situation now that I thought I would never see in my life. But predictions have been made that this would happen, and the policy now, in this one respect, is disastrous. The only way to ensure that prices eventually will come down is to ensure that we are going to get adequate supplies in a free market.

If we are to keep a free market, why, Secretary Shultz, should we not immediately, remove these controls because the country is convinced that the freeze is a transparent Band-Aid type of operation that brings gross inequities and eventually is a disaster as a policy? You simply cannot do it in this kind of a market, as I think you know better than any of us.

Now, what would be your recommendation to the President with respect to the freeze on meat prices today?

Secretary SHULTZ. Well, let me try to pick up a few points that you mentioned.

You bled a little bit for the meat producers and I don't know if there are any people from the oil States here. Beef and oil are the two places we are feeling the pressure, and I think it is well to take a look at what happened to the prices in those commodity categories.

The wholesale price index for steers from January to June 1973 has gone up 60 percent. So there has been a considerable price increase. The wholesale price index for beef and veal, 44 percent. The consumer price index for beef and veal, 38 percent. Food as a component in the first half of the year, as the vice chairman noted in his opening statement, has gone up, I think, 21.5 percent in that same period.

Now, I know you didn't ask about oil and gas, but let me just mention it because that is the other big pressure point which the people interested in that are coming to town and working us over. The wholesale price index for crude oil, January through June, up 23.6 percent. Wholesale price index for refined petroleum products, up 89.6 percent. The consumer price index for fuel oil No. 2, up 26.8 percent. Consumer price index for gasoline, up 18.8 percent.

So if there are going to be price controls, these are the areas that have knocked us over, and if we are not going to control them, we might as well forget it, because there is no point in controlling the people that don't need it, so to speak, or where the prices are not a matter of pressure.

On the question of the beef ceiling, I don't pretend to be an expert on the ins and outs of the industry, but as we try to work within the framework of a controlled system for phase IV we address the problem of the bulge that is there because of the costs that are in the system. Our thinking was that we should try to spread it out a little bit so it didn't all come onto the consumer at once. As we consider in the food area the problems of long term supply, it seemed to us that poultry and hogs had to be let go of immediately. The control system in phase II damaged the poultry market quite a little and cut the supply back down. It was building and the freeze hurt it again and now I think it is rebuilding.

In the case of pork we saw a great increase of what for me was a new word. All of you probably know the word "piggy sows." I didn't know what a piggy sow was till the freeze. When piggy sows are coming into the slaughterhouse in large proportions, it is bad news for 6 months from now or 8 months from now. So that had to be stopped.

As far as cattle were concerned, our information was and is that there is not a long term negative consequence to holding the freeze at the retail level. Now, there is predictably nad we knew that there would be some shortages prior to September 12 and, indeed, the very announcement of a date would create that problem. But we put down a date anyway, which we certainly mean that the ceilings will be off by that time without question in order to assure the cattlemen of what their long term picture will be.

To a certain degree, cattle can be held off the market. There is apparently a limit as to how much leeway there is, but in any case what is not put onto the market this week and next week and so on, presumably being held back for those high prices on September 12, that is going to come to the market around September 12. There is a big inventory of it out there that will come on the market on September 12 and maybe we won't have such a big gigantic price increase. If people begin to get the idea that might be so, then they might start sending their cattle to market a little earlier.

So that is our thinking. Perhaps it is erroneous, but I'm trying to explain to you the basis on which this decision was made and it is being subjected to a great deal of question and heat, as you have well explained.

Senator PERCY. Well, I would like to reask my question.

Do you believe we should keep the freeze on, on red meat, until September 12? Do you see any good for the consumer by freezing prices at these high prices when there is no meat to buy, or they are going to be dealing in black markets for the next month and 12 days?

Secretary SHULTZ. I don't think that wage and price controls work in a period where the economy is operating right up at its capacity. I'm sure they are going to produce lots of problems. That's where you get the supply problems connected with them, and there are black markets, and it is fabulous how fast the private market works. As I understand it, cattle now go from Omaha to Toronto or Montreal or somewhere and then they are imported back into the United States so that they can carry a higher price because they are imported and the market just clicks off a reaction like that very fast.

So I don't know that we're getting all that far, but I think there is a rationale to this decision and that is the position that we are in.

Senator PERCY. In other words, you don't want to answer the question as to what your own personal beliefs are as to whether or not we should. Today, we have got to vote on this issue, and we would like as much help on that vote as we can, to vote for the right policy. We would like to get your personal feelings as to whether we should vote aye or nay on an amendment to immediately take the freeze off of beef prices.

Secretary SHULTZ. The administration's position is that September 12 is our date.

We listened to the Congress, perhaps we listened too much to the Congress. I think all the Democratic Senators or at least 33 of them, or how many were present, voted unanimously not too long ago for a 90-day freeze on everything, and I am afraid we listened to that. It would have been better if we hadn't.

But at any rate I think it would be interesting for us in the administration to see what you think.

Senator PERCY. Well, I've said what I think and that is the way I'm going to vote, and I think you're going to be pleased that we will vote that way, but it must be terrible being a team player and have to duck for 12 minutes a perfectly simple straightforward question.

Thank God I am in the Congress.

Senator PROXMIRE. Congresswoman Griffiths.

Representative GRIFFITHS. Thank you very much.

I'm very glad to see Secretary Shultz, who had time to come to this committee hearing, and I am sorry that he could not come along with Secretary Brennan to the hearing on the economic problems of women. I personally have decided that the only brave Secretary in the Cabinet is Secretary Weinberger who did come.

I would like to say in relation to that freeze, that the only thing worse than a freeze, is a freeze with the date certainly set in advance for lifting. You guarantee the problem as soon as the date is certainly lifted, whether Democrats or Republicans voted for it.

I would like to ask you some questions regarding the economic status of women. The real job of this committee is to inquire into the economic status of all the employment in the country and try to see that those persons employed are fairly treated and that they are well paid.

In a 1972 study of "Employment and Discrimination by Banks," the Council of Economic Priorities reported that women employed by banks are overwhelmingly concentrated in low-paying jobs. The Council also had this to say:

> Existing legislation regarding fair employment is adequate, but enforcement by the Treasury Department is not. If a bank fails to comply with Executive Order 11-246, which limits employment discrimination by Federal statute, the Treasury Department can end the bank's status as a Federal contractor with the result that it can no longer be a repository for Federal funds, collect Federal taxes, or sell or cash bonds.

I would like you to comment on each of the following statements.

The Treasury has never denied Federal funds to any major bank found to be in noncompliance. Is that correct or not?

Secretary SHULTZ. Again, you sort of blind-sided me, Congresswoman Griffiths. I don't know the answer to the question.

Representative GRIFFITHS. The attitude of Treasury officials appears complacent. When the program specialist in the Treasury complaints section was asked how Treasury judges whether a bank is in compliance, he replied, we generally take a bank at its word. Is that right?

Secretary SHULTZ. Well, I think that the Treasury has, working with the banks, done quite a job in the area of equal employment opportunity. I have studied that a bit and I have been interested in that subject myself in the various positions that I have had, and it is my impression that there has been quite a change in the banking community.

Now, I think that it certainly had concentrated on the problems of blacks and Spanish-speaking. Just what the record is insofar as women are concerned I certainly want to check, but I do think that the Treasury work in improving employment opportunities for minorities, or in the case of women, majorities, has certainly not been the casual one that your statement implies.

Representative GRIFFITHS. Well, I hope you're correct but I think you're wrong.

More than 60 percent of all employees in banks are women. As far as I know, the last time I checked, there was only one vice president who was a woman in the city of Detroit, but they may have more now. But the truth is, all of those women are concentrated in the lowest paying positions and the Treasury is in a position to insist that those women be promoted or to withhold contracts of incredible volume to those banks. In my judgment it is high time that the Treasury went to work. The Treasury does not publish the names of banks it reviews, cannot publish the result of the reviews, and claims that it does not keep records of banks which fail to comply because there just are not that many.

Look at the facts. The facts belie the Treasury. The banks aren't complying. You are the officer that can enforce it, and I urge you to enforce it—to enforce the Executive order.

I would like to ask you also concerning taxation. As you are aware I am violently opposed to the marriage penalty tax paid by married couples where both partners work outside the home. For example, if a woman earns $14,000 a year, marries a man with the same income, together they will pay $984 more in Federal income tax for 1973 than if they had remained single.

Are you for it or against it?

Secretary SHULTZ. Well, I'm for marriage.

Representative GRIFFITHS. I am, too, but I don't think public policy should discourage it.

Secretary SHULTZ. I am for trying to work out problems like that, that it is a very hard kind of issue. Perhaps Commissioner Alexander can talk on it.

Representative GRIFFITHS. I would be glad to hear you state it.

Secretary SHULTZ. I listened to Eddie Cohen go through this how many times?

Representative GRIFFITHS. And I listened to Larry Woodward, and you know and I know that all we have to do is write into one of those statutes that when they figure their tax, if they didn't figure it as single, they do not have to pay any more money than if they were single. It is the simplest solution in the world and it can be done so easily.

Let's hear your story.

Secretary SHULTZ. Congressman Reuss had a good solution.

Senator PROXMIRE. Will you pull the mike a little closer, please, Mr. Alexander?

Mr. ALEXANDER. Yes; thank you, Senator.

The Internal Revenue Service joins the Secretary in the high regard for marriage and a desire not to discourage it, but we have to administer the law the way we find it.

Now, the change in the law that you mentioned——

Representative GRIFFITHS. Occurred one night when I had left the conference.

Mr. ALEXANDER. I wondered how it got through.

Representative GRIFFITHS. That's exactly how it did. There was nobody there who understood it.

Mr. ALEXANDER. Well, we've had flip-flops back and forth on the tax treatment of married couples as compared to single individuals for a long period of years, with first, perhaps, the emphasis and the benefits falling too heavily one way and then falling too heavily the other. The recent change was, as I recall, designed to more nearly equalize the status of the single individual, and that change, I think, was suggested by some of the leaders in the women's rights movement as well as others. That change seemed to have gone, in the instance that you mentioned, too far and swung the pendulum the other way.

Now, if you can persuade the others in your committee——

Representative GRIFFITHS. I expect you to help me and I expect Secretary Shultz to help me, too. I think you should support such a view. What would it cost the Treasury?

Mr. ALEXANDER. I don't know but I can find that out for you.

Representative GRIFFITHS. Would you so find out and supply it for the record?

Mr. ALEXANDER. I will supply it.

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

If married taxpayers were allowed the option to file as single individuals, each spouse paying tax based on the actual division of income and deductible expenses, the cost to the Treasury would be about $4 billion.

Representative GRIFFITHS. Well, the truth is that a woman's income which grows, and doubles the couple's income may triple their taxes, so that it really isn't fair.

Last year economists from Brookings Institution told this committee that the 1972 income levels' elimination of the rate advantage of income-splitting plus a special tax rate for heads of households and other single persons that had been enacted because of income coming into play, would increase income tax by over $21 billion a year.

What would it be, what would this figure be at 1973 income levels?

Mr. ALEXANDER. We'll have to get that for you, too, Congresswoman Griffiths.

Representative GRIFFITHS. Thank you.

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

The $21.6 billion that the Brookings study by Mr. Pechman and Mr. Okner cites for the benefit of income splitting and certain other provisions would be about $24.5 billion in 1973 based on the expected increase in overall tax liabilities from 1972 to 1973. I might point out that many people would measure the benefits of income splitting as the tax savings of present law over a structure which requires each spouse to pay tax as a single person, based on his own income and deductible expenses. By this measure the tax benefits of income splitting are less than $6 billion. The higher estimate obtained by Pechman and Okner is attributable to a number of factors. For example, they assume a return to the single rate schedule in effect prior to 1971 and they, in effect, require married couples to pay tax at single rates on combined income rather than permitting each spouse to compute tax on his or her separate income.

Representative GRIFFITHS. The same economists said that 97.8 percent of these taxes went to taxpayers with incomes of $10,000 or more.

Is that still true today? Will you figure that out for me and supply it for the record?

Mr. ALEXANDER. I will.

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

There is no reason to suspect that the proportion of tax benefits going to those with incomes over $10,000, as cited by the Brookings Institution economists, would change appreciably since 1972.

Representative GRIFFITHS. If individual taxation is not acceptable, could we not allow married persons the option of filing as though unmarried?

Mr. ALEXANDER. We could, but speaking for the Internal Revenue Service, I would hope that we would find a solution other than that.

Representative GRIFFITHS. Under present law, the deduction for household and child care services is not available to taxpayers who do not itemize deductions. Yet married couples who filed joint returns for the tax year 1970, 40 percent of those with adjusted gross incomes of less than $15,000 did not itemize deductions.

Why should the deduction be denied to taxpayers who take the standard deduction?

Mr. ALEXANDER. I'm not sure I fully understand this question.

Representative GRIFFITHS. Well, it is in the statute. What really is the purpose?

Mr. ALEXANDER. I think it bears on a matter of legislative policy and the cost of change. If I understand the question correctly, it relates to allowing both the standard deduction and certain itemized deductions, if not all the itemized deductions. The cost of such a change, I am certain, would be extremely great and would mean that to produce the same amount of aggregate revenue we would have to find other ways, perhaps other taxes, perhaps increases in the income tax rates applicable to taxpayers generally, to compensate for this loss.

Now, I do not have an exact figure of the amount.

Representative GRIFFITHS. For the record, will you supply it?

Mr. ALEXANDER. I will.

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

The cost of converting the itemized deduction for child care to a deduction to be taken from gross income is less than $100 million.

Representative GRIFFITHS. Because in reality this deduction was given for the low-income taxpayer and the truth is that it doesn't work out that way at all. The really low-income taxpayer isn't getting it because they're using a standard deduction, so there would be some positiveness in saying that they should be able to take that with the standard deduction.

Yes, Secretary Shultz.

Secretary SHULTZ. I don't have in my mind all the details of it, but I would remind you of the proposal we made in the Ways and Means Committee last April which I would hope could be worked on aggressively to simplify the individual income tax return. You may remember the effort with respect to middle-income taxpayers to find a way to simplify this extensive deduction procedure so that the form would be easy to fill out, and would run in a consecutive manner, and so on, and I think this is one of the deductions that would be affected in which I think a greater degree of equity would be provided, as well as simplicity, by this form.

Representative GRIFFITHS. Under present law in order to deduct the cost of child care, a single taxpayer need only work part time while a married taxpayer must work full time. Yet a wife who works part time is very likely to have children. Is the requirement of full-time work for the married justifiable?

Secretary SHULTZ. If I may, I would like to supply an answer to that for the record. It is not a subject that I have thought about.

Representative GRIFFITHS. All right.

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

In general, expenses incurred by taxpayers for the care of their dependents are personal expenditures and, consequently, they are not deductible. However, Congress has recognized that, in certain instances, dependent care expenses are so extraordinary and burdensome that they should be allowed as deductions notwithstanding their personal character.

Thus, section 214 of the Code was enacted in 1963 to provide relief in instances where adults, in order to earn a livelihood, were compelled to incur dependent care expenses either because: (1) they were single (or had an incapacitated spouse) and had no family member to care for their dependents or, (2) in the case of married taxpayers, both spouses had to work in order to maintain an adequate standard of living for their family. Accordingly, the deduction was made available to single taxpayers regardless of income levels and to married taxpayers only if their adjusted gross income did not exceed \$6.000 (the deduction was phased-out dollar-for-dollar for income above \$6,000). The maximum deduction allowed in all cases was \$600 for one dependent and \$900 for two or more.

In 1971, Congress liberalized section 214 to provide, among other changes, for an increased deduction (up to \$4,800 per year) and a substantially higher gross income limit (\$18,000 adjusted gross income with a phase-out of one dollar for each two dollars of income in excess of \$18,000). The deduction was also made applicable to expenses incurred for household help.

In order to make certain that the more liberal benefits of section 214 were available only to taxpayers who could not otherwise care for their dependents and complete their household chores. Congress required that in the case of married taxpayers both spouses had to be employed full-time. In particular, Congress was concerned about the abuse that would arise in the cases where a married individual who normally had household help decided to obtain part-time employment in order to be able to claim the section 214 deduction. The full-time employment requirement was not made applicable to single individuals because it was assumed that, in most cases, the option to remain at home would not exist.

Representative GRIFFITHS. Why should the deduction not be granted to the people in upper and middle income and the very wealthy brackets? What is really wrong with it? Why should not everybody be able to deduct for child care or, really, for any home employment.

In my opinion it would go a long way toward raising the wages of people and getting a whale of a lot of people off welfare.

Secretary SHULTZ. Deducting wages paid to people, anyone who works around a home, would mean a mammoth change in the revenue collection. That would be gigantic and, of course, that would favor the wealthy to the extent that these deductions are supposed to help the lower and middle income people.

Representative GRIFFITHS. Because they are not helping them, because we insist——

Senator PROXMIRE. Senator Javits has to go.

Representative GRIFFITHS. I have just one more question, and let me ask it because I know you will all love it. You will enjoy this one.

The one I am interested in is why do we grant a man the right to leave property untaxed to a charity but only half of it to his wife? Why cannot you leave your wife anything you have untaxed? What would it cost and why do we not do it?

Secretary SHULTZ. And, again, if I may, I would like to provide an answer for the record. I think you are taking up the question of estate taxation.

Representative GRIFFITHS. All right.

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

As I noted in my April 30 testimony before the Ways and Means Committee, revision of the estate tax marital deduction is one of the principal issues in the estate and gift tax area; and we have indicated our willingness to work with the Congress on that and other estate and gift tax changes.

I would point out, however, that under present law each estate has a specific exemption of $60,000. Together with the marital deduction provision which allows up to half of the adjusted gross estate to be left tax-free to a surviving spouse, this means that estates of $120,000 or less (after payment of debts and expenses) can be left tax-free to a surviving wife. Thus, liberalization of the marital deduction would affect relatively few estates, in 1970 about 30,000 of 1.9 million. Nevertheless, the revenue loss from an unlimited marital deduction would be very high, in excess of $500 million.

Representative GRIFFITHS. I ardently support this. I think it is only fair. I think it is ridiculous to do anything else. If you have any other view, if you think there should be a limit, would you mind discussing that, between a husband and a wife that they should leave the property without paying any tax?

Thank you.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Secretary, I shall only keep you a minute as I have to go to the Foreign Relations Committee. I stayed because I noticed one thing in your statement that affects me very deeply.

On the whole the statement seems very optimistic at a time when the order of the day appears to be pessimism in economic affairs. Now, let me tell you why I say that.

First, of unwelcome developments, the dollar has declined in terms of foreign currency. Second, we had to resort to a temporary freeze. Then you play that off by saying that you are very encouraged by the floating rates, that they are on the whole leading toward an international agreement. You say here with respect to the economy, given the essential support of restricted fiscal and monetary policies the economy will work its way through to much lower rates of inflation.

Do you mean to be optimistic? You say that Congress is apparently responding to the need for limiting spending. Do you mean to be optimistic or do I detect something which you had no desire to put forward?

Secretary SHULTZ. I meant to be candid and realistic and I had not in mind, when this statement was being prepared, trying to put an optimistic or pessimistic cast on it particularly.

Just to take the specifics that you mentioned. On the question of whether Congress will want to work with the administration to keep spending under control, I'm quite optimistic about it. I think, as I sense it around with all of the arguments about the composition of expenditures and so forth, I sense a great concern that that be held under control, and I believe Senator Percy has, I know he has told me about some recent actions here in the Senate on that. And aside from particular things that are done procedurally and in an overall sense, I think there is an attitude that we have to keep the spending under control, and I am encouraged by that and so I am optimistic on that score. I think we can work together and we can get that job done, as we did last year. So that is one point.

Now, on the question of exchange rates, that has been a major problem ever since we closed the gold window. We have gone to a sort of floating rate system and I think as a measure for the moment it is working pretty well. We are intervening to help maintain orderly markets but not on a great scale. And, on the whole, that part of it is reasonably well. And I think at the meeting of the ministers here, earlier this week, on long-term reform, I felt—and I think most everyone there felt—most of them made statements to this effect—was reasonably encouraging.

So I feel that we are getting somewhere on that. It was a hard problem. There are a lot of hard things ahead. I know you have had a lot of good ideas on that. You have been helpful to us. So we're working at it. The inflation problem is a terrific worldwide problem and it's derived mainly, as the vice chairman said, from international commodities, food and other commodities. That is what is pushing us and pushing everybody else.

I think the answer to the problem is to apply the basic disciplines of fiscal and monetary policy and to do everything we can to increase the supplies of these commodities that are in such short supply around the world. And we are trying to do that. We are getting somewhere with it.

We are beginning to see more constructive talks among countries about supply and demand conditions. Most of the countries are making efforts like we are to moderate the pace of growth in their economies. And if that comes about—you know these commodity prices are still shooting up. But if you've ever looked at the charts of those things, they go plunging down too. They come up and go down, both, very quickly.

Senator JAVITS. So, in fact, you are optimistic about our future?

Secretary SHULTZ. If you want to say that, yes, I'm an optimist about America, certainly. I think we can do these jobs. We have had problems. We can solve them. That's what we are here for.

Senator JAVITS. The other question I would like to ask you is this: Yesterday Mr. Stein appeared before us and was hit rather hard during questioning with the proposition of stop and go on price and wage controls. Would you say now that it would be good policy now to simply let American business and the American consumer know that phase IV is on, that it will be on-going, that we do not know when we can take off controls, so people do not get false illusions about this. Shouldn't we make it clear that this is our steady policy, instead of the idea that we are just doing this momentarily, that we will be off pretty soon which is always thrown in, theoretically, to humor people who do not like controls, but which, nonetheless, makes business very uncertain about what is going to happen tomorrow.

Secretary SHULTZ. Well, we have taken the position, as an administration, that here is the phase IV program. We have put it out to comment, and we've gotten a lot of good responses. And we will put out the final regulation prior to August 12. And that is the program. We've emphasized that.

Now, we have not particularly talked about the undesirability of controls in the long run. But I feel that they are very undesirable in the long run. And we have built into phase IV, in a little different way, a method by which sectors of the economy can become exempt from control.

In order to show that we meant it, we exempted in the initial regulations small businesses, 60 employees or less. We did not think that that constituted a big problem. We exempted long-term coal contracts, too, in order to show our emphasis on long-term supply considerations.

We exempted lumber, which had been a big problem in phase II. But where prices were allowed to go up, supply came on and demand suffered some and prices have plunged below the January level. We have invited people to come in and describe to us their supply and demand conditions. If they are such that we do not see an inflationary problem in that sector, then we think that we should exempt that sector, so that we do not burden them with redtape, and so that we are able—as this committee, I believe, has urged us in reports on this subject—to concentrate our administrative resources in the areas that contain the most difficulty.

Senator JAVITS. And that business can consider the total complex phase IV policy settled, plus the opportunity to get out from under controls as the case can be made.

Secretary SHULTZ. That is correct. The President has said, in commenting on the statement of the Labor-Management Committee that Senator Percy mentioned this morning: "That they recommended that we be out by the end of the year." But the President said: "That he hoped that that would be possible and he would work to that end. But he did not think it was wise to set a precise date." So that is the President's position.

Senator JAVITS. One last question, and that relates to this red meat which Senator Percy also went into with you, but which I think it is left in an unsatisfactory state. I do not know how anybody is going to vote, today or tomorrow, including myself.

Secretary SHULTZ. I know how Senator Percy is going to vote.

Senator JAVITS. Well, we know how he is going to vote. But I would like to ask you this question: What do you advise the American people to do, the American consumer? Do you advise him to hold out, even if theoretically red meat may be short in this area and that because in your judgment, as Secretary of the Treasury and head of a great deal of the function of the domestic economy, you believe he will do better in terms of stable prices and orderly markets if he does hold out and does not collapse in terms of the situation today?

Secretary SHULTZ. That would be my view. I think, actually, the consumer has been tending to do just the opposite—to try to buy ahead. And one reason why—not the only reason why—but one reason why the shelves are empty is that everybody has a little freezer—some have big freezers—and people have been filling them up. That will create shortages forthwith. I think that that is too bad.

Senator PERCY. They just want to get there before the hoarders do.

Secretary SHULTZ. Exactly.

Senator PROXMIRE. Mr. Secretary, the wholesale price index is out now. It came out about an hour and a half ago. It shows a decrease of 1.3 percent from June to July in wholesale prices. The principal component of the drop is the price of farm products and processed foods and feeds declined 4 percent.

Industrial prices were about unchanged. And consumer finished goods unchanged. Now, the performance of the latter group was because of the freeze during this period. The drop in food prices was something else.

I would like to call your attention to the fact that these were prices sampled as of July 10—almost a month ago. I have here the September futures in Chicago. They show that, whereas wheat was 293 on June 12 of the previous month, it dropped to 268 when this sampling was taken. Now it is up to $3.74.

Corn was $2.25 at the previous month. It dropped down to $2.09 and is now up to $2.78. Soybeans was $8.93 on June 12, went down to $6.70, now up to $10.10.

The point I am making is, that it seems that this July wholesale price index is definitely not a trend. We cannot rely on this as an indication that inflation is now under much better control and moving in the right direction. That is my reaction; what is yours?

Secretary SHULTZ. I agree with that. I think we do have a great sort of sense of masochism, though. If we have a bad report and we see some things out there that we know about that look good, we do not permit ourselves to talk about them. On the other hand, if we get a good report, we immediately discount it because we see some things out there that are bad. And we focus on them.

Senator PROXMIRE. There's no reason you have to do that. You can do anything you want.

Secretary SHULTZ. I agree with you. And, also, I think that we have——

Senator PROXMIRE. If you think this is indicative——

Secretary SHULTZ. I said at the outset, I agree with you. But I think we just massage ourselves terribly.

Senator PROXMIRE. Well, I don't want you to massage yourself terribly. I want you to give us the——

Secretary SHULTZ. The principle item there, I think, is the drop in the price of soybeans which is directly attributable to the export controls. That is the major difference. I think on the industrials, I would differ with you a little bit there. I think it is due to the freeze but also due to the fact that there was a tremendous amount of talk about how a freeze should be instituted, including your own proposals for a freeze, and this led to a great deal of anticipatory price increases. And those have been made. When the freeze came along, it stopped that. So I think it was a combination of the fact that you had a freeze, but you also had had a lot of anticipatory price increasing going on.

But this is just 1 month's statistic, and like you, I do not look upon it as saying that we now have got our problem solved.

Senator PROXMIRE. You indicated to us a little earlier that you were optimistic about the prospects for getting inflation under control, in response to Senator Javits, eventually if we follow the right policies.

Yesterday, Mr. Stein made it clear that the goals set earlier by the administration, of holding inflation below 3 percent, has been abandoned. Would you like to tell us this morning what target you are now shooting for this year?

Secretary SHULTZ. Well, I have come to the conclusion that targets like that, perhaps, are not too helpful.

Senator PROXMIRE. Well, what do you expect?

Secretary SHULTZ. Well, I don't want to sound in any sense—and I tried to resist this with Senator Javits' question as I will with yours—Pollyannaish in any way about the problem of inflation. It is severe. It is difficult. It is worldwide. And it is going to take policies here, and you have got to cope and expect that others around the world will also be working on this problem.

But in any case, as far as setting a target is concerned, I'm a little leery of it at this point. And I think that what we should do is all the things that we can think of that are sensible and reasonable to do that will help counteract the problem of inflation. And then we'll get there.

Senator PROXMIRE. Well, then, let me try to get as specific as I can on this. If we can do everything we can to be helpful and realistic, one program we should follow, according to much of the advice we have received, is put people in charge of the price controls who believe in them.

We had testimony from the immediate past head of the American Economic Association, Mr. Kenneth Galbraith, charging that asking you to administer price controls is like putting the Pope in charge of birth control.

Secretary SHULTZ. Somebody called my attention to that statement. It was very colorful and worthy of Professor Galbraith.

Senator PROXMIRE. Well, do you think you are really the right person to put in charge of this program?

Secretary SHULTZ. I'm no advocate of wage and price controls. I think that I'm doing my best to manage them in good faith to the extent that I'm involved. The actual operational management of wage and price controls is under the direction of Professor Galbraith's colleague in the economics department at Harvard University; namely, Mr. John Dunlop. He is the operator of the wage and price control system. And we talk and we worry about the price control policies, but the day-to-day operation of the system is under the charge of Mr. Dunlop.

Senator PROXMIRE. I am sure you would not want to make John Dunlop guilty by association. He is not in favor of price controls either, as Kenneth Galbraith is.

Secretary SHULTZ. You should talk to Mr. Dunlop about that.

Senator PROXMIRE. That is the impression I get.

Secretary SHULTZ. I would say this: Professor Galbraith and others say that if, all things considered, the only way to run this economy is through wage and price controls, then we might as well get used to the idea, and set ourselves up on a permanent basis and hire the people to do it right and so forth. If that were our policy, then I am not the man for that. And I would not want to touch it with a 10-foot pole.

If the policy is to get what mileage we can out of it, however long it is here, with the philosophy that basically we do not want it, and we want to get rid of it, then at least some of that is consistent with my own thinking.

Senator PROXMIRE. Well, in light of that, let us go through as quickly as I can, phase IV. Personally, I welcome the strict regulations that limit price increases to the dollar.

But I think you should go further and limit the allowable passthrough cost to direct costs only. That is, during this present critical period, overhead costs should be absorbed by the firm rather than passed down in higher prices. What do you think?

Secretary SHULTZ. Well, we thought about that, and we did not agree with that. It is a cost, and really, it is hard to distinguish the direct and indirect costs.

Senator PROXMIRE. It is also very hard to ascertain what the overhead cost is.

Secretary SHULTZ. But the dollar-for-dollar passthrough is different fom the percent passthrough which we previously had. But for these circumstances, the dollar-for-dollar passthrough is an attempt to contain the manner in which these commodity price increases come through the system—that we don't, in effect, have a layer of profit added.

Senator PROXMIRE. In view of the fact that we've had price control now for almost 2 years, has there been any study to indicate the degree to which the overhead costs do increase as the dollar costs increase, because many people that I have talked to challenge that there is such an increase?

Secretary SHULTZ. Well, I think one of the main reasons why we get the productivity result that you mentioned earlier here this morning is that you tend to have relatively stable so-called overhead costs. As output rises, you spread that volume over the same base and so overhead costs per unit decline and you have the statistical fact or illusion or whatever you want to call it, of an increase in productivity.

You are getting more output per unit of input when that happens. And I suppose that has happened. Now, the problem that was beginning to arise in phase II—and I believe we will have to watch this carefully in phase IV as well—is the tendency when you have profit margin controls to build up overhead costs and to incur costs that you might otherwise not incur because the firm may figure, well, we aren't going to be able to keep that money anyway and here is something that they can do and they will do it.

And that builds inefficiency into the system. I think that is a reason why we should be hesitant with profit margin controls. I'm not one to see them around too long.

Senator PROXMIRE. Why do we keep the nonfood retail sector under controls? This is not the source of inflation—highly competitive, very low margin, with the rate of growth of consumer spending now slowing down, we don't face shortages except in certain specific areas, such as food and petroleum.

With these exceptions, why should we waste valuable resources of time and energy administering a complicated program at the retail level?

Secretary SHULTZ. Well, I think it is a fair question and the retailing industry, the general merchandise industry, I'm sure, will begin to describe their situation. If we can see and feel some confidence that that is a sector that could be exempt, well, our program includes in it the possibility for that happening. I am not trying to prejudge the issue but we have tried to build into this program a method for examining systematically just exactly the type of thing that you mentioned.

Senator PROXMIRE. As you know, I've been persisting in pressing for public hearings on specific important applications for price increases. In implementing the Hathaway amendment in this respect, Congress clearly intended the information submitted to the Cost of iving Council, requesting significant price increases should be disclosed in full. What are you going to do about that?

Secretary SHULTZ. Well, we have regulations out on that subject and they have been published in the Federal Register. And they stand.

Senator PROXMIRE. In the first year, it was my amendment that originally got through. The first year there were no public hearings on price increases and none when Mr. Grayson was in charge. There were hearings on other things but not on price increases.

Secretary SHULTZ. We've had quite a few public hearings.

Senator PROXMIRE. Yes you have. But not on price increases.

Secretary SHULTZ. I do not know precisely how many. Some have been on specific things. I know right at the start of phase III, we had some extensive hearings on home heating oil and other aspects of the oil industry. And there have been others.

Senator PROXMIRE. But there are no regulations, as I understand it, indicating when you have to have public hearings with respect to price increases.

Secretary SHULTZ. I don't believe so.

Senator PROXMIRE. Well, I would wish you would seriously consider promulgating some.

Senator Humphrey.

Senator HUMPHREY. Well, Secretary Shultz, I wasn't able to be here yesterday when the witness that I had hoped to interrogate, Mr. Stein, was here because he has generally given this committee what I would call the economic snow job. And you have been much more frank and candid, as I have told you privately and now I state it publicly.

I have listened with care to the comments that you have made to Senator Javits and, of course, to the vice chairman. But the fact of the matter is, that over the past couple years, it is my experience on this committee, the economic doctors that have appeared at the witness stand have been telling us that the patient is getting better and better even though the pulse rate goes up, respiratory rate is up, blood pressure is up, and there are fainting spells.

But somehow or other we are told that it is just temporary and that we ought to look to better days. Now, I notice that the vice chairman has brought to your attention the wholesale price index. Of course, I have great regard for the Department of Labor and the Bureau of Labor Statistics and the professional people that handle these matters.

But I think the American people ought to know from this table today that this index is misleading, that that wholesale price index as it relates to agricultural commodities, of course, takes into consideration the first impact of the new harvest, much of which will be exported. And we can't still find out how much it is going to be.

It does not take into consideration what the vice chairman pointed out; namely, the speculation that immediately followed the embargo on soybean exports. Within 10 days, corn prices were going through the roof, and so were wheat prices. And that is why the futures reports, which we have presented today, by Vice Chairman Proxmire are what they are.

Soybean prices had a temporary reduction and they have rebounded with great zeal. They are up again. There is no indication that I know of, and, I think, I am somewhat competent in this field, that there's going to be any reduction whatsoever in agricultural prices as they relate to the consumer.

There will be temporary fluctuations for the farmer. He will be taken to the cleaners during the harvest season. And I want to say why. And I want to get it on the record. And then I will come to the question because this Government is not leveling with the American people.

We are going to have a basically good crop. We are going to have trouble harvesting it because of the fuel oil shortage. And it is there now and present. More significantly, many farmers are not going to be able to get credit to hold their crop back for marketing purposes to get a better price. They are going to be compelled to sell quickly.

Lots of crops are going to lie on the ground. And I predict from this table today that before the end of this month, there will be horror stories in the press of grain plowed underground with no storage because this administration has sold off the storage bins.

And finally there will be inadequate transportation. We haven't got enough transportation to move last year's crop. And we have 42 million more acres under crop conditions now, ready to be harvested, than we had last year and we have fewer boxcars, fewer hopper cars, and no relief in sight.

I think that the Cost of Living Council and the Department of Agriculture of the Department of Transportation are grossly derelict in not doing something about what is an evident fact—that anybody that knows anything about agriculture knows to be the truth.

So we have to just tell this audience out here that we are going to have a mess on our hands come late August and September.

And, finally, when I ask where is the fuel oil that is going to dry this soybean and the corn—this morning I put out a little statement that I am going to speak on in the Senate relating to the administration's actions or lack of actions to deal with the current fuel shortage. I charge that they are a double failure.

First, this administration does not have a mandatory allocation system to get fuel supplies where they are most urgently needed. And the reports from the food producing States are that those supplies are needed.

Second, the evidence available to me shows that prices charged by major oil companies for fuel oil and gasoline have gone up to 25 to 50 percent over previous contract prices. I have tried, without any success, to get the Cost of Living Council to provide Congress with the kind of comprehensive account of what is going on in oil prices.

My question, does the Cost of Living Council have any idea of how much the 1.5 percent mandatory guidelines on petroleum product prices are being violated? And they are being violated. Anybody that goes out and buys a gallon of kerosene or a gallon of gasoline. Everybody except in Washington. And they are being violated right in Washington right next to where I live and you live.

Now, what is the degree of violation, Secretary Shultz?

Secretary SHULTZ. Well, of course, in phase III, we imposed mandatory controls on the major oil companies only with passthrough rules as to cost.

Senator HUMPHREY. Well, that left about 9 out of 10 stations uncontrolled.

Secretary SHULTZ. Right. The oil industry is made up, as we all know, of many independent segments of stations, drillers, and so on. And then you have this big group or companies at the end of it. But in terms of prices, what has happened since January, crude oil in the WPI has gone up about 23.6 percent, January through June.

Refined petroleum products in the WPI, 89.6 percent. Fuel oil, No. 2, in the CPI is 26.8 percent. And gasoline in the CPI, 18.8 percent. So there have been very large price increases.

Now I have found myself spending my time in the last few days being asked to come to these congressional offices and groups and being told that the figures on beef—we have talked about them before you came in—they are sort of similar.

Senator HUMPHREY. Yes.

Secretary SHULTZ. To respond to the people who want to see these prices go a lot higher in the interest of supply, and the argument from your colleagues in the Congress who come from other States than you do, is that these commodities are vastly underpriced and the prices need to go higher in order to get the supply that we need.

So, at any rate, the prices of crude have gone up. They have gone up all over the world. Our domestic crude prices are about $1 lower than the world price. We know that that price has got to get up toward the world price or before long we'll be exporting oil. We certainly don't intend to do that. So we have big problems in the energy area and we have big problems in the food area.

And you have mentioned the acreage that was released; that in an effort to increase supply, we have done a lot of work on the transportation problem. We have learned something about it through the misery of the past winter and spring. And gradually we are developing a better ability to cope with those problems, I'm sure.

Senator HUMPHREY. I wish you would outline that, Secretary Shultz. I have been listening to witnesses in three administrations telling how they are coping with the boxcar problem.

Secretary SHULTZ. Well that is about what you do—cope with it.

Senator HUMPHREY. And we do not cope with it.

Secretary SHULTZ. The problems of the railroad industry, on demurage rates and so forth, the extent to which boxcars are used for storage—well, those are things about which we have tried to do something.

I think they are problems, myself, with legal, statutory governmental regulations on backhauls for trucks; why we have to have all those trucks backhaul empty is beyond me. But we seem to insist that that is the way to do things. It seems to me we ought to do something about that. And there are many aspects of the transportation picture that we need to work on.

Now, I think as far as the energy side is concerned, that we have a very serious problem in this country. And we need to work on it hard and energetically. And the President has made quite a number of proposals to the Congress and has taken a lot of action.

We have changed the mandatory oil import program around completely, and it is a much better program than it was. We have access to foreign oil the way that we didn't before.

I was glad, personally, to see this Senate vote on the Alaska pipeline. It is about time we built that pipeline. We have fabulous oil and gas up there in Alaska. And I hope some day, somebody will get the idea that we ought to do something about Naval Petroleum Reserve No. 4.

How a lot of oil—of gas under the ground, frozen, is going to help national security, I don't know. But there is a lot of it there.

We have natural gas. Natural gas is at a ridiculously low price. You ought to increase the price so we get more supply. And there are many, many other things. But I agree with you. This is a problem we ought to work on in terms of the short term, and we ought to be working even harder on it in terms of the long term—and a real research program that will teach us how to get gas out of coal, and some of the other things that will help us.

Senator HUMPHREY. I think you will find Congress responsible and responsive to any of those issues. In fact we have been taking some on our own. And some of the regulations that you've mentioned are statutory law. Those that need changes or recommendations should come to us.

But is the 1.5 percent guideline, mandatory guideline, operative or is it inoperative? I mean, when you listed out these price increases, what does this mean in terms of what your rules are?

Secretary SHULTZ. With respect to the companies covered by the mandatory controls, and examining their reports and so forth, it is my understanding that they conformed with the rules. Now the rule, of course, allows the cost passthrough. But, anyway, I can give you—that has been studied—I don't happen to have it right in my mind but I'd like to make a response for the record that goes particularly toward the reports of the oil companies as we receive them in the Cost of Living Council for the first 4 months of the year, I think is what we've got on hand.

Senator HUMPHREY. I would like very much to have the reports on the majors—the reports of their prices, the reports of their earnings—all that relates to the guidelines as established by the Cost of Living Council.

We have not been able to get those.

Secretary SHULTZ. We will assemble it.

I would just like to say a word on behalf of this industry. Everybody is assaulting it all the time. But they have done quite a job in producing gasoline. Now, last spring, everybody was saying that this summer we wouldn't have any gasoline. Well, it turned out that, with the efforts made by the industry, gasoline stocks rose contraseasonly. Instead of going down at this season of the year, they rose.

So somebody did something right there. We were told that these 40 million additional acres would never get planted because the tractors would stall in the fields without gas. Well, that didn't happen. And I think it is well to identify the problems in advance because that is the way to solve problems is by seeing them there and trying to do something about them. So I welcome that.

But let us not give up on it. Let us work on it. And I think what we have seen here recently gives some assurance that the industry will respond.

Senator HUMPHREY. When is the administration going to establish a mandatory allocation system in light of a scarce supply? Despite the improvements in supply, they are still scarce, Secretary Shultz. All the talk to the contrary about how much gas is around, you know that producing gasoline at the expense of fuel oil, it is a barrel of crude. What you take out of it is, depends on how you turn the dial, so to speak, on the refinery. So we have been taking gas out this summer. And gas is a good profit item. Fuel oil—it is cold up my way. It is very cold. We were within 3 or 4 days of no fuel oil last year. God Almighty blessed us with the warmest winter we had in 32 years. I do not think we can depend on the Lord all the time. I'd kind of look at the administration once in a while. What are you going to do about it?

Secretary SHULTZ. That is the first time in a long while the administration has been bracketed in that way.

Senator HUMPHREY. Well, it needs a little of it right now.

Secretary SHULTZ. Well, I think that the price regulations need to be looked at with this heating oil question very much in mind—that is, we need to use the price system within the framework of the controls. We're going to have to encourage heating oil production so that it is profitable.

I think that is what people respond to. We might as well get or accept that idea. Now, as far as the mandatory allocation is concerned, I am not the man to talk to. Governor Love is the person who is operating that process.

My own personal view is somewhat skeptical—that is, it's a question of allocating scarcity. You have a system for doing it that has served us pretty well for a long time—namely, price. That is the way we have allocated things.

Now, if you put into the industry a different method of allocation—not price but Government fiat of some sort that says, well, regardless of price, you've got to send some here and some there and so on, it is a sort of thing like the mandatory oil import program that I was never a fan of, as you may know.

It's what you fasten on to an industry and once you fasten it on, a great constituency is developed that is dependent upon those allocations or, in other words, getting oil at a price lower than they could otherwise get it. So they don't ever want to let go of it.

And before we know it, we have changed the basic relationship of Government to this industry. Perhaps, in a way, that is not all that desirable. But I don't say that in suggesting that the mandatory program should or should not be put on. I think that is a problem to be weighed in the process that Governor Love is managing for the President.

Senator HUMPHREY. I'm not merely asking about an allocation of scarcities. I'm also asking about priorities, of course. I just want to say once again—and I've been saying it all year—that unless there is an allocation with priorities for proper fuels—propane, fuel oil—for the agricultural sector, you are going to have a catastrophe because if you have a drop of 10 percent in the nutrient value of corn and soybeans in this year's crop, not just in the bean—I'm talking about the nutrient value, the feed equivalent value. That is what it's all about. It is not the weight, it isn't he size of the bean. I is the feed equivalent value. And that feed equivalent value is determined frequently by the continuity of the drying process.

If the drying process is interrupted for any period of time—3, 5 to 6 hours—you lose the nutrient value. Once you lose the nutrient value of the bean and the corn in our part of the country—and we have produced a lot of it—there will be prices in this country in the food markets that no one ever dreamed possible.

I do not want to be an alarmist but I want to tell you that the Department of Agriculture estimates are this thin already between uilization and estimated production. A drop of 10 percent will precipitate an economic catastrophe in this country and abroad because we will have to shut off our exports.

We'll literally throw the world markets into a tailspin. We will be in a situation here at home where the shortage of supply, the likes of which we never dreamed of. Now, somebody has got to come to grips with this problem, Mr. Secretary. And I am chairman of the Foreign Agricultural Policy Subcommittee. I've spent my last 6 months studying this, and I want to say to you, as Representative of this Government, as I have said to Secretary Butz, that we are on a hairline edge between a scarcity and an adequacy of supply.

Any interruption of that supply for any period of time for any reason will precipitate economic chaos at home and abroad because food prices abroad are even more important than they are here at home.

There's no monetary stabilization, no control over inflation, no way to do anything about the scarce supply of nutrient value of food. That is my theme, and I think I'm right.

Secretary SHULTZ. Well, I agree with you completely that increasing supply, doing everything we can to increase the supplies of these commodities, particularly food, is the basic thing; whenever we have any kind of a balance in a policy that says, well, we can do this for this reason, or we can do something else and it will improve supply, we have to make all our judgments on the side of an increasing supply.

We have been trying to make them there. I agree completely with your concern about that problem.

Senator PROXMIRE. Senator Percy.

Senator PERCY. For the eternal optimist that I have known Senator Humphrey to be, he's cast a note of gloom.

Senator HUMPHREY. I am worried.

Senator PERCY. Well, I think I would go back to your original statement, Senator Humphrey. I concur with you that we are going to have good crops. Thank heavens we are going to have them. Let's pray for good weather. I have flown over Illinois. It looks to me, looking down on the ground, as though they are growing beans and corn in the cemeteries now. We are using every last square inch of ground we can cover. And it is a response to price.

If we try to hold on prices and freeze retail prices, the farmer would not be producing that much grain and beans. I hope that this tremendous exercise that we have had will probably be the greatest adult education program in the country.

Economics is the issue, even ahead of Watergate. People want to talk about it back in our constituencies. I think it is a very good thing to have gone through this cycle. We've had some better instances and bad circumstances, but we are understanding, as a nation, how we respond as a people.

I think it has been a very valuable thing. I trust that we, in the Congress, are going to reflect this now in our agricultural policies. I had to vote against the Senate bill. I felt it was too long clinging to the vestiges of the past. There were only nine of us that did.

Senator HUMPHREY. Well, you were wrong.

Senator PERCY. Well, I think the House has given us a better bill, and I think we have just got to get away from the day of controlling or limiting production and paying people for not producing things. I hope we move very rapidly away from that.

Senator HUMPHREY. Well, may I say that the Senate bill did not limit production. In fact, it gave the price setting better than the House did.

Senator PERCY. I think we all agree now that we have got to have production encouraged, that the answer to price will be adequate supply. Meanwhile, in some of these temporary areas, is there anything that can be done from the standpoint of alerting the Nation to the problem of conserving energy, conserving fuel, finding ways to carry forward with the program that the President enunciated in his energy message, which I thought was specific and good and told Americans what they could do?

We can all rally together. We all don't have to rush to the courts or something. So if you realize that you do it, you can't hoard gasoline and fuel oil, so to speak, can we continue this educational job by the executive branch? Or can we help in what can be done to conserve energy when there is a period of temporary shortage?

Secretary SHULTZ. I think there is. That is an important part of the total program. Everyone can help in talking about it and also setting an example in what we do. Price, of course, helps here, too. I was interested to talk with one of the country's leading auto executives the other day.

He was complaining to me that such a high proportion of the sales was of small cars. I was listening to him but not very sympathetically. But it seems to me that the American consumer is making really a very quick response to price, and to the discussion of scarcity of gasoline in equipping himself and herself with a smaller car.

So I think that this is an element, too, in the conservation idea. If there's a reason why, it seems to me, the Congress ought to act on the President's proposals that the price of new natural gas be allowed to rise, it has both a conservation element to it and a supply stimulating element to it.

Senator PERCY. I'm concerned, Secretary Shultz, about our export policy on agricultural products. We have worked rather hard for years, the Government as well as the private sector, to build markets to convince countries of the world we are the great agricultural exporting country that we are and that we can be relied upon as a steady source of supply.

Now we have export controls, and I'm afraid that we are going to have countries like Japan that are leasing land in Australia to do something to get less dependent on our soybeans and other American products.

How soon can we expect these controls to go by the board? Can we resort to a country-by-country control, if you have to have controls, so that at least we take care of those customers that have relied upon us and have proven by their past purchases that they do want to depend on us and would be very bitter indeed if they found prices rising dramatically in their countries and then found they couldn't get the supplies that they purchased from us?

Secretary SHULTZ. Well, I agree with the statement that you have made, that the export controls are basically undesirable and our policy is against it. But price and food export controls on soybeans and related products are scheduled to end at the end of the crop year. I guess that would be at the end of September.

We have no plan at this point to institute export controls on the new crop. Now, that is not to say that it would never be done, but it. I think, should be regarded as an undesirable action taken only if we find ourself with a genuine emergency here at home. It is basically self-defeating, in part, for the reasons that you mentioned—the long-term impact on the markets for our foreign products, that we have been trying to build and we must build.

It is also self-defeating for our own sake because if we put a whole range of things that people most want to buy from us on control then, when they receive that dollar for something they sell to us, they say: "What good is it? What can I spend it on?" I can't spend it on the things I really want. So that the dollar declines in value.

Then when we import the crude oil or whatever it is we import, it, in effect, raises that price of that to us, so we might get a little lower price here on A. But through this chain of events we wind up with a higher price on B. It isn't clear at all to the consumer why this happens.

So I think we have to make up our mind that we are in this world economy and we have a great stake in it. It effects us. We have to reconcile ourselves to that fact.

Senator PERCY. Well, that is an eloquent statement and I concur with it.

In your statement today you mentioned that continued control of Federal spending takes on a new urgency. It is critical that Congress and the executive branch cooperate closely in this effort.

We have had a joint committee study the budget process in the Congress. I have never seen such a spirit of unity now. Democratic, Republican, Liberal, Conservative—call them what you may—they want fiscal responsibility and they want it restored back in the Congress.

I think we need to take advantage of that mood which, I think, is supported by the Nation. We're right at the critical stage now here in the Senate. We have voted out of subcommittee by an 8 to 0 vote a very tough bill on spending controls. The House is moving expeditiously, I think, and will vote out of the Rules Committee a comparable bill in September.

Mr. Burns told me that if we report out a procedure that puts a ceiling on the budget, but it is interpreted as a rubber ceiling, it would have a disastrous effect, he thinks, in confidence in the dollar. Whereas, if we adopt a stiff ceiling, intelligently arrived at, argue about priorities within the ceiling, but really make it very difficult to penetrate that ceiling, he thinks he can think of nothing that can be more encouraging to strengthen the dollar, confidence in the American economy, and the integrity of the Congress.

Would you concur in that assessment?

Secretary SHULTZ. Yes; I would agree with that. I know this committee has been helpful in that regard over the years and I'm sure will continue to be.

Senator PERCY. I have long felt, and Senator Ervin has joined me in the Government Operations Committee as chairman, that we really ought to move to a calendar fiscal year. Psychologically, that would simply say to Congress, we are not going to go home for Christmas or yearend until we get the budget to bed. The executive branch can operate from the beginning of the year, for the first time I believe, at least in our recent history, with budget figures that are the figures for the new year.

I realize that there are great problems in doing this quickly, so I have talked with Roy Ash about the possibility of getting the budget sent down to us earlier—in January or February. In our bill we've provided November 15, so that we can really begin work on that budget early and speed up the process then. From your vantage point, as a former Director of the Office of Management and Budget, do you see any real reason, operating reason, that we could not get the budget down sooner so we could begin work sooner—that is, is November 15 an unrealistic date?

Secretary SHULTZ. Well, I think it would be pretty tough. Of course, everything recycles itself. We're sort of on a yearly cycle and if everything gets pushed 2 months earlier, well then you get on that recycle and I'm sure it can be managed.

But I really think that the problem of getting the appropriations acted on by the start of the fiscal year can be met by the Congress if you would work at it very hard, right away, in January when you come back, and get the budget up early as it is, and pitch right in, and perhaps have some rules such as: That you can't consider any authorization bill or any new business until the budget has been taken care of, or something like that that focuses everybody's attention on that problem.

I think a lot of progress has been made this year. I have been very much impressed. I worked with the late Senator Ellender on this when he was chairman of Senate Appropriations Committee and he worked a miracle on the pace of work of the Appropriations Committee.

Senator McClellan, I know, has been very much of the same mind. But it does seem to me that we can get these bills through if you all would work on it. I think that there are some things we could do that would help.

Senator PERCY. I would like your comment on fiscal 1973–74. Not so much 1973. I would just like to say I think that you did a great job to hold spending below the $250 billion level. I hope that the world takes into account that we are now starting to manage our fiscal affairs in a better way than we have in the past.

From the standpoint of fiscal 1974, the President sent down a budget—$267.8 billion, I believe. We have passed a bill saying that it ought to be cut to $267 billion, so it is awfully close. So what are the latest estimates for expected revenue in fiscal 1974?

Secretary SHULTZ. Our most recent estimates were made for our debt ceiling discussion on June 1. At that time we estimated $266 billion.

Senator PERCY. $266 billion.

Secretary SHULTZ. Now, this estimating process is certainly far from an exact business. Since that estimate, I think the various things that have happened, including the fiscal 1973 returns, which calibrate the tax system, would suggest that the estimate should probably be made a little higher than that.

I've noticed some other estimators around town who do this are a little higher than that. So it is on that basis that we have said that, if we can hold expenditures to the level that the President proposed, we ought to be able to balance the budget, recognizing that all these numbers are estimates.

Senator PERCY. I assume the $266 billion assumes a very strong economy. George Meany, yesterday, predicted a recession by yearend. If that happened, we would obviously be out of balance on the budget, if we set spending at the $266 billion level, say. Do you concur or dispute George Meany on his prediction of a recession?

Secretary SHULTZ. Well, I don't think there is much chance of that. The economy is, after all, very strong. I know Senator Humphrey, in his remarks, characterized it as a patient and sort of chastised me nicely, not to describe the patient too well right now.

But there are a lot of good things we ought to recognize. There are 3 million more people at work this year than at this time last year. That is good.

Senator HUMPHREY. But there were 36 major cities this morning reported with 6 percent or over unemployment.

Secretary SHULTZ. Well there is a but with everything. But there are some good things.

Senator HUMPHREY. Yes; I'd love to think of those good things.

Secretary SHULTZ. The unemployment rate is down. The rate for married men is way down. The layoff rate is down. The prime rate is way up. There are problems but it isn't all bad. In fact, a lot of it is darn good.

I think there are a lot of sources of strength. There is a very strong plant and equipment boom. Inventories have not been built up, particularly, in this boom. It has been one of the puzzling things that inventories have not been built up very much.

I think our balance of trade is improving and so on. So I don't see a recession. I would say, however, that following the full-employment budget concept, that if we were to find ourselves in one, that I would not continue to advocate a balanced budget.

Senator PERCY. I would only like to say to Mr. Alexander that I was asked recently in a belligerent tone in an audience in Illinois: "Name one efficient branch of government. You fellows are terribly inefficient down there."

I said: "There is one I could name and you would agree with it." And he said: "What's that?" And I said: "Internal Revenue Service." They're the most efficient, effective collector of taxes in the world. I hope nothing would ever happen to that. I think everyone of us ought to stand behind the integrity of your Service, that nothing would ever happen to in any way remove confidence that the people of this country have.

People don't agree with the rates, maybe. And they can argue about it. But for the most part, we have more people in the world paying their taxes. If anything would happen to destroy confidence in your Service, I think it would be a disaster for the country and for all those countries where you have provided expertise on how to collect taxes efficiently, effectively, and, we always trust, fairly.

We appreciate very much your being here with us.

Mr. ALEXANDER. Thank you very much, Senator. And you can be sure that I will do everything I can to maintain the integrity of the Internal Revenue Service and public confidence in that integrity.

Senator PROXMIRE. Secretary Shultz, Senator Percy has expressed lofty and, I think, widely shared sentiments about the ending of export controls. And the administration has indicated, I think, that they would like to end them by the end of the year. You have just confirmed this—at the end of the crop year.

But a number of private experts, appearing before this committee, and the Senate Banking Committee, have told us that this is, in their view, unlikely. That we are very likely to have a situation where we are going to have a long term, very high demand for American food in Europe and elsewhere.

There is a strong argument for ending export controls—Mr. Seevers, of the Council of Economic Advisers, says: "That if it's a permanent overseas demand, we ought to let prices adjust and recognize that this is going to have very painful political reactions."

Let me ask you this. I assume at some point you are reviewing your present position on export controls. When do you expect to next review your position on it and come to a decision as to whether to continue them or not?

Secretary SHULTZ. First of all, we have put into place a new system, a new information system, about forward contract for exports. So we are gradually learning more about the situation through that. I am sure that we will want to review that information and the crop information as we get closer to the harvest time.

But the uncertainties about things here and abroad are not resolved. I had quite a discussion with my friends from other countries this past week about exchanging informations with them about their crops and their demands, and try to add up this total a little bit better than we had been able to do before.

The new information that we have is—being new, it's a little hard to evaluate. You know the people tend to overstate. So there is water in the estimates. But it is hard to know how much and how much will actually sort of dry out when the moment comes.

But we review the subject periodically. I would think, sort of before the new crop year starts, we want to get a look at it.

Senator PROXMIRE. That means within the next couple of months?

Secretary SHULTZ. Yes. At the same time, we have the same kind of problem here that I mentioned in connection with the anticipatory price increases about a freeze. The more people talk about a freeze, the more prices go up, and the more we sort of get washed into it. I think the more there is a sense of anticipation about export controls, the more it encourages speculation which raises the price beyond what they may need necessarily be, and tend to bring on the export controls.

So we are trying to get away from that and resist that, and not be sort of drumming on this all the time. I think it has a bad effect.

Senator PROXMIRE. As you know, the President made two highly controversial appointments to two top statistical positions in our Government economical statistic positions: head of the Census Bureau, Mr. Barraba, and his Chief, Mr. Failor.

These appointments were vigorously protested by the American Economic Association, unanimously protested by the executive committee. They were protested by the sociological profession also, in their convention—14,000 people taking part in their convention—unanimously opposed these appointments.

There was no support from any professional group for them. Were you consulted in these appointments?

Secretary SHULTZ. No, I was not.

Senator PROXMIRE. Yesterday, Mr. Stein said that he was not consulted. He thought he should have been. He felt that procedures were now being changed and that chief economic advisers would be consulted on future appointments.

I hope they are. Don't you think you should have been consulted on appointments of this kind?

Secretary SHULTZ. Well, I felt so and I made sure I was consulted about the Commissioner of Labor Statistics. I believe that we have confirmed an outstanding person to be Commissioner.

Senator PROXMIRE. Yes; he's a very competent person. I have one other area I want to question you on. I will be as brief as I can. I know the hour is very late and you have been most patient with us.

One weakness of economic policy formulation in this country is that we do not look very far ahead. One example of this is the way we handle the budget. We focus all our attention on the current year in considering the budget. When we really want to shift the country's spending, we ought to be looking 2, 3, or even 5 years ahead.

This point was emphasized very strongly by Mr. Schultze when he testified for us on Tuesday, as you know, he is a highly competent person, and was the former Budget Director.

This morning I would like to spend just a minute of time to look at least as far ahead as fiscal year 1975 because if Congress wants to have a meaningful input into the 1975 budget, the time to start is now and not next February.

Last January, the budget did contain estimates of the fiscal year 1975, full-employment receipts and expenditures. This was a very fine innovation to your credit. These estimates were revised in June.

On Tuesday, Mrs. Teeters gave us her estimates of the impact of legislative acts taken since the June estimate. The fiscal year budget picture now shapes up with this full-employment receipts, $296 billion, revised up $6 billion since January. Full-employment expenditures, $293 billion, revised up $5 billion since January, due to increase in trust and other uncontrollables. Full-employment surplus, $3 billion.

Would you agree that this is a pretty accurate statement of the fiscal year 1975 budget as it now stands?

Secretary SHULTZ. I have not reviewed that in detail recently, Mr. Vice Chairman, so I—but she is very competent, and I have no reason to question her.

Senator PROXMIRE. Now this estimate obviously does not take into account the future year impact of congressional changes, which may yet be enacted in the fiscal year 1974. If Congress cuts the Defense budget, this could have even more impact then in 1975 than in 1974.

Then interest rates have soared further since the June budget revisions, can you tell us what impact the continuation of 8 percent interest rates would have on the fiscal year budget estimates?

Secretary SHULTZ. Well, of course, I don't know what assumption Nancy Teeters used in making those projections about interest rates. The convention that we have used in our own budget work is basically, take the interest rates that exist and then assume that those interest rates stay through the years—in other words, not really to try to forecast interest rates, but just to say if they are what they are, and here is what the payments will be.

And I think that is a reasonable policy for the Treasury.

Senator PROXMIRE. What was your assumption on June 1, then, that the interest rates would be as they were then?

Secretary SHULTZ. Well we raised—I've forgotten what precisely the whole different structure of interest rates—but we raised our assumption about total interest costs in fisecal 1974 considerably—I've forgot just what it was. But I think it was about $1½ billion.

Senator PROXMIRE. Because interest rates had, by June 1 and since then—they've gone up further since then. So we probably have a tighter picture even then that we had at that time.

Secretary SHULTZ. That is correct.

Senator PROXMIRE. So it looks like a tight budget for 1975.

Secretary SHULTZ. We are talking about fiscal 1975; we are a year away.

Senator PROXMIRE. Yes.

Secretary SHULTZ. The interest rates that have risen so fast are mostly short-term rates. Long-term rates have been going up a little recently, but on the whole they have held pretty well. Now these short-term rates that go up so fast can also come down.

Senator PROXMIRE. They could come down.

Secretary SHULTZ. So I would not want to make any sort of full statement about what they are likely to be a year from now.

Senator PROXMIRE. They could come down. They could also go up further.

Secretary SHULTZ. Well, they're pretty high right now.

Senator PROXMIRE. No doubt you're familiar with the recent Brookings book entitled "Setting National Priorities for the 1974 Budget." In the book they describe two possible alternatives for tax reform, one that would raise $21 billion and one that would raise $46 billion by 1978.

Could you give us your reaction to these proposals, are they realistic and would they improve the equity of the tax system, and significantly help ease the otherwise very tight budget picture?

Secretary SHULTZ. Mr. Vice Chairman, I'm afraid that I have to confess I have not had a chance to study that. I have got that book. It is on my desk. I want to get into it. But I've been so busy.

Senator PROXMIRE. These would include higher capital gains and minimum tax rates, tightening charitable deductions, and eliminating the deduction of real estate taxes in mortgages.

Secretary SHULTZ. Well, we have presented tax reform proposals to the Congress April 30. It touches on some of those things, but not on others. I would think the proposals we have made are good proposals. They did add the tax shelter type problem; I think that has troubled people. And following on Senator Percy's comment about the IRS and the need for confidence in the tax system, I think it is importantly a matter of how well it is administered.

The IRS does do extraordinarily well. It is also a question of people's sense of the equity of the system as such, and the tax reform proposals for the present and the tax shelter problem I feel are great problems.

Senator PROXMIRE. At any rate, you think it would be constructive and realistic to expect some type of tax reform legislation that could raise some revenue—whether it would raise $20 billion or $46 billion is something I'm not asking you to respond to. But it would raise substantial sums; is that correct?

Secretary SHULTZ. I cannot see those kinds of sums in tax reform proposals that I would subscribe to.

Senator PROXMIRE. You say you have already recommended tax reform legislation.

Secretary SHULTZ. Our proposals—the President's proposals to adjust the tax shelter, along with the minimum tax revisions—would raise, gross, $1 billion, and net—in the sense that the present minimum tax would be replaced, so you would have to take that out—it would be net, I think, $800 million.

Senator PROXMIRE. And that is all you propose in the way of tax reform legislation?

Secretary SHULTZ. The big money in all these tax reform proposals is, as you know, the major changes in the capital gains treatment, depreciation rules, the investment tax credit, and things of that kind. So the argument is, at least as I think of it, less sort of tax reform and equity considerations than it is the question of how much encouragement do you want to give to investment in this country?

At least in my mind, I think we need to give a lot of encouragement to investment in his counry. I would hate to see us diminish it—which, without studying those proposals, they must do.

Senator PROXMIRE. Well, that is a very helpful response. Whether I agree with that or not, I think it is a perfectly logical and consistent response. What you are saying is that you cannot really raise substantial sums of well over $1 billion at least in tax reform legislation without cutting into the investment incentives that you think are essential for economic progress and for productivity improvement.

Senator Humphrey.

Senator HUMPHREY. Secretary Schultz, it's always good, as I said earlier, to have you as a witness.

Secretary SHULTZ. You're setting me up.

Senator HUMPHREY. No, I'm really not. I just feel that you really try to level with us, and for that, I'm grateful. I do not disagree with some of the observations that you have made about the economy. I had a group of foreign students not long ago in this very room and they were asking some very tough questions about our country. I pointed out to them what I thought we had here.

We have outstanding management. We have second tier management supervisory personnel, second to none. We have the best skilled labor force in the world. We have a reasonable supply of natural resources even though we have shortages in some, necessitating imports. We have a big market. We have an outstanding educational system. We have science and technology second to none. We have got all of those things. I believe that makes up the ingredients or the building blocks of a strong structure of an economy.

But the one thing that we do not have is what I'd call consistent leadership that gives a sense of confidence. I say this respectfully because just the fact that we are at phase IV, for example, we have gone through these periods of not facing up to what really was happening to us, all of which isn't the result of this administration, but refusing to come to grips with the problems that we have faced.

I think the questions that Senator Javits was putting to you earlier, as I said, were very fundamental—namely, what course we pursue, that at least we get a chance to work. I said in February of this year and when you were a witness, and when Mr. Stein was a witness, that I felt that the movement from phase II to phase III was premature and that it would result in nothing but trouble. I have looked over the record and those were the exact words.

Now your associate, Mr. Stein, has been very critical of me in those matters. He owes me a dinner, by the way—I think I should say. I'm sorry I did not get here yesterday. I bet him that he would not be able to accomplish his goal on inflation control. It is a dinner with everything—the whole business, at the best place in town. I'm going to send him a letter, tell him I'll take it early because you never know how long we're going to be around here.

Secretary SHULTZ. You mean you're going to take an early Christmas recess?

Senator HUMPHREY. Having said all of this, I wanted to call to your attention, in reference to your commentary on export controls, the study that was recently published by the Subcommittee on Foreign Agricultural Policy. I spoke about this yesterday in the Senate. I think what is important is for people to know what we are going to do.

It is the manner in which we do something that has precipitated such problems. For example, on the soybean matter, it would have been possible to extend, for example, soybean contracts that were to have been delivered within 3 months to 6 months without going into the immediate mandatory embargo. I think it is important for the American domestic consumer to know reasonably well what food supplies are going to be available for domestic sources.

We still don't have any idea what the exports are going to be and how much is going to draw down. Yesterday the Washington Post had an excellent editorial relating to soybeans. One sentence there that I thought was important says: "The administration does not like export controls."

Nobody likes it. But ducking reality in matters as urgent as the Nation's food supply is wrong in principle and dangerous in practice. The time is due and overdue to let the rest of the world know what share it can expect of the American harvest now being gathered.

I think that is the point. It is patient negotiation. It is entering into voluntary agreements where you can, and not getting into this bind of imposing these inflexible mandatory export controls precipitously. It just throws everybody into an economic tailspin.

So I believe that's your thinking on it, as I understand, and I hope it is, and that you will vigorously pursue that course because it is so important.

Now, on taxes, why has not the administration really faced up to the whole economic situation? I am going to ask you a frank and open question. Do you really believe that by manipulation of credit structure, using the Federal Reserve System in the monetary policy, tight credit, high interest rates, plus these wage and price controls and even tight control on the Federal budget, that we can handle the inflationary forces which are at work, not only locally but internationally?

Our inflation is even less than other countries. So it tells us that there are pressures worldwide and we are affected by those pressures. Do you believe that a sensible balanced economic policy—monetary and fiscal—can be outlined without something in the tax structure?

Secretary SHULTZ. From the standpoint of our connection with the world economy, I've said earlier that I think it is very important for us to recognize how much a part of the world economy we are. Our inflation is very heavily explained, I believe, not by the change from phase II to phase III, but the explosion of prices in these world-traded commodities, which we are feeling as everybdoy else is feeling.

But that is a side argument. In terms of what can be done to give us reasonably stable prices along with full employment or virtually full employment, we have had high employment. I think we have to work with the basic tools that have always worked for us. And that is our budget policy, our monetary policy. Those are the necessary conditions as far as the——

Senator HUMPHREY. Well, what about our fiscal policy, our tax policy?

Secretary SHULTZ. As far as the tax structure is concerned, I believe we ought to see to it that it is an equitable structure, and that when we look at it from the standpoint of incentive. that we give a lot of weight to the incentives to increase the supply of things that we particularly want, which for this reason, for example, in the President's recommendation, while the tax shelter recommendation takes a certain percentage away from exploration for oil and gas—because of that we explicitly added a recommendation for a sort of investment tax credit for exploration, just to emphasize the supply side of it.

That's what stands behind our response to Senator Proxmire's question of changing capital gains investment tax treatment and so on. I think we need to have a tax structure that encourages people to produce. We need those supplies.

Senator HUMPHREY. I have in many ways supported that. I supported the investment tax credit, for example. I think it did a little too much in both acceleration and depreciation in investment tax credit altogether. But we can get at that.

My concern here is whether or not we can have an effective anti-inflation policy by relying primarily—and that is what we were doing—on the Federal Reserve System and the prime interest rate and the discount rate. You know, 90 percent of the people in this country live off credit; maybe more than that.

Every time that interest rates are jiggled around by these backers, whether they're Federal Reserve bankers or the big ones, it is a tax by people who never got elected to anything. Every young man and woman who buys a home today is being taxed to death, not by the property tax but by the interest rate, if he can get the capital to make the downpayment.

Are we going to rely totally upon the banking structure of this country to control the economy? Are we going to put the fate of this country in the hands of a few people no matter how wise and good and decent they may be or think they are? Or are we going to have some public policy about this?

I am getting right down to it. Does the administration think we need a tax increase? Does it really believe that the present tax structure can work, even if we stay within the budget? Let us say that there are no loopholes in the budget. We take Mr. Nixon's budget ceiling and even cut it back as we hope we can.

Do you really believe that you can have some stability in places without a modification of the tax structure and corporate tax and income tax?

Secretary SHULTZ. Well, I think we need a balanced approach to the problem that gives us a balanced budget under these circumstances. I think fiscal policy should contribute to that and be determined about that. I don't think we need a more severe fiscal policy than that. But certainly we need that.

And to be sure, we are going to get it. We need everything that we can think of that will increase supply, market by market.

Senator HUMPHREY. Right.

Secretary SHULTZ. We need that. I hope we can get some mileage out of our wage and price control system. I can assure you we are trying to do that and to have a steadfast attitude on that subject.

Monetary policy—not individual banker's policy—which is the way in which they're all affected, is an essential, perhaps the essential, ingredient. There isn't anything more important than that. Experience over a long period of time shows that.

So I think that the operations of the Federal Reserve are central, are exceedingly important to how the economy is operated. I don't say that all the burden is or should fall on that. But we must have a disciplined money supply growth as well as a disciplined budget. If we don't, we will not succeed in conquering inflation.

Senator HUMPHREY. I understand that there is great importance to monetary policy by private bankers. Well, that is what they are. After they give this monetary policy, they make a big profit off it, too, and these interest rates have been going up and up and up. Some of us were saying a few minutes ago, they would continue to go up.

I don't think there is any prospect that they are going to come down. I am just asking you, as an outstanding economist, a man with great integrity—and I say that sincerely—whether we can just rely upon the thrust of the monetary policy or whether we are going to have to come to grips at taking a good hard look at this tax structure of ours?

Nobody really wants to talk about it. I think the time has come for somebody to open it up. Everybody wants to talk about a tax reduction. Nobody wants to talk about that we maybe ought to have to do something about taxes.

I don't know whether we ought to or not. But I know that if the patient is not doing well, you better start looking at the medication, and first take a good examination. I think we have done that. I would admit that we all pretty much agree what the problems are. Nobody really wants to bite the bullet, as they say—to take a look at the total picture. And I, for one—maybe it is my Populist background, my Midwest background. I deeply resent these unbelievable interest rates. We have got a law in our State that says anything above 8 percent, you are a criminal. We have a usury law. We are opposed to these rates.

Now you cannot borrow money out there at less than 10 percent. You have to be a cheat and a thief to start with. You really have to prostitute yourself to borrow any money. You've got to make a deal with the banker or somebody else so that you get around the law.

The people in my State do not want those interest rates. I think 8 percent is enough. After you get the 8 percent, somebody makes money off of it—not the Government. There's some private individuals that own stock in banks that are getting rich.

In the meantime, young married couples that I know cannot buy a home. Secretary Shultz, if they can, they are really taken through the wringer. Good God, it's incredible what they go through. And people, every bit of our consumer credit is related to these interest rates.

I think this Government has just leaned back and said to the bankers: "Well, you go ahead and adjust it and we will kind of roll with the punch." Rather than having the guts to come out and say: "We ought to take a good look at the whole picture—budgets, taxes, and the whole ball game," because it is easier to let the other guy do it.

Secretary SHULTZ. We have taken a good look at the whole picture, Senator. And on the tax question, let me just take you through our theory. First of all, we start with the proposition that a balanced budget is the right fiscal policy.

Now, if you think that a substantial surplus in the unified budget is the proper policy, then you would stop me right there. We talked earlier about how we must be concerned about inflation. But also, we don't want to turn this thing all the way down, either.

So the balanced budget seems to us like the right fiscal policy for right now.

Second, it seems to us that it can be gotten by controlling outlays; that is, the tax system as it presently exists, not tax reform type problems but just what the revenues are likely to be. If the revenues are likely to be about what we have forecast, we ought to be able to hold expenditures to that level, so we can get to a balanced budget by that route if we have the willpower to be able to do it. So that is the second point.

The third point is that, I believe and the President believes, if we were to have a tax increase of $5 or $10 billion, let us say, that it would get spent right away. There is now a kind of fiscal version of Parkinson's Law that you might state, that spending will rise at least to meet the revenue available and that that will just happen.

So that out of a tax increase we would, at best, hold the fiscal policy of a balanced budget anyway. So we're not really going to get ahead very far and what we will get out of that is somewhat bigger government. The President has taken a position that, on the whole, we have enough. And that is his line of reasoning on the tax question.

Now, there are many who disagree but I think it only emphasizes, at this point, the necessity of holding these outlays under control. How long it would take if the President were to recommend a tax increase to the Congress to get it, I do not not know. I suspect it would get all tangled up in tax reform and the President would not get a bill on his desk until next spring sometime. And it would be a long drawn out process.

So I believe that our alternative right now, in terms of the right fiscal policy, is to control the outlays. And that is what we are doing. That is where we are going to rivet our attention.

Senator HUMPHREY. I recall that the major charge made in 1969, of the previous administration of which I was a part, was that Lyndon Johnson did not come to the Congress in 1966 and ask for a tax increase so that he could stop what was beginning to be the fueling of the fires of inflation. We had big arguments about this.

Secretary SHULTZ. I agree with that.

Senator HUMPHREY. There were reasons for it. Some of the reasons you've mentioned right here why the President didn't do it. I'm not advocating one. I'm simply saying that when you are President of the United States and you run an administration and you see that the program that you have had is not working, then you talk about cutting outlays. Secretary Shultz, with the exception of 1 year which was the social security increase of 1972 when everybody was mighty happy to get it, including the President with his own little personal note, the checks went out. You know I understand that.

Secretary SHULTZ. I sat here—now, this is in the same room—but I sat here and opposed that when it first came up.

Senator HUMPHREY. I understand you did. But wisely, we overruled you.

Secretary SHULTZ. I went down the drain on that one.

Senator HUMPHREY. I'm simply saying cutting outlays did not do the job. Giving incentives alone did not do the job. I have voted to reduce taxes when Walter Heller was around here, and his economic policy. I followed that. The Congress four times has voted since 1960 to reduce Federal taxes. I voted for these programs to increase exports, programs for investment tax credit.

Some of my other friends in the Democratic Party said that was not the way to do it. I've tried to pick and choose as I see fit. No one would hate a tax increase more than Hubert Humphrey, the elected United States Senator. That is about as popular as taking a dose of strychnine. I know that it is not popular.

I'm simply saying that someone has got to come to this Congress and lay out a program because what we are doing is putting Band-aids on. And we keep changing them. We go from Johnson & Johnson to Curads. We have phase I, phase II, phase III, phase III½, and phase IV. We never ever really come up with the program.

I do not think that you have any evidence to prove that this program is going to work.

Secretary SHULTZ. Let me get in there if I may. In terms of programing, we have had a pretty steadfast program. We have had a policy of holding outlays within full employment revenues right along. And we have succeeded in that.

Senator HUMPHREY. But you have been playing games.

Secretary SHULTZ. We have been moving toward that. The employment picture has improved steadily. It is pretty good now. And I know you people keep quoting Brookings studies. You're familiar with the Brookings studies that show the impact of the change in the composition of the labor force and the unemployment rate. If you took the composition of the labor force in the mid-1950's and applied the present unemployment rate by demographic categories, you'd have about a 4.1 percent unemployment rate. We can do better. Now, we ought to try to do better. But we are not doing too badly in this regard.

So we have had a steadfast policy. I was interested to read—you mentioned Walter Heller—a piece that he wrote a week or so ago in the Wall Street Journal in which he was not exactly laudatory toward all the economic policies of this administration. But he did say that we were in a lot better shape than we were in 1968.

Why? Because, as we were approaching full employment, we had the budget under control in the sense that the outlays were within the revenues that the tax system produces, whereas in 1968 they were about $25 billion short.

Senator HUMPHREY. That is only 1 year. The record of this administration in 5 years is considerably worse than the record of the Johnson administration in 5 years, considerably worse in deficits, considerably worse.

Secretary SHULTZ. Well, I'm just trying to give you this contrast. I suggest to you that you read Walter Heller. I did not bring him up. I give him back to you.

Senator HUMPHREY. He took the whole year of 1968, that is true. The tax that was levied that year—the income started coming in in 1969.

Secretary SHULTZ. Well, let us leave him out.

Senator HUMPHREY. I was very much aware of that period.

Secretary SHULTZ. All I'm trying to say is, there hasn't been such a tremendous amount of shifting and stopping and going. As far as these phases are concerned, maybe we should not have gotten into this phraseology. But when you have a freeze, you know it's going to be short. It has to be followed by some kind of a controlled system.

So I and then II you're going to have II after I, and then you're going to try to ease yourself off. This committee, as a matter of fact, held some very interesting hearings which I read over—and also read the report of this committee, which suggested a precise structure for phase III—but also said that the phase II structure ought to be modified and modified considerably.

Well, we tried to modify it. And I think, as I said a minute ago, that on the whole the problems that we have now are not the result of that change. They are the result of prices in internationally traded commodities, that our control system does not deal with in any really effective way.

Be that as it may, the confidence in the phase III controls certainly disappeared completely and we had to change them—and the Senate certainly registered that. I think you must have been one of the 33 who voted for a 90-day freeze in the Senate Democratic caucus.

Senator HUMPHREY. I would have. I wasn't present that day or I would have.

Secretary SHULTZ. All right. It would have been 34 to 0, then. So we have more or less retreated back into a system more like phase II, differently constructed with a different way of trying to get out of it. Now, that is a certain amount of change there.

But I do not think—it isn't as though we are all over the place.

Senator HUMPHREY. I want this system to work, Secretary Shultz. I'm not that interested in politics, frankly, because our people are worried. I just really am coming to the tough question which none of us in Congress or the administration, I think, really wants to face up to in this country.

Do we need to take another look at our tax structure? I think that is a tough question. It is debated better in academic halls than it is around here because every time you open your mouth on this, you lose friends. I know that. But I'm looking at a lot of people today who are on fixed income who are really in trouble. It's pathetic what's happening to them. It is really a story of national tragedy.

I am looking at a lot of small business people. I know a little bit about them. I'm here to tell you that if you are a small businessman and trying to borrow money, you have got a better chance of swimming on the Sahara Desert. It just isn't possible. No way.

Secretary SHULTZ. You have to pay for it.

Senator HUMPHREY. Not even if you can pay for it.

Secretary SHULTZ. Credit is available. The supply of credit has been increasing very rapidly.

Senator HUMPHREY. Well, I want to tell you, it's mighty hard to get a hold of it at any rate you can afford to pay. This business of saying, if you can pay for it, yes, I suppose you can get almost anything if you can pay for it. But we have got to be thinking about the people of this country. And the people of this country cannot afford to pay for some of these things.

Secretary SHULTZ. Well, let me ask you to note down in connection with your statements about the tax burden of the elderly, the President's proposals to reduce the property tax burden on the elderly. And there are, in the tax reform proposals that we submitted to the Congress and had hearings on before the Ways and Means Committee, there's a specific proposal on this designed to remove the extraordinarily heavy burden that the elderly pay in the form of property taxes. And that was a rifle shot right into the problem you mentioned.

Senator HUMPHREY. We have taken care of that in the State of Minnesota. And we've done a very good job. What I'm talking about is the prices that these people have to pay. And that is why I'm simply saying—and I quit at this—I do not think you are going to control inflation until you have two things: A continuity and a willingness to stick with what you start to do.

Until you take a total balanced look at the monetary, budgetary and fiscal policy—and we have taken a look at the monetary and budgetary, but we are not taking a look at the fiscal policy because every politician knows that when you start taking a look at it, that is trouble.

But I think there is more in the offing unless we do. I am prepared to say that we have got to be doing something about it. I am not an expert in it. But I sure know that when there have been years and years of deficits, and years and years of incentives, and yet years and years of rising inflation, that something is out of joint.

And, Secretary Shultz, I am sufficiently willing—I am prepared to deal with these problems as a politician. I am prepared to take the risks because I don't think I am worth my salt around here as a Senator, unless I am willing to take a risk and do what I think is right for this country.

I really believe that one of these things that has got to be done is to take a total look at the tax program including tax reform.

And, with that, I am going to sign off. I have a feeling that you sort of feel that way too.

Senator PROXMIRE. Thank you, gentlemen, very much. It has been a most informative morning.

The committee will stand in recess until 10 o'clock tomorrow morning. We convene in this room to hear the Chairman of the Federal Reserve Board, Mr. Arthur F. Burns.

[Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., Friday, August 3, 1973.]

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

FRIDAY, AUGUST 3, 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 1114, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire, Fulbright, Humphrey, Javits, Percy, and Schweiker; and Representatives Reuss and Conable.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Jerry J. Jasinowski, John R. Karlik, Richard F. Kaufman, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will be in order.

Unfortunately, we are going to have a rollcall in the Senate in about 40 minutes, but if Congressman Conable will be here at that time, we can turn the meeting over to him.

Representative CONABLE. I can stay until 11 and then we will probably have some rollcalls in the House.

Senator PROXMIRE. This morning we welcome Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System, before the committee to present his midyear assessment of the economic situation.

What economic policy strategy can we and should we adopt in coming months to reduce inflation without aborting orderly economic growth? The fiscal policy we are likely to follow seems clear. This administration has no appetite for a tax increase. And Congress has even less appetite. There is agreement between Congress and the administration that total Federal expenditure must be held within a fixed limit. Spending in fiscal year 1973 was held below the President's $250 billion target. And in the current fiscal year it seems now it will stay within the administration's $268.7 billion ceiling.

But what monetary policy we should follow to reduce inflation while sustaining moderate economic growth is a puzzling and perplexing problem.

With interest rates moving toward all-time highs, and the housing industry starved for mortgage credit, and with economic growth slowing sharply in the second quarter, it is not surprising that many may feel that monetary policy has gone too far in the direction of restraint. Some have called for a turnaround to stave off a collapse of the home-building industry and all the attendant repercussions which such a collapse would have throughout the economy.

Others point to the fat 8.2-percent increase in the money supply in calendar year 1972 and the 6-percent increase in the first 6 months of the year coinciding with a surging inflation and call for sharp monetary restraint. You have a tough job, Mr. Burns, this morning.

We want to discuss to what extent the type of inflation which we have experienced in recent months is subject to control through fiscal and monetary policies. How can tight money in America hold down grain prices, or petroleum prices, in world markets? We also very much want to get Mr. Burns' views on the adequacy of the new phase IV and the extent to which it relieves the excessive burden which has been placed on monetary policy.

Mr. Burns, please proceed with your statement.

I beg your pardon, Congressman Conable.

Representative CONABLE. Mr. Burns, in this world of economic tradeoffs, I think we sometimes tend to focus on the negative to the point almost of despair. It seems as though there are many frustrations in economic policy nowadays and I want to say, sir, that we have reason for considerable gratitude that a man of such commanding respect and understanding of economic forces working in this country is presiding over our monetary policy, to the extent that the Chairman of the Reserve Board can do that.

I want to repeat again, the great respect with which you are held up here on the Hill and to thank you for spending as much time as you do before the Congress, talking about problems which don't affect us directly, but which supplement and tend sometimes to help cancel out the mistakes we make up here through the type of complementary action necessary frequently on the monetary side.

I realize how much time must be involved in the preparation of this sort and I think that your tremendous amount of work that you do on this is very much to be appreciated by the Nation.

Senator PROXMIRE. I want to thank Congressman Conable for that statement and say I warmly endorse every word of it. We are very proud of the fine job you have done, Mr. Burns, and, of course, very impressed by your wisdom and by the most helpful advice and the time you have given this committee and the Congress.

Representative REUSS. I hastily associate myself with everything that has been said.

Senator PROXMIRE. Please proceed, Mr. Burns.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. It is my turn now. This might turn out to be a very delightful meeting.

I want to thank you, Senator Proxmire, for your excellent introductory statement. I think you stated the problem facing monetary policy very accurately and perceptively.

I want to thank you, Congressman Conable, and you, Congressman Reuss, for the very kind sentiments you have expressed.

I am pleased to meet once again with the Joint Economic Committee to present the views of the Federal Reserve Board on the state of our national economy.

In my testimony before this committe in July 1972, I presented evidence of a significant strengthening in the pace of economic expansion. Recovery was finally underway in business capital formation, residential construction was moving up briskly, and consumer buying was continuing its marked uptrend.

The rate of expansion in aggregate economic activity rose further in the closing months of 1972, and rapid expansion continued on into 1973. The physical volume of production of goods and services advanced by more than 6 percent during the year ending this June, while the output of the Nation's factories and mines rose 9 percent.

These large increases in production were accompanied by a growing demand for labor as well as by sizable increases in average output per man-hour. Civilian employment rose by nearly 3 million persons during the past 12 months, and the rate of unemployment dropped from 5.6 to 4.7 percent of the labor force.

The pattern of growth in economic activity has been similar in many respects to that of earlier cyclical expansions. Thus consumers, besides spending rather freely out of their increased incomes, borrowed heavily to finance purchases of autos, furniture, and other durable goods. Business firms, meanwhile, enlarged their plant facilities and stepped up their acquisition of new and more modern equipment. They also increased their inventories; but as their sales often ran ahead of expectations, the overall ratio of stocks to business sales actually declined.

These domestic forces of economic expansion were reinforced by a strong upsurge in export orders. This June, the annual rate of our merchandise exports was $21 billion larger than a year ago—a rise of 44 percent. After allowance for price increases, the rise was still close to 30 percent. The extraordinary increase in foreign demand for our products has had substantial consequences both for production and prices. The dollar value of our imports also rose rapidly during the past 12 months; but the increase of about $16 billion in the annual rate reflected in large part the rise in import prices, and this rise too left its mark on our general price level.

As this committee is well aware, prices in the United States have risen very sharply since the beginning of this year. In fact, inflationary pressures over the past 6 to 7 months have been stronger than at any time since the Korean war.

In view of the strong cyclical expansion in production and employment, it would have been difficult to avoid an appreciable upward tilt of the price level in the best of circumstances. But as the tides of fortune would have it, several factors of an unusual character combined to impart to our inflationary problem a new and more ominous dimension.

First, the wage and price policy of phase III made it easier to pass on rising costs to product prices and also, here and there, to widen profit margins which had been suppressed previously.

Another and far more important development was the coincidence of strong business expansions in the United States and other countries. To a degree without parallel since World War II, economic activity has recently been booming in virtually all industrial countries. For example, industrial production during the past 12 months increased about 7 percent in Belgium and the Netherlands, 8 percent in West Germany, 9 percent in France, Canada, and the United Kingdom, and 19 percent in Japan.

With production increasing rapidly in the industrial world, there has been a swelling demand for industrial materials, machine tools, component parts, and capital equipment—goods for which this country is a major source of supply. The boom in other countries has thus had a considerable impact on our domestic markets.

The inflationary dimension of this worldwide boom became visible after mid-1972, when wholesale prices began to increase sharply in many countries. During the past year, prices at wholesale rose on the average about 6 percent in West Germany, 9 percent in France, 11 percent in Japan, and 13 percent in Canada—to mention a few examples. Toward the end of 1972, the rise in wholesale prices generally accelerated, and rates of inflation are now even higher than these year-to-year changes indicate.

The advance of prices has been particularly large for internationally traded commodities, such as agricultural products and industrial materials. The rise in dollar prices of these goods has been much larger than in German marks, Swiss francs, or Japanese yen, because of the huge decline in the purchasing power of the dollar over these and many other foreign currencies. The depreciation of the dollar thus immediately affected our price level; but its indirect effects were probably much larger. First, because rising import prices led to some substitution of domestic products and thereby served to raise their prices; and second, because a cheaper dollar also gave a sharp impetus to exports and thereby further reinforced the pressures of demand on our resources.

The most troublesome aspect of the recent worsening of inflation in the United States and other countries has been the rapid runup in food prices. At the very time when the demand for foodstuffs was rising in response to the worldwide expansion in incomes and employment, world agricultural production was restricted by unusually bad weather conditions in a number of countries. In the United States, moreover, the restrictive effects on output of earlier agricultural policies were reinforced by disappointing crop harvests and some decline in production of beef and pork. The resulting rise in our food prices was compounded by swelling export demands for agricultural commodities.

Sharply higher prices of industrial materials have also been a prominent feature of the recent accelerated pace of worldwide inflation. In the past 12 months, wholesale prices of crude industrial materials rose on the average by 18 percent in our country, and prices of intermediate materials increased 8 percent. By contrast, wholesale prices of finished goods other than foods rose about 6 percent.

Prices of industrial materials typically rise faster than those of finished goods during a period of cyclical expansion—and the more so when rapid economic growth occurs simultaneously in many countries. Recent price developments, however, have also been aggravated by severe capacity constraints on the production of major industrial materials. Calculations by the research staff of the Federal Reserve Board indicate that in the first half of this year the rate of capacity utilization in major material-producing industries—including petroleum refining, production of aluminum, steel, cement, synthetic fibers, paper, paperboard, and the like—was at the highest level since the second quarter of 1951.

In many of these industries, there has been very little growth of productive capacity in recent years. Environmental controls have held up construction of new plants, have led to shutdowns of some existing plants, and have prevented the activation of some older standby capacity. Moreover, investment in new capacity was discouraged by the relatively low profits of our domestic nonfinancial corporations between 1966 and 1971.

Productive capacity in the paper industry, and also in petroleum refining, appears to have grown less than 2 percent per year during the past several years. In the cement industry, productive capacity has shown little or no growth over the past 5 years. Not a single new cement plant has come into production during the past year and a half, and only one new petroleum refinery has been opened since 1969.

These are sobering facts. Lack of sufficient attention to investment incentives in these industries, and to the special problems they face as a consequence of environmental control programs, has resulted in shortages of many basic materials needed by American industry to expand production. For want of steel, aluminum, industrial chemicals, or adequate fuel supplies, business firms in various lines of activity have been unable to increase production rapidly enough to meet the demands of their customers; unfilled orders have mounted, and delivery delays have lengthened. Price pressures originating in short supplies of major materials have thus been generalized to semifinished and finished goods.

In short, our inflationary problem this year has arisen in substantial measure from sources well beyond the influence of domestic monetary and fiscal policies. A worldwide boom has been underway, the dollar has been devalued, and both agricultural products and basic industrial materials have been in short supply. Violent price increases that stem from such sources cannot readily be handled with customary weapons of economic stabilization policy.

It now appears, nevertheless, that a somewhat slower rate of growth in aggregate demand late last year and in the first quarter of 1973 would have been desirable. Consumer spending rose faster than we at the Federal Reserve Board had foreseen, and I believe much more than most business firms had expected. In the fourth quarter, the growth of real GNP reached an annual rate of about 8 percent, and this rapid pace continued in the first 3 months of 1973. So high a rate of expansion is welcome when most lines of activity have sizable unutilized resources at hand, but it raises problems when basic industrial materials are in short supply and when skilled labor is becoming harder to obtain.

Both monetary and fiscal policies moved in the right direction last year. In retrospect it appears, however, that restraint should have been somewhat greater. True, efforts to hold the line on Federal budgetary expenditures were successful. Contrary to widespread expectations, the President's objective of holding Federal expenditures down to $250 billion was not only reached but in fact exceeded. Actual budgetary outlays in the fiscal year just ended fell short of $247 billion. Nevertheless, a deficit of over $14 billion is still huge; it was particularly inappropriate at a time of rapidly advancing prosperity; and it played its part in stimulating private spending and aggravating price pressures.

Monetary policy began to move in the direction of restraint in the spring of 1972, when mounting pressures in financial markets were allowed to express themselves in higher short-term interest rates. As the year progressed, it became evident that the rise in short-term interest rates was not accompanied by moderation in growth of the major money and credit aggregates to the extent desired. The Federal Reserve, therefore, began to move more aggressively toward monetary restraint last fall. Margin requirements on common stocks were raised, and what is far more important, open market operations were directed toward reducing sharply the rate of expansion in nonborrowed reserves of commercial banks. Since the need for bank reserves was growing rapidly at that time, the rise in the Federal funds rate accelerated, and member banks turned increasingly to the discount window as a source of additional reserves.

By the end of last year, member bank borrowings reached an unusually high level. In January, therefore, the Board approved the first in a series of higher discount rates with a view to discouraging reserve expansion through the discount window and inducing the commercial banks to restrain loan expansion. Altogether, the discount rate has been raised six times this year to its present level of 7 percent—a rate that our financial markets had not experienced in over 50 years. In May, the Board also raised the reserve requirements applicable to any further increase in the amount of large-denomination certificates of deposit—CD's—outstanding at member banks. And the Board took the further and, I believe, unprecedented step of addressing a request to nonmember banks and agencies or branches of foreign banks to accept voluntarily the higher reserve requirements imposed on member banks. In late June reserve requirements were again increased—this time on demand deposits of member banks.

Since these restraining moves were taken during a period when credit demands were unusually heavy, interest rates on short-term securities increased sharply, and long-term rates followed suit—although with a lag and to a much smaller degree. The yield on 3-month Treasury bills has been above 8 percent of late, in contrast to a level of 5 percent at the end of last year and 4 percent at this time a year ago. And the prime rate of interest on bank loans to large businesses has increased since the first of January from 5¾ to 8¾ percent.

Some classes of loans and securities have remained sheltered thus far from the strong upward pressures in markets for short-term securities. For example, rates on consumer installment loans are on the average no higher now than they were 6 months or a year ago. Rates on loans to small buiness firms appear to have increased over the past 6 months by little more than one-half percentage point—in contrast to a rise of 3 percentage points in the prime rate on large business loans. Mortgage loan rates, however, are up sharply in recent weeks, although they are still below their earlier peaks in 1970.

All in all, existing interest rates in this country are clearly much higher than any of us would like. Some advance of interest rates is unavoidable during a business cycle expansion, particularly when the economy is booming—as it has of late. But the underlying reason for the high level of interest rates is the persistence of inflation since 1965.

Inflationary expectations have by now become fairly well entrenched in the calculations of both lenders and borrowers. Lenders commonly reckon that loans may be repaid in dollars whose real value will deteriorate because of inflation, and they therefore tend to hold out for nominal rates of interest high enough to insure them a reasonable rate of return. Borrowers, on their part, anticipating repayment in cheaper currency, are less apt to resist rising costs of credit.

The marking up of nominal rates of interest during periods of inflation is a process that is much too familiar to economic historians. Businessmen and laymen have also seen its recent manifestation in other countries. If I accomplish nothing else this morning, I want to emphasize the simple truth that inflation and high interest rates go together and that both the one and the other pose perils for economic and social stability in our country.

I wish I could offer hope that the general level of interest rates will soon decline. I cannot in good conscience encourage that thought. A lasting downward movement of interest rates cannot be reasonably expected until better control is gained over the forces of inflation. Some downward movement of short-term rates may occur, however, once we achieve a larger measure of success in moderating growth of the monetary and credit aggregates. Progress has been made in this effort, but less than we had hoped for.

In the first quarter of this year, growth of the narrowly defined money supply—that is, currency in circulation plus demand deposits—slowed abruptly. At the time, it appeared that transitory factors were reducing the publics demand for money, but that a substantial bulge in the money stock would probably soon developed. We therefore persisted in moving further toward monetary restraint.

As events turned out, the growth of currency and demand deposits during the second quarter exceeded our expectations. Taking the two quarters together, the annual rate of growth averaged 6 percent. This was well below the growth rate during 1972, but greater moderation was needed.

Strenuous efforts were made by the Federal Reserve to resist the resurgence of monetary expansion during the second quarter, and these efforts are continuing. We could, to be sure, have exerted still stronger resistance to that upsurge in money demand. Had we done so, we would have run the risk of stimulating far larger increases in interest rates—increases of a magnitude that might well have created serious turbulence in financial markets.

In any event, indicators of monetary and credit expansion other than the narrowly defined money supply indicate that our restrictive policy was beginning to bear fruit in the second quarter. For example, the annual growth rate of total bank credit declined to about 10 percent, compared with rates of increase of over 15 percent in the previous two quarters. Bank loan expansion, particularly loans to business, slowed materially, as lending policies at banks across the country tightened.

These are characteristic signs of developing restraint in the money and credit markets, and I therefore expect growth in the narrowly defined money supply to slow in the very near future. Let me make clear, however, that if the restrictive actions already taken by the Federal Reserve do not reduce growth of money and credit to an acceptable rate, further measures will be adopted as needed.

We have thus far avoided a severe stringency in credit markets. There has, however, been some loose talk of an impending credit crunch, which I believe is traceable to failure to appreciate the significance of what has been done to minimize the likelihood of any such event. Let me therefore try to clarify this vital dimension of the credit market.

Some weeks ago, the Board suspended the remaining ceiling rates on large denomination CD's. As a consequence, the situation that banks now face is very different from that of 1966 or 1969, when inability to bid for CD funds forced banks to act abruptly and deny access to credit to a wide range of borrowers. Under present circumstances, individual banks can obtain funds in the CD market if they—and ultimately the business firms that borrow from them—are willing to pay the price. Of late, as the cost of CD funds has risen, expansion in the volume of outstanding CD's appears to have moderated. But let me add that if further steps are needed to discourage banks from financing excessive expansion of business loans with CD funds, the Board could raise once again the reserve requirement on these deposits.

The Board, acting in concert with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, has also taken steps to protect the time and savings accounts of depository institutions, which are the preponderant source of mortgage funds for homebuilding. In recent months, as market rates of interest have become increasingly attractive to depositors, the inflow of savings funds to banks and other thrift institutions has dropped substantially. By lifting the ceiling on interest rates payable on time and savings accounts, the regulatory agencies have reduced the danger of severe stringency in the mortgage market.

Let me now turn briefly to the questions that are undoubtedly uppermost in the minds of the members of this committee. What are the prospects for cooling off the economy? What are the prospects for reducing the rate of inflation? What are the prospects of an early end to direct controls on prices and wages? What are the prospects for regaining stability in foreign exchange markets? These are interrelated and difficult questions; and while neither I nor my colleagues on the Board have the gift of prophecy, we do have the duty of advising the Congress to the best of our ability.

There are, we believe, some convincing signs that economic expansion is slowing to a more sustainable pace. To give one example, industrial production increased at an annual rate of around 9½ percent during the first 3 months of this year. From March to June, the increase receded to an annual rate of about 6 percent.

In part, this slowdown has reflected the impact of capacity constraints on the physical volume of production. But we also know that the advance of retail sales moderated and that an actual decline occurred in new housing starts during the quarter. All this may portend a more orderly growth of consumer expenditures, and therefore a lower rate of expansion in aggregate demand, over the remainder of 1973. However, the momentum of rising business expenditures for fixed capital and inventories, together wtih surging demands for our exports, seem likely to sustain a good rate of growth in industrial activity for some months yet.

It is against this backdrop of economic conditions that the prospects for price developments during phase IV and beyond must be considered.

The President's decision to terminate the freeze on prices that went into effect about mid-June came none too soon. Seriously adverse effects on agricultural supplies had begun to develop, because in some cases domestic prices were frozen at levels below production costs or below prices in foreign markets. Food prices, therefore, moved up sharply as soon as the freeze was lifted.

Food prices will probably continue to rise until the supply of agricultural products increases appreciably once again. Evidence on that score is discernible, but as yet inconclusive. The midyear crop report by the Department of Agriculture suggests larger harvests of wheat, soybeans, and corn in the United States. Our acreage restrictions on agricultural production, moreover, have now been largely eliminated. Also encouraging is the fact that more attention is being given to production of soybeans in the developing nations—notably in Brazil, Mexico, and Argentina. These are favorable trends for the longer term. In the near term, however, we must be prepared for a continuation of upward pressures on food prices.

The same is true of many industrial products. The controls imposed on prices of nonfood commodities under phase IV are stringent. Costs can be passed through only on a dollar-for-dollar basis, and many nonfood commodity prices will be effectively frozen until about mid-September because of the 30-day prenotification period. We cannot, however, realistically expect results in phase IV comparable to those of phase II. Economic conditions are very different now than in the summer and fall of 1971. At that time, we had substantial slack in labor markets, and a significant part of our industrial capacity was idle. Market forces therefore worked hand in hand with the control program in holding down wage and price increases. At that time, also, a more or less uniform rate of inflation had been underway throughout the economy for some time. The control program, consequently, did not need to allow many significant price increases in order to prevent disruptions in production or severe inequities.

Under present conditions, the repressing effects of the control program on prices will not have the support of market forces. Wage rate increases are creeping up; goods in many markets are in short supply relative to demand; foreign orders are there to take up slack that might be created by faltering domestic demand; import prices are still increasing as a result of the devaluation of the dollar. Relative prices, moreover, are badly out of equilibrium. Producers have experienced sharp increases in costs of materials and supplies over the past 6–9 months, and many of these cost increases have not yet been passed through to end products. In the present environment, the controls on prices and wage rates must therefore be administered with flexibility and practical wisdom if adverse effects on production and employment are to be avoided.

We have been operating under a system of direct controls over wages and prices for nearly 2 years now, and we can no longer count on benefits to the economy such as we experienced in phases I and II. In view of existing circumstances, markets should soon be allowed to function more freely, so that they can perform their accustomed role

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in promoting economic efficiency, in encouraging investment, and in allocating resources to areas of greatest demand.

There is a continuing role for income policies in a modern economy. We need to move, however, toward the elimination of mandatory controls in areas where competition is reasonably effective in regulating prices and allocating resources. Over the long run, we will probably need to have thorough surveillance over wage rates and prices in key industries where competition is inadequate, but the large majority of wage and price decisions are best left to market forces. Our economy has grown and prospered under free enterprise in the past. We should not overlook this teaching of our history or its confirmation in other nations.

If this judgment is accepted, greater reliance in dealing with inflation—both in the near future and over the longer term—will have to be placed on fiscal and monetary policies. A further rise of prices in the months ahead is unavoidable. But the resulting damage can be minimized if excess demand is avoided. The inflationary forces that now plague us will then have a better chance to burn themselves out.

The Federal Reserve is prepared to cooperate fully in this endeavor. It cannot, however, do the job alone. Additional fiscal restraint is also needed at this time. I for one would support stronger efforts to cut governmental expenditures or actions to increase taxes. Particularly appropriate, in my view, would be fiscal measures—such as a variable investment tax credit or a compulsory savings plan—that could be quickly reversed, under special legislative rules, if economic activity began to weaken, as sometimes happens after a prolonged period of economic expansion.

Evidence of a larger sense of fiscal responsibility in the United States would help greatly in restoring the confidence in the dollar that is so badly needed to stabilize foreign exchange markets. By May of this year, the average dollar price of 10 major currencies (those of Japan, Canada, and 8 European nations) had risen some 20 percent above the exchange parities that prevailed in the spring of 1970. This degree of realinement was generally regarded by financial authorities as necessary and helpful. But in the past 2–3 months, our Nation's currency has suffered further depreciation, with the average dollar price of the above 10 currencies up 7 percent, as the dollar price of the mark rose 20 percent, the French franc 10 percent, and the Swiss franc 12 percent.

This latest depreciation in the value of the dollar cannot be justified on any realistic evaluation of international price levels, or underlying trends in our economy, or our balance of trade or payments. In 1972, we experienced a trade deficit of nearly $7 billion—a condition that had to be corrected and is being corrected. By the first quarter of this year, the deficit shrank to an annual rate of less than $4 billion; and in the second quarter, the deficit practically vanished. Exports will probably rise substantially further over the remainder of this year and in 1974, as the effects of our strengthened competitive position cumulate. The improvement in our trade balance is therefore likely to gather momentum, so that by 1974 and 1975 we should be experiencing a sizable trade surplus for the first time since the mid-1960's.

The recent excessive depreciation of the dollar in relation to continental European currencies occurred despite this favorable outlook for the balance of trade and payments. Its causes cannot be identified with any precision. My own impression is that confidence waned with growing fears that inflation in the United States may have gotten out of hand. Other factors undoubtedly played their role—among them, the tightening of monetary policies abroad—especially in West Germany—the sharp speculative runup in the market price of gold, the spread of some uncertainty abroad about the ability of our Government to handle economic problems effectively, and wild rumors about another devaluation of the dollar.

The unsettled behavior of exchange markets since mid-May has been a cause of serious concern to the monetary authorities here and abroad. This concern heightened in early July, when market conditions for a time became disorderly, and normal commercial transactions were adversely affected.

In these circumstances, and after full consultation with the Treasury and representatives of other countries, the Federal Reserve began to intervene in the exchange market. As reported on July 18, in a statement issued jointly by the Board and the Treasury, intervention will take place in the future at whatever times and in whatever amounts are appropriate for maintaining orderly market conditions.

A little over a month ago, I testified before your Subcommittee on International Economics that I had misgivings about a general system of floating exchange rates. The experience of recent weeks has strongly reinforced my skepticism. While we should not return to a system of exchange rates as inflexible as the one that evolved under the Bretton Woods arrangements, we also cannot afford a system that is subject to the kind of destabilizing speculation we have seen recently.

A major objective of current negotiations on monetary and trading relationships is to design and adopt an exchange-rate regime that avoids these extremes. But success in arriving at monetary arrangements under which international commerce and investment can flourish will elude us unless steps are taken, both here and abroad, to bring an end to the nearly chaotic inflationary conditions that now prevail throughout much of the world.

The domestic and international tasks that lie ahead of us are difficult but they are manageable. They must be seen in perspective. Our Nation is experiencing great prosperity; but it is a marred and joyless prosperity, and so it will remain until we bring inflation under good control. We cannot do so until we put our financial house in order. A massive step in this direction would be taken if the Congress adopted this year proposals for budgetary reform such as were recently put forward by the Joint Study Committee on Budget Control. Its unanimous report favoring early enactment each year of a ceiling on expenditures, which would be organically related to the state of Federal revenues and the condition of the economy, deserves the enthusiastic support of this enlightened committee.

Thank you.

Representative Reuss [presiding]. Thank you very much, Mr. Burns, for a beautiful statement. Wise and honest, it couldn't be more helpful.

Because you did cover the waterfront, it inspired a number of questions which the popular branch of the Legislature will not ask, since the Senator seems to have vanished for a moment.

I made a number of notes as we went along. In your statement, you said: "The Board took the further and, I believe, unprecedented step of addressing a request to nonmember banks and agencies or branches of foreign banks to accept voluntarily the higher reserve requirements imposed on member banks."

You can call spirits from the vasty deep and so can I and so can any man, but will they come when you call for them? Did the foreign banks and the nonmember banks take the hint, or don't we yet know?

Mr. BURNS. Every foreign bank responded affirmatively.

Representative REUSS. What about the several thousand nonmember banks?

Mr. BURNS. This request was addressed to the larger nonmember banks. Only a minority of these banks responded favorably; however, the banks that did respond favorably accounted for a little over 50 percent of the total of nonmember bank deposits.

Representative REUSS. Considering you are powerless on that——

Mr. BURNS. This is not a bad response. It indicates, I think, that moral suasion is still a force in this world.

Representative REUSS. Still one doesn't want a system which is 50 percent leaky as to nonmember banks. Am I correct in my understanding that you favor, as I do, making the setting of reserve requirements for nonmember banks a power which should be lodged in the Federal Reserve?

Mr. BURNS. I am very glad to hear you say this, Congressman Reuss. I think this is essential. The number of nonmember banks leaving the system is increasing. In early years, his movement out of the Federal Reserve System, primarily because of the reserve requirements imposed on member banks, was confined to small institutions. Of late, some large banks have left the system, and at least one extremely large bank is now considering this momentous step.

If that happens, the movement will spread, and this is entirely understandable. Many of our bankers have been trained in universities which emphasize the achievement of maximum profit rather than public and community responsibility. We didn't like saying this, but it is a fact. These highly skilled bankers of today, when they take out their pencils and make their calculations, can see the possibility for improvement in their profits and therefore, also, in the standing of their common stock on the exchange, if they change from member bank status to nonmember bank status. If this outward movement accelerates, then the degree of control that the Federal Reserve now has over the monetary and credit aggregates will deteriorate badly.

Representative REUSS. You would not welcome carefully drawn legislation, not to have compulsory membership in the Federal Reserve, but to give the Federal Reserve control over members and nonmembers alike?

Mr. BURNS. Oh, yes, I think membership in the Federal Reserve System is unnecessary. What is necessary is control over the monetary and credit aggregates, so that the Federal Reserve can play its part in helping to steer this economy on a more or less stable course.

Representative REUSS. Turning to another subject, you have done some very innovative thinking about investment tax credits and various other incentives to investment. I noted in your presentation some very down-to-earth information about the paper industry, the cement industry, and pertoleum refinery industry—to mention three—where there has been a very severe lag in new plant and equipment.

Now, the trouble with the investment tax credit is that it gives everyone an incentive to put in new equipment, good, bad, or outrageous. My favorite example of the indiscriminate character of the credit is the Nevada brothel owner who makes affidavits that he used the credit to buy new equipment for his place of business. This doesn't really help productivity very much.

Would it not be possible to work out, possibly as a complement to the flexible investment tax credit that you mentioned, a credit that really zeros in and focuses on where we need the expansion? You mentioned three industries. There are, of course, a number of other laggers. Why not give them—and I would vote for it—a good juicy investment tax credit, but deny such a credit to those industries where it isn't necessary? Have you thought of that approach?

Mr. BURNS. Well, I have thought of the special problem of the materials-producing industries. In thinking about that, I recalled the experience that we had during, or right after, the Korean war. We found great shortages, and embarked on a program of accelerated amortization, so that a limited number of industries could amortize their investments in plant and equipment over a period of 5 years. This is an idea that we may want to adapt to the special problem that I think has arisen in a number of our key raw materials-producing industries.

I think, also, it would be desirable for the Congress to consider very carefully the growing problem for industry imposed by our environmental controls. These controls are essential, that is why the Congress is authorizing them. But these controls also are very costly to business, and they do nothing to add to capacity. That is true not only of pollution controls, but also of occupational health and safety legislation. Investments for these purposes, while eminently worthwhile socially, pose financial problems for industry. One approach may be to allow very rapid depreciation for investments of that kind or special tax credits.

I think this problem deserves the most thoughtful attention of the Congress.

Representative REUSS. My last question has to do with the material on fluctuating exchange rates in the last part of your statement. You were most helpful to us on this subject in our special inquiry of the International Economics Subcommittee a month ago. I have two questions; one, perhaps, you can answer in the record.

In your statement you said: "This concern"—meaning concern about unsettled behavior exchange profits—"heightened in early July, when market conditions for a time became disorderly."

And then you go on to say that that is when the Federal Reserve and Treasury did a little intervening.

As you know, I am very interested in this subject. Could you—not now, but when you correct your testimony—append a little section entitled "Disorderliness—what constitutes it?" It would be very helpful to know what a "disorderly market" looks like and what an "orderly market" looks like.

Mr. BURNS. I would be very glad to do that.

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

FEDERAL RESERVE BOARD STAFF MEMORANDUM IN RE: DISORDERLY MARKETS

Disorderly markets have certain features in common: exaggerated rate movements, wide spreads in quotations, a stifling of the intermediary role of professional dealers, and an unresponsiveness of prices and orders to the fundamentals operating at the time. Disorderly markets are by their nature unstable; in the absence of some stabilizing influence, disorder can increase to the point at which the market ceases to function.

The developments leading up to the Federal Reserve intervention in foreign exchange markets in July provide an illustration of how markets become disorderly. In May, foreign exchange traders of banks and commercial concerns were beginning to take the view that they were likely to sustain losses when they held a long position in dollars overnight and, conversely, to realize profits when they were short of dollars. In these circumstances, traders became increasingly unwilling to expose themselves to the risks of holding dollars. The market found it increasingly difficult to accommodate dollar sales as they appeared. A moderate-sized dollar offer which in normal conditions could have been easily handled would be passed from one dealer to another. Traders, hoping to make their rates unattractive to potential dollar sellers, widened very substantially the spreads that they quoted between bid and asked rates. As sales of dollars for foreign currencies continued in this atmosphere, market conditions worsened, and by early July the dollar declined by 2 per cent or more each day against major Continental currencies.

In the face of this widespread selling and rapidly-changing exchange rates, market participants lost confidence in their ability to assess exchange-rate relationships. Traders concentrated their attention on movements in spot rates for major Continental currencies and virtually ignored the other currencies and all forward exchange rates; consequently these markets virtually dried up. Moreover, major corporate customers suspended much of their normal foreign exchange business, and by July 6, a number of New York banks were refusing to quote exchange rates and had suspended all foreign exchange business—even in the major currencies.

As conditions in the exchange markets deteriorated during the first week of July, the need for official intervention to restore order in the markets was recognized by monetary officials here and in Europe. A communique implying that such intervention would be undertaken was issued on July 8 by the central bank Governors meeting at the B.I.S. in Basel, Switzerland, and intervention was in fact undertaken by several central banks, including the Federal Reserve, during the ensuing days, with the result that order in exchange markets was restored. The need for official intervention at that time was also recognized by the financial press, including supporters of floating exchange rates. For example, the London Financial Times, in its editorial of July 9, called the situation in the exchange market "not only absurd but dangerous" and urged immediate implementation of "a set of informally-agreed rules to govern the . . . period of floating." Several days later, the New York Times urged a reformed monetary system that would be "less crisis-prone than either the now dead fixed rate Bretton Woods system or the present state of disorderly floating, and growing export, import and capital controls."

Representative REUSS. My final question relates to what you said in your statement about having misgivings about a general system of floating exchange rates, because of the kind of destabilizing speculation we have seen recently.

I would just ask you this question. Are you sure that you have got the right villain in the piece—floating exchange rates? Are you sure the villain isn't a combination of one part Watergate, one part American inflation, one part Middle East oil money, one part in unfunded $90 billion overhang, and one part of a worldwide commodity shortage, all of which have contributed to the sad state of affairs we are witnessing?

It is my own feeling, for whatever it is worth, that if we could solve those problems that I have listed, and there may be a few more, floating exchange rates might look somewhat better than they do now. What do you think?

Mr. BURNS. I would not deny that. Yet I would also say that if we had had all of these grave disturbances but still had an international monetary system that made provision for par values and their maintenance through convertibility, we would have had a reasonably stable exchange market.

Representative REUSS. And with all of these other things fixed, we would have a reasonably stable exchange market with fluctuating rates, too, wouldn't we?

Mr. BURNS. That I don't know. The experience is mixed and the reasons varied. It is very much a matter of judgment, and I must warn you that everything that I say on the subject of floating exchange rates is influenced by my earlier studies and my most vivid recollection of what happened during the 1930's. It has colored my thinking.

I try to enter the modern world. I have flirted with floating exchange rates, and I have watched my fellow central bankers become quite comfortable with them, as they did in February, March, and April. They had less to do, less to worry about. I was, myself, at least a little infected by this contagion of tranquillity, but I remained skeptical. And in the past 2 months, my skepticism has been intensified. When markets begin functioning the way they have of late, these recollections of mine of the 1930's come sharply into focus in my mind.

Now, in fairness to the truth, and in fairness to your position, I must admit that experience with floating exchange rates has been mixed. Even in recent months, the Canadian dollar has been quite stable, relative to the U.S. dollar, and the Japanese yen has been remarkably stable relative to the U.S. dollar. Nevertheless, we have had days and weeks when it was difficult for businessmen to get quotations on some foreign currencies and difficult to get forward cover. This is a story that I will try to describe a little more fully in response to your earlier question.

Representative REUSS. Thank you very much.

Senator PROXMIRE [presiding]. Congressman Conable.

Representative CONABLE. Thank you, Mr. Vice Chairman.

Mr. Burns, in your statement you said: "The Fed is prepared to follow an even more stringent monetary policy than is now in effect, if necessary, to reduce the money growth rate."

I realize there is a certain amount of jawboning in such a statement, but you are doing what Congressman Reuss might describe as some calling of the spirit in vasty deep there. But I take it, in any event, that you disagree quite strongly with those who say monetary policy is now to restrictive and should be eased as the contraction takes place. We have a tendency to react rather briskly to changes in direction, don't we, and I take it you are saying we should hold off a little on the easing of monetary restriction. Is that correct?

Mr. BURNS. That is substantially correct. Those who believe that monetary policy is too restrictive are fearful—and I understand that thoroughly—that a recession may be imminent. If I thought so, I would begin the easing process at once. But I think that is a premature judgment.

Representative CONABLE. I notice in the Wall Street Journal today that the Home Loan Bank Board cut from 6.5 percent to 5.5 percent the portion of assets that savings and loan associations must keep liquid in order to free up $2.2 billion for the tight home mortgage market.

Now, that is, I guess, matching the December 1969 record low in liquidity requirement. Will this have any appreciable effect on easing the mortgage market, and I am wondering if you aren't concerned about what kind of precautions we have to take in dealing with such low liquidity requirements.

Mr. BURNS. There has been a sharp runup in mortgage interest rates recently in response to a sharp reduction in the inflow of funds to the savings and loan associations. The savings and loan associations have been borrowing very heavily from the home loan banks. Thus far this year, they have borrowed something like $4 billion. Their weekly rate of borrowing from the home loan banks has risen to something like $300 million.

Now, this borrowing has taken place because the savings and loan associations have large outstanding commitments and the inflow of funds is insufficient to enable them to meet these commitments and at the same time continue extending new mortgage loans. In the circumstances, I think that the action taken by the Home Loan Board in reducing the liquidity requirement is a reasonable action.

Representative CONABLE. I have also been noting some prediction that we will achieve a 9-percent prime rate, possibly today or Monday. Is there any sign of the prime rate leveling off? I realize that involves a crystal ball to a certain extent, but what are your expectations there, sir?

Mr. BURNS. Well, a central banker does his job best when he talks about the subject of interest rates to confine himself to the past and the present.

Representative CONABLE. Yes, I understand that. What is the prime rate in England and France right now?

Mr. BURNS. In England, it is now 11 percent; in Germany, it is higher; in France, I am not sure.

Representative CONABLE. Well, to what extent are our prime rates dictated by foreign rates?

Mr. BURNS. There is some influence, but I think that interest rates around the world have been rising because of the worldwide boom and because of the worldwide inflation. Our interest rates normally are lower than interest rates in other industrial countries, and that is still true of long-term interest rates. As far as short-term rates are concerned, our rates are higher than in some countries. They are certainly higher than in Switzerland and, I believe, in Belgium and the Netherlands. But they are lower, as I stated, than in England or in Germany.

Representative CONABLE. Mr. Burns, I notice when you talked about loss of confidence in the dollar, you didn't talk about the pending trade negotiations. I wonder if you would care to put that in some perspective for us. We are working in the Ways and Means Committee on a trade bill at this point and feel that it is a rather necessary measure, that there must be some effort to achieve some long-term improvement in trade relationships and some effort to negotiate. Yet I have the feeling that some people are putting rather too much confidence in what can be achieved through trade in terms of the Eurodollar overhang and in terms of probably long-term improvement in our balance of trade generally.

I wonder if you could mention that, since you didn't mention it in your statement, and discuss what considerations you see affecting our posture in these trade talks.

Mr. BURNS. Well, first of all, I think that the trade bill that is being considered by the Ways and Means Committee is a good bill and a necessary bill. To make any progress at all, we need that legislation. Progress, however, will be very slow and these conversations will go on and on. And while I expect positive results, I do not think that they will be of a kind to change our position fundamentally.

To change our position fundamentally we have to stay on a noninflationary track. That is something we ought to be able to do, although not immediately in the present context. But over the next 2 or 3 years we ought to be able to do this successfully and by ourselves pretty much.

When it comes to trade negotiations, we have to deal with other countries which have interests of their own and which interpret events very frequently in a different way than we do. I would say much the same about adjustments of exchange rates. To improve our trade position, I think we basically have to bring inflation to a halt. That should be our major weapon rather than resorting to frequent exchange rate adjustments or reliance on trade benefits that may be derived through international trade negotiations of the GATT type.

Now, there is one thing that the GATT negotiations should deal with, and that is a general lowering of tariff rates and some reductions in nontariff barriers. That will benefit us no more than it will benefit other countries. It may not improve our balance of trade as such, but it will mean, or should mean, a better utilization of resources in our country and elsewhere.

Representative CONABLE. One last question, sir. In putting your reliance on the stopping of inflation, you are talking in very absolute terms. Isn't the important thing that our rate of inflation be less than the rate of inflation of other countries, in particular our major trading partners, and those with whom we are competing for capital?

Mr. BURNS. You are quite right, but by putting the accent on stopping it, we may achieve the lesser goal you describe.

Representative CONABLE. Thank you.

Senator PROXMIRE. Before I start questioning you, I would like to admit a mistake I made the other day and correct it. I said that columnist Hobart Rowen was the one who carried in his column a statement that we are spending $12 million to promote the sale of agricultural commodities abroad. That was columnist Jack Anderson, both eminent newspapermen, both writing for the same syndicate, I guess.

Representative CONABLE. But only one of them here today.

Senator PROXMIRE. But only one of them here today, and that one I mistakenly said made the statement. You have given us a very different picture of the economic outlook, Mr. Burns, and of the policy needs than has any other witness during these hearings.

Despite the declining trend of real ouput growth and despite the fact that unemployment is still high, you seem to feel that the economy is still growing too fast and that more restrictive policies are needed.

You intentions regarding monetary policy are spelled out in your statement, where you say:

> I therefore expect growth in the narrowly defined money supply to slow in the very near future. Let me make clear, however, that if the restrictive actions already taken by the Federal Reserve do not reduce growth of money and credit to an acceptable rate, further measures will be adopted as needed.

That is a very strong statement.

Further on you give your view on fiscal policy when you say:

> Additional fiscal restraint is also needed at this time. I for one would support stronger efforts to cut governmental expenditures or actions to increase taxes.

No other witness has taken this position. Chairman of the Council of Economic Advisers Stein and Treasury Secretary Shultz, and our private witnesses, have all said that fiscal and monetary policy have already moved toward restraint; that no tax increase is needed; indeed, that with the economy already slowing down, further monetary-fiscal restraint could plunge us into a recession.

As I noted, and I suspect you feel also, we are unlikely to get much of a change in fiscal policy. Monetary policy is likely to be governing. So your decision is likely, in my view, to have more effect than that of any other Federal official.

You also stated:

> Our inflationary problem this year has risen in substantial measure from sources well beyond the influence of domestic monetary and fiscal policies.

As you note, I said in my statement, I don't see what monetary policy can do about the tremendous increase in demand for American food and shortage of oil. And in light of that analysis, why do you put such stress on the need for additional monetary and fiscal restraint?

Mr. BURNS. First of all, I am not opposed to further economic growth. On the contrary, that is precisely what I want to see continue. What concerns me is excessively rapid growth, not in the physical volume of production and activity, but excessively rapid growth in aggregate monetary demand.

Over the months immediately ahead, the special forces that you mention and that I dwell on in my statement will be actively at work, but I think that the chances that these forces will wear themselves out will be better if excess purchasing power or excess monetary demands can be avoided. Therefore, I believe that a moderately restrictive monetary policy is desirable.

I would hope that fiscal policy can make its modest contribution, so that the burden that monetary policy has to bear is not so large. I don't want to see interest rates keep on rising. I feel very uncomfortable about that, and, beyond a certain point, I think this could become very dangerous.

Now, in speaking of restraint, both monetary and fiscal, I am well aware of the possibility that restraint could be carried too far; I am well aware of the possibility that a quick turnaround of policy may be desirable and wise.

Fortunately, monetary policy is something that can be changed rather quickly, and the kinds of fiscal policy that I have urged are also policies of a kind that could be reversed. When I plead for higher taxes now, I recognize that 3 months later I might come before this committee and say: "Oh, no; I withdraw that suggestion, for circumstances have changed."

I recognize that if such legislation were enacted, it would be desirable to write into the legislation special rules, so that an increase in taxes or an imposition of compulsory savings could be terminated speedily. Therefore, what I am trying to do is to deal with the present inflation and continuing threat of inflation through measures that would also provide us with a reasonable insurance policy against a possible recession.

You have heard me talk frequently about a variable investment tax credit. Suppose that you lower it now and that a few months later it appears that an increase in the credit would be desirable. In that case, you would have at hand a tool that, in my judgment, would give you a very powerful insurance policy against recession.

Let me say just one more word, Senator. When people talk about a tax increase at a time like this, they are thinking of a standard type of tax increase; that is, a tax increase of indefinite duration. I am not thinking in those terms at all. I am thinking rather of a tax measure of a quickly reversible type. The dangers cited by other economists and Government officials who testified before this committee I also have in mind. I think my way of approaching it would deal with these problems in a reasonable way.

Senator PROXMIRE. You see, what concerns me and I think concerns others is that we do have some evidence in the second quarter there was a slowdown in the rate of growth, rate of real growth, of the economy. Of course, we have an enormous rate of growth in the first quarter but there was a slowdown and the slowdown was sufficiently sharp so that it appeared to be below that which is necessary to keep our growing manpower and other facilities occupied. We need about a 3- to 4-percent rate of growth. We got less than 3 percent in the second quarter.

Mr. BURNS. If those figures will stand up; I am very skeptical of them.

Senator PROXMIRE. Well, the interesting notion that you suggest, and you are the only one who made this suggestion, I disagree with it and I think most Members of Congress do, but it is a constructive and thoughtful suggestion that we give the President authority to vary the investment credit within certain limits, as I understand it.

The difficulties are several: No. 1, of course, is whether Congress is going to give up its taxing authority. No. 2, is whether that would be an appropriate weapon to use now when we have had 2 months of decline in orders for machine tools, which industry has the most sensitive reaction to the investment credit. No. 3, what this would do in terms of business confidence. As I talk to businessmen, the main thing they want in our tax system is certainty, assurance; they don't want change that seems to be arbitrary, that they can't count on.

Then, also, it is interesting, and I think it is indicative of the progress that we may have made in economic policy, that you, as certainly one of the outstanding economists and viewed by many as the outstanding conservative economist in our country, are sugesting a mechanism that represents the essence of fine tuning. Fine tuning in the sense of being able to manipulate the one aspect of the tax code in such a way to get expansion or restraint in a more sensitive and flexible and prompt way.

Would you feel that it might be more realistic to rely on spending restraint than a tax action by the Congress? I think there is a possibility that the Congress could cut below the $268.7 billion ceiling. Would you like to see us do that and, if so, how much?

Mr. BURNS. Well, the answer to your question, would I like to see you do it, is a ringing affirmative. As to how much, I would be very happy if you could reduce Federal expenditures in fiscal 1974 from the President's recommendation of $268.7 billion to $260 billion, and I would be happy——

Senator PROXMIRE. That would be a dramatic and sharp cutback, wouldn't it?

Mr. BURNS. I am just trying to tell you what it would take to make me extremely happy.

Next, let me tell you what would make me reasonably happy. I would be reasonably happy if you cut it back to $265 billion. Finally, let me say I would be not too uncomfortable if you stayed at the January figure. I am fearful you may go above it.

Senator PROXMIRE. Well, Mr. Burns, there are several reasons why I think there is a good chance we will stay at that figure. We now have the record of fiscal 1973 of staying below $250 billion, the president's ceiling.

When he doesn't impound funds, the President vetoes domestic appropriations the Congress wants, and the Congress is, by and large, unable to pass such appropriations over his veto. Occasionally we can, perhaps, but not very often. And on vocational rehabilitation, for example, we couldn't although that was one of the most appealing spending programs. At the same time, I think Congress is going to cut sharply below the President's recomendation in the military.

The House has already done it with weapons systems and that was a startling and dramatic action by the House. I think the record over the years, shows the Congress as a whole has consistently reduced overall spending below the President's request. So I think the prospects this year are excellent.

You seem to have very litle fear this will slow down the economy too much. Why is your Federal Reserve staff forecasting different from the administration's? They seem to have a different view than the administration, in view of their feeling that further restraint isn't required and your conviction that it is required. Does your staff study indicate a higher or lower growth of real output than the administration's estimate?

Mr. BURNS. I am not sure I know the answer to that question. My guess is that these men work closely with one another, and that the staff judgments are pretty much the same.

When you say I have very little fear, all that I can say to you is that as of today I consider talk about a recesion entirely premature. As of today we should focus on the problem of inflation and focus hard on it. As of today, however, any actions that we take should be of a kind that could be quickly reversible, because those who see a tapering off, a slackening in growth and an eventual downturn, could turn out to be right. There is always that possibility, and we ought to take it into account, whatever we do. My policy prescription is designed to do just that.

Senator PROXMIRE. In your statement, you refer to "loose talk" of an impending credit crunch. You then go on to list actions you have taken to minimize the possibility of such an event. You list the following actions: Suspension of interest rate ceilings on large CD's; lifting the ceiling on interest rates payable on time and savings accounts.

Really, only two identifiable steps that you have taken. And these have to be balanced against the determination——

Mr. BURNS. If I may interrupt, perhaps the most important one is the marginal reserve requirement that we imposed on the outstanding large CD's.

Senator PROXMIRE. All right. I will add that as three. But these do have to be balanced against the determination expressed elsewhere in your statement to take all necessary steps to increase monetary re-restraint.

How can we be sure there won't be a credit crunch?

Private forecasters continue to predict the possbility of a crunch. One forecast, Data Resources, estimates that unless the Fed backs off its tight money policy by September, we are very likely to have a crunch. And a crunch would mean, according to their forecast, 6 percent unemployment by mid-1974, a decline of 700,000 in housing starts, and a negatative real growth rate of minus 3 percent in early 1974. Do you think that situation won't develop or cannot develop under this prescription?

Mr. BURNS. I am glad you asked that question. The people who talk about a credit crunch have a capacity for getting excited about it but they never define what they mean by it.

Now, I don't get excited, but I too, have failed to define in this statement what I mean by "credit crunch," and your questioning gives me the opportunity to give you a definition. When I say that I am reasonably confident that there will be no credit crunch, I am reasonably confident because it is a determined part of Federal Reserve policy to keep the monetary aggregates expanding, but at more moderate rates. When the money supply grows, when bank credit grows, you do not have a credit crunch—as I use the term. Interest rates may rise, but if credit is available and the money supply is growing at a moderate rate, there is no credit crunch in my sense of the term. Therefore, the difference between my position and that of others may well be that others who use this term attach a different meaning to it.

Senator PROXMIRE. Well, the meaning that would seem obvious to me would be a lack of available credit in important sectors, lack of funds for housing, lack of funds for State and local government at any kind of a reasonable rate.

Mr. BURNS. My viewpoint stresses availability of credit. As long as you have credit available at a price, so that business can go on and credit can expand, and the money supply can expand, I would say there was no crunch.

Senator PROXMIRE. Suppose we have Henry Kaufman's suggestion. He, as you know, is an eminent economist, highly thought of; he has predicted a further substantial rise in the Federal funds rate to 13 or 15 percent in the next few weeks. Do you call that evidence of a credit crunch or would you say, after all, it is available at the price; it is available, that people are able or willing to pay that much?

Mr. BURNS. I don't want to comment on what the future of interest rates may be, but I will tell you this: In Chile, the going rate of interest on 6-month loans is now something like 130 percent. Why? Because you have a 175-percent rate of inflation, so that the real rate of interest actually is negative. Look at the interest rates in Brazil, or look at the interest rates in Argentina, where the rates of inflation have been high. Interest rates there are in the twenties, thirties, forties.

Now, if we in this country should suffer from a continuing high rate of inflation, we could have much higher interest rates and business could still go on, and credit could still be available. In a condition like that, while most unfortunate, I would say that we didn't have a credit crunch, we would have something a lot worse, and that is a crisis affecting the foundation of our economic and social order.

Senator PROXMIRE. My time is up.

Senator Percy.

Senator PERCY. Mr. Burns, I was over in the Foreign Relations Committee meeting this morning and I sent for your statement so I could quickly scan through your statement before I arrived. I want to again express appreciation for your very decisive analysis of the economy.

I would like to question you on the comments that you made in your statement, where you note that consumer spending has been heavy and consumer borrowing has been heavy, too. Could you give us a little more of an expansion on your thinking as to consumer psychology now? Is the consumer spending as much as he is today and borrowing against future income because he simply feels that purchasing power is continuing to be eroded and that he will always be paying higher prices in the future and, therefore, he had better get it now?

Mr. BURNS. I think we have had some of that in recent weeks; yes. But I do not believe that this, fortunately, is as yet a large nationwide factor.

Senator PERCY. Did you react favorably to the Senate action yesterday on passthrough costs for meat products, the vote of 82 to 5, which certainly was a decisive feeling on the Senate's part that the freeze on meat prices has not worked and has been disastrous so far as cutting off the supply.

Mr. BURNS. My reaction to that was favorable.

Senator PERCY. Also in your statement you said: "That phase III made it easier to pass on costs and to widen profit margins." Do you think that phase III was ill timed?

Mr. BURNS. Was what?

Senator PERCY. Do you feel phase III was ill timed, because of your comment that phase III made it easier to pass on costs and to widen profit margins?

Mr. BURNS. Well, with the benefit of hindsight, it certainly seems clear to me that it would have been wiser to move out of phase II into phase III more gradually.

Senator PERCY. Do you feel the experience we have just gone through reemphasizes the point you make in your statement, where you say that you express strong sentiment for the need to understand that controls are distorting the economy and that controls in the public mind, the consumer's mind, which may look awfully good to him to start with, may distort the economy and throw it so far out of balance in the end that the consumer is worse off than he was at the beginning of them?

Mr. BURNS. I see, really, no point in resorting to controls in markets or industries where competition is effective. That is true of a very large part of our economy.

On the other hand, where competition isn't doing its job well enough, I think controls can be used, but that, I think, is a limited sector of our economy. Therefore, in looking to the future, I hope we will take note of the many markets where competition is pretty effective, and just leave them alone. There will still be a need, however, to focus on the limited number of more or less monopolistic situations on the part of industry and on the part of labor.

Senator PERCY. I would appreciate very much an expansion on your thinking on export controls, particularly on agricultral products now. We have worked mightily through the years to build up markets abroad and now we are controlling exports to the very customers that through the years we have been trying to convince we would be a reliable, steady, low-cost source of food product.

Is there any way that we can fulfill our commitments to those countries that have been good customers of ours and have good faith in our ability to supply their needs, by having a country-by-country control rather than across-the-board, and favoring those countries that have been customers and not necessarily diverting our production to new customers that have not been buying at times when we were in surplus production?

Mr. BURNS. These are very difficult questions. First of all, let me say that once we had the price freeze, some export controls became unavoidable, since prices abroad were well above our domestic price level. This is another example of how one control will lead to another.

Second, you, of course, are right, we have stressed so much over the years the importance of widening the foreign markets for our products, particularly our agricultural products; we have been critical of various countries in the world, particularly those in the Common Market, because of their protectionist agricultural policies. When we slap on export controls, all of this becomes very confusing to the outside world.

As I understand the administration's policy, export controls now are restricted to soybeans, cotton seed, and their derivatives, and also to steel scrap. The hope is that these export controls will prove very temporary, and I strongly share that hope.

As to your final question about differentiating among countries, I think that we may solve some problems in the process and also create new problems. By and large, over the long run, I think this country would be best off if we had a policy that was uniformly applicable to all foreign nations. Now and then deviations may become necessary or unavoidable, but I think we ought to think very carefully about each deviation.

Senator PERCY. Mr. Vice Chairman, may I ask unanimous consent to continue for 4 or 5 minutes more? I very much regret I must leave shortly, and I have just two other questions, or one comment.

As we all know, Mr. Burns has long advocated the Congress looking at a flexible investment tax credit and I would like to say that I enjoyed working with Mr. Burns and sending out questionnaires to 250 of our business leaders in America, but I have not had a chance to fully report back to Mr. Burns on the results of this survey.

But I can say this, when I commented on this at a recent meeting in the Cabinet room with the President, when he asked for suggestions on phase IV, I mentioned the survey that Mr. Burns and I were taking and the President has asked me to send the results over, which I am doing today.

I was impresed with the fact that out of 250 surveys sent out—you expect to get 10 or 20 percent of the survey back—we have 175 responses, a great many of them made out in handwriting by the chief executives of some of our Nation's largest corporations. We have a sprinkling, also, of smaller business that took a deep, intense interest in it, and a full one-third of the business community favored a flexible investment tax credit.

That means two-thirds of the public were dubious—but I was rather surprised to find even a third favored it, because you would expect all business to say: "No; we don't want a flexible one; we are afraid of losing what we have."

Just looking at this same survey on the question of the President's trade bill, 98 percent opposed the Burke-Hartke tariff bill and we have an overwhelming response in favor of the administration's bill—91 percent—although quite a few did comment unfavorably on the stocks provision. But I think that is a pretty strong level of support from the business community for an economic trade policy when we get into talks in Tokyo that are extremely important.

I will send all of this material over to you, Mr. Burns, but I just wanted to thank you very much indeed for what you have done to cooperate with us in seeing that we do get back this kind of economic information for the guidance of the Congress, which I think is extremely helpful.

Mr. BURNS. These are fascinating results and I would like to study them. I think you are quite right, that one-third of today's businessmen are in favor of a variable——

Senator PERCY. Mr. Burns, I am afraid they cannot hear you.

Mr. BURNS. I say, when you find that one-third of the businessmen are in favor of a variable investment tax credit, that is most encouraging. I think that as they understand the objective better, and as the fears of having the investment tax credit removed, diminish, my guess is you will find that a positive response will grow.

Senator PERCY. My last question is really in the area of expertise of our vice chairman and Senator Humphrey, but I have been deluged with correspondence from savings and loans associations and I am really beside myself to know how to respond.

I note this morning in the Wall Street Journal on the front page, and perhaps it has been already noted in these hearings, that the Home Loan Bank Board freed up, in effect, about $2.2 billion, put it into the market because it recognizes the great problem.

But on behalf of the great many constituents that all of us have throughout the country, I think we value your feelings on their comments, particularly with respect to what has happened on the change in police that the Fed has announced. The Fed announced new higher allowable interest rates that banks could pay on savings, and the Federal Home Loan Bank Board followed suit on savings and Loans associations, allowing them to pay higher rates.

First, the letters that we are getting inundated with indicate the banking system and banks can pay the higher interest rates because bank loans turn over more quickly. Second, the savings and loan industry is locked into longer term loans, yet they also have to increase their interest rates, but the banks have sucked them dry of new deposits. Savings, in any event, are flowing out of savings and loans.

Third, the future for savings and loans on the housing market looks grim; last night, at least. Savings and loans don't and won't have funds to loan for housing.

Fourth, savings and loans particularly object to the 4-year certificates that can be offered which have no interest rate maximums. On the other hand, I might say the commercial banks will give us letters saying this is a policy they all can do.

Savings and loans have advocated, first, not allowing 4-year certificates with no maximum on interest rates and, second, rolling back interest rate maximums on savings.

Could you advise us in your judgment what should be done, whether you do see savings and loans losing funds as a result of the new rates, whether housing is going to be hurt, and when you might think that interest rates will go lower or should they be in any way rolled back? I am simply paraphasing questions of tremendous amounts of correspondence that I have had in recent weeks.

Mr. BURNS. Well, I am not surprised. I think that must also be true of your colleagues in the Senate and in the House. I assure you I, too, have been working on this problem. I have had many meetings, a great deal of correspondence, and I have given a great deal of study to this problem. Let me make a few comments that may perhaps be helpful.

First, the action taken on July 5 by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board was to raise the interest rate ceilings on passbook deposits and on consumer-type certificates of deposit. This action was taken for two basic reasons. First, simple justice to savers required it. The man who has $10,000 or more can buy a treasury bill and he can earn now over 8 percent on it, while the wage earner who has just a few hundred dollars, or a few thousand at most, is confined pretty much to passbook accounts or small certificates of deposit with a much lower rate of interest. So simple justice to savers in a period of rising interest rates, when financial institutions are also better off, seems to require higher ceiling rates.

Our second basic reason, perhaps one that looms larger in our thinking, was to protect the mortgage market, particularly the savings and loan associations. The evidence before us was that the inflow of funds to these institutions was diminishing at a rapid rate. We were projecting trends, and it seemed rather clear to us that this difficulty would intensify. To minimize the difficulties for these financial institutions. the savings and loan associations and the mutual savings banks, it seemed desirable to raise the interest rate cielings so that people would be less eager to withdraw funds from these institutions and buy market instruments.

Now, in addition to raising ceilings, we did something that had never been done before. We permitted a 4-year certificate without an interest rate ceiling. We did that because we wanted to give these institutions a limited opportunity to compete with market instruments for funds of the public. Initially, we at the Federal Reserve Board did not impose a limit on these 4-year, "no ceiling" certificates, but we quickly recognized that some of the commercial banks were misusing—or so we felt—this newly won privilege. We therefore imposed a limit on the 4-year certificates of 5 percent of their time and savings deposits. So the limit now is exactly the same as in the case of the savings and loan associations.

We also took other steps. We have been studying advertisements by various financial institutions. This is not a subject that I paid any attention to in the past, but I was shocked when I saw some of the advertisements that the heads of savings and loan associations brought to me, and I picked up some of my own in the New York Times and other newspapers. These advertisements did not disclose the penalties with any precision. I think they were misleading. I saw one advertisement to the effect that the bank would pay an interest rate in excess of 11.5 percent over a 4-year period. And if you examine the arithmetic, it can't do that.

In view of that, we are now in the process of putting a new regulation out for comment. The law requires it, and we have left only a brief period for comment. There is no question in my own mind that that regulation will become effective. It will require that every advertisement specify the penalty that attaches to early withdrawal from one of these longer term certificates. The penalty will have to be spelled out on each deposit certificate. The regulation goes beyond that. It also specifies that every purchaser of a new certificate will be handed by the member bank—the only group we regulate—a brochure which explains the penalties for early withdrawal in very simple language, and which gives a number of arithmetical illustrations, so that any man who can read and who can count will understand what will happen if he should withdraw his money before the 2-year certificate or 4-year certificate expires.

And, in addition, we have instituted promptly a monitoring system consisting of reports from a rather large sample of banks. Actually, it covers all of the weekly reporting banks. The first returns came in yesterday—they referred to a week ago. These reports will be compiled weekly.

What they show is that the commercial banks covered in this sample—and my guess is, I have not had time, nor has my staff had time to analyze these reports adequately—but it appears from the sample, which covers something like 50 percent of the universe, that the increase in the small denomination certificates, that is the 4-year certificates, has been $570 million, which is not a large figure. The total outstanding of time and savings deposits in the banks covered by the sample is well over $100 billion. Moreover, most of that $570 million came from the commercial banks themselves, from individuals who converted passbook deposits into certificates bearing a higher rate of return.

Now, I am also working with the savings and loan associations. A new system of reporting has been initiated—also weekly—so that we can see precisely what is happennig to the savings and loan associations. We will be fully apprised of developments in that area. If injuries are being done to savings and loan associations, I can assure you that we will waste no time in doing what we can to put a stop to it.

I think I should make one additional observation. To the owner, or to the manager, of a savings and loan association, a sharp reduction in the inflow of savings funds or some net outgo is likely to appear as a result of competition by commercial banks. In any particular instance, that may well be true, but to an economist sitting where I am, the main problem facing the savings and loan associations is that with market interest rates so high, the inflow of funds—quite apart from this new regulation governing passbook deposits and the longer certificates and what they call the wild card—quite apart from all of this, the rate of inflow unhappily has been diminishing and may well continue to diminish.

Senator PROXMIRE. I hope you make that available to this committee and the Senate Banking Committee.

Mr. BURNS. I would be very glad to make those reports available.

Senator PROXMIRE. Just one other point. I would like to say the next time I lose an election, I sure hope I can have solace from you and Senator Percy. You make marvelous psychiatrists, you know. No man is a loser.

Here you lose 2 to 1 on your variable investment credit; you lose 2 to 1 and you say this is a surprising victory.

Mr. BURNS. Senator, when I made such a survey about a year ago, I lost 100 to 1.

Senator PERCY. Look at the trend.

Senator PROXMIRE. You still lost.

Mr. BURNS. Yes.

Senator HUMPHREY. When you lose, you lose. I know.

Mr. BURNS. Senator, when you lose on a given day, you lose on that day. But as you have so well demonstrated, there is always a good future for one who tries.

Senator HUMPHREY. I really like you. Thank you very much.

Senator PERCY. Mr. Vice Chairman and Senator Humphrey, I think we might end on an optimistic note that we can all share before we go in recess. When we come back, I am happy to tell Mr. Burns, I think the Government Operations will report out, because the subcommittee reported 8 to 0, a very fine drastic reform of the congressional procedure for handling our budget and getting our budget under control.

Although we all look on ourselves as humanitarians, I think we are fiscally conservative and I think we can look forward to great progress in this area.

We certainly appreciated Mr. Burns' assistance in this area, and he said if we report out a tough procedure for setting our own limits and ceilings, it will be the greatest element of confidence that can be interjected in the international banking community that we have gotten our affairs under control. But if we put rubber in the ceilings, there would be a disastrous consequence and it would backfire on us. So I hope we all stand firm.

Senator PROXMIRE. I could certainly appreciate a 1–to–2 victory, but it is 2 against.

Senator Humphrey.

Senator HUMPHREY. Mr. Burns, like Senator Percy, I am also a member of the Foreign Relations Committee, and as people have noted around here, the Congress is organized but not very well. It is a little difficult to spread one's physical being between the New Senate Office Building and S–116 of the Capitol. Even a Soviet gymnast can't quite do that and I can't quite find the ways to do it, either.

I have read your statement and there are just a few items I wanted to make note of.

First of all, the one thing that has concerned me more than anything else is that in light of the number of positive factors that there are in the economy; for example, in your statement, you are talking about the depreciation of the value of the dollar and you have given a good deal of testimony later in your statement.

You say: "This latest depreciation in the value of the dollar cannot be justified on any realistic evaluation of international price levels, or underlying trends in our economy, or our balance of trade or payments." Then you go on to explain some of the increase, for example, in exports, the improvement in our trade balances slightly to gather momentum, and you come down to where you say: "Its causes cannot be identified with any precision."

Mr. BURNS. It might have been a more accurate statement, Senator, if I had said I cannot do so.

Senator HUMPHREY. Well, you are a well-recognized expert in these matters and one for whom we have great respect. What I am getting at is, isn't it possible that some of this uncertainty, which can be expressed in the words "lack of confidence," is due to the stop-and-go, hit-and-miss, scattered quality of the Government?

For example, we started out here back in 1969 saying, of course, that inflationary forces were already underway, with criticism of the previous administration for not having taken steps, particularly in the taxation field, early enough, and then the administration proceeds to come in and ask for a reduction in taxes.

Then we had a period of time in which people were taking vows, like it was an oath, that never, never would we have controls. Those vows were taken right up to the first week of August 1971, and, wham, on comes a freeze. Then comes on, without any notification to anybody, the surcharge on our imports. Then we get phase II. Phase II starts to work and, obviously, had some inadequacies and some distortions as any control program has, which you indicated time after time. But at least there were some indications that it was beginning to have an effect. And, bang, off it goes, and with all of the fanfare of a Madison Avenue advertising campaign that the millennium was about to come.

I can remember the witnesses being before this committee, Herbert Stein and others, telling us that things are really going on the upswing now, all is going to be well, and in May of this very year I had prominent witnesses of the administration telling me right here in this room that they would achieve a 2.5-percent inflation rate.

Now, you know, you are either blowing bubbles or smoking something in order to come to that conclusion after you had inflation rates going to 9 percent and a wholesale price index getting out of hand. And then all at once we come around to where we have the freeze again, that is called $3\frac{1}{2}$, and now we are up to 4.

That is what has been going on in the administration.

Insofar as spending is concerned, the administration has held down spending, despite the argument of impoundments I won't burden you with, even though I say the courts have proven we were right and whether the Congress is wise or not, it sets the policy and it has control of the purse and there is no king or emperor that is going to overrule us. Thank God the courts have taken a stand.

But we have imposed on ourselves—at least by acts of the Senate, and I gather the House is doing the same—spending ceilings. Senator Percy has said we will come up with a new budget proposal. So there are signs from the Congress of fiscal responsibility. No runaway spending. Plus the administration has been impounding money.

Why is it that people all over the world sort of think we are on a binge over here? Why this devaluation of the dollar? Why is the stock market going down when the earnings of the very corporations whose stocks are plummenting are way up? Would you mind giving me, Mr. Burns, your medical and psychological, economic, and politic analysis of the condition of the patient, why he doesn't seem to be able to get out in the field and battle and do better?

Mr. BURNS. I wish I could give an adequate reply to your questions, Senator. My own definite impression is—and it is gathered largely from conversations with the central bankers of foreign countries and private financiers both here and abroad—that the main reason for the distrust in the dollar and the most recent depreciation is the sudden awakening that we didn't have inflation under control, that we are not going to reach the goal of a 2.5-percent rate of inflation by the end of the year, and that actually the rate of inflation is quickening and quickening sharply and that we are not doing nearly as well as we did a year ago.

All this has come as a surprise. Not many months ago this country was being congratulated for its performance in the field of prices by governmental people around the world—certainly by those concerned with matters of finance. Well, suddenly they discovered that we had joined the family of sinners. That came as a surprise to them. They had thought we were setting an example of good control over inflation.

I think that is the main factor. Then there are various other factors which I mentioned, and you added to my list, which undoubtedly played some role, but it is very hard to evaluate their precise significance.

Now, Senator, may I add a word about your own fiscal comment and that of Senator Percy before he left, and also Senator Proxmire's earlier comment about control over governmental expenditures. I think that once this new legislation that the Congress has been working on is adopted, it will become a source of great confidence, a source of building confidence among financial people all around the world. It is something that will also mean a lot to the American public, and not only for financial reasons. For it will mean that the Congress will act directly on the budget, that it will be a legislative budget, that priorities will be set by the Congress, and they will be set within an aggregate of spending that itself can be defended on economic and financial grounds.

I think it is a wonderful new thing you have in hand.

Senator HUMPHREY. We are going to do that and I hope the mechanism that we establish will be equitable. But, again, one of the things—yesterday, the acute chargé d'affaires of the Swedish Government had a luncheon. Inflation in Sweden is running between 8 and 10 percent. Their currency is good. The rate of inflation in France is higher than ours. The rate of inflation in Japan, good grief, it makes us look like we got paralyzed around here. We are not even able to move and yet the yen, everybody has a yen for the yen, to put it simply, today. It is the prize currency.

So it isn't just the rate of inflation which is causing devaluation, it cannot be. Because if the factor that determines the value of the currency in the international market is the rate of inflation, even with our rate which has been increasing, it is not as bad as many of the other societies, the other nations.

What I happen to believe—and I just share my thoughts—is there is some merit to consistency, to persevering, to a pattern; and frankly, I don't think anybody knows what is going to happen tomorrow. On the one hand, we get a statement saying that phase IV is going to be tough. On the other hand, we have people come up here and say: "Well, we are tough, but, boy, we have to get rid of them." Anybody that is handling money that is making huge investments, that is looking toward economic expansion or whatever economic adjustment they want to make, they want to know what the groundrules are going to be. Nobody knows what the groundrules around here are going to be.

I might even add, Mr. Burns, I have been even a little bit disturbed about the rate of money supply, the growth of money supply. I asked staff members to bet me the chart here on money stock compounded annual rates of change and the rapid growth rate in 1972, starting in January, up until about November 1972, the growth rate was about 8 percent.

Then, starting in December 1972, up through March 1973, it was down, slowed down to about 2.4 percent. Then an abrupt slowdown.

From April, that is April 1973, up through June 1973, a rapid increase up to 11 percent.

My question is: Does this flexibility, really not only flexibility, these gyrations in the creation of supply of money, doesn't that also add to the pattern of uncertainty, the lack of any firm pattern or any pattern of consistency?

Mr. BURNS. Senator, you can look in different ways at the money supply. If I showed you a chart on the total stock of money, the total stock in existence, you would be impressed by the rather stable growth, looking at that chart.

Suppose I did something else and showed you next the rates of growth from year to year? You would find variability, a good deal of variability. Next, suppose I showed you a chart with the rate of growth from quarter to quarter. Variability would be greater. Month-to-month, still greater. Week-to-week, still greater. And having done that, suppose I took the weekly figures and multiplied them by 52 to get the annual rates. You would then see enormous, astronomic fluctuations.

What you see in the figures, therefore, depends on how you present them or analyze them or view them. If you take any single yardstick, with the rate of growth measured in some standard fashion, and compare the degree of stability of our money supply with that of other countries in the world, you would find that our behavior is very much better.

You may ask the question: Why can we not get something like a uniform rate of growth, week-by-week, or month-by-month? The fact is, first, that we at the Federal Reserve merely exercise an influence over reserves that commercial banks have. That influence is limited directly to the member banks. These reserves themselves cannot be predicted for short-time units with great accuracy. A thousand and one factors may play upon reserves. But over a period of 2 or 3 months, we can get about the result that we seek.

But now, what is the relation between reserves and money requirements are zero for nonmember banks, as far as we are concerned. Among member banks, they vary as between time deposits and demand deposits; and also with the size of the bank. The larger the bank, the higher will the reserve requirement be. But, as you know, money moves around from one financial institution to another. Therefore, with a given volume of reserves, you can get highly variable bank deposits of a kind that count in our statistics on the money supply.

Now, next, Senator, take——

Senator HUMPHREY. Could I just interrupt, Mr. Burns? The point where the money supply, for example, in the 4-month period which is not week-by-week, but that is a reasonably good period, was increasing at the rate of 11 percent prime rate interest. Interest rates are going up. As the money supply kept increasing, the interest rates went up.

I have a little bias on interest—I am sure you have met me before on this question—because I think it is bankers imposing taxes on people and they are not elected. I think when people impose taxes, they ought to get elected and you have a chance to kick the rascals out. We can't kick many rascals out of the interest imposers. They are either long-term appointments or they are in private, commercial, or investment banking structure.

The interest rate is going up, and it is going up rapidly at the very time that the money supply is increasing. Also, the interest rates going up make most of the people in this country lawbreakers. You know, most of the States in the country have maximum rates of interest, what they call user rates. People in my State, for example, bankers—others are not permitted to loan money—charge more than 8 percent. Of course, everybody in the blooming business in the State of Minnesota doing that today is actually committing a crime, because we have interest rates in this country today which violate the law of the land.

In order to be able to meet those interest rates, you have to play games all around, find out, have compensatory balances, and all kinds of tricks that are used in order to make it look like you have an 8-percent rate when, in fact, the rate may be 10, 11, 12, or 13 percent.

I notice one place in your statement that you spoke of a more balanced monetary fiscal policy and you included some reference to taxes. No one likes to talk about taxes.

In your statement you say: "The Federal Reserve is prepared to cooperate fully in this endeavor," speaking about the matter of using monetary policies and working out fiscal policies to control inflation. "Additional fiscal restraint is also needed at this time." I gather we are speaking there of budgetary restraint primarily, and in the Federal, State, and local government. "I for one would support stronger efforts to cut governmental expenditures or actions to increase taxes."

Now, you are the one man that comes up here and has the courage to use those words, "to increase taxes." Yet, as I said in the first part of my statement here, in my opportunity to discuss matters with you, the criticism that was made of the previous administration was the failure to impose a tax restraint at the time it was needed. The tax came on too late.

Is it your judgment, Mr. Burns—or let me put it this way: Do you see any way that we really can gain some degree of economic stability with moderate growth which an economy like ours needs, and respect in the international financial community by merely hanging onto monetary, tight monetary policies; that is, higher interest rates and tighter credit and wage and price controls, without looking at our tax structure?

Or to put it positively, do we need to look at that tax structure and see whether or not additional revenues along with fiscal restraints are needed?

Mr. BURNS. Well, I am delighted to have you say this, Senator. I couldn't agree with you more.

Senator HUMPHREY. What is your judgment; do you feel that the balance requires the three—monetary, fiscal restraints, and tax?

Mr. BURNS. I do.

Senator HUMPHREY. And if you feel it requires tax, let me ask you what you think about, for example, modification of the capital gains tax, in which if you held your investment capital over a longer period of time you get a better rate and if you come down, let's say to where you held it only a year, you get a higher rate. In other words, a kind of a reverse flexibility that we are talking about, so that the longer you hold that capital for investment purposes, the longer it is applied for capital purposes, the better your rate?

Mr. BURNS. I think that is a sound principle and I would support it; yes.

Senator HUMPHREY. Do you believe this administration—you are Chairman of the Federal Reserve Board and I know you conduct yourself on the basis of trying to speak your mind and speak your policy and lay before us the policies that you believe are right. In other words, I don't consider, even though the President appointed you, that you are within the control of any administration, that you are speaking as the Chairman of the Federal Reserve Board.

Mr. BURNS. Now, if I may just interrupt for a moment, the Senate did confirm me. I sometimes wonder whether it might be a good idea, although I can see minuses as well as pluses, to have me, once confirmed by the Senate, be reconfirmed.

Senator HUMPHREY. Be reconfirmed now and then. It might not be a bad idea. We haven't had any problem with you, Mr. Burns, that necessitates that. But speaking theoretically, yes.

My point is, is it your judgment an administration that seeks to really do something to put some stability in this economy and dampen down the forces of inflation, should not merely rely upon the banking structure of this country to take the rap and do the hard work and really rely only upon the budgetary process, but also to come in with a sensible tax reform package that includes increased revenues?

Mr. BURNS. Senator, these are questions that economists and others differ on. I have given you my view. This question has been studied conscientiously by some of my colleagues in the administration. They have not reached my conclusion, but I hope they will.

Senator HUMPHREY. And your conclusion?

Mr. BURNS. My conclusion is that we have got to use all of our tools, because if we use one of our tools, such as monetary policy, and put excessive weight on it, we may distort our economy. Therefore, I would look, at a time when the inflation problem is acute, not only to monetary policy, but also to expenditure policy—and the record of the administration on this, I think, is good. And I would look also to the companion tax policy as you have recommended.

Senator HUMPHREY. I would like to visit with you much more and I thank you much more for your candid and frank views. I know the vice chairman has some questions here. If we have time, maybe we can come back.

Senator PROXMIRE. Mr. Burns, let me take one last round both you and Senator Humphrey seem to agree on, and if you and Senator Humphrey agree on something, I think most people would feel it is probably a very wise policy. But I am going to disagree with you. That is, I disagree with both of you that we are in a position where what is called for in economic policy is restraint. I think it is very hard to employ the kind of restraint in economic policy that would get the results we want.

On the basis of the testimony we have had, the statistics I can see, this is not a classic demand type of inflation. We have very, very serious food shortages, very serious fuel shortages, some other shortages. But, by and large, it is spot shortage-type information. Your own statistics show our economy is operating at 82 percent of capacity. We have, as you know, more than 4 million people out of work. Under the circumstances, it seems to me that a restraint is going to do one thing for sure and that is to increase unemployment. It is going to mean we are going to have less of our capacity utilized; it is not going to reduce prices.

We had restraint in the past, in the recent past, as you know, in 1970, and inflation was aggravated during that period. So I don't see anything in this prescription of higher taxes or lower spending, although I would like to see lower spending for other reasons, but I don't see anything in that prescription that is going to get the kind of policy results we all want—moderate growth and moderate inflation.

Senator HUMPHREY. May I say to Senator Proxmire, I didn't necessarily say we ought to have higher ones. I said we ought to have tax adjustments. I have to say when the corporation is making 32 percent above taxes more a quarter this year than they made last year, and made 15 percent more last year than they did the year before, it might not be a bad idea to take a look at the corporate tax structure. I think it might be a good idea to take a look at capital gains.

Senator PROXMIRE. What I am saying is you are the only witness who appeared before us who called for additional restraints. Senator Humphrey called for that, too. It doesn't make you wrong; you may very well be right. But I think we need more justification as to how this kind of policy is going to get results without increasing unemployment.

Mr. BURNS. I can only repeat what I said earlier, Senator. The inflation we face is very serious. Some forecasts that economists are making about the economy are entirely premature judgments, and that is an absolutely objective statement on my part. I have worked in this area for years. I may be wrong, but that is my judgment today. If the evidence changes 1 month or 2 or 3 from now, my judgment will change. But I can only give you the best advice that I can at any given time.

Senator PROXMIRE. When can you tell us about this capacity statistic? Your figures show we are operating at 82 percent of the capacity—Federal Reserve Board figures.

Mr. BURNS. They are Federal Reserve Board figures about which I am very unhappy and I wish we didn't publish them.

Senator PROXMIRE. If they are not accurate, I think they ought to be changed. Mr. Adams from Wharton said their capacity figures show something like a 94 or 95 percent utilization figure. He challenged your figures. He said he thought they weren't as accurate as theirs.

Mr. BURNS. I, too, challenge them; others have. Our staff is reworking them and, actually, we will publish very soon, Senator, a special index, one that is factually defensible, for capacity utilization of the raw materials-producing industries.

Senator PROXMIRE. This would be helpful because the Wharton system just didn't impress me at all. Their system is to try to recognize what we have operated before, on the level of operation, and then calculate on that basis whether we are close to capacity.

It seems to me capacity is a reasonably objective physical determination, is it not, in most industries?

Mr. BURNS. That is what we have done in the raw materials area. It is a very difficult statistical problem. That is why we haven't done better in the past and why others haven't done better. I can't find my paper——

Senator PROXMIRE. Let me proceed to something else.

Mr. BURNS. No. I want to tell you something that will be of interest to you. The rate of utilization in the second quarter, according to this index, is matched only in one past quarter, at the time of the Korean war. The index now stands at 96 percent.

Senator PROXMIRE. What index is it that stands at 96 percent?

Mr. BURNS. This is the index of the degree of utilization of capacity in a rather large group of the major materials-producing industries.

Senator PROXMIRE. Well, then, shouldn't our policies be directed at the materials-producing industries which are responsible for the overwhelming amount of this inflation? The testimony by Mr. Dunlop is that 60 percent is food, of the inflation—food inflation; that the remaining part, it is very sensitive to the international situation and these materials-producing industries you are talking about. It is a generalized policy of credit restraint and fiscal restraint designed to meet the problem without creating other problems that would be very serious?

Mr. BURNS. As I suggested earlier, I think I would want to consider very carefuly the desirability of rapid amortization, over 5 years, let us say, such as we had at the time of the Korean war in the case of these raw materials-producing industries.

Senator PROXMIRE. That would be a tax cut.

Mr. BURNS. I know that. But when I talked about fiscal restraint before, I was speaking of the overall result.

Senator PROXMIRE. And the overall result is what worries me very much. We had an increase to 9.3 percent in black unemployment in the past month. We had an increase in the unemployment of teenagers. Women's unemployment is very high. I think this general kind of approach can have a very cruel effect and a socially unjust effect.

Mr. BURNS. Well, it is a question of judgment. I certainly want to supplement the general approach with specific measures to deal with some of these very difficult specific situations, as you mentioned. Let me repeat the kind of measures of overall restraint that I have any interest in are measures that can be reversed quickly. So that I am entirely sensitive to the problem that you have in mind. You and I are dealing differently with it, but we are looking at exactly the same problem.

Senator PROXMIRE. Then there is the statement you made, I think it is very well put, and something I think is in sharp contrast to the position the administration has taken. I got the impression—I think it is a fair impression—the administration would like to end controls as soon as posible. All of us would, but when they said, "end controls," they mean as income policies as I understand them to speak, and end them pretty much permanently throughout our economy.

You said, and this is most welcome to me, we should have thorough surveillance over wage rates and prices in key industries where competition is inadequate, and you say on a long-term basis.

That is quite a sharp difference and it is a very welcome difference. Does that mean—let's be as specific as we can—does that mean in the steel industry, for example, the automobile industry, the other industries where you have oligopoly or you have conditions that administer prices, that you would have some kind of guidelines, wage guidelines, where you have big powerful unions, and price guidelines where you have administered prices of the kind I referred to?

Mr. BURNS. I would hesitate to point to specific industries or specific trade unions at this time. But I think eventually we ought to have a wage and price review board such as we talked about 2 or 3 years ago. It would be the obligation of that board to determine criteria, unless these criteria—and this would be preferable—were spelled out in legislation. The board would apply these criteria to monopolistic or oligopolistic situations.

Senator PROXMIRE. You would do that more or less on a permanent basis?

Mr. BURNS. Yes. I think we will come to it, not because any one of us likes it as such, but there is not much point in controls in industries and in markets where competition is doing the job effectively. Let's focus on the unsatisfactory spot situations. I don't think they are very numerous.

Senator PROXMIRE. Mr. Burns, you not only come to us as the chairman of the Federal Reserve Board, but also as the head of the agency that has the responsibility for dividend and interest control. That is one area that we talked about construction and health as being inflationary. We have had—and Senator Humphrey has been the outstanding spokesman in the Congress on this—we have had an explosion in the interest rate area, and as you have indicated, it is likely to get higher. I am not referring to monetary policy for the time being; I am not referring to the kind of manipulation you have commented on so well already. What I am talking about is whether that particular function, in your view, just can't be exercised under present circumstances because conditions make it impossible to have a system of holding interest rates within reason when you have the kind of economic conditions we have.

Mr. BURNS. Well, as you know, the Committee on Interest and Dividends tried to restrain the prime rate, and we did so. The effects were not wholesome. We are realists and recognized that.

Senator PROXMIRE. Have you thrown in the towel on that?

Mr. BURNS. Oh, no.

Senator PROXMIRE. If the prime rate goes to 9 percent—it is expected to go to 9 percent next week—doesn't that come close to throwing in the towel? Doesn't that come close to the highest level we have ever had?

Mr. BURNS. I think the answer to the last question is yes, but we have not thrown in the towel; on the contrary. I think we did something very constructive and very helpful to the country. We pioneered in this area by developing a dual prime rate. We drew up a set of guidelines for the commercial banks. In substance, we said to the commercial banks, the rate that you charge to your large customers, the large corporations, we will let that be determined by the market and we in the committee will stop worrying about that. However, the rate that you charge the small businesses, the rate that you charge to consumers, the rate that you charge to farmers, the rate that you charge to home buyers, these are matters of the gravest concern to the Congress and to the people of America, and we expect you to moderate any increases in these interest rates. This program, I think, is an innovation that has worked.

Senator PROXMIRE. You said in your statement, while the prime rate had gone up, I think 3 percent, that the rate for small business had gone up one-half of 1 percent in the past 6 months. Isn't that in your testimony?

Mr. BURNS. We started a monitoring system in January 1972, and I can tell you what the figures show. Let me give you first the best part of the picture, but I will give you all of this evidence in full. As a matter of fact, if we do not supply it to your committee on a regular basis, we should, and you let me know.

Take the interest rate on consumer installment loans on new automobiles. That interest rate is now 18 basis points lower than it was in January 1972. The interest rate on installment loans for mobile homes is 37 basis points lower than in January of 1972. The interest rate on installment loans for appliances and the like is exactly the same.

The interest rates on personal loans on an installment basis is 4 basis points higher. The interest rate connected with credit card plans is up 13 basis points.

Senator PROXMIRE. I hate always to see something black when you come up with something so beautiful and white. But the way it strikes me, is interest rates must have been way out of line in all of these areas a year ago. Imagine, 18 basis points less in these areas, when the interest rate that these people who are offering the money, the cost of money to them must have been so much less at that time. They must have really been extorting the consumer. Either that or they are losing money hand over fist now.

Mr. BURNS. I will suggest another possible interpretation. But if you want cheerful figures, look at the interest rates charged by major automobile finance companies. I will give you absolute figures now.

In June 1971—this record goes back a little earlier—the interest rate on new cars was 12.13 percent. January of 1972, 12.07 percent. June 1972, 11.85 percent. The last figure I have, for May 1973, is 11.91 percent.

Senator PROXMIRE. I am chairman of the Consumer Finance Subcommittee of the Senate Banking Committee, and these are fascinating figures. I didn't realize that. I think we should go into that and get an explanation for it. It is astonishing. It does indicate perhaps the performance now is good, but a year and a half ago it must have been appalling.

Mr. BURNS. Well, I will tell you——

Senator PROXMIRE. Maybe there is another explanation.

Mr. BURNS. Earlier, I think, although I didn't intend to, I made some comment on the Committee on Interest and Dividends, perhaps suggesting I was taking a great deal of credit for this performance. I think my committee had something to do with this result, but I honestly think competition among financial institutions had more to do with it than my committee.

Senator PROXMIRE. Where was that competition a year and a half ago?

Mr. BURNS. Competition is a changing thing. These interest rates, you know, can be judged one way or another. Never overlook the fact that in connection with loans of this kind, you have a tremendous amount of administrative work.

Senator PROXMIRE. Let me just ask a question in one other area, because it has bothered me a great deal and bothered many people in the country.

As you know, the American Economic Association Executive Committee unanimously opposed the appointment of Vincent Barabba as head of the Census Bureau. They emphatically opposed Edward Failor as his chief. He was opposed by the outstanding professionals, statistics users, in our country. The statisticians, the sociology people, without exception. Many came in with very strongly worded opposition to these appointments.

First, I would like to ask you, what do you think of the quality of those appointments?

Mr. BURNS. I don't know these men at all. Never met them, know nothing about them.

Senator PROXMIRE. What do you think of the failure to consult the Secretary of the Treasury? Yesterday, we had Mr. Shultz tell us he wasn't consulted at the time. The day before we had Mr. Stein say they weren't consulted. They both said they should have been consulted and were not.

Mr. BURNS. Well, I think they should have been consulted, of course. I, too, might have been consulted.

Senator PROXMIRE. You were not consulted on this?

Mr. BURNS. Not on these.

Senator PROXMIRE. Shouldn't you be consulted? You use these figures.

Mr. BURNS. Should—let me not say "should"; but I would have liked to be consulted.

Senator PROXMIRE. Why shouldn't you be consulted? Shouldn't the Federal Reserve Board be informed by competent professionals?

Mr. BURNS. Whether I should or should not be consulted is a matter to be decided by others. I would like to be consulted because I have a certain interest, even a certain standing, in that professional group. I was, I should say, consulted on one recent statistical appointment, and that is the appointment of the new Commissioner of Labor Statistics.

I think the appointment they made—I am prejudiced. The man who received that post is a former student of mine, and he worked in my bureau in New York for a good many years. He is a personal friend over many years. But making full allowance for that, I think he is a man of very fine qualifications for the post. I was consulted, and I was glad I was consulted about this man.

Senator PROXMIRE. Would you agree the position occupied by Mr. Failor, who is the principal official in charge of statistics in the Commerce Department, that that should be subject to Senate confirmation?

Mr. BURNS. Oh, yes.

Senator PROXMIRE. Thank you, Mr. Burns. I believe Senator Humphrey may have some questions. I have some questions I would like to have you answer for the record for Chairman Patman.

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

RESPONSE OF HON. ARTHUR F. BURNS TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question No. 1. How would you characterize recent monetary policy? In specific using a scale from "Loose" to "Credit Crunching," would you call the Federal Reserve's policy stance during the past three months: loose, easy, moderately expansive, neutral, moderately restrictive, tight, or credit crunching? What about the last six months? The last year? The question asks for your best judgment on the overall stance the Federal Reserve has taken in the past three, six and twelve months.

Answer No. 1. Since mid-1972, monetary policy has become increasingly restrictive. The Federal Reserve has restrained the supply of bank reserves that it provided relative to the sharply rising demands for credit and money that were being generated by vigorous economic expansion. As a result, money balances have expanded considerably less rapidly than GNP, while interest rates, particularly short-term rates, have risen progressively higher. However, no severe credit dislocations have taken place; and the sustained move to restraint has not precipitated a credit crunch.

Question No. 2. A year ago the Treasury bill rate was only 4%. Six months ago it was 5.3%. Three months ago it was 6.3%. This week it reached 8.3% at Monday's auction. Other interest rates have also been skyrocketing these *past three, six and twelve months. Many economists and financial analysts say that the skyrocketing interest rates indicate that the Federal Reserve's stance has become progressively tighter and is at least tight if not credit crunching at the present time. Wouldn't you agree with this? If not, what do these rate trends indicate?*

Answer No. 2. As noted in the response to your first question, Federal Reserve policy has played a part in the rise of interest rates. This has been an indirect result of the System's actions to hold down the rate of growth of the monetary aggregates in an economic environment marked by inflationary overheating. However, unlike the periods of monetary restraint in 1966 and 1969, Federal Reserve policy has permitted the monetary aggregates to continue expanding at a moderate pace. Credit flows have been ample. Thus, while short-term rates are higher than in other periods characterized as "credit crunches", the continued large flows of credit are in marked contrast to such previous periods. The highest level of interest rates reflects, of course, factors other than monetary policy—particularly the great strength of overall public and private credit demand, and the effects that rapid inflation and expectations of continued inflation are having on borrower and lender attitudes.

Question No. 3.(I). The money stock, conventionally defined, grew more than 8% in 1972, and although the rate of growth slowed significantly in the first quarter of this year, it has been nearly 11% in the first quarter of this year, it has been nearly 11% in reecnt months. Several questions are suggested.

Has the Federal Reserve tried to hold the growth of the money stock below 11%? Below 8%? Below 6%?

Answer No. 3(I). Month-to-month and even quarter-to-quarter fluctuations in the money stock are not very meaningful since there are so many factors influencing financial flows and money demand in the short run. Thus, the basic thrust of M_1 expansion—and of monetary policy—is much better characterized by averaging out rates of growth over a longer period. Between the fourth quarter of 1972 and the second quarter of 1973, M_1 growth averaged 6 per cent at an annual rate. The 6 per cent growth rate in money is substantially less than the 10 per cent rate of expansion in nominal GNP experienced over the same period; even so, it may be regarded in retrospect as having been somewhat too high, given the current inflationary environment.

Question No. 3 (II). Has control of the money stock been subordinated to other targets in the past three, six or twelve months? If so, what targets and why?

Answer No. 3 (II). The money stock, conventionally defined, is one of a number of key financial variables taken into account in the formulation of monetary policy. Monetary aggregates, including the money stock, are always watched, but it is the trend of growth over a period of time that is most important. Very low or high growth rates of M_1 can be tolerated for short periods if accompanied by movements in other variables—such as interest rates and credit conditions—that portend a return to more appropriate growth over the longer run. For example, rapid growth in M_1 during the second quarter was accompanied by a sharp rise in interest rates. The rate rise indicated that reserves were being provided grudgingly relative to the large demands for money and credit of the period, and reflected the fact that policy actions were working cumulatively to slow growth in the money stock and other aggregates. Thus, it would not be a correct reading of the evidence to say that the money stock has been subordinated to other objectives over past months.

Question No. 3 (III). At what rate (6% per year, 8%, 11%, 15%, etc.) would reducing the growth of the money stock become the Federal Reserve's top priority task?

Answer No. 3 (III). The continuing top priority task of the Federal Reserve is to seek the monetary and financial conditions that are most likely to help in achieving maximum sustainable economic growth with minimum inflation. This goal is sought by influencing the entire financial environment. Although reasonable control of M_1 is regarded as being highly important, due consideration must be paid also to other financial variables. Thus, the answer to this question must be that the appropriate rate of expansion in the narrowly defined money supply depends on specific economic circumstances—both real and financial. In the current environment, with economic activity at very high levels and inflation an intensely serious problem, M_1 growth trending above 6 per cent would appear to be excessive.

Question No. 3 (IV). At what rate (4%, 2%, 0, —2%, etc.) would increasing money supply growth become the top priority?

Answer No. 3 (IV). The basic answer here is the same as for the previous question: desirable monetary growth rates depend on specific economic circumstances. In general, however, very low monetary growth rates for a sustained period are risky and might well be incompatible with the nation's goal of maximum sustainable economic growth.

Question No. 3 (V). Does the Federal Reserve have ample powers now to control money supply growth, assuming a desire to do so? If not, what powers do you need to do so?

Answer No. 3 (V). The Federal Reserve has available to it reasonably effective devices to control the money stock over longer-run periods of, say, two to four quarters. But there is increasing concern about the attrition of deposits that are subject to reserves locked up in the Federal Reserve Banks. This attrition is a result of the growth in the number and relative importance of nonmember commercial banks. Monetary control now also faces the potential threat of a similar growth in the issuance of checking account-type deposits by nonbank savings institutions. These deposits are outside the direct control of the Federal Reserve. The Board has repeatedly recommended the extension of its reserve requirements to all demand deposits or demand deposit-type instruments in an effort to permit better control of the linkage between the reserves that are supplied and money growth.

Question No. 3 (VI). Reserve requirements were reduced substantially last fall. As quoted in the February 1973 Federal Reserve Bulletin (p. 71, note 19):

"Effective Nov. 9, 1972, regulations D and J were revised to (1) adopt a system of reserve requirements against demand deposits of all member banks based on the amount of such deposits held by a member bank, and (2) to require banks—member and nonmember—to pay cash items presented by a Federal Reserve Bank on the day of presentation in funds available to the Reserve Bank on that day. These changes reduced required reserves approximately $2.5 billion, effective Nov. 9; and $1.0 billion, effective Nov. 16, and increased required reserves $300 million, effective Nov. 23. On the same dates RPD's were reduced $2.3 billion and $785 million and increased $235 million, respectively."

What effect did these changes have on money supply growth?

Answer No. 3 (VI). The statistics noted in this question apply only to the reduction in required reserves that resulted from the change in Regulation D, initially effective November 9, 1972. The reserve requirement change was not undertaken as a monetary policy action. Rather, it was designed to introduce a more equitable basis for assessing reserve requirements on the banks and it was timed to offset the absorption of reserves occurring as a by-product of efforts—through Regulation J changes—to improve and speed up the payments mechanism (requiring faster payment by banks on Federal Reserve cash items). Thus, while the changes in the structure of reserve requirements released $3.2 billion of reserves in November of 1972, the speedup of payments absorbed an estimated $2.1 billion of reserves.

The $1.1 billion of reserves freed by these actions, net, was offset through open market operations by the amount required to implement monetary policy objectives. The decline in the outstanding level of reserves against private non-bank deposits (RPD) during the phase-in of the reserve requirement reduction is a technical reflection of the lower reserve ratio and does not indicate any change in System policy regarding rates of growth sought in the monetary aggregates.

Question No. 3 (VII). Based on figures in the Wall Street Journal last Friday (July 27), in the year ending July 25, 1973, the Federal Reserve's combined holdings of U.S. Government securities, Federal agency issues and acceptances plus loans to member banks increased by nearly 10%. What effect do purchases of Government securities, Agency issues and Acceptances and member bank borrowings have on money supply? If the answer is to increase it, would not money supply growth have been less these past twelve months, if the Federal Reserve had restricted the increase in these portfolio items to 5 or 6%. If not, why not?

Answer No. 3 (VII). Other things equal, Federal Reserve acquisitions of securities and loans to member banks increase the reserves of the banking system and hence permit growth in M_1. However, reserves supplied in this manner are also absorbed by liabilities of banks other than demand deposits (e.g., Treasury deposits and time deposits) and by changes in bank excess reserves. In the year ended July 25, for example, required reserves for private demand deposits at member banks increased by 5.2 per cent (adjusted for changes in reserve requirements); over this period total money supply (including currency and nonmember demand balances) increased by 6.8 per cent.

The growth in M_1 would probably have been restricted by smaller growth in the Federal Reserve System's portfolio. However, the resulting greater scarcity of money supply relative to the public's demand for money would have caused a larger rise in interest rates than in fact occurred.

Question No. 3 (VIII). What harm would result if the Federal Reserve supported the Government securities market to prevent yields on bills or any other instrument from rising above 8% or even 4¼%?

Answer: No. 3 (VIII). The only way the Federal Reserve can hold interest rates on Government securities at levels below those dictated by the market is to purchase more of them and thereby remove overhanging supplies from the market. As indicated in the answer to the previous question, larger security purchases by the Federal Reserve would supply more reserves to the banks and hence foster a larger increase in the money supply.

A policy of maintaining particular levels of interest rates on Government securities, regardless of the consequences for the creation of reserves, would eliminate the ability of the Federal Reserve to carry out its statutory objectives. In the current environment, the result would be stronger, very possibly runaway, inflationary pressures.

Question No. 3. (IX). Wednesday's New York Times (August 1, p. 60) quotes you as saying "I think the difference would have been negligible" when asked how much different the price level would be if money supply growth in the first half of 1973 had been 4.5% per year instead of 6.1%. Do you believe it would have been very much different if theg rowth rate had been 4.5% in 1972 instead of 8.3%? Do you believe it would now and in the future matter much if money supply growth averaged 4.5% per year instead of 6.1% as a permanent matter? Would you explain exactly what role you, as a professional economist and as the Chairman of the Federal Reserve Board, believe money supply growth plays in our economy?

Answer No. 3. (IX). If money growth in 1972 had been 4½ per cent, it is likely that price increases in 1973 would have been somewhat less rapid. However, because so large a part of the price increases were due to special circumstances—including particularly the great increase in world demand for industrial raw materials and foodstuffs, the widespread shortages of capacity in steel, cement, petroleum and many other material-producing industries, the concurrent drop in world-wide agricultural production, and the devaluation of the dollar—the upward pressure on prices would inevitably have been very strong. In this environment, any reduction in M_1 growth would have been largely offset by a larger rise in velocity.

With a large part of the upward price adjustments from special factors in process of being worked off, a growth in money as a permanent matter of 4½ per cent per year, instead of 6.1 per cent, would take pressure off prices in the future. Of course, the rate of growth in money would also influence output and employment, and policy would have to consider these variables, as well as prices, in setting future targets for the monetary aggregates.

As to the role of money in our economy, it seems evident that a certain amount of money growth is required to finance secular growth in overall economic activity. But it must be remembered that money growth is only one of a large number of influences on the economy. Fiscal and other governmental policies and a myriad of decisions and attitudes in the private sphere—many of which are independent of monetary and financial conditions—all affect economic activity. Thus, while monetary policy needs to encourage the money growth that is most likely to foster long-run non-inflationary expansion of the economy, this will not of itself assure the desired level of economic activity.

Moreover, the increase in money required for attainment of economic objectives is not invariant. The public's demand for money shifts, depending on interest rates and the availability of close substitutes for money. In addition, if inflationary pressures are strong, or alternatively, if the economy is moving into recession, the central banks would be obligated to encourage less, or more, money growth than needed over the long run in order to help bring the economy back to a sustainable course.

Thus, money supply is important to the economy. But policy cannot be guided by any predetermined, invariant money growth target. The rate of money growth will depend on the cyclical condition of the economy, the strength of inflationary pressures, shifting demands for money relative to other liquid assets, and the impact on the economy of fiscal and other governmental policies.

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Question No. 4. Last, I want to ask you a series of questions to clarify the failure of the Committee on Interest and Dividends to impost interest rate ceilings:

(I) You are concerned with reducing inflation, are you not?

(II) Would you agree that credit has grown rapidly in the past three, six or twelve months? If not would you provide data which would support any other conclusion?

(III) Would you agree that the expansion of bank loans has been especially rapid lately? For example, as reported in the latest available Federal Reserve Bulletin, loans at all commercial banks increased from $341.6 billion to $414.7 billion, or by 21%, between May 31, 1972, and May 30, 1973. As reported in the July 27th Wall Street Journal, commercial and industrial loans of twelve weekly reporting New York City member banks rose from $24.1 billion to $30.6 billion, or by 27%, between July 26, 1972 and July 25, 1973.

(IV) Would you agree that the rapid growth of bank loans and other credit has been an important factor contributing to the current inflation?

(V) Would you agree with the proposition that price ceilings operate to restrict supply? If not, in full or part, why?

(VI) What is puzzling is why the Committee on Interest and Dividends has failed to put ceilings on bank loan and other interest rates. Wouldn't such ceilings have held down the growth of bank loans and other credit, and wouldn't this have held down inflation?

Answer. No. 4. As indicated in my initial statement, the Board is greatly concerned with reducing inflationary pressures.

I would agree that credit has expanded recently at a faster rate than is desirable, and that increasing bank loans to business and industry have been a factor in the price inflation that we are experiencing. But I call your attention once again to the combination of special factors, as noted in the answer to the preceding question.

I have said in other contexts that money is not an item that can be priced—or price controlled—like a commodity. The flows of funds through financial markets are rapid and complex, and attempts to control any sector, such as commercial banks, merely divert flows from one market to another. Our experience prior to mid-April, when the CIA was exerting pressure to hold down the prime rate while market rates were rising, was that corporate borrowers moved from commercial paper into the banks to take advantage of lower rates. When the dual prime rate was established and the "large business" prime rate was permitted to move up, corporate borrowers returned to their normal credit channels.

Other examples of the effects of rate controls can be seen in 1966 and in 1969–1970 when the Federal supervisory agencies reduced the supply of lendable funds at banks and thrift institutions by restricting access to funds from the market to meet demands for loans. Conditions developed that have since been described as "credit crunches"; institutional lending rates were not so high as they are now, but banks could not meet loan commitments and mortgages were not available to many qualified borrowers at any rate.

Imposition of ceilings, particularly on market rates of interest, certainly would restrict the supply of credit in controlled markets, since savers (the ultimate source of lendable funds) cannot be forced to lend or invest at what they would regard as nominal or even negative rates of return. All borrowers, even the Treasury, would find it difficult or impossible to meet their requirements. Available funds would be sent abroad to take advantage of higher rates, thus increasing our balance of payments problems, or would disappear into uncontrolled or "black" markets. Financial markets would be disrupted and inflationary pressures would be increased rather than reduced.

For these reasons, the Committee on Interest and Dividends has refrained from recommending the imposition of mandatory ceilings on interest rates.

Question No. 5. I am sure you are familiar with Governor Brimmer's analysis of the dollar outflow in February and March of this year. I thought it was a fine piece of work and covered a number of important issues involving not only the effectiveness of the Voluntary Foreign Credit Restraint Program but the increasing significance of the activities of branches of American banks overseas and the activities of the branches and agencies of foreign banks in the United States. One thing Governor Brimmer did not touch on which seems important to me is the question of the Federal Reserve's response to dollar outflows. That is, what policies does the System adopt during such periods?

The extraordinary rise in the System's portfolio during the last ten years has puzzled me for some time. In examining the figures, I note a $3 billion increase in the portfolio from $27.2 billion in 1960 to $33.7 billion in 1963. That increase was not inconsistent with the rate of increase in the 1950's. But between 1963 and 1966 there was a $10 billion increase to $43.7 billion. During the next three year period, 1966 to 1969, the portfolio rose by $14 billion to $57.5 billion and rose another $14 billion to $71 billion in 1972. The interesting thing about the last three year period is that over half of the increase, $7.5 billion, occurred in a single year in 1971. That was a year of massive dollar outflows which culminated in the first devaluation. There were further substantial increases in the portfolio during the period of dollar outflows before and after the February 1973 devaluation as well and currently the system's holdings of Government securities total $74.9 billion, an increase of almost $4 billion since the beginning of the year.

Is it not true that a significant amount of the increase in the portfolio over the last ten years represents an effort by the Federal Reserve System to accommodate dollar outflows through the banking system? Did the System, consciously or unconsciously, pump up the monetary base in order to compensate for the loss of funds overseas and prevent credit restrictions in domestic markets?

Answer No. 5. Changes in the Federal Reserve's open market portfolio, and other monetary policy actions, reflect System efforts to achieve its basic monetary and credit policy objectives. The amount of open market operations needed to achieve these objectives will, however, depend in part on the impact on bank reserves of balance of payments flows, as well as, of course, on other domestic factors affecting bank reserves.

As the public record indicates, the System has not made major shifts in policy objectives in periods of speculative capital flows in response to those flows. Moreover, it should be noted that capital flows to or from the United States generally do not affect bank reserves, as they do in foreign countries. Private capital outflows from the United States (e.g., through a reduction in private holdings of money market instruments) may lead to an increase in foreign official dollar holdings, but that increase ordinarily takes the form of a rise in foreign official holdings of U. S. Treasury securities. These shifts in types of U. S. assets held by private investors and by foreign central banks may have some small effect on the relative interest rates on different instruments, but they would not affect the reserve base.

The reserve base would, of course, be affected if the foreign central banks transferred their dollar holdings to Federal Reserve Banks in order to purchase a reserve asset (gold or SDR's). During part of the period covered by your question, transfers of foreign official dollar balances to the Federal Reserve Banks was one factor affecting total commercial bank reserves. To the degree that international capital flows affected the reserve base, the effect would be offset by open market operations if necessary for the achievement of overall monetary policy objectives.

Question No. 6. Like many others, I have been struck by the phenomenal increase in the assets of foreign branches of U.S. banks in recent years. As you know, total assets of foreign branches rose from $7 billion in 1964 to $61.3 billion at the end of 1971. On December 31, 1972, foreign branch assets had risen by an additional $18.7 billion to $80 billion. At the end of January 1973 total assets were $81.2 billion and had climbed to $87.9 billion by the end of February, the latest period for which data are published in the Federal Reserve Bulletin.

The February 1973 increase of 8% in foreign branch assets seems unsual. The increase in February 1972 was only 3%, and the total increase from February 1972 to February 1973 42%. However, there was also an 8% increase in total assets in June 1972, when Britain floated the pound after a massive wave of speculation. It appears to me that these precipitous jumps in branch assets during periods of international monetary crises indicate that the foreign branches are being used as conduits for currency speculation, and that a more detailed analysis of the kinds of transactions which occur during these periods would provide an even more dramatic indication of the extent to which the operations of these institutions reflect speculative activity.

In February I asked you, Dr. Burns, to provide an analysis of the speculative activities of U.S. banks and their foreign branches during the period preceding the devaluation of the dollar. In your reply of June 1, you indicate that there was an unusual rise in foreign credits extended by banks in the United States during the three week period prior to February 12 but make no mention of the credits extended by foreign branches. I would like to take the opportunity to request such an analysis of the loans and deposits of foreign branches during this three week period and also the three week period preceding the decision to float the pound on June 23, 1972, and your comments on the implications of the data for the international monetary position of the United States.

Answer No. 6. In this question you have noted the rapid increase in the balance sheet totals for the foreign branches of U. S. banks during February 1973 and June 1972. Although weekly figures on foreign branch operations are not available, the main outlines of branch activity are reflected in the monthly data to which you refer.

In general, much of what appears on the balance sheets of the foreign branches reflects their active role in the interbank market. Of the $6.8 billion increase in assets in February 1973, $5.4 billion reflected increases in claims on commercial banks in foreign countries; at the same time, $4.1 billion of the increase in total liabilities was accounted for by increases in liabilities to foreign commercial banks. Interbank accounts of the foreign branches reflect the branches' intermediation in the Euro-dollar market and also branch acquisitions of foreign exchange balances, mainly in connection with transactions for customers.

In February, the foreign branches increased their net spot position in currencies other than U.S. dollars by about $1 billion. (This net increase resulted from a rise of $3.4 billion in branch assets denominated in currencies other than U.S. dollars, while liabilities in currencies other than dollars rose $2.3 billion.) Banks that account for the bulk of the rise in the branches' net spot positions in currencies other than dollars have indicated that a large share of their increased spot position was offset by forward sales of these currencies to customers. When banks make forward sales of foreign currencies to their customers, they customarily cover their positions by making spot or forward purchases of the same currencies.

In June 1972, the earlier date for which you request information, most of the $5.2 billion rise in branch assets and liabilities also reflected interbank transactions—gross branch claims on foreign commercial banks rose $3.5 billion, while gross liabilities to foreign commercial banks rose $3.0 billion. In June 1972, the branches increased their net spot position in U. S. dollars, as gross dollar-denominated assets rose $3.0 billion, while dollar-denominated liabilities rose $2.6 billion. Thus, in this month the growth in branch balance sheets mainly reflected intermediation in the Euro-dollar market.

Your question also raises the issues whether the foreign branches are being used as conduits for currency speculation. In a broad sense the existence of efficient banking systems here nad abroad is bound to facilitate rapid movements of funds, whether for speculative or other purposes. There is no reason to believe U. S. banks' foreign branches play a unique role at such times. If the facilities of branches of U. S. banks were not available, there would probably be an expansion in the activities of banks of other nationalities. For example, the *Bank of England Quarterly Bulletin* for June 1973 reported that American banks account for only about one-half of the non-sterling claims of all banks operating in the United Kingdom as of April 18, 1973.

The final section of your question inquires about the implications of the data for the branches on the international monetary position of the United States. In the February episode there was an unusual bulge in their net position in foreign currencies. However, the data in Tables 21a and 21b of the *Federal Reserve Bulletin* indicate that over the long run the branches have maintained a steady and reasonably balanced position between dollar-denominated assets and dollar-denominated liabilities. Thus the operations of the branches do not appear to have had a significant long-term effect on the international monetary position of the United States.

Question No. 7. One of the chief officers of a major U.S. multinational bank said recently that he would favor some form of regulation of the Eurodollar market even if it meant imposing reserve requirements. Obviously he meant that reserve requirements should be imposed on the branches of U.S. banks in London, Nassau, Panama and the Cayman Islands which are not subject to reserve requirements by local authorities, and I would assume that he meant that requirements should be imposed on these branches by U.S. officials.

Currently some 13% of the loans and investments of all insured banks in the United States are held by the foreign branches of less than 1% of those banks, and the majority of these assets are concentrated in areas where they are not subjects to reserve requirements, interest ceilings on loans and deposits and other forms of regulation. The foreign branches are legally and administratively an integral part of the parent bank; have the full resources of the parent bank *behind them in case of need and, through the parent bank, the resources of the Federal Reserve System as lender of the last resort. Their regulation by the Federal Reserve Board is both logical and necessary in view of their potential impact on the American credit system and is implicit in the powers granted to the Board under Section 25 of the Federal Reserve Act. Therefore, the imposition of reserve requirements and rate ceilings on foreign branches would help to safeguard the domestic banking system as well as go a long way toward ensuring orderly growth in international financial markets.*

I urge the Federal Reserve Board to assume its responsibilities for regulating the increasingly important segment of U.S. banking activity which is conducted by the banks' foreign branches and request your comments on the Board's position in this matter.

Answer No. 7. The Board has for some time recognized that foreign branches may have an impact on U.S. credit markets and on the U.S. balance of payments. Since 1969, the Federal Reserve has applied reserve requirements to the deposit liabilities of foreign branches of member banks to the extent that these branches make loans to U.S. residents or provide funds to their U.S. parent banks. These reserve requirements were initially applied marginally (above reserve-free bases). In May 1973, the Board acted to phase out the reserve-free bases, and when this is accomplished the requirements will apply to all foreign branch deposits that are used to conduct a U.S. banking business.

The Federal Reserve does not apply reserve requirements to the deposits of foreign branches where the funds are used in foreign banking. Since the foreign branches are subject to the regulations and requirements established by monetary authorities in their country of domicile, it would place the branches at a severe competitive disadvantage vis-a-vis foreign banks if the Federal Reserve were to apply additional U.S. reserve requirements to their foreign banking business.

Frequently foreign authorities do not regulate the purely external (i.e., Eurocurrency) activities of banks located in their countries. The advisability of applying regulations to these activities is a complex issue, and the subject of debate. Most proposals for applying regulations to the Euro-dollar activities of international banks contemplate regulations that would be applied to international banks of all nationalities, and wherever located. This would require agreement of the banking authorities in all major countries, both on the need for regulation and on the technique for implementing such regulation. There is now no consensus among central banks and governments on either issue.

The absence of regulations on Euro-dollar activity does not threaten the soundness of the operations of the foreign branches of member banks. These branches are subject to examination by U.S. regulatory authorities, as well as to general restraints under Regulation M on the type of permissible foreign activities.

Question No. 8. As you know, I introduced legislation providing for Federal chartering of foreign banks in 1967 and 1969. At that time, there was relatively little interest in the subject. Now there seems to be considerably more interest because of the competitive advantages enjoyed by these banks and because they contributed substantially to the dollar outflow in February and March. There is also some concern that American banks are using the broader scope of activities currently permitted foreign banks as an argument for widening their own range of activities.

You are no doubt familiar with Govrnor Rockefeller's proposal to inaugurate out-of-State branching through agreements at the State level. The Governor of New York and the State's banking authorities must be aware that, if implemented by even a few States, their proposal will have serious implications for banking regulation at the Federal level as well. I would like your comments on the possible impact of Governor Rockefeller's proposal from the Board's point of view and your comments also on the need for Federal chartering of foreign banks in the context of both banking structure and monetary policy.

Answer No. 8. It is my understanding that Governor Rockefeller's proposal, as outlined initially in June by the New York Superintendent of Banks, would have required Federal enabling legislation if member banks were to have interstate branching privileges. The proposal has since been modified to permit bank holding companies in one State to acquire banking offices in another State with a similar law on the books. Such reciprocal legislation would be entirely within the purview of section 3(d) of the Bank Holding Company Act (the Douglas amendment), which specifically provides for the possibility that interstate acquisition of banks could be authorized by State legislation.

Your question is directed to a subject which has increasingly drawn the attention of the Board in recent years, as the operations of foreign banks in the United States have been growing to significant proportions. The absence of Federal jurisdiction over some categories of foreign bank operations in this country has permitted the development of a lack of uniformity in the rules applying to U.S. commercial banks and to foreign banks with regard to their operations in the United States. One possible approach, as you have proposed, is Federal chartering of foreign banks.

The Federal Reserve System's Steering Committee on International Banking Regulation, which was established at the Board's direction earlier this year, is currently studying the possible need for Federal chartering of foreign banking institutions, and practical alternatives to Federal chartering. This is an important subject on the Board's agenda, and I hope that the Board will be able to make an early recommendation on this matter.

In view of the status of the Steering Committee's work, I do not feel I can speak for the Board on Governor Rockerfeller's proposal at this time.

Senator HUMPHREY. I am going to take a minute.

Mr. Burns, when we get a chance to talk to you, it is both enlightening and sometimes provocative. I think this day it has been particularly enlightening.

You mentioned being chairman of the Committee on Interest and Dividends and told us a little bit about its work, particularly about more recent efforts of the dual system.

I think it would be good for our record, Mr. Vice Chairman, if we had as much information as we could get as to how that system is actually working. You give us some specific examples.

Senator PROXMIRE. For the record, we would appreciate it.

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

The dual prime rate system was devised to afford some protection to certain borrowers—small businessmen, farmers, consumers, and homebuyers—and at the same time to minimize distortions in the flow of funds that had resulted from the Committee's efforts to hold down the prime rate. Banks were permitted to raise rates on "large business" loans in small increments and in orderly fashion in accordance with market forces, but were asked to hold the rates on loans described above at the mid-April level unless increases could be fully justified by increases in costs.

The dual rate system appears to be working well. The prime rate has advanced to a very high level but it has moved in ¼ percent increments and still remains substantially below other highly competitive market rates, such as the rate on federal funds, on commercial paper, and on negotiable certificates of deposit.

The interest rate surveys which I cited earlier show that recently there has been some upward movement in the "protected" rates, particularly mortgage rates. These rates reflect the increased cost of funds to lending institutions, including higher rates paid to savers and, in the case of thrift institutions, a recent large outflow of funds. Some upward movement in mortgage rates is necessary to assure that funds will continue to be available to finance homebuilding. It is notable, however, that these rates remain well below short-term market rates and in many instances have not increased as much as other long-term rates.

In addition to the "cost pass-through" constraint on consumer and small business rates, the Committee's interest rate criteria impose a restraint on the profit margins of commercial banks.

Senator HUMPHREY. I recall that in February of this year you told this committee how important it was for banks to hold down their interest rates. That in your capacity as chairman of the Committee on Interest and Dividends, as well as Chairman of the Federal Reserve Board, you would do all you could to keep those interest rates down and keep them stable. And you said: "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 refrain from price advances and limit their profit increase, banks should also participate in this national effort."

The only group that has really done a job is the working people. They have stayed pretty well within the guidelines. Why, I don't know. I don't know what hit them, but organized labor has pretty well acted very responsibly and stayed within the guidelines.

Prices have gone up, the wholesale price index is up, and at the same time you made the statement I quoted, the prime rate was about 6 percent, mortage rates were about 7.5. In the space of 5 short months, the prime rate has jumped to 8¾, and the mortgage rates have increased from 8 to 8½, that is, if you can get any money. Those rate estimates are just nothing but theoretical figures.

Don't these figures really tell us there are in fact very limited and ineffective attempts to hold down interest rates, because at the same time that we are talking about holding down these rates, the monetary policy is to tighten the money supply and raise the interest rates?

Mr. Burns. You see, Senator, the demand for credit has been so huge, has been rising so rapidly, that in spite of an excessive increase in the growth of the money supply, interest rates have risen. In other words, demand has increased much faster than supply.

We tried holding down the prime rate but, as I said a moment ago, and I will be glad to elaborate if you like, the result was not satisfactory. Then we evolved what I think we should have done in the first place, a plan under which the rate of interest charged to the larger corporations will be determined in the marketplace through competition. I think competition is very keen in that market. At the same time, special attention will be given by the banks to the four groups that are so important to the country and to the Congress; namely, small business, farmers, homebuyers, and consumers.

Senator Humphrey. Now, housing starts are down about 12 percent in the month of June, as I recall. Aren't these interest rates sometimes rather meaningless unless there is a supply of money that is going to be available? So let's say you are holding down mortgage rates. What about the supply of money? When you have that open competition for the big boys, doesn't that mean that they drain the lake?

Mr. Burns. Well, that is a good question. I have started a monitoring system on that as far as the commercial banks are concerned. One of our guidelines that the banks have is to maintain the volume of lending, you see. But unfortunately, we have thus far gotten only one report. We don't have a base figure against which to compare it, and therefore I am not in a position to give you a factual answer. However, when I meet with bankers, I talk to them about this. I have assurances from them that they are attending to the problem, and they know I am watching over what they are doing.

Senator Humphrey. You keep a good hard, cold eye on them all of the time, Mr. Burns. I think you can do it, because what I worry about—and again I don't have any evidence, it is just a worry—namely, when you have the open competitive market for the top borrowers, the big corporations, they can pass that along pretty well. That isn't a charge that comes in the cost of production. They are willing to bid up that money and thereby to sop up the pool of capital, and unless you have some kind of a guideline that the rate of loans—that is, the volume of loans for those in the dual system that are to receive some consideration from your committee and from the government, that that volume is to be maintained—the low interest simply means it is low for some people that can get it, but for the other folks that can't, it is nonexistent.

Mr. BURNS. You are quite right.

Senator HUMPHREY. No more questions.

Senator PROXMIRE. Before I yield to Senator Javits, let me just say I couldn't agree more with Senator Humphrey's observation on that. It is not just a matter of not wanting to work in the national interest or help small business. It is just a matter of surviving as a banker.

If you or I were the head of the bank and your prime customers were giving you a higher rate, much higher rate than the small business, it would be crowding the hero's bench not to give the money to your prime customers when it is limited and not to those from whom your return is much lower.

Mr. BURNS. Senator, fortunately, we still have many heroes, even in the banking fraternity—men who are responsive to the needs of their community.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Thank you, Mr. Vice Chairman.

Thank you, Mr. Burns. I will not keep you very long, because I appreciate you had a long difficult morning. But I did have one or two points. I have been engaged, myself, in a few difficult things.

One is this: You hear a lot today about the fact we are going to balance the budget in fiscal 1974, give or take a few billion dollars. Now, I note that you express this opinion; is that your view, or the Board view? You start the statement by saying, "The Board view."

Mr. BURNS. You are very perceptive, Senator. This is a view that is not shared by all members of the Board. That is why that sentence is written as it is. However, I am not the only member of the Board that has this view.

Senator JAVITS. Then you say, I think, "Appropriate in my view, would be fiscal measures—such as a variable investment tax credit or a compulsory savings plan—that could be quickly reversed, under special legislative rules," and so on.

If we are going to balance the budget or come close to it, the question is asked, why put on a tax? Why flex our muscles and show how brave we are by putting on a tax?

Mr. BURNS. Well, Senator, there are times when a budget deficit can be justified, and there are times when a budgetary surplus can also be justified; and as far as budgetary balance for fiscal 1974 is concerned, so far it is only a gleam in the eye.

Senator JAVITS. I don't want to put any words in your mouth. When you say, "a gleam in the eye," do you feel that the question of whether we will or will not balance the budget is in such grave doubt? Are the benefits of a balanced budget worth imposing a new tax on the basis which you say, to wit, refundable, if it is a compulsory savings tax, in order to make a major contribution to straighten out the economy of the United States?

Mr. BURNS. Senator, I feel better about the budget today than I did before this meeting started, having listened to Senator Proxmire, Senator Percy, and Senator Humphrey, who spoke eloquently on the need for strict control over budgetary expenditures. I think that in making financial plans now. we should plan for a modest surplus, while being ready, if circumstances change 2 to 3 months from now, to revise that judgment.

Senator JAVITS. And to guarantee that surplus, you feel this type of tax would be justified?

Mr. BURNS. I think the tax should be of a kind that would be quickly reversible, so that we would not run up against the difficulty that concerns Senator Proxmire and many others. I think that is the right kind of tax to consider, rather than taxation of the usual sort which involves an increase of tax rates of indefinite duration. I would have the new tax subject to special legislative rule that would admit of a quick reversal, if necessary.

Senator JAVITS. Do you have an order of magnitude of dollars in mind? Simply an order of magnitude?

Mr. BURNS. Well, anything between $5 and $10 billion would fit my present judgment.

Senator JAVITS. Mr. Burns, would you evaluate for us what that would mean? Suppose we passed a special tax, let's say just for the sake of argument, the compulsory savings idea, refundable once we found it wasn't needed or the economy was turning around perhaps toward recession; what would it mean to us? What is the benefit we get out of it? Why should the people do it, and why should we do it in their name?

Mr. BURNS. Senator, we are living in a time when confidence in the dollar, confidence in this country's financial policy, has greatly weakened. It has weakened at home and weakened abroad. We are living in a time when there is an incipient but dangerous flight from paper currency. We are living in a time when people in this country and elsewhere are speculating actively in land and real estate, when people are buying gold, when people are speculating on commodities, when people are trying to get hold of hard things because their confidence in paper currencies, and particularly in the dollar, which for such a long time was the great symbol of safety and stability and strength, has diminished. Therefore, I think that adoption by this Congress of the enlightened recommendations of the Joint Study Committee on Budget Control would help to restore confidence in the dollar. Also, passing of a tax increase bill, enlightened in the sense that it could be quickly reversed under special rules, would help enormously in rebuilding the confidence that we need if we are to have the respect of the world politically and if we are to restire the value of the dollar.

The dollar is now a badly undervalued currency and that is hurting our economy. When a currency is undervalued, as you well know, Senator, we sell our goods to people of other countries at giveaway prices.

Senator JAVITS. Mr. Burns, I happen to feel, personally, that our country, notwithstanding the active economy and the rosy predictions, is in retail trouble precisely because I see a very serious erosion of confidence in the ability of the United States to handle its affairs, by its own citizens and by the world from which it must buy essential materials. We can no longer get along without them. We cannot remain alone in the world.

I agree with you that some evidence—and this is certainly on the minimal side—is required to assure the world that the American people are very responsible and will resolve their problems and that the dollar is—as it deserves to be, on the substance of our values and our assets and our people—the finest currency in the world.

They do not believe it and I really believe they will not believe it unless we take some such measures as you suggest. I want to tell you that I know it is not very happy politically, but I don't think any of us were sent here for that purpose.

We were sent here to urge and vote for what we thought was in the interest of our country and our time. I deeply believe you are absolutely right. I am so concerned that the balance of forces here of those who want a certain size budget and those who don't and those who want certain priorities and those who don't, and those who want a heavy defense budget and those who don't, is so evenly balanced that, though it might be desirable to cut $10 billion out of expenditures—that is the nicest way—it simply isn't going to happen.

We are just about as far as we are going to get on that, and unless one does what you suggest, there is no other single way that the world will be impressed with the fact that we know that for years we didn't pay the bill created by war and that we resolved to pay it in order to make ourselves not only solvent but confidence-deserving in the world.

I thank you very much.

It is not easy for you either recommending this measure, yet we may have to come to do it; so low is our economic position abroad sinking that we may simply have to do it.

I have just one other question and that relates to a long-standing subject of mutual interest—productivity, which I think you have dealt with. I will not endeavor to duplicate what others here may have said, but I am very interested in one point.

You say: "Moreover, investment in new capacity was discouraged by relatively low profits of our domestic non-financial corporations between 1966 and 1971."

Mr. Burns, explain to us why, notwithstanding the demagogic idea that these big corporations are bloated with profits, drunk with wealth, and that this is all very antisocial, why you make that statement. In other words, why is it contrary, if you are going to run an economy which has freedom as its base and not just the State running everything, including everybody's personal life?

Mr. Burns. Senator, let me first run over a few figures with you, which are not widely known. Let's take the published statistics on corporate profits before taxes. I take the figures in that form because in view of certain adjustments that I make, I cannot use after-profit figures.

Start with those figures and then take out the earnings of the Federal Reserve System. They don't belong there in the first place. It is misleading to include them.

Next, take out profits earned by subsidiaries of our corporations abroad, because we want to look at the profits earned in our own domestic economy. Next, take out the profits of financial corporations. What you have left is the great bulk of American enterprise—manufacturing, mining, construction, public utilities, wholesale trade, retail trade—in short, all of our domestic nonfinancial corporations.

And then you find that corporate profits of domestic nonfinancial corporations in 1971 were a good deal lower than in 1966, 1967, 1968, 1969, and 1970. So that you had for years a very low level of profits.

Now you had a revival in 1972, and that revival has continued this year. But for a number of years, profits suffered grievously in our country, and one of the consequences has been underinvestment. That underinvestment has been particularly acute in the materials-producing industries.

We had a good deal of discussion about that. I wish you had been here, Senator. We had discussion about that subject and the thought was explored about the possibility of doing something special. Here, you and I have just been talking about a tax increase. But in the case of these industries, where you had no significant increase in capacity—and it is these industries that account for much of our inflationary problem at the present time—in those industries we might well want to consider a policy similar to that which we used during the Korean war of rapid 5-year amortization.

Another thought that we explored a little is the growth of investment expenditures to deal with our environmental controls—the pollution problem, and also the new investment made necessary by the Occupational, Health, and Safety Act. Now, investments of that kind are growing, and I think investments of that kind are socially necessary. That is why the Congress passed the legislation. But providing special tax treatment for investments of that sort, I think, would be wise.

When we look at overall investment figures, they can mislead us, because much of that now goes into investments of a kind that do not add to the Nation's industrial capacity or to profitability.

Senator JAVITS. Thank you very much, Mr. Burns. I just had one corrollary point, and that is, how are profits recognized, say, in Japan, which is kind of everybody's paragon, for a materially strident powerful economy?

Mr. BURNS. Well, profits are held in higher esteem in Japan and in much of Western Europe than by our own people nowadays, and I think that is unfortunate.

Senator JAVITS. Thank you very much.

Senator PROXMIRE. Thank you very much, Mr. Burns, for brilliant testimony. You have done a marvelous job this morning.

The committee will stand adjourned, subject to the call of the Chair.

[Whereupon, at 1:10 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, OCTOBER 17, 1973

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

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

Present: Senators Proxmire and Javits; and Representatives Griffiths, Moorhead, and Carey.

Also present: John R. Stark, executive director; William A. Cox, Lucy A. Falcone, Jerry J. Jasinowski, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; 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.

The Joint Economic Committee hearings this morning and tomorrow are scheduled because the committee felt the need for additional testimony from independent experts regarding the economic outlook and policy needs. The committee heard testimony from independent experts regarding the economic outlook and policy needs. The committee heard testimony from the administration and the Federal Reserve during our midyear hearings at the beginning of August. However, because of the August congressional recess, it was not possible at that time to complete our testimony from private witnesses. We are most fortunate to have as witnesses this morning a panel of three very distinguished experts to discuss the economic outlook and monetary and fiscal policy.

Like most observers, I am concerned about the outlook both for inflation and unemployment; 1974 seems destined to be another year in which the economy confounds the experts by demonstrating that inflation and rising unemployment can indeed go together. Almost all observers, including our three witnesses this morning, expect unemployment to rise over the next year, and the current 4.8-percent unemployment rate is, in my opinion, already far too high.

At the same time, the inflation problem may continue to be severe. While the spectacular rise in food prices of recent months is unlikely to be repeated, an even more basic cause of inflation may assert itself as unit labor costs rise sharply because of the slower growth of output and low productivity gains which most observers expect.

Given this highly unsatisfactory outlook for both inflation and employment, gentlemen, I am surprised and distressed by the complacency with which both economists and policymakers seem to view the outlook. With over 4 million people out of work and with the real earnings of the average worker lower than they were a year ago, self-congratulation on the prospects for a "soft-landing" seems to me to be misplaced.

The remark is frequently made that all the economists in the world stretched end-to-end would never reach a conclusion. But I am developing quite a different view of the economics profession. The ease with which economists seem to reach virtual unanimity on controversial questions is often both amazing and disturbing. Let me cite two current examples.

First, virtually every economist I have heard or read recently seems convinced that 4-percent unemployment represents a "tighter," or more inflationary, labor market today than it did 15 years ago and that 4-percent unemployment is hence an inappropriate or irresponsible or demogogic goal for short- or medium-term economic policy.

As far as I can tell, this near unanimous conviction on this very basic issue stems from a quite limited analysis of changes in the age and sex composition of the labor force. I repeatedly ask witnesses what examination they have made of other dramatic changes in the labor market such as changes in education and changes in the occupational and industrial structure of employment. I ask them to specifically identify the labor bottlenecks. I ask them why it is more inflationary to have a higher proportion of women workers, when all the evidence indicates that for a given job women can be hired for lower wages than men. I ask what analysis they have made of the fact that the most rapidly growing segment of the population is now adults 25 years of age and older, and that this enormous bulge in the adult population should give us an abundant supply of well-educated full-time workers? As far as I can discover, none of these labor market questions has been analyzed. Yet, economist after economist tells me with conviction that the labor market has changed in an inflationary direction. The newly appointed member of the Council of Economic Advisers, Mr. Fellner, is so convinced of this conclusion that he is apparently determined to make a higher unemployment target a central issue of economic policy, he so testified before our banking committee, I am a member of that committee, when he appeared this last week.

A second recent example of the surprising and perhaps mistaken unanimity of economists is their sudden widespread conviction that the economy is operating at the limits of capacity. Every day I hear or read that production is being restrained and economic growth limited by capacity limitations and there is no question that this is true in some specific areas where there are material shortages.

But I think that the overall conclusion is being stated far more confidently and emphatically than the evidence warrants. For years I have been told that the Federal Reserve's capacity utilization index is one of our worst statistical series. Arthur Burns testified in August that it was so bad it was a mistake to publish it. I have been told we really have good measures of capacity utilization—that we have no good measures, I should say, of capacity utilization. If there are no good measures, how in the world can everyone suddenly be so certain that we are at the limits? Certainly, we are not at the limits in terms of labor utilization. Payroll employment in manufacturing is still not back to the 1969 level. Weekly hours of work in the manufacturing sector are below what they were in 1965 and 1966. The notion that we are stretching the limits of our physical capacity seems to have acquired credence due to repetition rather than to any abundance of hard evidence.

A third objection to the weirdly sheep-following stance of economists is most convincing of all to me. If, in fact, rising employment and tight labor markets were threatening to aggravate inflation, how would this manifest itself?

Would it not be reflected in sharply rising wages or strikes that reflected such wage demands? After all, how does a low level of unemployment in fact translate itself into higher prices, if not through a wage push?

But what is the fact? Have wages been pushing prices up? Far from it. As I have pointed out, real wages have for many months now been consistently lagging behind the rise in the cost of living.

Economist after economist appeared before this committee over the past 18 months and warned as with one voice that if we did not bring inflation under control in late 1972 and into 1973, wages would roar ahead at an inflationary pace and shove prices through the roof.

As it turned out, economist after economist who testified to that effect was wrong—dead wrong. Inflation has been far worse than any of these eminent economists predicted. Virtually all of them to a man were far below the mark.

But there are no data—none—to indicate that wage increases played any part in this inflation. In fact, all the data points in precisely the opposite direction. Wage increases stayed moderate. Prices went out of sight. And even then, did the inflation result in inflationary wage settlements as economists so universally predicted? No indeed! Once again they were wrong to a man.

So you can see why it is very hard, at least for this Senator, to take seriously solemn advice from the economic profession that we must not follow policies that would reduce unemployment further, that to do so would aggravate this inflationary binge. This advice is especially hard to understand when the guts of the inflation is not a labor shortage at all but a material shortage—a shortage of paper, and chemicals, and oil, and especially—especially—of food. Softening the economy permitting unemployment to rise will not solve this problem.

I have already talked too long.

I look forward to inquiring of our distinguished panel this morning whether they share the common view on these issues I have raised and, if so, why they are so sure they are right.

Our first witness is Mr. Michael Evans of Chase Econometric Associates. Prior to joining Chase, Mr. Evans was a professor at the Wharton School of the University of Pennsylvania, and he is the author of several well-known works on forecasting and econometrics. I believe this is his first appearance before this committee, and we are delighted to welcome you, Mr. Evans.

Our second witness is an old friend of the committee, a man who has given us a very, very helpful guidance in the past and served as a most distinguished Chairman of the Council of Economic Advisers, widely recognized as one of the eminent economists in the country, professor at the University of Michigan, the former Chairman, as I say, of the Council, and I believe this is your first appearance before the committee, Mr. McCracken, since you left Government service, and it is a great pleasure to have you back.

Mr. McCRACKEN. Thank you.

Senator PROXMIRE. Our final witness is Mr. Paul Samuelson, professor at the Massachusetts Institute of Technology, Nobel Prize winner, author of the most widely-read textbook in the history of economics, and Newsweek columnist, and certainly a very distinguished economist, as we all know. Mr. Samuelson, it is a great pleasure to have you with us today. I have read your most recent Newsweek column, and I look forward to discussing it with you in a little while.

I would like to thank all our witnesses for sending their prepared statements to us in advance. I have read them with great interest. I would be grateful if you could each limit your oral remarks to about 10 minutes and your entire prepared statement will be placed in the record if you do not read it. Mr. Evans, go ahead.

STATEMENT OF MICHAEL K. EVANS, CHASE ECONOMETRIC ASSOCIATES, INC.

Mr. EVANS. Thank you, Senator Proxmire, I am very pleased to be here today and present my views on the economy, many of which fall into the consensus which you briefly discussed, but some of which are slightly different.

I think it would be useful to start off with an overall picture by referring to gross national product for the rest of this year and for 1974. In terms of current dollars gross national product is expected to rise at a rate of 11.3 percent for the entire year of 1973 which leads to a figure of $1,285 billion. In 1974 the rate of growth of current dollar GNP will be substantially lower. It will be 7.2 percent, and on a quarterly basis the quarterly increments will be 6 percent for the first half of the year and approximately 7 percent for the second half of the year.

However, as we all know by now, it is not possible to get a very accurate picture of the economy simply by looking at GNP in current dollars. Instead, it is necessary to break it down into components of real growth and inflation.

In the area of real growth I find myself in substantial agreement with the broad consensus of economists in predicting a slowdown for next year but no recession. In terms of real growth rates, while the third quarter figures have not yet officially been released, they have been widely quoted in the press as a 4-percent growth rate.

This figure is expected to decline to a growth rate of 2.8 percent in the present quarter followed during the first half of 1974 by two quarters of real growth of approximately 1½ percent. This rate of increase will pick up during the second half of the year but for the year as a whole, real growth in GNP will average only 2.4 percent.

Accompanying this will be a substantial rise in the rate of unemployment. The present 4.8-percent figure is expected to go no lower than that on a quarterly average, and rise to a level of 5.3 percent near the end of 1974.

The rate of employment will continue to increase throughout 1974 but at a substantially slower rate. Employment has been growing at approximately 500,000 to 600,000 per quarter. This rate of increase is expected to decline to a rate of 200,000 per quarter throughout 1974.

With regard to the question of inflation, once again economists are fairly united in predicting substantial inflation for 1974. I am not opposed to that line of thought but my estimates of inflation are somewhat lower than the figures which have most frequently been quoted in the press.

We might look first at the consumer price index which is the most commonly quoted price index. It will rise at the rate of 5.7 percent this year but the growth is expected to decline to 3.8 percent next year. Other well known price indexes will not decline that much. The wholesale price index for industrial commodities, that is, excluding food, which is expected to rise 6.9 percent this year will climb an additional 4.7 percent in 1974.

The implicit GNP deflator, which is expected to increase 4.9 percent this year, will grow 4.7 percent next year.

The biggest turn around, therefore, is in the consumer price index, and the reason for that stems from my prediction of food prices. The consumer price index for food is expected to rise 7.7 percent this year. However, it is expected to increase only 0.7 next year, and furthermore, will decline approximately 5 percent from its present levels by mid-1974.

I believe that this forecast is not in the broad consensus of economists' forecast to which you referred in your opening remarks, and I believe that the reason for this stems from the fact that agricultural exports will continue to decline at the end of this year and during at least the first half of next year.

There are several reasons for this. Some of them have to do with weather factors abroad. For example, the wheat crop in Russia has been reported to be up 17 percent over last year so that Russia will not need to import large quantities of grain from the United States. In addition, many other foreign countries, including Japan, bought more than a year's supply of grain from the United States this year because of this belief that farm prices would continue to rise and because of their fear of export controls. Hence, these countries will buy substantially less from the United States in 1974 than they did in 1973 because of their extra purchases this year.

In view of this fact, plus in view of the fact that wheat, corn, and soybean crops are all up substantially from the levels of 1972, I expect that there will be a further decline in grain prices. This will be reflected with some lag in livestock and livestock product prices. We would expect prices of eggs, poultry, and dairy products to decline most rapidly in response to lower grain prices, with pork and beef prices taking somewhat longer to come down.

I certainly do not foresee a return to the food prices of 1972, but I do see a modest decline of approximately 5 percent during the next 6 to 9 months, and this when balanced against all the other forces will result in an increase of the consumer price index of 3.8 percent for 1974, which I reiterate is somewhat below the consensus forecast.

When we examine the components of gross national product, we find that in two areas, cars and housing, substantial declines are expected for 1974, although here I might add that the declines I am predicting are not quite as great as those which others have forecast.

In the housing sector I expect that housing starts will decline from their level of 2.1 million units this year to 1.9 million units next year, a decline of some 10 percent. However, it should be pointed out that the 1.9 million figure expected for next year is above the 1.8 million figure which was quoted for September. This suggests that my forecast includes the fact that the housing slump from 2.5 million units in January to 1.8 million units in September is near its end, and while housing starts may go lower in one of the next 3 months we have pretty much reached the bottom in housing. I expect it to turn around and reach a level of close to 2 million units at the end of 1974.

With respect to consumption we have all read that the various consumer attitude indexes show marked declines and, in fact, are at or near all-time lows. I expect that these will have some negative effect on consumption but I do not expect it to be large.

Automobile purchases are expected to decline from 11.9 million cars in calendar 1973 to 11.1 million cars next year. However, all other major components of consumption are expected to increase both in terms of constant and current dollars.

Durable spending overall next year will be up 3.8 percent, nondurable spending up 6.3 percent, and services spending up 7.8 percent. Even when these figures are adjusted for inflation and the rise in the consumer price index, we find that there is an increase in all those major components.

The other sectors of the economy are expected to do fairly well. Plant and equipment spending by businesses is expected to rise from $137 billion this year to $151 billion next year or an increase of just over 10 percent. Inventory investment is expected to remain at approximately its current level during 1974.

The net foreign balance will be higher in 1974 than it was for all of 1973 but will decline somewhat from its current peak levels due to the decline in agricultural exports, which I have already discussed.

Finally, Government spending is expected to advance pretty much in line with the administration's official budget estimates. We expect an increase in total government purchases, which includes States and local spending, from $279 billion to $307 billion, an increase of $28 billion or approximately 9 percent. This figure can be disaggregated further into 8 percent for Federal spending and approximately 10 percent for State and local spending.

With respect to total Federal Government expenditures our figure for fiscal 1974 is $276 billion. If this number were to be converted to the unified budget estimate, which is the most widely quoted, the figure would be approximately $10 billion less or $266 billion.

These are my views on the outlook. We have also prepared alternative forecasts which include a tax increase for 1974, and I would like to discuss these very briefly.

In my opinion, a 10 percent surcharge on personal and corporate income taxes next year would contain no redeeming features. I say this because it would considerably reduce the rate of real growth and would cause a recession as defined by the National Bureau of Economic Research. However, it would not slow down the rate of inflation. The reason for this is that we have learned in the past several years that tax increases themselves contain various inflationary features, as many wage earners try to earn higher wage rates to offset the tax increase, and many businessmen try to pass along the lower after-tax profits in terms of higher prices. So, therefore, I think it would have, as I say, no redeeming features; it would lead the economy into a recession and would wipe out any supposed advantages of a "soft" landing.

I will conclude my remarks at this point so we can get to the other witnesses.

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

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF MICHAEL K. EVANS

My remarks this morning cover three specific areas: (1) the outlook for the economy by major sector through 1974 and 1975, (2) the assumptions for fiscal and monetary policy which have been used to generate these forecasts, and (3) the effects which alternative policies would have on the economic outlook. We turn first to a general summary of our forecasts.

ECONOMIC OUTLOOK

Gross national product is estimated to have risen $30 billion, or 9.5%, last quarter to a total of $1302 billion. While this is well above the average percentage increase for the economy, only 4% of the growth is due to an expansion of real GNP, while 5½% represents a rise in the implicit deflator. In the fourth quarter real growth wil be even less impressive, with an increase of only 2.8% and an accompanying rise in the implicit deflator of 4.2%. This will result in a $1285 billion figure for 1973 GNP, or a rise of $130 billion. The rise of 6.1% in real growth corresponds closely with many forecasts made last year, but the 4.9% rise in the implicit deflator is far above even the highest estimate made then. Furthermore, the use of the implicit deflator tends to understate the true magnitude of inflation this year. The consumer price index is expected to use 5.7% and the wholesale price index for industrial commodities (WPI) is expected to increase 6.9% in 1973.

While there has been some confusion about interpreting the preliminary August figures, there is much less disagreement about the course of economic activity next year. Turning briefly to the August numbers, the decline in industrial production has been labeled a "fluke" by virtually everyone, stemming as it did from a 23% decline in auto production. Much was made of the fact that the remainder of the index rose 0.5%, or 6% at an annual rate. Yet this performance is not really so spectacular. We should remember that the industrial production index is seasonally adjusted, and that plants in those industries which are straining against capacity ceilings were kept open rather than being shut down for vacations; hence the index rose somewhat in August for that reason alone. The personal income figures, which showed a $10.6 billion increase in August, were also misleading in that larger than proportional increases occurred for transfer payments, dividends, and interest income. The critical wages and salaries component rose only $5.8 billion, or 8.4% at annual rates, and this too was biased upward by the "vacation factor" mentioned above. Thus while a 4% growth rate, if continuously maintained, could not be considered pessimistic, the August figures do not show as much strength as has been suggested.

There is little controversy with respect to the 1974 predictions, at least for real GNP. Our forecast remains at a real growth rate of 2.4% for next year; the consensus forecasts published by the National Association of Business Economists and the American Statistical Association both average 2.6% for next year. While these forecasts are not completely independent, since many of the same economists participate in both polls, the similarity is striking. While we must be cautions that we are not once again falling into the trap of "consensus forecasting" as we look ahead to 1974, I think there are several salient differences with 1968 which are worth mentioning. First, econometric forecasting has come into its own much more during the past five years. In 1968 the Wharton model was the uncontested front-runner, and much of the consensus forecast was based around its output. Today there are at least a half-dozen econometric models being used for forecasting, and while the results are not always independent, the forecasts have differed substantially during the past few years. Second, the economy was spurred by an unprecedented injection of money during the latter half of 1968, which was intended to partially offset the tax surcharge but in retrospect clearly overwhelmed it. There is no question that the Nixon administration could avert a slowdown next year if it were to repeat that experiment—but this is considered extremely unlikely. Third, the timing of the cycle then and now is much different; the economy was then just recovering from the 1967 slowdown and still had substantial forward momentum, whereas now we are just ending a period of supergrowth. Thus in our opinion there is virtually no chance that the slowdown next year will not develop on schedule.

Consumption and savings

In line with the forecast of a slowdown next year, even the most optimistic Detroit economists do not believe that new car sales will remain much above the 11 million level, which is down rather sharply from the 11.9 million level estimate of a 7% decline from 1973 levels. First, the softness of the economy itself, and the attendant rise in the unemployment rate to 5.3%, will discourage sales of new cars. Second, substantial rises in new car prices will dampen consumer demand somewhat. This is particularly true for the lower-priced cars, for which the price increases announced so far are the largest. The new automatic seat belt configuration is unlikely to attract many new buyers. The posting of average expected gas mileage is expected to tilt sales further toward smaller cars, which probably means that imported cars will increase their market share. Finally, the by now well-advertised breakthrough of the stratified charge engine may convince some buyers to wait until they can buy a car which meets the strict pollution control standards and yet delivers 1965 gas mileage.

Having said all this, we do not mean to overemphasize the cyclical fluctuations in auto sales. The idea that fluctuations in car sales are a major component of the business cycle probbaly belongs to the folklore of the 1950's. Some recent work we have done suggests that the transitory income effect is now greater for beef than it is for cars; steak has replaced the auto as the major luxury good. In any case, if we adjust for strike years, the maximum year to year decline in auto sales since 1961 has been 7%, so the 1974 decline is still quite substantial.

All other major components of consumption are expected to rise during 1974 in both current and constant dollars. Major household appliances are expected to increase 3.4% next year in current prices, while furniture and furnishings should rise 8.6%. The much larger increase in the latter category is due to a higher rate of inflation; the constant-dollar increase for both categories is approximately 3%. Both of these will rise far less than has been the case during the past two years, due to a slower growth income and the slump in housing. Other durables, which are not tied to housing, will be up a healthy 10%.

In the nondurable sector, food prices will rise only 1% next year; thus a 5.2% increase in current dollars translates into a 4.2% increase in constant dollars. However, the picture will be much different for other nondurables. Clothing purchases will increase 7.9% in current prices, but will rise only 2.6% in real growth. Other nondurables largely fuel, will be up 7.1% and 1.9% respectively. The increasing price of oil, which affects the price of petroleum-based synthetic fibers, is quite important here. Furthermore, cotton prices will be much higher next year than they were in 1973, although some decline from recent peaks is expected shortly. Finally, consumer services will grow at a rate of 7.8% in current dollars and 3.3% in constant prices.

Investment

We expect housing starts to end their decline very soon, as the worst of the squeeze on homebuilders and buyers is almost over. By the end of the year, interest rates will have dropped substantially and mortgages will once again be available to all qualified buyers. The 2.5 million level of starts which occurred at the beginning of the year would have been substantially reduced even in the absence of rapidly rising interest rates because of higher labor and material costs and rising vacancy rates. Our estimate is that housing starts probably would have dropped to 2.2 million without any additional push from tight money. We do expect the number of starts to average 1.85 million during the current quarter. After this, however, a sharp reduction in interest rates and a substantially easier policy on the part of the Fed should push this figure back to the 1.9–2.0 million range.

Furthermore, it is our opinion that the risk is on the upside, not the downside. By this we mean that if there are no disocations in the economy next year, housing starts could return to the 2.2 million level, as lumber prices should remain at reasonable levels and the employment situation should ease somewhat. While our best estimate remains 1.9 million housing starts for next year, we consider a forecast of 2.2 million units to be more likely than one of 1.6 million units.

Fixed business investment is expected to rise $4 billion this quarter for a 1973 total of $137 billion, up some 16% from the $118 billion figure recorded last year. This rate of increase will not continue into 1974, with a forecasted increase of 10% and quarterly increments of $2 to $3 billion. The slowdown will be due to a lower rate of growth of industrial production and the lagged effects of this year's tight money and high interest rates; on the other hand the large backlog of orders will insure that there will not be a decline in this category. While plant and equipment spending cannot be said to be the bulwark of next year's growth, it out-performs the rest of the economy in both current and constant dollars.

Wages and prices

If there is one place where a consensus forecast has not developed, it is in the area of prices, particularly prices of agricultural products. Our forecast of a 3.8% increase in the CPI is taken to be somewhat lower than the consensus estimate, although the 4.7% increase expected to be recorded in both the implicit GNP deflator and the WPI is somewhat closer to the average prediction.

Yet the decline in food prices, which explains the discrepancy in the behavior of these price indexes next year, is becoming increasingly well-documented. First, harvests of the major crops appear to be slightly larger than earlier government estimates, and with the exception of wheat, grain prices are falling sharply. This will eventually result in greater supply and hence lower prices of livestock prices, although this will take longer for beef than other livestock products. As we predicted, but to the surprise and consternation of many others, beef prices have come down after the freeze ended. Once again, the imposition of a freeze worked to keep prices up to a ceiling level they would not have otherwise held, rather than to push them down.

The price elasticity for beef is substantial, and hence it is no surprise that higher prices are being met with a decline in the quantity demanded. However, for some reason it seems neecssary to invent fabrications for the smaller demand for beef, instead of referring to the normal downward-sloping demand curve. Housewives claim they are "patriotic" by not buying beef, rather than admitting that they do not believe it is value received or cannot afford it, which perhaps is difficult to admit in this land of plenty. In any case, beef prices were artificially *inflated* by the freeze; now that it has ended they are beginning to decline. This, plus the sharply lower price on grains, will reduce prices received by farmers some 15% from third quarter levels and 25% from the peak August figures. As a result, the food components of the CPI will rise only 1% in 1974 over 1973 and will decline some 3% from the preesnt to mid-1974. This in turn will result in an increase in the CPI at only a 2% annual rate during the first half of 1974.

It should be pointed out that this hardly means that the inflation problem is solved. During the same period, the non-food component of the CPI will be increasing at over a 4% rate, as will the implicit GNP deflator, and the WPI will be rising at a 3% rate. Thus the indicated medium-term increase in the rate of inflation is in the 4–4½% range, well above what the Nixon administration thought it could accomplish as recently as a year ago. Yet in view of the many dismal forecasts arguing that food prices will still go higher and that the rate of inflation will be equalled or exceeded next year, it is important to point out that none of these events seems very probable.

Events in the wages area have been fairly quiet, with the vast majority of union negotiations centering in the 6–7% range and negotiations being remarkable only for the lack of strikes. While the exact cost of the Chrysler settlement is not know, due to the uncertainty of how many workers will take advantage of the 30-and-out rule, it is our opinion that fewer workers than expected will take advantage of this pension plan during the next few years: most of the militancy has been with the younger workers. Hence it would appear that Chrysler settlement also falls within the 6–7% range. Although prices have been zooming in recent months and there has been much rhetoric on the subject, the relatively small increases in prices during the next few quarters will halt any further wage-price spiral. For 1974 we expect wage increases to average approximately 7% in the manufacturing sector and 6½% in the nonmanufacturing sector, which are approximately the figures reached this year. Increasing wage rates will not provide any new impetus to inflationary pressures next year; although unit labor costs will rise between 4 and 5%, this is equal to the projected increase in prices.

Corporate profits

After-tax profits are expected to decline from the high-water mark of $71.6 billion reached during the second quarter, which represented a spectacular 34% increase from a year ago. However, much of this was due to an unprecedented $10 billion in inventory profits, which is expected to return to a $5 billion level by mid-1974. Our estimated decline of some $7 billion in after-tax profits is thus seen to be due primarily to a swing in inventory profits rather than changes in the fundamental economic variables such as sales and margins. The slowdown in the economy will cause profits to decline somewhat; however, this will be partly offset, particularly in the nonmanufacturing sector, by lower interest rates. While prices and unit labor costs will increase by the same proportion, capacity utilization rates will decline 2 to 3%, thus raising unit fixed costs as well. In spite of these factors, a 10% decline in profits is quite mild in the face of any economic slowdown; it compares favorably with the 10% drop in 1967, when inventory profits declined by only $1½ billion, and the far worse decline of 23% in the 1970 recession.

Monetary sector

Treasury bill rates are expected to continue their decline from August peaks, with an average rate of under 7½% for the fourth quarter. The new issue rate for corporate bonds is expected to rise slightly, from 8.2% to 8.4%, and reach another peak in November. After that, however, rates should decline sharply, with the treasury bill rate reaching 5% by June 1974 and the bond yield averaging 7% in the second quarter of next year. The prime rate, which is now expected to top out at 10%, will decline to a 7–7½% range by mid-1974. These rate changes will be accompanied by a very slow growth in the money supply for the next two quarters, but it will then return to a 6½% rate of growth for the remainder of the year.

PRINCIPAL ASSUMPTIONS

We now turn to a discussion of the principal assumptions which have been used to generate these forecasts, with particular emphasis on the similarities and differences with the official Administration estimates.

(1) Defense expenditures are expected to rise $1.8 billion this quarter and then increase at a modest rate of $0.5 billion per quarter for the remainder of fiscal 1974, plus an additional $1 billion increase in 1974.1 because of the 5½% pay increase. During fiscal 1975 we assume that they will increase $1 billion per quarter in addition to the annual pay increases. While the increments during fiscal 1974 appear quite modest, our total estimate of $77.2 billion is still somewhat above the official budget estimate for defense purchases, which calls for an actual decline of $0.2 billion from the fiscal 1973 to a level of $74.9 billion. While a decline in defense spending from one year to the next is not unprecedented in a peacetime economy, we do not believe that it will occur next year. There are no further reductions to be taken in Southeast Asia, troop withdrawals from Europe do not seem to be a likely possibility, and considerable pressure is building for the reinstatement of many military research and development programs which were diminished or curtailed during the last seven years.

(2) Federal nondefense purchases of goods and services are expected to increase by approximately $1 billion per quarter through mid-1974 and $1.5 billion per quarter thereafter, plus the usual pay increases. The major increases in this category are due to higher expenditures for space and other high-technology research and development programs, veterans' medical care and hospital services, and law enforcement and justice outlays. Our estimate for fiscal 1974 of $35.9 billion is actually below the official budget estimate of $36.2 billion. However, the difference lies entirely in the purchase of agricultural products by the Commodity Credit Corporation, which were projected to rise $1.3 billion over fiscal 1973. It is unlikely that these expenditures will rise more than $½ billion, if at all.

Hence we are projecting slightly higher outlays for nonagricultural purchases than are shown in the Administration budget although our total figure is some $0.3 billion lower.

(3) We are still expecting the 5.9% increase in social security benefits to become effective in mid-1974, although the alternative date of January cannot be dismissed out of hand. In any case, the $1.5 billion differential due to the January date would not have an appreciable effect on the economy.

Old-age and health benefits are expected to rise at an 8% rate throughout the forecast period, plus an additional $3 billion associated with the 5.9% benefit rise in July and a $2 billion rise at the beginning of 1974 when the Federal government takes over various state-administered programs which provide welfare payments to the aged, blind, and disabled. The rate increase will be financed by a rise in the income base for social security payments to $12,600; the other $2 billion will be offset by a drop in grants-in-aid payments, as discussed below.

(4) Veterans' benefits are expected to increase by $0.4 billion per quarter throughout the forecast period, while other Federal transfer payments to persons are expected to rise $0.3 billion per quarter. State and local transfer payments are projected to increase $0.5 billion this quarter and next, but then fall $1.5 billion in 1974.1 as the $2 billion of obligations are assumed by the Federal government. After that, these transfer payments should rise at an annual rate of $0.4 billion per quarter.

(5) Our projection for grants-in-aid in fiscal 1974 is actually $1.4 billion less than the revised government estimate. Our estimate for the current fiscal year is $40.7 billion, virtually identical with the $40.5 billion figure recorded for fiscal 1973. At the beginning of the year, the budget estimates also stated that there would be no increase in grants-in-aid in fiscal 1974. Since then, actual grants for fiscal 1973 have been recorded to be $1 billion less than were projected, but the estimate for 1974 has been raised $1½ billion. It is not likely that this upward adjustment is reailtistic, particularly since the actual number was lower than the estimate, and the emphasis in the current Administration is not on expansion on social services. This figure may have been artificially inflated to provide for some overage in another category of spending—like defense.

(6) We have not included any tax increases in our standard forecast, although in our alternative forecasts we do examine the implications of both a tax surcharge and the surcharge-refund scheme similar to the plans proposed recently. We consider it extremely unlikely that any changes in tax legislation will be passed next year; we have previously discarded our assumption about tax reform, and consider the possibility of a surcharge next year to be less than 5%.

(7) Prices received by farmers are expected to average 164% of 1958 prices during this quarter, down substantially from the peak of 210 which was reached in August. Since the prices are calculated as of the 15th of each month, the "montly average" figure for August represented virtually the peak price for almost all commodities. These figures compare with 146 at the beginning of the year and 123 for the first half of 1972. Our forecast now calls for a decline in this index to 156 for the first half of the year. After that, farm prices are expected to increase at an annual rate of approximately 7% per year throughout the rest of 1974 and 1975.

(8) In spite of the flurry of activity in the foreign exchange rate market, we have made no changes in our assumptions about the prices of imported and world-traded goods, since we have been including assumptions about further weakening of the dollar ever since our March forecast. We have assumed for some time that the French franc would weaken in the fall, that the dollar would come under further downward pressure, and that the joint Common Market float would therefore end in a solo float of the DMark. As a result, we expect import prices to rise some 14% next year, with a 17% increase in crude materials prices.

(9) Plant and equipment spending, corporate profits and inventory investments are all expected to be $2 billion lower in 1974 as a direct result of Phase IV regulations. In our opinion. Phase IV has no downward effects on wages or prices, and hence no particular adjustments have been included for these variables.

The complete assumptions for all key fiscal and monetary policy variables are given in the table entitled Assumptions: Standard Forecast.

ASSUMPTIONS: STANDARD FORECAST

Name of policy variable	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4
Government purchases:											
Federal	107.3	109.9	111.3	114.7	116.5	118.5	121.0	125.5	128.0	130.5	133.0
National defense	74.2	76.0	76.5	[1] 78.0	78.5	79.5	80.5	[1] 82.5	83.5	84.5	85.5
Other	33.1	33.9	34.8	[1] 36.7	38.0	39.0	40.5	[1] 43.0	44.5	46.0	47.5
State and local	168.0	173.0	178.0	183.0	187.5	192.0	196.5	201.0	206.0	211.0	216.0
Other Goverment spending:											
Federal transfer payments	93.8	96.1	97.8	101.2	103.1	108.1	110.1	112.2	114.3	119.4	121.5
Old-age and health benefits	60.0	61.5	62.5	65.2	66.4	70.7	72.0	73.4	74.8	79.2	80.6
Veterans' benefits	13.4	13.8	14.2	14.6	15.0	15.4	15.8	16.2	16.6	17.0	17.4
Other domestic transfers	18.1	18.4	18.7	19.0	19.3	19.6	19.9	20.2	20.5	20.8	21.1
Grants-in-aid	40.5	41.0	41.5	40.0	40.5	41.5	42.5	43.5	44.5	46.5	47.5
Federal Government receipts:											
Social security taxes	79.1	80.7	82.4	86.9	88.1	89.5	90.9	92.5	94.1	95.7	97.3
Adjustments in personal income taxes	−3.2	5.7	5.7	−1.2	−3.9	3.5	3.5	−1.2	−3.9	3.5	3.5
Decrease in corporate profits taxes due to investment tax credit	1.1	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Other Government variables:											
Size of Armed Forces	2.33	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
Civilian government employmen	13.62	13.74	13.84	13.96	14.08	14.20	14.32	14.44	14.56	14.68	14.08
Military wage rate (dollars per hour)	4.22	4.23	4.24	[1] 4.47	4.48	4.49	4.50	[1] 4.75	4.76	4.77	4.78
Civilian wage rate (dollars per hour)	4.34	4.40	4.46	[1] 4.55	4.61	4.67	4.73	[1] 4.83	4.89	4.95	5.01
Monetary variables:											
Unborrowed reserves	30.4	31.1	31.5	32.2	32.9	33.5	34.1	34.7	35.3	35.9	36.5
Required reserve ratio on demand deposits	.127	.127	.127	.127	.127	.127	.127	.127	.127	.127	
Required reserve ratio on time deposits	.045	.045	.045	.045	.045	.045	.045	.045	.045	.045	.045
Amount of bond financing (billions of dollars)	28.8	29.3	30.0	29.5	29.0	28.5	28.0	28.5	29.0	29.5	30.0

[1] Government pay increase this quarter.

We have often used the Chase Econometrics macroeconomic model to generate forecasts based on alternative assumptions about key fiscal and monetary policy variables. Since our estimates of government spending differ by relatively small amounts from the official budget estimates, we have not included forecasts with alternative levels of spending. We have, however, chosen three alternative scenarios which may be of interest.

ALTERNATIVE FORECASTS

In the first alternative forecast, we simply impose a 10% surcharge on personal and corporate Federal income taxes beginning in 1974.1 and remaining throughout 1975. The results are decidedly unsatisfactory. The surcharge plunges the economy into a recession, with an actual decline in real GNP during the first two quarters of 1974. The unemployment rate rises to 5.8% by the end of the year, as compared with 5.3% in the standard forecast. Corporate profits decline from $72.6 billion in 1973.2 to $57.4 billion in mid-1974, a decline of over 20%. Furthermore, since there are various inflationary aspects of tax increases, the consumer price index rises 3.7% in 1974, compared to 3.8% in the standard run. The relative performance is somewhat more favorable in 1975, when prices rise only 3.0% as compared to 3.6% in the standard forecast, but unemployment remains 0.5% or more above the baseline and real GNP grows as a very sluggish 3%. In sum, a tax surcharge next year would contain no redeeming features, since it would increase unemployment substantially while not reducing inflation for at least a year.

In the second alternative forecast, we consider a slightly different variation of the surcharge, namely one that includes a refund of the extra taxes throughout 1975, although we do not consider this to be a realistic proposal. It does indicate the possible pitfalls of trying to over-fine tune the economy.

The forecasts are identical through 1974, since the surcharge is in effect throughout the year in both alternative scenarios, and we do not adjust for factors representing the anticipation of the refunds. In 1975 the economy switches directions dramatically. Coming from a year of recession and an overall growth rate of 1.2%, real GNP zooms upward and increases at an average rate of 9½% during the last three quarters of 1975. The unemployment rate falls from 5.8% to 4.5% by the end of 1975 and after-tax corporate profits recover from their trough of $57.4 billion to $91.8 billion by the end of that year. The rates of inflation for 1975 in this alternative solution are similar to those in the standard forecast, but that is misleading, since they should be substantially lower following the 1974 recession. By the end of 1975, prices are rising between ½% and 1% faster than the standard run, depending on which price index is used. This inflationary pattern would obviously continue into 1976 and a rate of inflation approaching 5% would occur if this particular scheme were implemented.

Such a simulation clearly points out the difficulties of trying to overmanage the economy. While the idea of a tax increase at boom times and refunds during slumps sounds intuitively appealing, it is more likely that the increases would become effective during periods of slowdown and the refunds would start just as the economy was beginning to recover. This would produce phenomena such as the swing in real GNP from −0.5% to +9.7% in the space of 4 quarters, which has very little benefit for anyone.

In the last alternative, we consider the impact of supplying an additional $5.5 billion to the housing market, as has recently been suggested by the Nixon Administration. Given that the average price of a single-family home is now about $27,000, this would support approximately 200,000 new housing units. Thus housing starts in the fourth quarter of this year would be 2.04 million, rather than the 1.84 million figure contained in the standard forecast. We have furthermore assumed that the money for an extra 200,000 units will continue to be made available through 1974 but will gradually be phased out during 1975.

Besides helping out the housing market considerably, this move has relatively little effect on the economy. Real growth for the year is recorded at 2.7% instead of 2.4%; the rate of inflation is only slightly higher. Unemployment in the construction sector drops by ¼%, but this is only about 10,000 workers, so the effect on the overall economy is not large. The marginal employment effect in the construction sector should not be expected to be large, since the entrepreneurs and skilled tradesmen will undoubtedly remain employed next year regardless of the exact level of housing; they will just work shorter hours. The money and capital markets are not affected very much because we are assuming that excess funds will be available by the end of the year in any case. In short, this particular move helps housing without having much of an effect on any other major sector of the economy.

CONCLUSION

In these remarks I have discussed our forecast of the economy through 1974 and 1975, which includes a slowdown but no recession next year. Our assumptions about monetary and fiscal policies are rather similar to those of the Administration. We believe that a tax surcharge next year would plunge the economy into a recession without reducing the rate of inflation, whereas a surcharge followed by a tax refund would cause not only a recession but a subsequent period of rapid inflation.

THIS FORECAST WAS PREPARED BY CHASE ECONOMETRICS, INC., ON SEPT. 24, 1973, AND IS THE 1ST FORECAST IN A SET OF 4 FORECASTS; THE PRINCIPAL ASSUMPTIONS FOR THIS RUN ARE STANDARD FORECAST—SLOWDOWN IN 1974 AND INFLATION CONTINUES

TABLE 1.1.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	1,272.0	1,302.2	1,324.8	1,344.7	1,365.1	1,387.9	1,411.9	1,441.8	1,473.2	1,506.8	1,540.2	1,285.4	1,377.4	1,490.5
Consumption expenditures	795.6	810.3	823.9	834.1	848.3	861.5	875.4	892.1	908.3	925.2	942.0	802.3	854.8	916.9
Durable goods	132.8	133.4	133.8	135.5	137.7	138.9	140.1	143.8	147.1	149.9	152.0	133.0	138.1	148.2
Nondurable goods	330.3	337.8	344.9	346.9	352.2	357.5	363.3	369.4	376.2	383.3	390.6	333.8	355.0	379.9
Services	332.6	339.1	345.3	351.7	358.5	365.1	372.0	378.9	385.0	392.0	399.4	335.5	361.8	388.8
Gross private investment	198.2	204.7	207.9	209.0	209.2	212.2	215.4	219.8	227.8	237.3	246.6	201.3	211.5	232.9
Fixed investment	193.7	196.2	197.0	199.3	203.2	207.0	210.0	214.9	221.4	228.9	236.4	194.2	204.9	225.4
Nonresidential	134.1	139.5	143.7	147.5	150.4	152.5	154.4	158.3	163.4	169.4	175.5	137.0	151.2	166.6
Structures	47.2	49.5	51.3	53.1	54.4	55.8	56.8	58.4	60.4	62.8	65.4	48.3	55.0	61.8
Equipment	86.9	90.1	92.4	94.4	95.9	96.7	97.6	99.9	103.0	106.5	110.0	88.7	96.2	104.9
Residential structures	59.6	56.7	53.3	51.8	52.9	54.5	55.6	56.6	57.9	59.5	61.0	57.1	53.7	58.8
Nonfarm	59.1	56.0	52.6	51.1	52.2	53.8	54.9	55.9	57.2	58.8	60.2	56.5	53.0	58.0
Change in inventories	4.5	8.5	10.9	9.7	6.0	5.3	5.4	4.9	6.5	8.4	10.2	7.1	6.6	7.5
Nonfarm	4.4	8.5	10.9	9.7	6.0	5.3	5.4	4.9	6.5	8.4	10.2	7.0	6.6	7.5
Net exports of goods and services	2.8	4.3	3.7	3.9	3.6	3.7	3.7	3.4	2.9	2.8	2.5	2.7	3.7	2.9
Exports	97.2	101.8	103.9	106.2	108.1	109.7	112.1	114.9	117.6	120.6	123.8	98.1	109.0	119.2
Imports	94.4	97.5	100.3	102.4	104.5	106.0	108.5	111.5	114.6	117.8	121.3	95.5	105.3	116.3
Government purchases	275.3	282.9	289.3	297.7	304.0	310.5	317.5	326.5	334.0	341.5	349.0	279.0	307.4	337.7
Federal	107.3	109.9	111.3	114.7	116.5	118.5	121.0	125.5	128.0	130.5	133.0	108.5	117.7	129.2
National defense	74.2	76.0	76.5	78.0	78.5	79.5	80.5	82.5	83.5	84.5	85.5	75.2	79.1	84.0
Other	33.1	33.9	34.8	36.7	38.0	39.0	40.5	43.0	44.5	46.0	47.5	33.2	38.5	45.2
State and local	168.0	173.0	178.0	183.0	187.5	192.0	196.5	201.0	206.0	211.0	216.0	170.5	189.7	208.5

TABLE 1.2.—OTHER MAJOR ECONOMIC INDICATORS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep (M1)	260.7	264.7	266.5	267.7	272.2	277.3	281.0	284.6	288.1	291.5	294.7	262.1	274.6	289.7
Money supply +TD −CD (M1½)	540.7	550.7	556.1	564.2	578.6	592.1	602.3	616.4	630.3	644.4	659.0	544.5	584.3	637.5
Money supply with time dep (M2)	601.5	617.2	624.4	631.8	643.0	656.9	668.6	684.3	698.9	713.6	729.0	605.7	650.1	706.5
Index of industrial production:														
Total	124.8	126.7	128.4	129.1	129.4	130.1	130.9	132.4	134.6	136.9	139.0	125.7	129.9	135.7
Manufacturing	124.8	126.1	127.6	128.1	128.3	128.9	129.7	131.2	133.5	135.9	138.0	125.2	128.7	134.6
Steel	119.8	119.5	119.6	118.6	115.9	116.0	115.2	116.6	120.1	124.0	125.6	119.4	116.4	121.6
GNP in 1958 dollars	834.3	842.6	818.4	851.3	855.4	831.0	866.9	875.9	887.3	898.7	909.7	838.7	858.7	892.9
Implicit GNP deflator	152.5	154.5	156.1	157.9	159.6	161.2	162.9	164.6	166.0	167.7	169.3	153.2	160.4	166.9
Consumer Price Index	131.5	134.1	135.3	135.8	136.7	138.0	139.5	140.6	141.7	143.0	144.5	132.4	137.5	142.4
Wholesale price index (indus. comm.)	125.7	127.7	129.4	130.3	131.4	132.3	133.5	134.5	135.6	136.7	137.8	126.0	131.9	136.2
Disposable personal income	869.7	883.8	902.2	922.9	938.9	949.7	963.7	987.1	1,005.7	1,023.7	1,043.0	876.8	943.8	1,014.9
Corporate profits before tax	129.0	125.9	124.7	118.2	116.6	118.0	121.7	125.1	130.4	135.5	141.0	124.8	118.6	133.0
Corporate profits after tax	71.6	70.2	69.5	65.5	64.5	65.3	67.5	69.5	72.6	75.6	78.8	69.6	65.7	74.1
Treasury bill rate, 91-day	6.61	8.49	9.14	7.90	6.22	6.33	5.98	6.00	5.92	5.86	5.79	7.47	6.61	5.90
Prime commercial paper rate	7.47	9.96	10.46	9.04	7.19	7.02	6.80	6.70	6.65	6.58	6.51	8.54	7.51	6.61
Corporate bond rate, new issues	7.71	8.21	8.39	7.65	6.99	7.25	6.99	7.07	7.16	7.27	7.38	8.00	7.22	7.22
Index of capacity utilization	90.70	91.07	90.78	89.87	88.97	88.42	87.92	88.02	88.52	88.89	89.19	90.66	88.79	88.65
New passenger car sales, SAAR	12.17	11.68	11.36	11.03	11.14	11.17	11.08	11.27	11.60	11.87	11.87	11.93	11.10	11.65
Total private housing starts	2.21	2.03	1.84	1.86	1.91	1.93	1.95	1.98	2.00	2.01	2.03	2.12	1.91	2.01
Unemployment rate	4.9	4.7	4.8	4.8	5.0	5.2	5.3	5.3	5.2	5.1	5.0	4.9	5.1	5.1
Personal savings rate	5.9	5.7	6.0	6.9	7.0	6.6	6.4	6.9	6.9	6.8	6.9	5.9	6.7	6.9
Federal Government surplus or def	0	4.4	4.5	−3.5	−7.5	−3.5	−3.9	−9.8	−8.4	−6.4	−4.9	.9	−4.6	−7.4

TABLE 1.1A.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	9.5	9.5	6.9	6.0	6.1	6.7	6.9	8.4	8.7	9.1	8.9	11.3	7.2	8.2
Consumption expenditures	8.3	7.4	6.7	4.9	6.8	6.2	6.5	7.6	7.3	7.4	7.3	10.4	6.5	7.3
Durable goods	1.9	1.7	1.2	5.2	6.3	3.7	3.4	10.6	9.1	7.6	5.7	13.3	3.8	7.4
Nondurable goods	10.1	9.1	8.4	2.3	6.1	6.0	6.5	6.8	7.4	7.5	7.7	11.3	6.3	7.0
Services	9.4	7.8	7.3	7.5	7.7	7.4	7.6	7.4	6.5	7.3	7.6	8.5	7.8	7.5
Gross private investment	7.8	13.1	6.3	2.2	.3	5.8	5.9	8.2	14.7	16.7	15.7	12.9	5.1	10.1
Fixed investment	8.2	5.2	1.6	4.7	7.9	7.3	5.9	9.3	12.1	13.7	13.1	12.7	5.5	10.0
Nonresidential	10.2	16.2	11.8	10.7	7.8	5.7	5.0	10.0	13.1	14.5	14.3	15.9	10.4	10.2
Structures	16.8	19.2	14.5	14.4	9.9	10.1	7.2	11.2	13.7	16.2	16.5	15.8	13.9	12.2
Equipment	6.7	14.6	10.3	8.7	6.5	3.1	3.7	9.3	12.7	13.6	13.1	16.0	8.4	9.1
Residential structures	3.7	−19.7	−23.6	−11.5	8.4	12.1	8.2	7.4	9.4	11.2	9.5	5.8	−6.1	9.5
Nonfarm	4.8	−21.0	−24.0	−11.8	8.4	12.2	8.3	7.4	9.4	11.3	9.6	5.7	−6.3	9.6
Exports	33.4	18.8	8.4	9.0	7.0	6.0	8.9	9.7	9.5	10.3	10.7	33.5	11.1	9.3
Imports	21.0	12.9	11.5	8.4	8.5	5.6	9.3	11.2	11.3	11.0	12.1	22.2	10.3	10.4
Government purchases	10.1	11.0	9.0	11.6	8.5	8.6	9.0	11.3	9.2	9.0	8.8	9.4	10.2	9.9
Federal	6.8	9.7	5.1	12.2	6.3	6.9	8.4	14.9	8.0	7.8	7.7	3.9	8.5	9.8
National defense	−.5	9.7	2.6	7.8	2.6	5.1	5.0	9.9	4.8	4.8	4.7	1.1	5.1	6.2
Other	24.4	9.7	10.6	21.8	14.2	10.5	15.4	24.7	14.0	13.5	13.0	10.5	15.9	17.4
State and local	12.3	11.9	11.6	11.2	9.8	9.6	9.4	9.2	10.0	9.7	9.5	13.3	11.3	9.9

TABLE 1.2A.—OTHER MAJOR ECONOMIC INDICATORS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	6.9	6.2	2.7	1.8	6.7	7.4	5.4	5.1	4.9	4.7	4.4	5.2	5.4	4.9
Money supply +TD −CD (M1½)	7.8	7.4	3.9	5.8	10.2	9.4	6.9	9.3	9.0	9.0	9.1	6.8	8.3	9.4
Money supply with time dep. (M2)	15.0	10.4	4.6	4.8	7.1	8.7	7.1	9.4	8.5	8.4	8.6	11.1	7.1	9.0
Index of industrial production:														
Total	5.6	5.8	5.5	2.2	1.0	2.1	2.5	4.7	6.6	6.7	6.0	9.9	3.3	4.5
Manufacturing	7.5	4.1	4.7	1.7	.7	1.9	2.3	4.7	7.0	7.1	6.2	10.6	2.8	4.6
Steel	3.6	−.8	.3	−3.5	−8.9	.3	−2.7	4.8	12.0	13.0	5.5	11.5	−2.5	4.4
GNP in 1958 dollars	2.4	4.0	2.8	1.4	1.9	2.6	2.7	4.1	5.2	5.1	4.9	6.1	2.4	4.0
Implicit GNP deflator	7.1	5.5	4.2	4.6	4.1	4.0	4.2	4.3	3.5	3.9	3.9	4.9	4.7	4.1
Consumer Price Index	8.8	7.7	3.8	1.4	2.8	3.6	4.4	3.2	3.1	3.7	4.2	5.7	3.8	3.6
Wholesale price index (indus. comm.)	14.5	6.3	5.4	2.9	3.2	2.8	3.6	3.2	3.3	3.0	3.3	6.9	4.7	3.2
Disposable personal income	8.5	6.5	8.3	9.2	6.9	4.6	5.9	9.7	7.5	7.2	7.5	10.0	7.6	7.5
Corporate profits before tax	31.1	−9.7	−3.7	−21.0	−5.5	5.1	12.4	11.3	16.9	15.6	16.2	27.4	−5.0	12.1
Corporate profits after tax	27.5	−7.5	−4.3	−22.4	−6.4	5.2	13.3	11.9	17.9	16.7	17.0	25.6	−5.6	12.8

TABLE 1.2B.—OTHER MAJOR ECONOMIC INDICATORS (ACTUAL CHANGE)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Treasury bill rate, 91-day	0.97	1.88	0.66	−1.24	−1.68	0.11	−0.35	0.02	−0.08	−0.06	−0.07	3.40	−0.86	−0.71
Prime commercial paper rate	1.18	2.49	.50	−1.41	−1.85	−.16	−.22	−.10	−.05	−.07	−.07	3.85	−1.03	−.90
Corporate bond rate, new issues	.03	.51	.17	−.74	−.66	.26	−.26	.08	.09	.10	.11	.41	−.78	0
Index of capacity utilization	.63	.37	−.29	−.92	−.90	−.55	−.50	.10	.50	.37	.30	4.86	−1.86	−.14
New passenger car sales, SAAR	−.33	−.49	−.32	−.33	.11	.03	−.09	.19	.33	.27	0	.98	−.82	.55
Total private housing starts	−.19	−.18	−.20	.02	.05	.02	.02	.03	.02	.02	.01	−.24	−.21	.10
Unemployment rate	−.1	−.2	0	.1	.2	.2	.1	−0	−.1	−.1	−.1	−.7	.2	0
Personal savings rate	−.0	−.2	.3	.9	0	−.4	−.2	.5	0	−.1	0	−.3	.9	.2
Federal Government surplus or def	5.0	4.4	.1	−8.0	−4.0	4.0	−.4	−5.9	1.4	2.1	1.5	16.8	−5.5	−2.8

THIS FORECAST WAS PREPARED BY CHASE ECONOMETRICS, INC., ON SEPT. 24, 1973, AND IS THE 2D FORECAST IN A SET OF 4 FORECASTS; THE PRINCIPAL ASSUMPTIONS FOR THIS RUN ARE 1ST ALTERNATIVE—10-PERCENT TAX SURCHARGE FOR 1974 AND 1975

TABLE 1.1.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	1,272.0	1,301.7	1,324.2	1,339.5	1,352.0	1,366.9	1,384.1	1,409.0	1,437.7	1,470.4	1,503.8	1,285.1	1,360.6	1,455.2
Consumption expenditures	795.6	809.7	823.4	827.9	837.0	845.4	854.9	867.7	881.0	895.3	910.2	802.1	841.3	888.5
Durable goods	132.8	133.3	133.7	133.7	134.6	134.7	134.9	137.9	141.1	143.9	146.3	133.0	134.5	142.3
Nondurable goods	330.3	337.6	344.7	344.1	347.2	350.6	354.7	359.6	365.5	371.8	378.8	333.7	349.2	368.9
Services	332.6	338.8	345.0	350.0	355.2	360.1	365.3	370.2	374.4	379.5	385.2	335.3	357.7	377.3
Gross private investment	198.2	204.6	207.8	209.9	207.2	206.6	206.5	208.8	216.2	226.5	237.5	201.2	207.6	222.2
Fixed investment	193.7	196.2	197.0	199.1	202.0	204.3	205.6	209.2	215.2	222.9	231.0	194.2	202.7	219.6
Nonresidential	134.1	139.5	143.6	147.4	149.5	150.2	150.4	152.8	156.9	162.4	168.3	137.0	149.4	160.1
Structures	47.2	49.5	51.3	53.1	54.2	55.3	56.0	57.3	59.0	61.2	63.6	48.3	54.7	60.2
Equipment	86.9	90.1	92.4	94.3	95.3	94.8	94.4	95.5	97.0	101.2	104.8	88.7	94.7	99.8
Residential structures	59.6	56.7	53.3	51.7	52.5	54.1	55.2	56.5	58.3	60.6	62.7	57.1	53.4	59.5
Nonfarm	59.1	56.0	52.6	51.0	51.9	53.4	54.5	55.7	57.6	59.9	61.9	56.5	52.7	58.8
Change in inventories	4.5	8.4	10.8	10.9	5.2	2.4	.8	—.5	1.0	3.6	6.4	7.1	4.8	2.6
Nonfarm	4.4	8.4	10.8	10.9	5.2	2.4	.8	—.5	1.0	3.6	6.4	7.0	4.8	2.6
Net exports of goods and services	2.8	4.5	3.7	4.0	3.7	4.4	5.3	6.0	6.5	7.1	7.3	2.6	4.4	6.7
Exports	97.2	101.9	104.0	106.3	108.1	109.6	112.1	114.9	117.6	120.6	123.8	98.0	109.0	119.2
Imports	94.4	97.4	100.2	102.2	104.3	105.3	106.9	108.9	111.1	113.5	116.6	95.4	104.7	112.5
Government purchases	275.3	282.9	289.3	297.7	304.0	310.5	317.5	326.5	334.0	341.5	349.0	279.0	307.4	337.7
Federal	107.3	109.9	111.3	114.7	116.5	118.5	121.0	125.5	128.0	130.5	133.0	108.5	117.7	129.2
National defense	74.2	76.0	76.5	78.0	78.5	79.5	80.5	82.5	83.5	84.5	85.5	75.2	79.1	84.0
Other	33.1	33.9	34.8	36.7	38.0	39.0	40.5	43.0	44.5	46.0	47.5	33.2	38.5	45.2
State and local	168.0	173.0	178.0	183.0	187.5	192.0	196.5	201.0	206.0	211.0	216.0	170.5	189.7	208.5

TABLE 1.2.—OTHER MAJOR ECONOMIC INDICATORS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	260.7	264.7	266.5	267.2	271.6	276.1	279.1	282.4	285.6	288.7	291.7	262.0	273.5	287.1
Money supply +TD −CD (M1½)	540.7	550.7	556.1	564.1	578.9	592.4	602.3	616.5	630.4	644.4	658.4	544.5	584.4	637.4
Money supply with time dep. (M2)	601.5	617.2	624.3	631.5	642.9	656.6	667.8	683.3	697.5	711.6	726.0	605.7	649.7	704.6
Index of industrial production:														
Total	124.8	126.7	128.4	128.3	127.5	127.1	127.0	128.0	130.1	132.6	135.1	125.7	127.5	131.4
Manufacturing	124.6	126.1	127.5	127.4	126.4	125.9	125.7	126.6	128.7	131.3	133.9	125.2	126.3	130.1
Steel	119.8	119.4	119.5	119.1	114.2	111.8	109.1	108.7	113.6	117.5	120.5	119.4	113.6	115.1
GNP in 1958 dollars	834.3	842.6	848.3	848.1	847.2	848.0	850.0	856.6	867.3	879.4	892.0	838.6	848.3	873.8
Implicit GNP deflator	152.5	154.5	156.1	157.9	159.6	161.2	162.8	164.5	165.8	167.2	168.6	153.2	160.4	166.5
Consumer Price Index	131.5	134.0	135.2	135.7	136.6	137.8	139.1	140.0	140.9	141.9	143.0	132.4	137.3	141.4
Wholesale price index (indus. comm.)	125.7	127.7	129.4	130.3	131.2	132.1	133.2	134.2	135.2	136.2	137.2	126.0	131.7	135.7
Disposable personal income	869.7	883.4	901.5	906.8	919.5	927.0	937.7	957.7	973.2	989.6	1,007.0	876.5	922.8	981.9
Corporate profits before tax	130.1	125.9	124.7	116.3	112.1	111.9	114.0	116.8	122.2	128.0	133.7	125.1	113.6	125.2
Corporate profits after tax	72.6	70.2	69.5	59.9	57.5	57.4	58.5	60.0	63.0	66.2	69.4	69.8	58.3	64.6
Treasury bill rate, 91-day	6.61	8.49	9.14	7.73	6.05	6.06	5.59	5.53	5.39	5.28	5.15	7.47	6.36	5.34
Prime commercial paper rate	7.47	9.96	10.45	8.91	7.00	6.77	6.42	6.22	6.09	5.97	5.84	8.54	7.27	6.03
Corporate bond rate, new issues	7.71	8.21	8.38	7.57	6.91	7.13	6.81	6.84	6.90	7.96	7.03	8.00	7.11	6.93
Index of capacity utilization	90.55	91.05	90.75	89.42	87.91	86.76	85.83	85.69	86.18	86.87	87.53	90.61	87.48	86.57
New passenger car sales, SAAR	12.17	11.67	11.36	10.85	10.80	10.69	10.51	10.67	11.03	11.39	11.49	11.93	10.71	11.15
Total private housing starts	2.21	2.03	1.84	1.86	1.91	1.94	1.97	2.03	2.07	2.12	2.16	2.12	1.92	2.10
Unemployment rate	4.9	4.8	4.8	4.9	5.3	5.6	5.8	5.8	5.7	5.5	5.3	4.9	5.4	5.6
Personal savings rate	5.9	5.7	6.0	6.0	6.2	6.0	6.0	6.6	6.6	6.7	6.7	5.9	6.1	6.7
Federal Government surplus or def	0	4.3	4.3	13.4	7.7	10.7	9.4	3.1	4.6	7.4	9.4	.9	10.3	6.1

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TABLE 1.1A.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	9.5	9.4	6.9	4.6	3.7	4.4	5.0	7.2	8.1	9.1	9.1	11.2	5.9	7.0
Consumption expenditures	8.3	7.1	6.7	2.2	4.4	4.0	4.5	6.0	6.1	6.5	6.7	10.4	4.9	5.6
Durable goods	1.9	1.5	1.3	0	2.5	.3	.7	9.1	9.0	8.2	6.4	13.3	1.1	5.8
Nondurable goods	10.1	8.9	8.4	−.6	3.6	3.9	4.7	5.5	6.6	7.0	7.5	11.3	4.6	5.7
Services	9.4	7.5	7.3	5.8	6.0	5.5	5.7	5.4	4.6	5.4	6.0	8.5	6.7	5.5
Gross private investment	7.8	13.0	6.2	4.1	−5.1	−1.2	−.3	4.5	14.3	19.0	19.2	12.9	3.1	7.1
Fixed investment	8.2	5.2	1.5	4.3	6.0	4.4	2.7	7.0	11.4	14.3	14.4	12.7	4.4	8.3
Nonresidential	10.2	16.3	11.8	10.4	5.7	1.9	.6	6.3	10.8	13.9	14.7	15.9	9.0	7.2
Structures	16.8	19.1	14.5	14.1	8.8	8.2	4.8	8.9	12.0	15.0	15.4	15.8	13.2	10.2
Equipment	6.7	14.7	10.3	8.4	4.0	−1.7	−2.0	4.8	10.1	13.3	14.3	16.0	6.8	5.4
Residential structures	3.7	−19.7	−23.7	−12.3	6.8	11.5	8.6	9.0	13.2	15.5	13.6	5.8	−6.6	11.5
Nonfarm	4.8	−21.0	−24.0	−12.5	6.8	11.6	8.6	9.0	13.3	15.7	13.7	5.7	−6.8	11.6
Exports	36.4	19.3	8.1	8.8	6.9	6.0	8.9	9.7	9.4	10.4	10.7	33.4	11.2	9.3
Imports	21.0	12.9	11.4	8.1	8.2	3.5	6.1	7.6	8.0	8.6	11.0	22.2	9.7	7.5
Government purchases	10.1	11.0	9.0	11.6	8.5	8.6	9.0	11.3	9.2	9.0	8.8	9.4	10.2	9.9
Federal	6.8	9.7	5.1	12.2	6.3	6.9	8.4	14.9	8.0	7.8	7.7	3.9	8.5	9.8
National defense	−.5	9.7	2.6	7.8	2.6	5.1	5.0	9.9	4.8	4.8	4.7	1.1	5.1	6.2
Other	24.4	9.7	10.6	21.8	14.2	10.5	15.4	24.7	14.0	13.5	13.0	10.5	15.9	17.4
State and local	12.3	11.9	11.6	11.2	9.8	9.6	9.4	9.2	10.0	9.7	9.5	13.3	11.3	9.9

TABLE 1.2A.—OTHER MAJOR ECONOMIC INDICATORS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	6.9	6.2	2.7	1.1	6.6	6.7	4.3	4.6	4.6	4.4	4.2	5.2	4.7	4.5
Money supply—TD+CD (M1½)	7.8	7.4	3.9	5.8	10.5	9.3	6.7	9.4	9.0	8.9	8.7	6.8	8.3	9.3
Money supply with time dep. (M2)	15.0	10.4	4.6	4.6	7.2	8.5	6.8	9.3	8.3	8.1	8.1	11.1	7.0	8.7
Index of industrial production:														
Total	5.4	6.0	5.5	—.2	—2.4	—1.4	—.2	3.2	6.5	7.6	7.5	9.9	1.4	3.1
Manufacturing	7.0	4.6	4.6	—.5	—2.9	—1.8	—.7	3.0	6.8	8.1	7.9	10.6	.9	3.0
Steel	3.8	—1.3	.2	—1.3	—16.4	—8.6	—9.5	—1.4	18.0	13.6	10.3	11.5	—4.9	1.3
GNP in 1958 dollars	2.4	4.0	2.7	—.1	—.5	.4	1.0	3.1	5.0	5.6	5.7	6.1	1.2	3.0
Implicit GNP deflator	7.1	5.3	4.1	4.7	4.2	4.0	4.1	4.1	3.1	3.5	3.3	4.9	4.7	3.8
Consumer price index	8.8	7.5	3.7	1.4	2.7	3.4	4.0	2.6	2.3	2.8	3.3	5.6	3.7	3.0
Wholesale price index (indus. comm.)	14.5	6.3	5.3	2.8	2.9	2.6	3.4	3.0	3.1	2.9	2.9	6.9	4.5	3.0
Disposable personal income	8.5	6.3	8.2	2.4	5.6	3.3	4.6	8.5	6.5	6.8	7.0	10.0	5.3	6.4
Corporate profits before tax	34.8	—13.0	—3.8	—26.9	—14.4	—.7	7.6	9.6	18.6	19.0	17.9	27.6	—9.2	10.2
Corporate profits after tax	33.4	—13.0	—4.3	—55.0	—16.2	—1.1	7.8	10.2	20.2	20.3	19.1	26.0	—16.5	10.8

TABLE 1.2B.—OTHER MAJOR ECONOMIC INDICATORS (ACTUAL CHANGE)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Treasury bill rate, 91-day	0.97	1.88	0.65	—1.41	—1.68	0.02	—0.48	—0.06	—0.14	—0.11	—0.13	3.40	—1.11	—1.02
Prime commercial paper rate	1.18	2.49	.50	—1.54	—1.91	—.23	—.35	—.20	—.12	—.13	—.13	3.85	—1.27	—1.24
Corporate bond rate, new issues	.03	.51	.17	—.81	—.66	.22	—.33	.04	.05	.06	.07	.41	—.89	—.17
Index of capacity utilization	.47	.50	—.30	—1.33	—1.51	—1.15	—.92	—.14	.48	.69	.66	4.81	—3.13	—.91
New passenger car sales, SAAR	—.33	—.49	—.31	—.51	—.05	—.11	—.19	.16	.36	.36	.10	.98	—1.21	.43
Total private housing starts	—.19	—.18	—.20	.02	.05	.03	.03	.06	.05	.05	.04	—.24	—.20	.18
Unemployment rate	—.1	—.2	.0	.2	.3	.3	.2	.0	—.1	—.2	—.2	—.7	.5	.2
Personal savings rate	0	—.2	.3	—.0	.2	—.2	—.0	.6	.1	0	.1	—.3	.2	.6
Federal Government surplus or def	5.0	4.3	.0	9.1	—5.6	3.0	—1.3	—6.3	1.5	2.8	2.0	16.8	9.4	—4.2

THIS FORECAST WAS PREPARED BY CHASE ECONOMETRICS, INC., ON SEPT. 24, 1973, AND IS THE 3D FORECAST IN A SET OF 4 FORECASTS; THE PRINCIPAL ASSUMPTIONS FOR THIS RUN AR
2D ALTERNATIVE—10-PERCENT TAX SURCHARGE FOR 1974, BUT REFUND IN 1975

TABLE 1.1.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS

Variable name	1973. 2	1973. 3	1973. 4	1974. 1	1974. 2	1974. 3	1974. 4	1975. 1	1975. 2	1975. 3	1975. 4	1973	1974	1975
Gross national product	1, 272. 0	1, 301. 7	1, 324. 2	1, 339. 5	1, 352. 0	1, 366. 9	1, 384. 1	1, 418. 5	1, 463. 7	1, 512. 8	1, 560. 4	1, 285. 1	1, 360. 6	1, 488. 8
Consumption expenditures	795. 6	809. 7	823. 4	827. 9	837. 0	845. 4	854. 9	879. 2	902. 7	926. 8	950. 9	802. 1	841. 3	914. 9
Durable goods	132. 8	133. 3	133. 7	133. 7	134. 6	134. 7	134. 9	141. 5	147. 2	152. 5	156. 7	133. 0	134. 5	149. 5
Nondurable goods	330. 3	337. 6	344. 7	344. 1	347. 2	350. 6	354. 7	364. 8	375. 3	385. 8	396. 3	333. 7	349. 2	380. 5
Services	332. 6	338. 8	345. 0	350. 0	355. 2	360. 1	365. 3	373. 0	380. 2	388. 5	398. 0	335. 3	357. 7	384. 9
Gross private investment	198. 2	204. 6	207. 8	209. 9	207. 2	206. 6	206. 5	206. 9	220. 7	238. 8	256. 5	201. 2	207. 6	230. 7
Fixed investment	193. 7	196. 2	197. 0	199. 1	202. 0	204. 3	205. 6	209. 9	218. 2	229. 1	240. 5	194. 2	202. 7	224. 4
Nonresidential	134. 1	139. 5	143. 6	147. 4	149. 5	150. 2	150. 4	153. 0	158. 6	167. 0	176. 6	137. 0	149. 4	163. 8
Structures	47. 2	49. 5	51. 3	53. 1	54. 2	55. 3	56. 0	57. 3	59. 4	62. 1	65. 3	48. 3	54. 7	61. 0
Equipment	86. 9	90. 1	92. 4	94. 3	95. 3	94. 8	94. 4	95. 6	99. 2	104. 9	111. 3	88. 7	94. 7	102. 7
Residential structures	59. 6	56. 7	53. 3	51. 7	52. 5	54. 1	55. 2	56. 9	59. 6	62. 1	63. 9	57. 1	53. 4	60. 6
Nonfarm	59. 1	56. 0	52. 6	51. 0	51. 9	53. 4	54. 5	56. 2	58. 9	61. 4	63. 2	56. 5	52. 7	59. 9
Change in inventories	4. 5	8. 4	10. 8	10. 9	5. 2	2. 4	. 8	−3. 0	2. 6	9. 6	16. 0	7. 1	4. 8	6. 3
Nonfarm	4. 4	8. 4	10. 8	10. 9	5. 2	2. 4	. 8	−3. 0	2. 6	9. 6	16. 0	7. 0	4. 8	6. 3
Net exports of goods and services	2. 8	4. 5	3. 7	4. 0	3. 7	4. 4	5. 3	5. 8	6. 2	5. 7	4. 0	2. 6	4. 4	5. 4
Exports	97. 2	101. 9	104. 0	106. 3	108. 1	109. 7	112. 1	114. 8	117. 6	120. 6	123. 8	98. 0	109. 0	119. 2
Imports	94. 4	97. 4	100. 2	102. 2	104. 3	105. 3	106. 9	109. 0	111. 3	114. 9	119. 8	95. 4	104. 7	113. 8
Government purchases	275. 3	282. 9	289. 3	297. 7	304. 0	310. 5	317. 5	326. 5	334. 0	341. 5	349. 0	279. 0	307. 4	337. 7
Federal	107. 3	109. 9	111. 3	114. 7	116. 5	118. 5	121. 0	125. 5	128. 0	130. 5	133. 0	108. 5	117. 7	129. 2
National defense	74. 2	76. 0	76. 5	78. 0	78. 5	79. 5	80. 5	82. 5	83. 5	84. 5	84. 5	75. 2	79. 1	84. 0
Other	33. 1	33. 9	34. 8	36. 7	38. 0	39. 0	40. 5	43. 0	44. 5	46. 0	47. 5	33. 2	38. 5	45. 2
State and local	168. 0	173. 0	178. 0	183. 0	187. 5	192. 0	196. 5	201. 0	206. 0	211. 0	216. 0	170. 5	189. 7	208. 5

TABLE 1.2—OTHER MAJOR ECONOMIC INDICATORS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	260.7	264.7	266.5	267.2	271.6	276.1	279.1	283.4	287.6	291.7	295.4	262.0	273.5	289.5
Money supply+TD−CD (M1½)	540.7	550.7	556.1	564.1	578.9	592.4	602.3	616.7	630.1	643.7	657.7	544.5	584.4	637.1
Money supply with time dep. (M2)	601.5	617.2	624.3	631.5	642.9	656.6	667.8	683.8	698.0	712.1	727.0	605.7	649.7	705.2
Index of industrial production:														
Total	124.8	126.7	128.4	128.3	127.5	127.1	127.0	129.6	133.9	133.7	143.0	125.7	127.5	136.3
Manufacturing	124.6	126.1	127.5	127.4	126.4	125.9	125.7	128.0	132.5	137.5	142.0	125.2	126.3	135.0
Steel	119.8	119.4	119.5	119.1	114.2	111.8	109.1	105.1	119.1	125.8	132.5	119.4	113.6	120.9
GNP in 1958 dollars	834.3	842.6	848.3	848.1	847.2	848.0	850.0	862.9	883.9	905.8	926.1	838.6	848.3	891.7
Implicit GNP deflator	152.5	154.5	156.1	157.9	159.6	161.2	162.8	164.4	165.6	167.0	168.5	153.2	160.4	166.4
Consumer price index	131.5	134.0	135.2	135.7	136.6	137.8	139.1	140.0	140.8	141.9	143.4	132.4	137.3	141.5
Wholesale price index (indus. comm.)	125.7	127.7	129.4	130.3	131.2	132.1	133.2	134.3	135.4	136.6	138.2	126.0	131.7	136.1
Disposable personal income	869.7	883.4	901.5	906.8	919.5	927.0	937.7	990.1	1,011.8	1,035.8	1,060.8	876.5	922.8	1,024.6
Corporation profits before tax	130.1	125.9	124.7	116.3	112.1	111.9	114.0	120.8	131.0	141.3	152.8	125.1	113.6	136.5
Corporation profits after tax	72.6	70.2	69.5	59.9	57.5	57.4	58.5	71.4	77.9	84.5	91.8	69.8	58.3	81.4
Treasury bill rate, 91-day	6.61	8.49	9.14	7.73	6.05	6.06	5.59	5.85	5.83	5.86	5.90	7.47	6.36	5.86
Prime commercial paper rate	7.47	9.96	10.45	8.91	7.00	6.77	6.42	6.47	6.53	6.54	6.53	8.54	7.27	6.53
Corporate bond rate, new issues	7.71	8.21	8.38	7.57	6.91	7.13	6.81	6.99	7.09	7.21	7.37	8.00	7.11	7.17
Index of capacity utilization	90.55	91.05	90.75	89.42	87.91	86.76	85.83	86.50	88.20	90.08	91.55	90.61	87.48	89.08
New passenger car sales, SAAR	12.17	11.67	11.36	10.85	10.80	10.69	10.51	11.02	11.70	12.32	12.53	11.93	10.71	11.91
Total private housing starts	2.21	2.03	1.84	1.86	1.91	1.94	1.97	2.06	2.10	2.13	2.12	2.12	1.92	2.10
Unemployment rate	4.9	4.8	4.8	4.9	5.3	5.6	5.8	5.7	5.3	4.8	4.5	4.9	5.4	5.1
Personal savings rate	5.9	5.7	6.0	6.0	6.2	6.0	6.0	8.5	8.0	7.8	7.6	5.9	6.1	8.0
Federal Government surplus or def	0	4.3	4.3	13.4	7.7	10.7	9.4	−32.5	−29.3	−24.9	−20.9	.9	10.3	−26.9

TABLE 1.1A.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	9.5	9.4	6.9	4.6	3.7	4.4	5.0	9.9	12.7	13.4	12.6	11.2	5.9	9.4
Consumption expenditures	8.3	7.1	6.7	2.2	4.4	4.0	4.5	11.4	10.7	10.7	10.4	10.4	4.9	8.8
Durable goods	1.9	1.5	1.3	.0	2.5	.3	.7	19.5	16.3	14.3	11.0	13.3	1.1	11.2
Nondurable goods	10.1	8.9	8.4	−.6	3.6	3.9	4.7	11.4	11.5	11.1	10.9	11.3	4.6	9.0
Services	9.4	7.5	7.3	5.8	6.0	5.5	5.7	8.4	7.7	8.8	9.7	8.5	6.7	7.6
Gross private investment	7.8	13.0	6.2	4.1	−5.1	−1.2	−.3	.9	26.7	32.7	29.7	12.9	3.1	11.2
Fixed investment	8.2	5.2	1.5	4.3	6.0	4.4	2.7	8.3	15.8	20.1	19.9	12.7	4.4	10.7
Nonresidential	10.2	16.3	11.8	10.4	5.7	1.9	.6	6.8	14.7	21.2	23.1	15.9	9.0	9.7
Structures	16.8	19.1	14.5	14.1	8.8	8.2	4.8	9.5	14.1	18.7	20.7	15.8	13.2	11.7
Equipment	6.7	14.7	10.3	8.4	4.0	−1.7	−2.0	5.2	15.1	22.8	24.5	16.0	6.8	8.5
Residential structures	3.7	−19.7	−23.7	−12.3	6.8	11.5	8.6	12.4	18.8	16.9	11.5	5.8	−6.6	13.6
Nonfarm	4.8	−21.0	−24.0	−12.5	6.8	11.6	8.6	12.5	18.9	17.0	11.5	5.7	−6.8	13.7
Exports	36.4	19.3	8.1	8.8	6.9	6.0	8.9	9.7	9.4	10.4	10.8	33.4	11.2	9.3
Imports	21.0	12.9	11.4	8.1	8.2	3.5	6.1	8.1	8.4	12.7	17.4	22.2	9.7	8.7
Government purchases	10.1	11.0	9.0	11.6	8.5	8.6	9.0	11.3	9.2	9.0	8.8	9.4	10.2	9.9
Federal	6.8	9.7	5.1	12.2	6.3	6.9	8.4	14.9	8.0	7.8	7.7	3.9	8.5	9.8
National defense	−.5	9.7	2.6	7.8	2.6	5.1	5.0	9.9	4.8	4.8	4.7	1.1	5.1	6.2
Other	24.4	9.7	10.6	21.8	14.2	10.5	15.4	24.7	14.0	13.5	13.0	10.5	15.9	17.4
State and local	12.3	11.9	11.6	11.2	9.8	9.6	9.4	9.2	10.0	9.7	9.5	13.3	11.3	9.9

TABLE 1.2A.—OTHER MAJOR ECONOMIC INDICATORS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	6.9	6.2	2.7	1.1	6.6	6.7	4.3	6.2	5.9	5.6	5.2	5.2	4.7	5.8
Money supply +TD −CD (M1½)	7.8	7.4	3.9	5.8	10.5	9.3	6.7	9.5	8.7	8.7	8.7	6.8	8.3	9.2
Money supply with time dep. (M2)	15.0	10.4	4.6	4.6	7.2	8.5	6.8	9.6	8.3	8.1	8.3	11.1	7.0	8.9
Index of industrial production:														
Total	5.4	6.0	5.5	−.2	−2.4	−1.4	−.2	8.1	13.3	14.3	12.4	9.9	1.4	6.9
Manufacturing	7.0	4.6	4.6	−.5	−2.9	−1.8	−.7	7.6	13.9	15.2	13.2	10.6	.9	6.9
Steel	3.8	−1.3	.2	−1.3	−16.4	−8.6	−9.5	−11.1	49.2	22.4	21.4	11.5	−4.9	6.4
GNP in 1958 dollars	2.4	4.0	2.7	−.1	−.5	.4	1.0	6.1	9.7	9.9	9.0	6.1	1.2	5.5
Implicit GNP deflator	7.1	5.3	4.1	4.7	4.2	4.0	4.1	3.8	2.9	3.4	3.5	4.9	4.7	3.7
Consumer price index	8.8	7.5	3.7	1.4	2.7	3.4	4.0	2.4	2.4	3.2	4.0	5.6	3.7	3.1
Wholesale price index (indus. comm.)	14.5	6.3	5.3	2.8	2.9	2.6	3.4	3.3	3.5	3.5	4.5	6.9	4.5	3.4
Disposable personal income	8.5	6.3	8.2	2.4	5.6	3.3	4.6	22.3	8.8	9.5	9.7	10.0	5.3	11.0
Corporate profits before tax	34.8	−13.0	−3.8	−26.9	−14.4	−.7	7.6	23.6	33.8	31.5	32.7	27.6	−9.2	20.1
Corporate profits after tax	33.4	−13.0	−4.3	−55.0	−16.2	−1.1	7.8	88.7	36.4	33.4	34.9	26.0	−16.5	39.6

TABLE 1.2B.—OTHER MAJOR ECONOMIC INDICATORS (ACTUAL CHANGE)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Treasury bill rate, 91-day	0.97	1.88	0.65	−1.41	−1.68	0.02	−0.48	0.28	−0.03	0.03	0.04	3.40	−1.11	−0.49
Prime commercial paper rate	1.18	2.49	.50	−1.54	−1.91	−.23	−.35	.05	.07	.01	.04	3.85	−1.27	−.74
Corporate bond rate, new issues	.03	.51	.17	−.81	−.66	.22	−.33	.19	.10	.13	.16	.41	−.89	.06
Index of capacity utilization	.47	.50	−.30	−1.33	−1.51	−1.15	−.92	.66	1.71	1.88	1.47	4.81	−3.13	1.60
New passenger car sales, SAAR	−.33	−.49	−.31	−.51	−.05	−.11	−.19	.51	.68	.62	.26	.98	−1.21	1.19
Total private housing starts	−.19	−.18	−.20	.02	.05	.03	.03	.09	.04	.02	−0	−.24	−.20	.18
Unemployment rate	−.1	−.2	0	.2	.3	.3	.2	−.1	−.4	−.4	−.3	−.7	.5	−.3
Personal savings rate	0	−.2	.3	0	.2	−.2	0	2.4	−.4	−.3	−.2	−.3	.2	1.9
Federal government surplus or def	5.0	4.3	0	9.1	−5.6	3.0	−1.3	−42.0	3.2	4.4	4.0	16.8	9.4	−37.2

THIS FORECAST WAS PREPARED BY CHASE ECONOMETRICS, INC., ON SEPT. 24, 1973, AND IS THE 4TH FORECAST IN A SET OF 4 FORECASTS; THE PRINCIAPAL ASSUMPTIONS FOR THIS RUN ARE 3D ALTERNATIVE—NIXON IMPROVES THE HOUSING MARKET

TABLE 1.1.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS

Variabel name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Gross national product	1,272.0	1,301.7	1,326.0	1,348.0	1,369.0	1,392.3	1,416.7	1,446.0	1,476.1	1,509.1	1,542.2	1,285.6	1,381.5	1,493.4
Consumption expenditures	795.6	809.7	823.4	833.5	847.7	861.0	875.1	892.0	908.3	925.2	942.2	802.1	854.3	916.9
Durable goods	132.8	133.3	133.7	135.5	137.7	139.1	140.3	144.0	147.3	150.1	152.2	133.0	138.1	148.4
Nondurable goods	330.3	337.6	344.7	346.7	352.0	357.4	363.2	369.4	376.3	383.3	390.7	333.7	354.8	379.9
Services	332.6	338.8	345.0	351.3	358.0	364.6	371.6	378.5	384.7	391.8	399.3	335.4	361.4	388.6
Gross private investment	198.2	204.6	209.5	212.9	213.7	217.0	220.4	224.1	230.8	239.6	248.7	201.7	216.0	235.8
Fixed investment	193.7	196.2	198.7	203.2	207.7	211.7	214.9	219.0	224.1	231.0	238.2	194.6	209.4	228.1
Nonresidential	134.1	139.5	143.6	147.5	150.4	152.7	154.6	158.6	163.9	169.8	175.9	137.0	151.3	167.0
Structures	47.2	49.5	51.3	53.1	54.5	55.9	56.9	58.6	60.6	63.1	65.6	48.3	55.1	62.0
Equipment	86.9	90.1	92.4	94.4	96.0	96.8	97.7	100.0	103.2	106.8	110.2	88.7	96.2	105.1
Residential structures	59.6	56.7	55.0	55.7	57.3	59.1	60.3	60.4	60.3	61.2	62.3	57.6	58.1	61.1
Nonfarm	59.1	56.0	54.4	55.0	56.6	58.4	59.6	59.7	59.5	60.4	61.6	57.0	57.4	60.3
Change in inventories	4.5	8.4	10.8	9.7	6.0	5.3	5.5	5.1	6.7	8.6	10.4	7.1	6.6	7.7
Nonfarm	4.4	8.4	10.8	9.7	6.0	5.3	5.5	5.1	6.7	8.6	10.4	7.0	6.6	7.7
Net exports of goods and services	2.8	4.5	3.7	3.9	3.6	3.7	3.7	3.4	2.9	2.8	2.4	2.6	3.7	2.9
Exports	97.2	101.9	104.0	106.3	108.1	109.7	112.1	114.9	117.6	120.6	123.9	98.0	109.0	119.2
Imports	94.4	97.4	100.2	102.3	104.5	106.0	108.4	111.5	114.7	117.8	121.4	95.4	105.3	116.3
Government purchases	275.3	282.9	289.3	297.7	304.0	310.5	317.5	326.5	334.0	341.5	349.0	279.0	307.4	337.7
Federal	107.3	109.9	111.3	114.7	116.5	118.5	121.0	125.5	128.0	130.5	133.0	108.5	117.7	129.2
National defense	74.2	76.0	76.5	78.0	78.5	79.5	80.5	82.5	83.5	84.5	85.5	75.2	79.1	84.0
Other	33.1	33.9	34.8	36.7	38.0	39.0	40.5	43.0	44.5	46.0	47.5	33.2	38.5	45.2
State and local	168.0	173.0	178.0	183.0	187.5	192.0	196.5	201.0	206.0	211.0	216.0	170.5	189.7	208.5

TABLE 1.2.—OTHER MAJOR ECONOMIC INDICATORS

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Money supply, no time dep. (M1)	260.7	264.7	266.5	267.7	272.2	277.2	280.9	284.5	288.0	291.3	294.5	262.0	274.5	289.6
Money supply +TD −CD (M1½)	540.7	550.7	556.1	564.2	578.5	592.0	602.2	616.2	630.1	644.3	658.9	544.5	584.2	637.4
Money supply with time dep. (M2)	601.5	617.2	624.4	631.8	643.1	657.1	668.8	684.5	699.1	713.8	729.2	605.7	650.2	706.7
Index of industrial production:														
Total	124.8	126.7	128.4	129.1	129.5	130.2	131.1	132.7	134.9	137.2	139.2	125.7	130.0	136.0
Manufacturing	124.6	126.1	127.5	128.1	128.4	129.1	129.9	131.4	133.8	136.1	138.2	125.2	128.9	134.9
Steel	119.8	119.4	119.5	118.5	116.0	116.1	115.4	116.9	120.4	124.3	125.9	119.4	116.5	121.9
GNP in 1958 dollars	834.3	842.6	849.4	853.5	858.0	863.8	870.0	878.7	889.4	900.5	911.4	838.9	861.3	895.0
Implicit GNP deflator	152.5	154.5	156.1	157.9	159.6	161.2	162.8	164.6	166.0	167.6	169.2	153.2	160.4	166.8
Consumer Price Index	131.5	134.0	135.2	135.7	136.6	137.8	139.3	140.4	141.5	142.8	144.3	132.4	137.4	142.2
Wholesale price index (indus. comm.)	125.7	127.7	129.4	130.3	131.4	132.3	133.5	134.5	135.6	136.6	137.8	126.0	131.9	136.1
Disposable personal income	869.7	883.4	901.7	922.5	938.4	949.5	963.7	987.1	1,005.7	1,023.8	1,043.0	876.6	943.5	1,014.9
Corporation profits before tax	130.1	125.9	124.9	118.6	117.1	118.6	122.5	126.0	131.3	136.4	141.9	125.1	119.2	133.9
Corporation profits after tax	72.6	70.2	69.6	65.8	64.8	65.7	68.0	70.0	73.1	76.1	79.4	69.9	66.1	74.6
Treasury bill rate, 91-day	6.61	8.49	9.14	7.90	6.23	6.34	5.99	6.01	5.94	5.87	5.80	7.47	6.61	5.91
Prime commercial paper rate	7.47	9.96	10.45	9.04	7.19	7.03	6.81	6.71	6.66	6.59	6.51	8.54	7.52	6.62
Corporate bond rate, new issues	7.71	8.21	8.38	7.65	6.99	7.25	6.99	7.07	7.17	7.27	7.39	8.00	7.22	7.23
Index of capacity utilization	90.55	91.05	90.76	89.85	88.98	88.48	88.01	88.12	88.62	88.98	89.24	90.61	88.83	88.74
New passenger car sales, SAAR	12.17	11.67	11.36	11.03	11.14	11.18	11.09	11.29	11.62	11.89	11.89	11.93	11.11	11.67
Total private housing starts	2.21	2.03	2.04	2.06	2.11	2.13	2.15	2.08	2.05	2.06	2.06	2.17	2.11	2.06
Unemployment rate	4.9	4.8	4.8	4.8	5.0	5.2	5.3	5.3	5.2	5.0	5.0	4.9	5.1	5.1
Personal savings rate	5.9	5.7	6.0	7.0	7.0	6.6	6.4	6.9	6.9	6.8	6.9	5.9	6.7	6.9
Federal Government surplus or def	0	4.3	4.4	−3.4	−7.4	−3.3	−3.6	−9.5	−8.1	−6.1	−4.6	.9	−4.4	−7.1

TABLE 1.1A.—GROSS NATIONAL PRODUCT IN CURRENT DOLLARS (PERCENT CHANGE, ANNUAL RATES)

Gross national product	9.5	9.4	7.4	6.7	6.2	6.8	7.0	8.3	8.3	8.9	8.8	11.3	7.5	8.1
Consumption expenditures	8.3	7.1	6.8	4.9	6.8	6.3	6.6	7.7	7.3	7.4	7.3	10.4	6.5	7.3
Durable goods	1.9	1.5	1.4	5.2	6.5	4.1	3.6	10.7	9.2	7.5	5.5	13.3	3.9	7.5
Nondurable goods	10.1	8.9	8.4	2.3	6.1	6.1	6.6	6.8	7.4	7.5	7.7	11.3	6.3	7.1
Services	9.4	7.5	7.3	7.4	7.6	7.4	7.7	7.5	6.6	7.3	7.7	8.5	7.8	7.5
Gross private investment	7.8	13.0	9.6	6.5	1.6	6.1	6.3	6.7	12.0	15.3	15.1	13.1	7.1	9.2
Fixed investment	8.2	5.2	5.1	9.0	9.0	7.6	6.1	7.6	9.3	12.3	12.5	12.9	7.6	8.9
Nonresidential	10.2	16.3	11.8	10.7	7.9	5.9	5.2	10.2	13.3	14.6	14.2	15.9	10.4	10.4
Structures	16.8	19.1	14.5	14.4	10.2	10.5	7.4	11.4	14.0	16.2	16.3	15.8	14.1	12.5
Equipment	6.7	14.7	10.3	8.7	6.7	3.3	3.9	9.5	12.8	13.6	13.0	16.0	8.5	9.2
Residential structures	3.7	−19.7	−11.4	4.5	11.7	12.2	8.4	.9	−1.1	6.0	7.7	6.6	.9	5.1
Nonfarm	4.8	−21.0	−11.6	4.5	11.8	12.3	8.5	.8	−1.2	6.0	7.8	6.5	.7	5.1
Exports	36.4	19.3	8.1	8.8	6.9	6.0	8.9	9.7	9.5	10.3	10.7	33.4	11.2	9.3
Imports	21.0	12.9	11.4	8.4	8.5	5.6	9.3	11.3	11.4	11.1	12.1	22.2	10.3	10.5
Government purchases	10.1	11.0	9.0	11.6	8.5	8.6	9.0	11.3	9.2	9.0	8.8	9.4	10.2	9.9
Federal	6.8	9.7	5.1	12.2	6.3	6.9	8.4	14.9	8.0	7.8	7.7	3.9	8.5	9.9
National defense	−.5	9.7	2.6	.78	2.6	5.1	5.0	9.9	4.8	4.8	4.7	1.1	5.1	6.2
Other	24.5	9.7	10.6	21.8	14.2	10.5	15.4	24.7	14.0	13.5	13.0	10.5	15.9	17.4
State and local	12.3	11.9	11.6	11.2	9.8	9.6	9.4	9.2	10.0	9.7	9.5	13.3	11.3	9.9

TABLE 1.2A.—OTHER MAJOR ECONOMIC INDICATORS (PERCENT CHANGE, ANNUAL RATES)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1975	1975
Money supply, no time dep. (M1)	6.9	6.2	2.7	1.8	6.7	7.4	5.4	5.1	4.9	4.6	4.4	5.2	5.4	4.8
Money supply+TD—CD (M1½)	7.8	7.4	3.9	5.8	10.2	9.3	6.8	9.3	9.0	9.0	9.1	6.8	8.3	9.4
Money supply with time dep. (M2)	15.0	10.4	4.6	4.8	7.1	8.7	7.1	9.4	8.5	8.4	8.6	11.1	7.1	9.0
ndex of industrial production:														
Total	5.4	6.0	5.5	2.2	1.2	2.3	2.7	4.8	6.7	6.6	5.8	9.9	3.4	4.6
Manufacturing	7.0	4.6	4.6	1.8	.9	2.1	2.5	4.8	7.0	7.1	6.1	10.6	2.9	4.7
Steel	3.8	−1.3	.2	−3.2	−8.7	.3	−2.4	5.2	12.1	12.9	5.3	11.5	−2.4	4.6
GNP in 1958 dollars	2.4	4.0	3.2	2.0	2.1	2.7	2.9	4.0	4.9	5.0	4.8	6.1	2.7	3.9
Implicit GNP deflator	7.1	5.3	4.2	4.7	4.1	4.0	4.1	4.2	3.4	3.9	3.9	4.9	4.7	4.0
Consumer Price Index	8.8	7.5	3.7	1.3	2.7	3.5	4.3	3.1	3.0	3.6	4.2	5.6	3.8	3.5
Wholesale price index (indus. comm.)	14.5	6.3	5.3	3.0	3.2	2.7	3.6	3.2	3.3	3.0	3.3	6.9	4.6	3.2
Disposable personal income	8.5	6.3	8.3	9.2	6.9	4.7	6.0	9.7	7.5	7.2	7.5	10.0	7.6	7.6
Corporation profits before tax	34.8	−13.0	−3.1	−20.0	−5.2	5.4	13.0	11.5	16.7	15.6	16.2	27.7	−4.7	12.3
Corporation profits after tax	33.4	−13.0	−3.6	−22.0	−6.1	5.6	13.8	12.1	17.6	16.6	17.1	26.1	−5.5	13.0

TABLE 1.2B.—OTHER MAJOR ECONOMIC INDICATORS (ACTUAL CHANGE)

Variable name	1973.2	1973.3	1973.4	1974.1	1974.2	1974.3	1974.4	1975.1	1975.2	1975.3	1975.4	1973	1974	1975
Treasury bill rate, 91-day	0.97	1.88	0.65	−1.24	−1.67	0.11	−0.34	0.02	−0.08	−0.06	−0.07	3.40	−0.86	−0.71
Prime commercial paper rate	1.18	2.49	.50	−1.41	−1.85	−.16	−.22	−.09	−.05	−.07	−.07	3.85	−1.02	−.90
Corporate bond rate, new issues	.03	.51	.17	−.74	−.65	.26	−.26	.08	.09	.10	.11	.41	−.77	.01
Index of capacity utilization	.47	.50	−.30	−.91	−.87	−.50	−.47	.12	.50	.36	.26	4.81	−1.78	−.09
New passenger car sales, SAAR	−.33	−.49	−.31	−.33	.11	.04	−.09	.19	.33	.27	0	.98	−.81	.56
Total private housing starts	−.19	−.18	0	.02	.05	.02	.02	−.07	−.04	.01	.01	−.19	−.06	−.05
Unemployment rate	−.1	−.2	0	.1	.2	.2	.1	0	−.1	−.1	−.1	−.7	.2	0
Personal savings rate	0	−.2	.3	1.0	0	−.4	−.2	.4	0	−.1	0	−.3	.9	.1
Federal Government surplus or def	5.0	4.3	.1	−7.8	−4.0	4.1	−.3	−5.9	1.3	2.1	1.5	16.8	−5.4	−2.6

Senator PROXMIRE. Mr. McCracken, please proceed.

STATEMENT OF PAUL W. McCRACKEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN

Mr. McCRACKEN. Thank you, Mr. Vice Chairman. It is a privilege to be back again in my capacity as, I guess, as an "elder statesman" now.

I would broadly share with Mr. Evans views about the profile of economic development. My comments will not be quite so precise numerically.

What we face as we look ahead is much more one of crosscurrents in the economy rather than any well-defined recession. Indeed, the fear that we might be seeing a recession for 1974 has been dissipating a bit in the last several weeks. In the consumer durables area, however, we do have to expect some weakening.

If we go back to about a year ago, the proportion of people indicating that it was a good time to buy exceeded those who thought it was a bad time to buy by about two to one. Now the proportions are about reversed because of the significant decline in consumer attitudes, consumer sentiment, because of the fact that there had been some anticipatory buying of automobiles this year out of fears, perhaps exaggerated, about the problems of the seatbelt-ignition interlock, and that sort of thing. I would expect myself that we could see a decline in the auto market of close to 1 million cars in 1974. That would still leave a very good year but, of course, a year that would show a decline from the high levels that we have achieved in 1973.

I might add that as one looks at the profile of what has happened to consumer sentiment there are, I think, two characteristics that are worth pointing out, beyond simply the fact that consumer sentiment is now at virtually an all-time low. One of these is that this sentiment seems to be much more centered on general economic conditions than on concern about their own situation, although that is not absent, but the most bearish views that people have are not so much concerned with their own personal situation as to employment conditions or the economy generally.

Another feature that I think is worth pointing out is that confidence for the longer run has been jarred by developments in the last year. These sometimes can turn around fairly rapidly. In other words, people's long-run expectations may be heavily centered on what the short-run situation is. But it is worth keeping in mind that longer-run confidence has been affected, and it would be only reasonable to assume that this is going to have an impact on consumer spending.

In spite of this, and the probability that we may see some weakening in residential construction, as Mr. Evans has indicated, the resistances to a recession remain very strong. The relationship between inventories and sales, for example, is not where this relationship has normally been on the eve of a recession. For manufacturing and trade together it is down about, at about the 1.4 level. It has normally been around the 1.6 zone on the eve of a recession. If we were to have that today with current levels of sales, inventories would have to be about $25 to $30 billion higher than in fact they now are.

The capital goods boom looks solid. If one looks at capital appropriations, the backlog of appropriations, at contracts for commercial industrial building—all of these are running a third higher than a year ago. This ought to presage a very strong increase in these outlays for next year. The 10 or 11 percent which Mr. Evans indicated in his comments seems reasonable.

The third area of support here is that almost certainly for many companies, many industries, any softening in their domestic demand could be offset, at least in part, by their substantially improved competitive position in the foreign market. If one looks at the wholesale price index for, say, Germany and Japan since 1970 denominated in U.S. dollars (that is taking into account that their own price level has risen and that it takes more dollars to buy D-marks and yen) the German wholesale price index has gone up about 45 percent, and the Japanese index, as thus measured, about 50 percent. Our own index would have gone up from 13 to 15 percent in that same period.

So there has been an enormous exchange in our competitive position.

Purchasing power and affluence is there in world markets, and consequently the potential for a significant increase in manufactured exports is quite high, and is undoubtedly limited now by the heavy backlog of domestic orders.

As for the implications of all of this for policy, I would hope that some evidence of an easing of monetary policy does mean that we are getting off the track of a zero rate of growth or even a slightly declining trend in the money supply which prevailed in the third quarter. Possibly it merely means that we are more nearly getting back on about the average for 1973 as a whole, taking into account that the second quarter was a little above the trend as it were, and the third quarter below. But if we are seeing monetary policy get back on the track of a more rapid rate of growth, then this may well turn out to be a rather good performance in monetary policy.

The rule of timing here is that if the change is to be well-timed it has to seem at the time to be a little premature.

As for fiscal policy, once again I have nothing much to add to what Mr. Evans has suggested.

I would oppose a general tax increase even if it could be obtained in the current session of the Congress. The impact of this would be very apt to be hitting the economy by, say, the middle of next year, and I do not see any evidence which would suggest that we want that kind of effect coming into the picture at that time.

I did have in my statement here a few comments about business policy. It is important that American businesses make a great leap forward in terms of their sophistication about doing business in the international economy. During the long period that the dollar was over-valued this heavily took the form of buying businesses, and this was about their only alternative. Now it is possible to compete in the foreign market, and many of our companies need to take a real searching look here at what is needed in order to participate effectively in the foreign markets. Foreign competitors in many cases are way ahead of them in regard to these matters.

I also would not support the elimination of the investment tax credit or giving the President the authority to vary the investment tax credit. I think this is a structural thing. We do have an imbalance at the present time between plant capacity and labor force capacity. I think we have run out of plant capacity while we still have employable labor, and for a variety of reasons we may well in the period ahead have to tilt or adjust the allocation or the division of our output slightly more in favor of capital formation in order to keep plant expansion moving ahead while, at the same time, we take cognizance of our environmental concern.

I think one of the key problems we now face is that at a time of continuing concern about the problem of inflation we face the fact that the distortions that are almost inherent in the wage and price control program are accumulating as the effectiveness of the program seems to be diminishing. My own guess is that the effectiveness of that program has about run its course, and that in regard to one of the decisions which will have to be made next year; namely, what to do with this program, the decision probably should be to terminate it.

Thank you very much.

Senator PROXMIRE. Thank you, Mr. McCracken.

[The prepared statement of Mr. McCracken follows:]

PREPARED STATEMENT OF PAUL W. MCCRACKEN

Mr. Chairman, I welcome this opportunity to appear before the Committee again. As Chairman of the Council of Economic Advisers and as a private citizen, I have been here many times, and I regard hearings by this Committee as an extremely important part of the process by which good economic policy is fostered.

That an almost obsessive pessimism characterizes public sentiment today is evident from readily available empirical evidence. Perhaps the most obvious and most important thing to say about this low state of confidence is that the deterioration of sentiment generally has been severe. Since the third quarter of 1972, when confidence was at a high level, the University of Michigan Survey Research Center's index of consumer sentiment has declined 24 percent and to a lower level than it reached at any time in 1970.

Moreover, concern seems to be centered more on the general economic situation than on personal financial prospects. Again the Survey Research Center's data are illuminating. While consumers' expectations about their own prospects have deteriorated, those expecting an improvement in their own situation still outnumbered those fearing a deterioration by almost two to one in the second quarter. By contrast those expecting bad times for business conditions during the next 12 months outnumber those expecting good times by 9 percentage points in the second quarter, compared with a net positive score of 39 percentage points in the third quarter last year. This is confirmed in the weekly Sindlinger data also. Questions about current and expected income have elicited far less negative responses than questions about employment prospects or the business situation generally.

PATTERN OF CONSUMER SENTIMENT

[In percent]

Item	1972 (3d quarter)	1973 (2d quarter)
Expected change in financial situation:		
Better off	33	30
Worse off	7	18
Net	26	12
Business conditions expected during next 12 months:		
Good times	54	35
Bad times	15	44
Net	39	−9

Source: Survey Research Center, Institute for Social Research, The University of Michigan, report of Sept. 18, 1973.

Finally, confidence in the longer run has been adversely affected. By the second quarter of this year the proportion of households expecting bad times for 5 years ahead was more than double those expecting good times. This is a somewhat more pessimistic five-year view of business conditions than existed in the 1970 recession.

BUSINESS CONDITIONS EXPECTED FOR NEXT FIVE YEARS

[In percent]

Year and quarter	Good times	Bad times	Net
1969: 1	37	23	14
1970: 2	22	44	−22
1972: 3	32	26	6
4	31	31	
1973: 1	19	44	−25
2	20	46	−26

Source: Survey Research Center, The University of Michigan.

There are two questions to ask about this large swing in sentiment. One has to do with the impact of the change of business conditions. And the second has to do with whether this sour, sullen attitude about our prospects is justified. In my judgment it is vastly overdone, though the evidence seems persuasive that while it persists it will have some adverse effect on consumer demand.

Obviously the economy has had rough going during this year. The first point to make here is that few are in a position to point the finger for not having foreseen the price explosion. Virtually all forecasters, whether using IBM's best or country doctor judgment, projected the 1973 price increase at about 3½ percent. And the range of 3–4 percent would probably bracket well over 90 percent of all the price forecasts for this year made during the latter part of 1972.

The second point to bear in mind is that some of the mystery about this 1973 price explosion begins to fade as we get a retrospective view. The largest and most obvious source of the inflection was the explosion in food prices. Because that has been much discussed, and is a particularized problem, I do not propose to discuss it further here. Three general forces exerted a synergetic squeeze play on the economy. The most important factor is that economists generally overestimated the capacity of the economy to produce. The source of this in turn was probably a monistic tendency to assume that the economy had abundant slack so long as unemployment exceeded 4 percent. If we had examined a more sophisticated array of evidence, we would have been alerted that pressures in the economy were already building dangerously.

At just this juncture monetary policy became preoccupied with direct action on prices (i.e., interest rates) and in the process the rate of monetary expansion got out of contol for a period, with the money stock in the second quarter rising at just short of an 11 percent annual rate. And this was at a time of highly expansive fiscal policies, partly reflecting the March-April unwinding of last year's excessive over-withholding.

This was also the time that our external trade was changing in a way destined to exert a significantly expansive general effect on the economy. Since foreign trade has for us usually been of de minimus proportions, this was an expansive thrust that came up on our blind side. This time it was not a pretty cash fund matter even for the large, diversified, and relatively self-sufficient U.S. economy. The vigorously expanding world economy and the adjustments in our own exchange rates did produce a turn about in our trade position large enough to play a significant general role during the last year. Indeed, for the year ending with the second quarter the domestic demand for output in real terms rose 5.1 percent, but the demand for domestic output (because of the improvement in exports relative to imports) rose 6.1 percent. For an economy already stretched tightly an additional one percent point of expansion could have been expected to produce a highly leveraged effect on the price level, and clearly it did.

As we look ahead into 1974, the prospect is more one of cross currents than of a well-defined or consistent path. There are, of course, some clear sources of potential weakness. Housing starts have already declined 20 percent. The share of the national income going to corporate profits, already well below the 12.8 percent average for 1963–65, is apt to decline further in 1974. It is only reasonable to expect substantial declines in consumer outlays on durable goods. A year ago surveys indicated that 46 percent of all households considered it a good time to buy and only 25 percent a bad time. Now the figures come close to being reversed. Sales of domestically-produced automobiles in 1974 can be expected to decline as much as 1 million units—reflecting large anticipatory buying in 1973, bearish consumer sentiment, and the industry's inability to change the production mix to small cars as rapidly as demand has changed. Since the proportion of their incomes that consumers spend has in recent quarters been about in line with historical experience, and sentiment has been weak, more cautious consumer spending must now be expected for 1974.

Resistances to a recession, however, remain formidable. We may have seen in recent weeks one of the best-timed turn-abouts away from a restrictive monetary policy in the Federal Reserve's history. The golden rule for a well-timed change, not often observed in real life, is: "The right time to change will at the time seem premature." If an easing is occurring now, the diffused and visible effects of the change will be showing up in the economy by perhaps mid-year.

Capital outlays again in 1974 will be more limited by the ability of the capital goods industries to deliver than by inadequate demand. Backlogs are high, and the volume of projects being approved is large. Indeed, the problem here is apt to be such large increases in selected areas that the demand for labor wih pertinent skills will far outpace the supply available, and the raw material for tripping off another wage explosion will be created.

An over-looked buffer against recession is, once again, our external trade potential. While Germany and Japan have taken steps recently to curb their domestic booms, world demand should remain strong, and exchange rate adjustments have improved our international competitive position in a quite fundamental way. From 1970 to April 1973 our index of prices for industrial commodities at wholesale rose 13 percent. If we take into account not only the rise in price levels abroad but also the fact that it takes more dollars to buy foreign currencies (particularly D-marks and yen), the dollar-denominated rise in the German price level during this period works out to be 45 percent, and for Japan 48 percent.

There can be little doubt that now there are large unexploited export markets for American companies, and that these would begin to look more attractive for development if the flow of domestic orders should weaken.

Finally, a large shift to inventory liquidation does not seem probable, and it takes hard work to get much of a recession if capital goods and inventories do not slump. Given current sales volumes, inventories would need to be roughly $20 billion above present levels for the inventory-sales ratio to approximate what has prevailed on the eve of downturns in the past. Indeed, one of our problems has arisen from the undue delay of businesses earlier in the current expansion to enlarge stocks to levels more in line with rising sales and sales expectations. The result of this delayed stock-building has been a mad scramble for materials in tight markets.

With these supports, it might still be possible to get a recession, but it would take some doing. What is more likely is a period of sluggish growth, but the U.S. economy in 1974 will employ more people and generate more real purchasing power and output than in 1973.

The most serious problem we face is the possibility that 1974 will be a year of sharply accelerating cost inflation. The slower rate of increase in output itself will have an adverse effect on productivity and therefore labor costs per unit of output. Moreover, the 1973 rise in the consumer price index must be expected at some point to trip off escalating demands for larger wage increases. Moreover, the extremely heavy build-up of demands on the capital goods industries could become troublesome. The figures are impressive. Construction contracts for industrial and commercial buildings, contracts and orders for new plant and equipment, newly approved capital appropriations, and the backlog of capital appropriations—all of these are now roughly one-third above their levels a year ago. The danger is that a frenzied scramble for skilled workers will trip off another wage explosion—beginning with construction workers and spreading across the labor force. If these developments converged in time, we could have a more unpalatable combination of inflation and sluggish economic activity than now seems probable.

What are the implications of this for economic policy? A few words about what might be called business policy may be in order here first. Many businesses in retrospect did themselves a disservice by overreacting to the 1970 recession. Projects were cut out of capital budgets or at least deferred that, if they had kept on schedule, would have put now some much needed new capacity on stream.

Ultra-conservative inventory policies in 1971 and 1972, years in which stocks could have been enlarged prudently, have hampered production in 1973. Businesses should ask themselves if in the capital budgeting frenzy of 1973 they may be including some projects which, from the perspective of 1977, they will wish they had not approved. If so a review of capital budgets now would be good for the businesses themselves, and it would also help to even out the over-all volatility of investment expenditures.

In spite of talk about long range planning, within too many businesses the long-range decisions actually made are those that they feel comfortable with in the short run.

American businesses also need a great leap forward in their sophistication about developing export markets. For some the problem is that they have never thought in terms of the export market. For many backlogs are so choked with domestic orders that they are in no position to go after foreign business. A disinclination to adapt to foreign requirements for product design or marketing and distribution channels is a pervasive problem.

This is the golden opportunity for U.S. businesses to establish a strong position in these markets. Inflation abroad is more virulent than here. Exchange adjustments have radically improved our competitive position in world markets.

As for fiscal policy the path that it is presently on is about right. Firm restraint on the rise in outlays is essential. The Congress could make a major contribution by passing legislation reforming the appropriations process.

Two negative comments on fiscal policy are in order here. The time is past for a general tax increase. This would have been useful a year earlier, but a general tax increase even if passed in this session of the Congress would exert its visible effect on the economy around mid-1974, and the case that it would then be needed or desirable is not persuasive.

Neither should there be legislation giving the President limited authority to vary the investment tax credit. If this were done, it can confidently be predicted that in operation it would be apt to be destabilizing in its effect. Businesses would be watching the same indicators as the President, trying to anticipate his decision, and this would tend to create bulges and air-pockets in orders—precisely what the proposal would be supposed to avoid. This feature of the tax system should be considered to be a long-range policy designed to alter slightly the allocation of our GNP in the direction of more investment. The expansion in plant capacity has already lagged behind the growth in the labor force, leaving some job-seekers stranded, and a significant amount of capital formation now must also go toward curbing pollution rather than expanding capacity in the conventional sense.

While managers of monetary policy have been receiving low marks recently, and monetary policy did somewhat over-fuel the current expansion, we may now be seeing an unusually well-timed change. While precise numerical targets for monetary expansion imply a spurious precision as to what is needed or can be delivered, a target of something like a 5 percent annual rate of growth in the money supply would be consistent with letting the overheated temperature cool, but at the same time minimize the danger of a recession. The managers of monetary policy will get better treatment from historians than from their contemporaries.

The most difficult issue for economic policy today is posed by the controls program. This program has been managed with an admirable blend of firmness and flexibility. Any controls program, however, accumulates a growing array of distortions and imbalances, and these must be weighed against the diminishing effectiveness of the program in countering inflation. We are probably close to the point we have derived about all of the benefit from this effort at price-wage control that it is reasonable to expect. Even the authority to impose another freeze is now counter-productive because it creates a heavy incentive for those wtih some scope for price decisions to keep them at the high end of the spectrum. While there is time for further evidence to accumulate before the decision must be made about extending the enabling leigslation, the longer run vitality of the economy would probably be better served if this legislation were to lapse.

The prognosis for the economy at the moment is better than sentiment about it. We have a better opportunity, if monetary policy has been shifting, of cooling off the economic over-heating and letting adjustments work through the economic system than at any time in recent decades. The dangers are as much that in haste we shall do the wrong things as that we shall fail to do the right things. And that is just as true for business managers as for the managers of economic policy.

Senator PROXMIRE. Mr. Samuelson, please proceed.

STATEMENT OF PAUL A. SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. SAMUELSON. In making my opening remarks, I will try to be responsive to some of the questions that you have directed to economists. The American economy, I think, is probably now poised at a turning point. I reluctantly have to join with the fashionable forecast in this matter. It would be nice to be original and differ, but it would also be nice to be right, and I have found that it is often necessary to join with the consensus because the consensus has a way, imperfect as it is, of being more right than any other particular method or group.

As an illustration, in the first quarter of this year, the consensus forecast began to form that from the middle of the year on, we would have a very significant slowing down in the rate of growth of the economy. My own reading of the overall pattern of evidence suggested that there was more continuity in the economic system, and that this was a little bit unlikely; but when I reviewed, for example, the forecast of Mr. Evans at Chase, and when I looked at his previous track record and the reasons he gave for his forecast, I decided that I was not a brave enough man to stand up against that growing consensus. And it is now a matter of self-congratulation to me that I did not go out on a limb, because events have increasingly tended to suggest that it is right.

So I agree that, on the basis of the evidence now available to us, the American economy does seem poised at a turning point.

The overexuberance of the election year 1972 is most likely to give way in 1974 to what is called a growth recession. I would like to call attention to the fact that during the overexuberance between mid-1971 and the spring of 1973, demand-pull inflation had a very significant role to play—not just in the area of commodities, food, metals, fiber, but also in industrial prices. I only do this because in your questions directed in the beginning to us, I thought I discerned a certain one-sidedness which suggested that you had learned a lesson of the years after 1957 but may have foregotten the longer lessons of history that it is not just wage push which pushes up prices. One cannot have, I think, a correct analysis of the dynamics of inflation if one thinks, either as a reactionary or as a questioner of the consensus, that it is all the result of and always the result of those blasted unions who push up prices. The wage front has been and was in 1972 remarkably quiescent; and one of the problems for policy, I think, is to ask ourselves, how we can keep it that way?

Well now, a growth recession is forecast by most of the so-called experts. That is not a forecast I personally regard with any complacency. I do not think the whole name of this game should be to decide whether there shall be a genuine National Bureau recession as measured whether there is an actual decline in real output for two successive quarters as against, say, the more fashionable forecast of a growth recession, because there are plenty of human sufferings involved in a growth recession itself. It means job opportunities will be deteriorating; it means productivity will be deteriorating. I do not mean to suggest that everything should now be done to prevent a growth recession, to try to keep up the exuberance of demand of recent quarters, but I do want to stress that a growth recession is something which itself is an evil, and creates a problem.

Secondly, I have to agree that we do face "stagflation"—in 1974, we shall have both inflation and stagnation in job opportunities and business sales. I have tallied a dozen-odd bank, business, and university forecasts, and find that almost to a man they expect inflation to continue in 1974 at more than a 4-percent rate as judged by the GNP overall price indicator. There are times when the Consumer Price Index runs ahead of that index; we have been through those times recently. There are also times, and Mr. Evans has suggested they are just ahead, when the Consumer Price Index will not grow as much as the overall price inflator. I believe I am correct in reading the numbers which have been handed out by Mr. Evans, that his own rates for the fourth quarter of 1974 are above 4 percent.

I call your attention to this because gone are the days when policy believed that it could feasibly attain price stability; gone are the days when we thought we could attain reasonable price stability—a euphemism for a 1-percent price increase—in the Consumer Price Index. We shall all feel very happy if in the next couple of years we get the overall price index to behave in the general neighborhood of 3½ or 4 percent, and, alas, you will not find among the consensus forecasters very many who think we are likely to realize that goal.

The conclusion that follows from this policy is not, I think, that we should drastically change policy in order to make the forecast correspond to the goal of a more reasonable price inflation, because I think a cost-benefit analysis of what would be entailed by such Draconian policies will show you can buy very little in the next couple of years in improved price behavior, and you will pay very much for that by a tremendous deterioration in employment opportunities, of productivity growth, and—I could even add—in business profits.

Now, since the consensus seems to be well represented here, I think I ought, as a friend of the public, to at least represent the minority view, the respectable minority view is that there will be a full-fledged recession. There are a few economists, with good track records—I am not referring to the people who have full-page ads on the financial pages about disasters to come, because there is no relationship between what they have ever said and the reality—but somebody, for example, like Mr. Somers of the Conference Board. In a forecast made under his own personal responsibility, he has been on record as expecting that in the last half of 1974 there will be a full-fledged drop in real GNP, and actually a drop at more than a 3-percent annual rate for those couple of quarters. Such a drop in production could presumably be expected to take a much greater toll in unemployment than any of the figures before you now.

Thus, the overall rate by most estimates will be climbing, not drastically, but steadily, from its recent neighborhood of 4¾ percent and climbing toward 5¼ percent; but if there is a full-fledged recession we will experience rates of above 5½ percent and some forecasts I have seen suggest even above 6 percent.

Now, what the Congress and the Executive and the Federal Reserve authorities do can have an important effect on whether or not we will have that serious recession. If President Nixon and the Congress were to be stampeded by the food inflation, and that is the inflation which bothers the person in the street the most into following drastically restrictive fiscal and monetary policies, the kinds of policies which so often in our economic history were followed under similar circumstances, then they could bring on a serious period of stagnation. I have repeatedly said in public lectures and before this committee that if you look at recent recessions and turn them upside down and look at their bottom they say on them: "Made in Washington." That can also be true of the next recession, and I hope that contingency will be kept in mind.

I think that such Draconian policies would be bad even from the viewpoint of those who wish to be very hard against inflation in the longer run because if such policies were followed. If we bring on a genuine old-fashioned recession of the sort the National Bureau will certify, then in the congressional elections coming up in 1974 you will almost certainly have a reaction against that, and an offshoot in the opposite direction; so even for those whose greatest concern is where the price level will be half a dozen years from now, such policy, I think, is bad.

I note that Mr. Burns quite recently urged new taxes to fight inflation. It has seemed to me that in recent years I found myself more often in agreement with Mr. Burns than was always the case. Perhaps it is because I have grown wiser, perhaps there are other reasons for it. But this particular suggestion by Mr. Burns impressed me as being a measure whose time had already gone by. I agree with the other panelists that now is much too late in this business cycle to introduce restrictive consumer taxation for the purpose of fighting inflation, and I think by making it a rebatable tax you do not change the cogency of my criticism. We also have to remind ourselves that this is the same Mr. Burns whose Federal Reserve has just been congratulated by Paul McCracken for having in good time loosened the credit markets in the last several weeks. I am not myself persuaded that all the dramatic changes of interest rates in the past few weeks have been due to the Federal Reserve, and I am also not persuaded that the Federal Reserve has changed its opinion as much about the proper degree of tightness for the future to come. In 90 days we will learn more about the last openmarket committee hearing.

Or again, Mr. Vice Chairman, your yourself have referred to Mr. William Fellner, the new member selected by President Nixon for the Council of Economic Advisers. Mr. Fellner is a very distinguished economist, a very good friend of mine, and I admire him. And let me say that, although I would disagree with the strong views he has been expressing recently, I wish also to remark that Mr. Fellner deserves an "A" for frankness. The strong views he has been expressing in public have, in fact, been the views of some executive advisers in private, not for the record, for a very considerable period of time, and I do think that those views deserve a serious airing.

What Mr. Fellner, as I understand it, has proposed is that we deliberately raise our target goal for unemployment, that we deliberately in the coming juncture of the business cycle contrive or permit a softening of the economy in order to fight inflation, and that we do not give in to the populist pressures which will thereby be invoked because that will only put off the evil day when the unavoidable medicine of unemployment must be applied to cure the inflationary ills of the economy.

Well, I believe that such opinions should be heard, and minority opinions in the seminar rooms of Yale University very often need to be heard; but I also believe that if adopted by Congress and the Executive they could do much harm to the American standard of living in the years just ahead, and the help that they would be to that standard of living in the years beyond that seems very tenuous.

Prof. Milton Friedman, I understand, also regards a recession as both inevitable in consequence of past monetary policies and, as a matter of fact, desirable both in terms of bringing inflation down to a more tolerable level and in terms of preventing its reacceleration. With respect, I cannot agree that such views provide the soundest basis for policy at this time.

What should be the goal of fiscal and monetary policy now? I think the goal of fiscal and monetary policy in the next many quarters should be first, yes, do permit growth to fall below the excessive 7-plus-percent rates of last year. Where were the monetarists last September, when the consensus in our profession was that leaning against the wind called for contractionary monetary policy in the short run? I myself believed and counseled at that time that the rate of growth of the money supply, as one of the many criteria that I would think the Federal Reserve ought to use, should be brought down below that long-term 5 percent or 4 percent goal of the monetarists but I got no support from the coterie of monetarism at that time.

I say as an aside that I do not consider it catastrophic for public policy in the long run to let the rate of real growth fall, in the next few quarters, below the 4 percent which represents par for the American economy—the par level we need to have real growth if our growing labor force and our growing productivity is not to result in extra unemployment. But I believe it should be the goal of policy at this time not to permit any lasting tendency for real growth to fall below, say, a 2-percent annual rate of growth in 1974.

And I think that policy should be laying the foundations now for a return in 1975 to the 4-plus-percent growth rate that represents the long-term par for the American economy.

This involves—to repeat—not raising taxes to fight inflation. Fighting food inflation—which properly exercises the American public—by means of overall fiscal and monetary policy, I have compared to putting a tourniquet around the patient in order to check the bleeding at the chin; it represents, I think, disastrous policy.

With respect, I disagree with Paul McCracken on the advisability of discretionary variability in the investment tax credit being given to the Executive, but advocating it be given does not mean that I advocate it should be used now. Again, we are too late in this business cycle to have that constitute good timing.

Such a compromise policy will involve some support to the languishing housing industry. It will keep consumer spending, which has been going through the fat years of 1971–73, from going into the lean years of 1974–75, and it should succeed in keeping a cycle of boom-and-bust in inventories from creating the instability of the pre-World War II years.

The recommendations made here do take practical notice of the real inflationary problem. These recommendations will contribute toward a lessening of the 6- to 7-percent overall inflation rates experienced so far this year. They would fit in well, I think, with the gradual dismantling of phase IV price-wage controls. I am not as hellbent eager in my timing to get rid of the price-wage controls as Paul McCracken's testimony suggests that he is. Like any alternative prudent program, the effect of these recommendations will be nullified if a premature abandonment of all price controls—one rather like what happened on that disastrous decision day of January 11 of this year, when phase II was prematurely dismantled—in the face still of the most rapid rate of increase in our GNP—if a premature abandonment were to bring on a wage explosion in 1974–75, were to terminate what seemed to be the only honeymoon experience we have been going through in the American economy in recent years; namely, the remarkable abatement of the cost-push element from the collective bargaining side of the American economy.

Thank you.

Senator PROXMIRE. Thank you, Mr. Samuelson.

[The prepared statement of Mr. Samuelson follows:]

PREPARED STATEMENT OF PAUL A. SAMUELSON

1. The American economy is now poised at a turning point. The overexuberance of the election year 1972 is most likely to give way in 1974 to what is called a *growth recession.* I.e., between now and the end of 1974, the annual rate of real growth in the GNP will be less than the 4% needed to keep the rate of unemployment from rising as a result of growing population and overall productivity.

2. Ahead we face "stagflation". I.e., in 1974 we shall have both inflation and stagnation in job opportunities and business sales. I have tallied a dozen-odd bank, business, and university forecasts and find that they preponderantly expect price inflation to continue in 1974 at more than a 4 per cent rate. Thus, the Chase Econometrics model of Dr. Michael Evans, my co-panelist today, expects that we shall have about a 4.2% rise in the general price index in the 4 quarters of 1971—this despite an envisaged slowdown to 2.2% real growth in 1974 and a Federal Reserve contrived growth of the money supply forecast at about the average rate from last Spring to the end of 1974 of 5% (the rate of M growth recommended by so many monetarists). I select Dr. Evans' numbers both because his is a good track record among recent forecasters and because it is one of the more optimistic of the forecasts that cross my desk these days.

3. Although the bulk of expert opinion is still against this, the American economy might face in 1974 a full-fledged recession. Thus, Dr. Albert Somers of the Conference Board, in a personal forecast made available in September, expects the last half of 1974 to be a full-fledged drop in real GNP at more than a 3% annual rate. Such a drop in production can presumably be expected to take its toll in unemployment. While the overall rate is climbing from its recent neighborhood of 4¾% to the neighborhood of 5½% or above, the rates of unemployment of unskilled workers, minority urban workers, and female workers can be expected to rise to much higher levels.

4. What the Congress, the Executive, and the Federal Reserve authorities do by way of policy can have a decisive effect on whether or not we shall have a serious recession. If President Nixon and the Congress are stampeded by the food inflation into following drastically restrictive fiscal and monetary policies, then they could bring on a serious period of stagnation. This will put a great burden on those in the community who can least afford to bear that burden; and yet, according to these same expert forecasts, it will have only a marginal effect on the rate of price inflation in the years ahead. Worse than that: If the government is stampeded now into deliberately bringing on a recession, that will produce

later the electorate backlash that is sure to lead to overinflationary fiscal and monetary policies after the 1974 Congressional elections.

5. Dr. Burns recently urged new taxes to fight inflation. This was advice much too late in this business cycle. And I remind you that this is the same Governor Burns whose Federal Reserve has been encouraging a loosening of the credit markets in the last several weeks. Or again, Dr. William Fellner, the new member selected by President Nixon for the Council of Economic Advisers has been publicly advocating a draconian resort to higher unemployment as the only way to cool off the U.S. economy. Such recommendations have their place as minority opinions in the seminar rooms of Yale University; but they can do much harm to the American standard of living in the years just ahead. Professor Milton Friedman regards a recession as both inevitable in consequence of past monetary policies, and as desirable in terms of bringing inflation down to a more tolerable level. With respect, I cannot agree with these views.

6. The goal of fiscal and monetary policy in the next many quarters should be—

To permit real growth to fall below the excessive 7+ % rates of 1972.

But to resist any tendency for real growth to fall below a 2% annual rate in 1974.

To lay the foundations now for a return in 1975 to the 4+ % growth rate that represents the long-term par for the American economy.

7. Such a compromise policy will involve some support to the languishing housing industry. It will keep consumer spending, which has been going through the fat years of 1971–73, from going into the lean years of 1974–75. And it should succeed in keeping a cycle of boom-and-bust in inventories from creating the instability of pre-World War II years.

8. The recommendations made here take proper notice of the real inflationary problem. They will contribute toward a lessening of the 6–7% inflation rates so far this year. They would fit in well with the gradual dismantling of Phase 4 wage-price controls. But, like any alternative prudent program, the effect of these recommendations will be nullified if a premature abandonment of all price controls brings on a wage explosion in 1974–5.

Senator PROXMIRE. Thank you, gentleman, for very helpful, constructive statements.

Each one of you, as I understand you, is forecasting and seems to accept the slowdown in real growth perhaps to as low as 2 percent in 1974 and a rise in unemployment to 5.3 or 5½ percent. Why should not monetary and fiscal policy become expansive enough to maintain a 4 percent real growth rate and an unemployment rate of at roughly the present 5 percent right now? As Mr. Samuelson has said, and as I insisted in my opening statement, this is a material shortage inflation. Every indication is that it is not an inflation that is caused by a shortage of labor which has resulted in higher wages pushing up prices, and, under these circumstances, why should we not have monetary and fiscal policies which are designed at least to prevent the unemployment situation from worsening and enabling us to continue to grow at the historic 4 percent level?

Mr. Evans, you start out.

Mr. EVANS. Well, first of all, I think I really should point out that we have learned one lesson fairly well in the last 5 years, and that is monetary and fiscal policies act only with a lag. So even if those policies were to be implemented today, in my opinion, they would not act soon enough to keep the economy from slowing down considerably in the first half of next year.

Senator PROXMIRE. If I can interrupt, if they act with a lag, it seems to me my point may be made a fortiori, because your conclusion seems to be the slowdown is not going to come next month or the month after but later in 1974, especially in the latter part of 1974, is that wrong?

Mr. EVANS. Actually, my position is that the first half of the year will have the greatest slowdown, and that by midyear the economy will already be beginning to be picking up slightly. There is a slight lag between the change in output and the change in unemployment so in my forecast itself I do have unemployment peaking in the third quarter of next year, that is correct. But the economy in terms of real growth and industrial production and things of that sort, will have already begun to accelerate, although at a rather slow rate, so there is some question of timing.

But let me get to the broader question, since all of 1974 will have a rather poor growth rate. Even the second half of the year is below the 4 percent rate which many people consider to be approximately at equilibrium, so the question is why should the Government not act?

I believe that we have a problem of unemployment which cannot be directly solved by the standard monetary and fiscal policy measures. In other words, I have no agreement with those people who say 4 percent unemployment is fine and things cannot go below that and so forth. But I think that monetary and fiscal policy are not the correct tools to push the unemployment rate down to levels of 4 percent or less, and I think——

Senator PROXMIRE. What are the direct tools?

Mr. EVANS. I think that we have to go in and work directly with those people who are unemployed. The vast majority of people who are unemployed today have very low levels of education, very low levels of training and, therefore, there are many businesses that feel that these people——

Senator PROXMIRE. Very low on what basis? Historically, they are much higher than they have been. For instance, you take the minority groups, you take the youth, you take the women, their training and educational skills are far higher than they were 20 years ago, they are higher than adult men were 20 years ago.

Mr. EVANS. Yes, but the rate of unemployment is not very high in females age 25 to 54. The great body of unemployment is in the teenage area, below 25, and particularly in the black teenager.

Senator PROXMIRE. They are the people who, as I say, the skills are better than the mature workers were a few years ago. We have not had that kind of transformation in the need for skills in the last few years, have we or have we not?

Mr. EVANS. I believe there has been a steady movement in that direction. I would also point out that while I agree that teenagers perhaps have better skills than they did 10 or 20 years ago, the general skill level of the population has been increasing over time, over the last 20 years or whatever, and so these people, the teenagers and particularly those in minority groups, still have relatively less skill than anybody else in the economy and, therefore, in the profitmaking economy, any free economy, people will choose to hire those people last.

Senator PROXMIRE. Has not our experience been that the one element that really results in training monitor groups and women and others and brings them into the labor force in a constructive way is the need for more labor? When an employer needs a greater labor supply he will get it and train it. He will hire it, and if he has to take a little while and if it is costly to do it he will do it. But as long as there is this slack he will not do it.

Mr. EVANS. Yes, but there is a cost to doing it.

Senator PROXMIRE. Sure there is a cost to doing it.

Mr. EVANS. In times of high employment, hiring capacity and so forth, this cost will be passed on to the consumer and this cost of training will be borne in one way or another by the consumer which will add to the rate of inflation which I believe the Government would not like to see occur.

Senator PROXMIRE. Well, there is no evidence, as I say, that we can see that inflation has worsened because of having to pay higher wages to get more people into the workstream.

Let me ask Mr. McCracken, would you like to take a crack at this?

Mr. MCCRACKEN. I would. I think the point which Mr. Evans emphasized first does need to be kept in mind. So far as the first half of next year is concerned the policy decisions which will shape the course of the first half of the year are probably pretty well already in the works. In other words, if we were to change fiscal and monetary policy right now we would be talking about having an impact on the economy possibly by the middle of next year, something like that.

Now, in my prepared statement, of course, I did express the hope that we may be seeing an easing or a shift toward a more expansive monetary policy. I want to emphasize, by the way, that I expressed in my prepared statement the hope that that was happening. I do not know whether it is happening or not. It may not be. It may be that some of the easing of the market conditions which we are seeing is simply a leveling out of the demands for credit. The data on business loans might suggest that. Nonetheless, I would like to see monetary policy becoming more expansive.

Senator PROXMIRE. How about the overall point that I am asking you about as to whether it will not be wise to try to adopt whatever policies are necessary to maintain growth at a 4-percent level during this period and to prevent unemployment from increasing?

Mr. MCCRACKEN. Here, we do have to face the fact that we are running out of plant capacity. Where is the real constraint to expanding employment by a great many employers? It is simply the fact that raw materials, component parts, and that sort of thing are becoming increasingly difficult to obtain. In the auto industry, my impression is this is a more serious constraint on production than the inability to get additional employees.

Senator PROXMIRE. Let me just interrupt on that because I read your Wall Street Journal article. I did not see it, frankly, before I made my opening statement this morning. It is very competent and exactly on this point, the need for more plant capacity.

Mr. MCCRACKEN. Precisely.

Senator PROXMIRE. But it seems to me in view of the diminution of workers since 1969, in fact we have fewer workers in manufacturing now than we had then, more in the service sector, can you make the argument that we need more plant capacity in the service sector? Do you take that into account in pointing out that the overall ratio between plant capacity and workers is less now? When you look at the mix does that not somewhat reduce the force of your argument?

Mr. MCCRACKEN. Well, I do not think so, because it is worthwhile to just look at the economy now and ask where are the constraints on expanding production further? In most cases the demand is there.

For manufacturing, generally, the critical problem is where to get the critical materials.

Senator PROXMIRE. I was in Rhinelander, Wis., Monday, and visited the St. Regis paper plant. That plant is working three shifts a day, 7 days a week. They need more capacity, no question about it. They are at full capacity, and there are a number of other situations like that around the country. But I just wonder, overall, how general that is, whether we can project on the basis of a relatively few material shortages which have been the spectacular elements in our inflation, whether we can say we have this as an overall problem.

Mr. MCCRACKEN. It is quite pervasive at the present time. It is certainly true in the case of paper. They are producing paper, as you say, 7 days a week and three shifts per day. At the same time, we still do not have enough paper. And it is not just paper. It is steel. It is component parts. It is a very pervasive problem at the present time, and it is important to bear in mind that we seem to have hit the outer limits of our capacity to produce in terms of constraints on plant capacity while the unemployment rate is still 5 percent. This, I think, does tell us something.

Now, I think no one should be complacent about any kind of unemployment. I, myself, would like to see a reexamination of some manpower types of programs.

Senator PROXMIRE. I do not quite understand how a policy that would increase unemployment to 5½ percent and slow growth to 2 percent, would solve the capacity problem.

Mr. MCCRACKEN. I do not believe I proposed increasing unemployment.

Senator PROXMIRE. I know you do not want that, but would not that be a consequence of permitting the growth rate to slow down, as you say it will, and as all of you gentlemen seem to indicate might have some salutary effect on inflation?

Mr. MCCRACKEN. The policy decisions that are going to be made from here on are pertaining to the economy from the middle of the year or so to next year. The slowing down of the economy that is going to occur if it does occur in the first half of this year, is going to be in response to policies that have already been pursued. So I do not think you can raise the question: What do we do now by way of trying to alter that? That is pretty well in the works already.

Senator PROXMIRE. Mr. Samuelson.

Mr. SAMUELSON. In response to your question whether policy now should be directed toward restoring a 4-percent growth rate, I would agree it should in the sense that policy which is newly adopted now will have its effects about the middle of next year and I would regard it as a good thing if some of these forecast numbers for growth in the middle of next year at no more than a 2- or 3-percent rate were pushed back up toward 4 percent.

I would reinforce that by drawing attention to the fact that the fashionable forecast may be wrong, and the unfashionable forecast just could be right; then we would be especially grateful for more expansionary monetary and fiscal policy adopted now.

However, if I tried to answer your original question literally that we do everything on earth now to keep the economy from ever falling below the 4-percent rate which perhaps it did enjoy in the second quarter——

Senator PROXMIRE. I would not say ever, but when we have a level of unemployment as high as it is at the present time.

Mr. SAMUELSON. Yes. In other words, if we try to do something about the fourth quarter rate of real growth and the first quarter of next year, it could be perhaps raised slightly, but it would take very extreme expansionary policies.

Now, it would seem to me that aiming for that 4-percent target rate of growth is a more defensible simple target than any other level to aim for from the longrun point of view; it dodges the question of whether 4 percent is a natural level, or whether 4.8 or 5.1 percent is.

But I would still have to say that in framing a long-term goal, I would put in my target two things: (1) The rate of growth which brings in the unemployment target with it, and (2) the rate of price inflation. Now, the recent rate of price inflation has been very, very high indeed, and so you are in a situation now where there is still lots of inflationary pressures in midstream that came from upstream and are still going to work their way downstream. So it seems to me not unreasonable, if ever you are going to pay more than lipservice to the problem of bringing inflation down and to pay real genuine attention to what I regard as the more important problem—of keeping inflation from accelerating—to gear our policy toward what will happen in the middle of next year and to do things now that will only have their primary effects then; from that point of view, we should take into account the fact that we are no longer in a boom period on the basis of the evidence, and that we are looking down the throat of a growth recession.

I would not, by the way, think it disastrous if we went from now until the end of the world at 6-percent inflation with everything adjusted to that—including the plight of the elderly, the real victims of inflation—but I cannot look without concern on the prospect that 6-percent inflation might do what it has done so many places abroad, become 8 or 9 percent.

Senator PROXMIRE. My time is up.

Senator Javits.

Senator JAVITS. Thank you.

Gentlemen, first, let me express my pleasure, and what I know will be that of the minority, with the fact that men like yourselves give us time and indispensable advice; and while we realize you are professionals and want your advice to be made broadly public, I can never refrain from appreciating the voluntary work which goes into preparing for such a hearing.

I know each of you, perhaps Mr. Evans not as well as I know Mr. McCracken, but I just wish to express that, I am sure, all of us feel the same way.

I am particularly worried about three things, and I would like to use my time to have you successively sharpen your views on that. One, wages. We are beginning to see indications of the fact that the fantastic discipline of the American worker, defying even convictions of those who say: "Well, political leaders—or labor leaders are all political functionaries and they are going to respond to Sam Gompers' famous word 'more' all the time." Well, this has not been so. Labor's restraint has been absolutely remarkable.

Now, the first question, what do you see in the way of that restraint? We see some signs that both the rank and file, and the AFL-CIO, the principal labor federation, may be moving away from that concept, so we ought to know what can we do to encourage their staying with it? Actually, the trend of real wages is bad from their point of view. So what can we do to encourage a continued statesmanlike, highly patriotic discipline by labor, on the whole?

Second. What can we do about the unemployment rate, which is likely to rise in the future? Shall we have a manpower bill with more public service jobs, which happens to be my baby as I am the ranking member of the Labor Committee, or what else can we do about it, in your judgment? You are talking about millions of people, and we are politicians, it is very worrisome to us.

And the third question concerns housing. Again, you know, we all think in macroterms and rationalize things by saying: "Well, housing starts are off a bit, maybe that is good for the economy, maybe it will deflate it some." But millions of Americans are very badly housed, and notwithstanding the President and the Secretary of Housing and Urban Development telling us what mistakes we made in housing in the past, and the fact that you have a sour project in this city or that city, the fact is that millions of other Americans are better housed because we had extensive Government programs, and having been a child in a slum where four families used one toilet, I do not like to see these Federal programs done away with suddenly like that.

So aside from all the niceties of what it does to the economy, what shall we do about housing? We want to sustain housing, build it up, have more, and all these nice details about the economy take second priority to that. So those are my questions. I would appreciate it if you each would answer them.

Mr. Evans.

Mr. EVANS. In response to your three questions, first, you asked about the wage rates or what we see what can be done about keeping them from accelerating once again, I, like most members of the profession, was happily surprised that wages did not increase any more than they did in 1973. I believe that one of the reasons for this is that labor in previous years was playing catchup, which is to say that their wage increases were based on inflation during the past few years, and most of them had caught up by 1973.

Now this argument will no longer be particularly valid as we move out in 1974, 1975, and 1976 because of the very high rate of inflation this year, and I think that most labor leaders, and in fact the rank and file, expect wage increases which are pretty much close to being determined as follows: If there is a 3-percent productivity increase plus the increase in cost of living, whatever it was, if it was a 3-percent cost-of-living increase, then wages go up 6 percent, I think the formula has been fairly well established except that the cost-of-living number that goes in there is usually last year's cost-of-living number. So we had many increases of 6 percent because these took in a 3-percent productivity increase and a 3 percent cost-of-living increase in 1972.

I do not think all of this will come into the wage bargaining of 1974 partly because of the slowdown and partly it is a light year in the bargaining counter for major equipment, but I think part of it will show up and wage rates will begin to accelerate once again.

I do not think that there is a great deal that can be done about this except through controlling the rate of inflation. We have heard various opinions on the rate of inflation here, and almost everyone expects that to be at least 4 percent next year, so I think that labor will have to play some catchup and I really do not think there is a great deal that can be done about it.

I have not made my views clear on controls before this but I do not believe that continued controls are the answer. I think that the controls will be phased out next year, and I think that is the right decision. I do not think we can rely on controls to keep wages at a moderate increase in face of the situation when prices did rise so fast this year.

So I think that wage rates will accelerate next year, and from a policy point of view there is not a great deal that can be done about it because the determinants have already occurred.

With respect to the unemployment picture it is clear that the higher the rate of unemployment goes the more people there are out of work, but once again my answer to you would be similar to my answer to Senator Proxmire which is to say that, although I am certainly not in favor of higher unemployment, I think that various methods of reducing it other than direct monetary and fiscal policy should be applied. Manpower training is one possibility. Another possibility, which has been suggested by some, is to concentrate this effort more in the private sector, by which I mean that businesses would hire people who were unskilled or untrained and did not have the basic requirements for the job for one reason or another. Businesses would employ them at the going wage rate but would receive various subsidies. This would not penalize businesses which, I think, still look for persons who are best qualified for the job which is necessary, but there should be an offset: the Government should provide subsidies for hiring such unskilled people and train them on the job. I think this is a better way to attack the unemployment problem than through overall fiscal and monetary policy.

Finally, with respect to the housing situation, it depends to some extent what level housing starts are, how many people are better housed. Yet housing starts in the beginning of this year and last year were at an all-time high; we had a rate of 2½ million housing starts and added to that 600,000 mobile homes, half million, and yet the inner core of the cities and the gettoes continue to deteriorate. Many people were still trapped in there and could not afford to move out because they did not have the incomes and in many cases they did not have jobs.

So I am personally of the opinion that in order to work most effectively with the problem of the inner city and the ghetto which, I admit, is quite severe and of primary importance, I would be more in favor of increasing these people's incomes through job training of the sort I mentioned and thus give them enough income to allow them to have standard housing instead of substandard or dilapidated housing. I think this could be combined with the Federal program which could build more houses but I think one has to attack both angles, one has to work on the income of these people as well as the availability of housing.

Senator JAVITS. Mr. Vice Chairman, I do not want to impose on the members as to my time, I have 2 or 3 minutes. Do you think you gentlemen can tell it to me in that time?

Mr. McCRACKEN. Just a couple of quick comments. The possibility of a sharp acceleration of wage rates, I think, is one of the great dangers we face. One aspect of this which we have to bear in mind is the possibility that once again for a variety of reasons we will get heavy further demands in the construction industry—for example from an all-out effort to build oil refineries and that sort of thing. This would put heavy pressure on some highly skilled trades, and we could get an outbreak, an explosion there that would tend to move across the labor market. Thus far, of course, it has been surprisingly quiescent.

I am not quite as pessimistic about housing as I would have been 2 or 3 months ago. My guess is that during much of 1974 we may be seeing an expansion of housing again. If we are getting a turn about in monetary policy now, by then we ought to see a real response.

Mr. SAMUELSON. Very briefly, there is cause for concern that the moderation on the wage front will not last. It seems to me that here the Government has to do something for the workers and for organized labor, and if, for example, organized labor wants the controls to be removed then I think that is a very good reason for removing them because one of the best reasons for not removing them too fast would be if those controls would jeopardize the moderation we have had on the wage front.

I also want to warn all of us against congratulating ourselves so much on the fact that a large sector of the American labor movement is taking cuts in real wages or not having the usual increases in real wages. The moderation of the rest of the economy is an actual sacrifice for them.

On unemployment, I want to warn against a very popular ploy. If somebody believes that the proper target on fiscal and monetary policy for unemployment is now very high, such as 5¼ percent, then he is well advised by anyone to say: "Of course, I am not for 5¼ percent unemployment. I am for 4 percent unemployment brought about by some other method, such as manpower training." But he leaves those hostages as to whether, in fact, the Executive and the Congress are going to put in those particular measures. We have been doing a lot of talking on that subject.

The Swedish economy now spends 2 percent of its GNP on overall labor market policies, public employment, retraining, relocating and so forth. Two percent of our GNP would be more than $20 billion. So in agreeing to relax our targets to 5 percent or more I would say we ought to be very leery about doing it unless we get the other parts of the package and demonstrate they are working.

Senator JAVITS. I wish to identify myself with everything you said in that regard. As the ranking member of that committee I will move heaven and earth to do what you say.

Thank you very much.

Senator PROXMIRE. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Vice Chairman, and thank you gentlemen for one of the most interesting presentations I have heard before this committee.

I am not an economist but I am an elected official who has to stay close to the people. Mr. McCracken, when you say in your prepared statement: "An almost obsessive pessimism characterizes public sentiment today." That is certainly the experience I have had back home. People turn to me and say: "It is time for Congress to take some leadership and do something about the economy." The something is never specified. The one thing that is resurgent in your testimony here today is that you gentleman feel we can or should not do something. One of the things uniformly you recommend is that we do nothing about a tax increase, and I am inclined to say regardless of how many votes that will cost me I will go along with that sentiment. [Laughter.]

The only policy declaration directed to the Congress was by Mr. Samuelson, who says his proposed compromise policy will involve some support to the languishing housing industry, and yet as I heard Mr. Evans, he said he thought that the decline in housing was at an end, and Mr. McCracken was optimistic about housing. Are you saying to us, gentlemen, that the economy of this great country is still basically sound and will recover and move along the well as can be expected, and you and the Congress had better not do too much tinkering? Is that the sentiment of the panel?

Mr. SAMUELSON. Well, speaking just for myself, I would agree there is a great deal of pessimism in the country, there is almost a malaise. It was connected for a long time with the too lengthy delay in ending the Vietnam war. It is now connected with Watergate and things that happen in Washington, and, objectively, people are more apprehensive and pessimistic than seems to be in the economic cards. I mean you see this in terms of the doomsday prophecies that are made all the time.

Now, it does not follow from that, to me, that, the best advice I can give you is: "Don't rock the boat. You are just doing great, continue to do that great stuff which you are doing," because it seems to me there are a lot of things that can be improved, and I would like to take this opportunity since you asked the question, to make more explicit some fiscal policy considerations.

There is a very odd canard going around that the cause of the recent inflation has been government spending out of control, and if only the President would get some backing so that he could resist these congressional onslaughts that we would get rid of the inflation.

Well, you can puncture that by just looking at the statistics of what government spending was in real terms in the middle of 1971 before the inflation accelerated and where it is now. I was very surprised to see Mr. Burns, for example, speak about the excessive trend of government spending. Now if you use government spending on goods and services as your test, it just is not true. The public sector has been growing at a slower rate than the overall, and has actually, in certain of those periods, not increased at all.

Now, I suppose Mr. Burns must be adding in some of the expansions in the transfer payments. We have had, for example, increases in social security. We have at long last acted so that the older people who are retired on social security do not become, as they would otherwise become, the prime victims of inflation.

I think there are many parts of the defense program, which my value judgment says could, with safety and profit, be cut; but my sense of social priorities, of the public dollar and the private dollar, taken against the background of the past inflationary problem and our future problems, do not suggest to me that the fault is in over-government spending on goods and services, or that there is where the pinch should come.

Quite to the contrary. I think a lot of very high priority social programs have had a lot of talk, but have not been legislated. Just to take one, the negative income tax, which at one time members of both parties were in favor of. Where is the legislation on that particular subject? What betting odds are there that it will get anywhere in the next year or two on that subject?

Representative MOORHEAD. Any other members of the panel want to make a comment?

Mr. MCCRACKEN. I would like to take up the comment which Professor Samuelson just made. I do think there is quite an agenda of things which ought to be considered, bearing in mind that there is a significant part of the unemployment problem that will be very difficult to get at just by generally more expansive fiscal and monetary policy.

I have had occasion recently to talk with businesses who participated in some of these educational programs. In one case it was for girls who had been quite deprived in terms of their normal educational opportunity. I was very much impressed with the success that they thought they had had with this program. I think this experience ought to be reviewed.

Some kind of family assistance program along the lines that Professor Samuelson indicated, I think, would be enormously worthwhile.

I suppose when the pessimism extends to Watergate and that sort of thing it is a little bit more difficult to deal with that, at least in the Joint Economic Committee.

We do need more expansive monetary policy than we have been having, at least since the middle of the summer. There is some slight evidence that it could be emerging. But these are some of the things. We have to work at it in both ends.

The most important thing is not just uncritically, though, to put more coal into the boiler and hope that somehow the problem will disappear. It is a more complex problem.

Representative MOORHEAD. My next question, I want to direct primarily to Mr. Evans but hopefully with comments by the others. One thing I noted, in all three prepared statements, was the lack of concern expressed about what is now called the energy crisis and, of course, particularly the oil situation in the Middle East. But I did notice, Mr. Evans, that in yesterday's Journal of Commerce you had some comments to make that were reassuring,[1] that we would have the present crisis eased by at least 1977. Specifically, what does your forecast presuppose, particularly in nearer terms, but particularly between now and 1980 in terms of legislation or other administration measures to foster increased domestic supplies, and does your forecast, which is, I think, more optimistic than most, involve the scrapping of environmental safeguards such as the environmental impact statements and sulfur emission standards and so forth?

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[1] See comments in article entitled "End Sighted to Energy Crisis by 1977," beginning on p. 331.

Mr. EVANS. The energy problem is enormously complex and some of the questions such as: Will there be a Middle East boycott of Arab oil? I cannot answer. I do not know that other people can answer them either. But looking out a little further into the future, the price of oil has risen so dramatically in the past year that now, as I said on Monday, which was the basis for the article on Tuesday, so many new methods, not new, but methods which have never been used on a full-scale basis before now become reasonably profitable. These include coal gasification; exploration drilling for oil, which previously was not profitable; and a little later into the future, tar sands and things of this sort. So basically, my argument was that the price of crude oil has increased so rapidly this year that this will open up all sorts of new possibilities.

Now, with respect to the environmental safeguards, here again, I think we have to play this on a year-by-year basis. My long-range forecast did not include any relaxation of the present congressional action. I do, however, suspect that in the next year or two, this winter and possibly next winter, there will be some relaxation made just to assure enough fuel; that we will go to perhaps higher sulfur fuel.

This was based on the fact that with the price of oil at $5 to $6 a barrel, these particular processes, particularly coal gasification, become profitable. The methodology for that was never put into operation before because the companies would have lost money if they had gone ahead with it, but now it is quite reasonable. We have a tremendous amount of coal supply, we have about 48 percent of the world's coal supply, we have proven reserves of coal for some 2,300 years at present consumption rates and even though there is an exponential increase we have plenty of coal around so, I think, this could be a major source of energy. This is partly the reason for my optimism.

But perhaps I can make a very brief comment on your earlier question which Professor Samuelson and Professor McCracken have answered and that is, I do not think any self-respecting economist would go up and say that Congress was doing fine by doing nothing. All economists like to think, whether they are right or wrong, they have inputs they can add to the process.

What I would caution against is this view of instant monetary and fiscal policy. Decisions are made so quickly today that people think you press a button and monetary policy eases and the economy recovers, or you press a button and you have a tax cut or tax increase and things happen immediately, and I think every piece of evidence we have in the past 5 years, as I mentioned earlier, is in the opposite direction.

In my opinion, we have this tremendous surge of expansionary pressures in both monetary and fiscal policy occurring in 1972 which do not show up until 1973. We had a cutback in easy monetary and fiscal policy which has already happened and will show up in 1974. If we did not want a slowdown in 1974 the time to do something about it was 6 months ago. So I cannot expect the policies to have effect in 3 to 6 months; we have to look out further.

So far as long-range programs, and I will be very brief, it seems to me all this talk we heard this morning about falling real wages, which is very true, can best be met in the long run through increases in productivity. I think the Congress and the administration ought to work in the direction of increasing productivity. This is a very long-run goal which does not show results this year or even next year but, in my opinion, is the best way to move toward full employment at the slowest rate of inflation.

Representative MOORHEAD. Thank you very much. My time has expired, Mr. Vice Chairman; I ask unanimous consent that the article entitled "End Sighted to Energy Crisis by 1977" be made part of the record at this point.

Senator PROXMIRE. Without objection, so ordered.

[The article referred to follows:]

[From the Journal of Commerce, Oct. 16, 1973]

END SIGHTED TO ENERGY CRISIS BY 1977

(By Peter T. Leach, Journal of Commerce staff)

The energy crisis in the United States will be over by 1977.

This optimistic forecast by at least one economist comes at a time when the threatened cutoff of Arab oil supplies to U.S. oil companies coupled with the impending shortage of fuel oil this winter has sent shock waves across the nation's energy sector.

But Dr. Michael Evans, president of Chase Econometrics, a subsidiary of the Chase Manhattan Bank, thinks that the worst shortages of petroleum and natural gas will ease in four years as the increasing cost of oil and gas encourage greater domestic exploration and production.

Dr. Evans presented his views on future economic growth and on the outlook for food, fuels, and natural resources before a seminar on the "U.S. Economy—Limits to Performance in the World Growth Race" at the bank's headquarters yesterday morning.

Looking beyond the present shortage of fuels, Dr. Evans said that alternative sources of energy will come into increasingly economic use by 1980. And further on down the road, he predicted that the era of fossil fuels would end within 50 years with the advent of the hydrogen or fusion era.

Dr. Evan's predictions are at sharp variance with the view of most analysts within the oil industry who think that the United States will become even more dependent on external sources of oil, with oil imports accounting for 57 per cent of our supplies by 1985, up from the present 23 per cent. And of course, most observers are predicting an ever-increasing dependence on Arab producers, who control the bulk of the world's proven reserves.

According to the Chase economist, the idea that the U.S. will come to depend on Arab supplies or that oil-rich Arab countries will be able to purchase large sectors of the American economy with their swollen foreign exchange reserves is "ridiculous."

He conceded that whatever the outcome of the present Middle East war, the cost of crude oil will continue to rise, even above the present $5-6 price per barrel. But he pointed out that the continuing rise in price will encourage American oil companies to squeeze every last drop out of existing wells and to explore for new oil deposits in the U.S.

As the price of crude oil rises, Dr. Evans said, alternative sources of fossil fuel energy will come into economic use. The strongest immediate alternate is the coal gasification process which can produce a low BTU fuel of about one third the potency of natural gas at a cost up to * * * a barrel for use close to the gasification plant.

The use of low-potency coal gas will help ease fuel shortages by the end of this decade. A high BTU coal gas could be produced at a cost of $12 a barrel, but this would not be a feasible alternative to crude oil unless oil prices reach that level.

A second potent source of alternate energy supplies is the vast reserve of a low-grade petroleum substance in the Athabasca tar sands in Alberta, Canada. Dr. Evans said that fuel could be produced from the bitumen in tar sands at a cost of $7-8 a barrel by as soon as 1980.

THIRD SOURCE

A third energy source lies in the oil locked up in the shale in Colorado and Wyoming, which can provide 50 years of oil supplies at the present rate of consumption. But the technology of producing oil from the shale is not well defined and is not likely to produce commercial quantities before 1985.

A critical problem with obtaining oil from either oil shale or tar sand is the problem of what to do with the tremendous amounts of waste created in the process. According to Dr. Evans, oil can be extracted from tar sands in huge underground plants, leaving the waste sands underground, but oil shale cannot be left underground, because when heating in the oil extracting process, shale expands by half its volume.

Nuclear power plants will supply some 15 per cent of the U.S. energy needs by 1985, although environmental concerns have so far limited their contribution to less than 3 per cent. Dr. Evans pointed out that together with the other little-used sources of energy, this should supply more than half of the country's requirements.

Within 50 years, the United States will have an economy fueled by hydrogen, Dr. Evans predicted. The hydrogen or fusion process creates tremendous amounts of energy when hydrogen is combined with its heavy isotopes, deutereum or tartium, at temperatures approaching those on the surface of the sun.

The harnessing of the fusion process has never taken place on earth except in the explosion of the hydrogen bomb, but scientists in the U.S., Europe, Japan, and the Soviet Union are hard at work on the means of furnishing and containing the heat needed to create the fusion process.

Since the amount of heat created during fusion is sufficient to melt any known substance, the process is likely to take place eventually within a plasma wall created by an electric force field.

Dr. Evans said that the use of the hydrogen fusion process will eventually solve the earth's energy problems since hydrogen is the most plentiful element on earth and the byproducts of the process will not pollute, but will return to earth as water. He predicted that offshore fusion plants will be able to supply all the U.S. energy needs.

Senator PROXMIRE. Congresswoman Griffiths.

Representative GRIFFITHS. I would like to ask each of you if the trade bill passes the Congress in roughly the way it is now, with nondiscriminatory treatment of both Russia and China, what, in your judgment, will be the chief export of America, 5 years after it becomes the law? What do you think it will be?

Mr. SAMUELSON. Well, I have the least informed guess.

Representative GRIFFITHS. All right.

Mr. SAMUELSON. So I will give it. Soybeans, whether you pass the bill or whether you do not pass it.

Representative GRIFFITHS. OK.

Mr. EVANS. Let me expand a little more on this since I have had some thoughts on it. I think I would like to look at these things in terms of change; in other words, 5 years, what will be the biggest effect rather than the actual level.

Representative GRIFFITHS. Well, that is the way I want to look at it. That is what I want to know.

Mr. EVANS. In terms of dollars, you mean? I will have to pass on that one. I do not know the answer to it.

Representative GRIFFITHS. Mr. McCracken.

Mr. MCCRACKEN. Well, I am an Iowa farmer, and what Professor Samuelson said sounded good to me.

Representative GRIFFITHS. Right.

Mr. MCCRACKEN. I think, in all seriousness, that it would be agricultural exports.

Representative GRIFFITHS. It will be food and fiber.

Mr. McCRACKEN. Food and fiber.

Representative GRIFFITHS. I would like to ask you, do you think that if it is true that we could set up a mechanism which estimated the amount of food and fiber that America needed, and somehow or other hold this out equitably, fair to the farmer, fair to the rest of the world, or are Americans going to have to bid for their food against every other nation?

Mr. SAMUELSON. Well, in partial answer to that question, let me record that fact that I have been very disturbed by the ethics of our springing on the rest of the world export controls following upon a period when we had gone to great efforts to get the rest of the world to depend upon our agricultural exports. I am thinking, for example, of the many slaps in the face which we have directed toward the Japanese; and among them is the fact that they have come to depend overwhelmingly upon us for their soybean supplies. They use that protein much more efficiently than we do. I can appreciate the real political pressures on Congress and the Executive, because it is the food inflation which the voter in the street has been most exercised about, but it has bothered me as a matter of ethics.

Now, you direct the question of whether with full warning in the future we could more defensibly pursue the same lines.

Representative GRIFFITHS. Fairly and equitably to the farmer.

Mr. SAMUELSON. I have a first offhand reaction that there is nothing illegal or reprehensible about the rest of the world advancing in their prosperity, and that when one fool wants to consume because it has the money another fool will want to consume. So that I cannot think it an affront to the American consumer that other people are enjoying a better diet or higher protein diet; and, just offhand, it does not seem to me unfair that we should have to, as you say, compete with the rest of the world in terms of our currency payments for that.

Representative GRIFFITHS. I know I have a limited amount of time but if others have answers that you would like to expand, please put them in the record because I want to ask one more question.

I would like to advise you that this committee has done a very comprehensive review of all income maintenance programs in this country. It amounts to more than a hundred billion dollars annually. It is the largest item in the Federal budget, and unknown to you now but it will be known to you shortly, we are going to spring upon the Congress and the world suggested reforms, reforms that would cost between $15 and $20 billion and would bring a remarkable amount of equity in these programs. One variation will be the negative income tax.

Now, what I would like to ask you is, can we afford to do this now or could we afford, as of next year, to do this sort of thing? What will the inflationary effect be if we are going to export all this food and fiber? Would it mean that hereafter we will have to keep upping that amount to make sure that those people are fed?

Mr. McCracken, would you like to answer?

Mr. McCRACKEN. Yes; I will make a comment. Yes, we can afford it. I obviously cannot comment on the details of it.

Representative GRIFFITHS. No; but we are going to send you a copy of it, all of you and we will ask you to comment when you are ready.

Mr. McCRACKEN. Good, fine.

About $15 billion, I believe was the figure you used. That is approximately 1½ percent of our national income. That does not strike me as of a magnitude which is simply unrealistic if it will accomplish major advances, as you indicate.

Representative GRIFFITHS. It will indeed.

Mr. MCCRACKEN. So the answer to the first question is yes, we can afford it.

On the second question, I do think we need to be cautious about extrapolating into the indefinite future the very severe food problem, the food price problem which, of course, we have had in the past year. A good deal of the agricultural revolution which has enormously increased the productivity of American farmers has not yet gone to the rest of the world. With a shift of emphasis in our own agricultural programs away from restricting production, my guess is that we will not have as a major continuing problem the very high level rates of inflation in food prices that we have seen in the last year. Indeed, my guess would be quite the opposite.

I was in Japan at the time the soybean export control went into effect—or at least a few days later. It certainly had an enormous detonation effect there, quite understandably. I do not like export controls and I think we ought not to have them on an ongoing basis.

On the other hand, obviously, any government in a very difficult, almost pathological, situation has to retain ultimate concern about its own supplies. I believe I am correct that even with export controls soybean shipments to Japan this year will be about 20 percent above last year. So I do not like them, but there are times when they have to be used.

Representative GRIFFITHS. Thank you very much. My time is up.

Senator PROXMIRE. Congressman Carey.

Representative CAREY. Thank you, Mr. Vice Chairman.

When I look at the overview here and the consensus that we may face, in the words of Mr. Samuelson, a full-fledged recession in 1974 on the heels of costly inflation at the public's expense, I am reminded of the comment Casey Stengel made in the old days of the amazing Mets. He looked up and down the team, which was losing by 13 runs and still four innings to go, and said: "Can't anybody up here play the game?" [Laughter.]

Now, it seems to me that in these waning days of the Congress that we do not have before us any legislation of any kind in the hopper, which will cope with our responsibilities to mitigate, or ward off a recession—to cope with what I consider to be excessive unemployment, even at 4.8, or whatever it may rise to in 1974, and I gather that the consensus is: One, do not raise taxes to fight inflation because that would be detrimental or would increase the, or accelerate the recession expectation. But we did pass, back in 1971, with great fanfare, the job development credit program, consisting basically of the 7-percent investment credit, the accelerated depreciation range, and a few other items. We face lack of capacity in key industries, and when you do not have capacity, especially in the raw materials sector, you cannot get new satellite industries at the growing rate to increase the employment, and is it time, and this is my question, that we look at what was called the Job Development Credit Act, that we look at the export incentives of this program, look at the 7-percent investment credit, accelerated depreciation range and try to target incentives to industry, on the one hand, to increase capacity and to increase the employability in those industries, through training programs, and so forth, and, on the other hand, instead of dealing with an average 4.8 percent rate of unemployment in the country, remember the advice of the good Secretary of Labor, Willard Wirtz, that averages can be deceiving. When a man stands with one foot in a bucket of ice water and the other one on a hot plate, on the average he might be comfortable but it is not true physically.

Instead of dealing with 4.8 average unemployment, reckon with the real world. Unemployment in Bedford-Stuyvesant, N.Y., is 22 percent, and higher than that among young females. In areas that fled from the old farm economy, before it became the new IBM, there were satellite areas in the major cities that had equal rates of unemployment. In Kentucky, Indiana, outside Indiana, we saw rates of 18-percent unemployment. Now try to target the programs on the one hand for manpower and target the programs in industry so they become the Job Development Credit that we legislated in 1971. That means a new tax approach. Is that reasonable? Because Mr. Evans said there is not any prospect of a tax program coming out in 1974.

What about that kind of a tax program? It is beyond the wit and ingenuity of the Congress to conceive a tax program that increases capacity, energy as well, and at the same time targets in on the major sectors of unemployment.

Mr. Evans. Well, I will speak on that very briefly. In principle, I am very much in favor of such an approach. I believe it would be somewhat difficult to implement, but I think certain facets of it would include a variable investment tax credit which gives a higher rate of tax credit to those firms and those industries which did increase capacity, productivity, and employment.

The way the investment tax credit is currently structured it is 7 percent pretty much across the board on all equipment no matter what it goes for. I certainly think the Congress could sit down and with study work out a plan of this sort which would be very beneficial.

I would also recall an early comment I made about giving various credits to businessmen who hired the untrained and so forth by paying part of their wage. I believe this also could be done through various tax incentives or lower tax rate in this area, and I also think that would be a very promising approach.

So while the problem is an extremely complex one, I have felt for some time that Congress should move in that direction.

Representative Carey. Congressman Moorhead referred to the energy problem, and I am interested by your optimistic, if I can call it that, determination that by 1977 we will be in better shape. Unfortunately, I sat in with the energy task force over on our side the other day and heard the Atomic Energy Commission discuss its overview. It is not quite so optimistic. The coal gasification, for instance, while it may represent a potential investment down the range does not posses a mature industry. We cannot realize that energy potential unless we get a huge Government subsidy.

So far as the basic source of fossil fuel right now, I fear that you economists ought to take a look at the way Government is working there and say that there is absolutely going to be a recession unless we get somebody in charge of it. At this juncture we have an individual in the White House, Mr. DiBona, handling one segment and Mr. Wakefield and Governor Love handling another segment. We have a new Assistant Secretary of State for Security Affairs, Mr. Donaldson, who will handle a new segment, and Mr. Casey, formerly of the SEC, handling his segment. That is exactly where the energy problem is dispersed at this time.

Do you not think we ought to recognize we ought to have a boss around here and get somebody who can play that game and put it in one shop and realize the energy impact on the economy and get going on that?

Mr. McCracken. May I respond to that?

Representative Carey. Yes.

Mr. McCracken. Back when I was Chairman of the Council of Economic Advisers I was Chairman of a Cabinet Committee on Energy. This is back so long ago that people were not sure whether it pertained to a geriatric problem or to something else. I am not sanguine about our energy problem. Indeed, I would put it more strongly. I think we are finding it very difficult really to factor into our thinking the extent to which this is going to pinch and bind in the next several years. There are, as I am sure Mrs. Griffiths knows, major areas in Michigan where there will be no new gas connection, to an industrial plant, and for most corporations now one of the first questions that has to be answered before they go any further in their capital budget on any project is, "Is fuel going to be available?"

Representative Carey. May I comment on that? One of the leading chemical producers, about the largest multinational chemical company indicated recently it would not enter into any new contract for any product unless it can get assurance that it had feedstocks to produce the product. So aside from heat and light, the impact on industry down range I do not think has been sufficiently examined by economists because the very same man who made this statement said the unit of exchange in the world will no longer be monetary as we have known it, either in terms of gold or sound currency. It is going to be the unit of energy. I have not seen any economic forecast based on the unit of energy as the international trading mechanism yet.

Mr. McCracken. Let me comment on the organizational comment which you raised. I would strongly support the view there ought to be an energy czar. I think we are facing something that takes on some of the proportions of the rubber problem which we had in the beginning of World War II. We have to make a quantum jump ahead here in terms of the nature of this problem.

Representative Carey. Well, again, because time is expiring, I would hope that you would give some views on some of the new ideas in taxation to place before the Congress, one that we stop collecting taxes on the wages of the working poor. You know Mrs. Griffiths' study indicated that income maintenance programs are such that on the one hand we collect taxes at the very lowest level of wages earned by the working poor, and there has been a suggestion that we try to use some of that money for tax forgiveness, negative income tax, whatever you wish. Maybe we could even convert them into a housing allowance so the working poor would have access to more decent housing. In other words, I do not think we have exhausted the wit and ingenuity of Congress in terms of reshaping our tax programs so that they do something while they are not increasing.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you.

Mr. McCracken, for some time economists taught us that 4-percent unemployment represented a good operating target, given the existing structure of the economy and just this morning Mr. Samuelson said that in this opinion it is a pretty good target.

Economists calculated the Federal budget as it would be if the economy were operating at 4-percent unemployment. They dubbed this the "full employment" budget. With some difficulty, they sold this rather complex approach to the budget to many in Congress and the executive branch, as I understand, the 1972 budget was calculated on that basis. That is how they arrived at in 1973, $250 billion ceiling and the 1974, $267.8 billion ceiling was calculated on that same basis.

Now, the new appointee to the Council of Economic Advisers, Mr. William Fellner has strongly challenged the idea that a 4-percent unemployment target is realistic. He has, as Mr. Samuelson said, he has the great virtue of being straightforward and outspoken, and I think it is a fine virtue and I hope that he will retain it. But he is convinced that 5 percent is the best we can do.

At his confirmation hearing I asked Mr. Fellner whether the full employment budget should be recalculated at 5-percent unemployment, or whether it should perhaps be abandoned entirely. His answer was quite revealing. He said: "I do not think it really makes much difference whether you compute it at the 4-percent level and then decide that the full employment budget should be in appreciable surplus, so you get a balance at 5 percent." Of course, that made it clear he wants 5 percent.

Mr. McCracken, it was while you were still Chairman of the Council of Economic Advisers that the Nixon administration first began to rely very strongly on the rule of balancing the budget at full employment—defining full employment as 4-percent unemployment.

Did you support that approach and that target at the time?

Mr. McCRACKEN. Yes, I did.

Senator PROXMIRE. Do you still support it?

Mr. McCRACKEN. Yes. The concept of the full employment budget has, I think, been helpful in the management of budget policy. I would—if I held the view that 5-percent unemployment is par for the course, then I think the full employment budget should be calculated at that level.

But I do want to emphasize, Mr. Vice Chairman, I am not complacent about 4.8 or 5 or even 4 percent. Society should not be complacent about 4.8 or 5 or even 4 percent. Society certainly ought to drive the unemployment rate as low as possible, but if we are pushing a generally expansionist policy we do need to be sensitive about the point at which the nature of this problem starts to shift just from needing more expansionist policy to more complex policies to deal with this problem.

Senator PROXMIRE. You do not see anything in the change, in the nature of our work force, for example, which Mr. Stein repeatedly has called to our attention and Mr. Fellner seems to be relying on heavily, to warrant increasing that target from 4 percent to 4½ to 5 percent?

Mr. McCRACKEN. There have been changes.

Senator PROXMIRE. There have been changes in all kinds of ways, though.

Mr. McCRACKEN. Nonetheless there have been the groups whose unemployment rate was above the average for the labor force. These groups are somewhat larger now. If you were to take the unemployment rates group by group, which 10 years ago averaged 4 percent, I suppose that average would be 4½ to 4¾ percent now.

Senator PROXMIRE. Well, yes.

Mr. McCRACKEN. 4½ percent.

Senator PROXMIRE. But it seems to me if you are going to talk about 4.8 percent now being equivalent to 4 percent 5 years ago you have to identify bottlenecks, labor bottlenecks, that are responsible here. Can you identify labor market bottlenecks which we hit at 4.8 percent unemployment? You refer in your prepared statement to the danger of: "A frenzied scramble for skilled workers" and the problem that "demand for labor with pertinent skills will far outpace the supply available." What are the specific skills which are in such short supply? Why can't people be trained to take these jobs?

Mr. McCRACKEN. The danger that I was alluding to in my prepared statement there was that we would get a combination of an extremely heavy capital goods boom, possibly with particularly heavy emphasis, say, in construction of oil refineries. The demand for pipefitters, steamfitters, and critical skills like this where the demand is already very heavy, would so far outpace supply that we would once again, as we had for several years, have a wage explosion, and this would have repercussions for the labor force generally. I think the basic bottlenecks we are facing now are not so much basic labor bottlenecks, although I am sure there are pinchpoints in terms of skill. We have run out of plant capacity. We have people whose raw material input is paper who are not going to be expanding employment until that Wisconsin papermill, which is already, as you have indicated, working 24 hours a day, can somehow turn out more paper.

Senator PROXMIRE. What we have to do, it seems to me, is to provide some incentives. I talked to the head of that papermill and asked what he wanted to do about his full capacity plight. He said to me: "Our problem is that although we are operating at such breakneck speed, we are not making money. We will make less this year than last year." He suggested more flexibility on wage-price controls now. They are not allowed to pass through increase costs. Perhaps we should permit sufficient flexibility so that the profit margin is sufficient to attract capital for expansion. That seems to me to be an obvious need in areas where you do have that kind of limit.

Mr. McCRACKEN. No question about it.

Senator PROXMIRE. I am very concerned about the failure to appreciate the real possibility of a recession next year. Mr. Samuelson spoke about it in his presentation. I wonder if we really appreciate the possibilities here. Your own University of Michigan survey, I have an article here from the Chicago Tribune. It indicates an alarming situation. Let me just read a couple of quick paragraphs from it:

> Consumer pessimism has reached a 25-year high and a recession is now "quite possible," according to the prestigious Survey Research Center of the University of Michigan.
>
> The organization said its latest survey on consumer attitudes shows continued deterioration, thus suggesting a downturn in consumer demand will occur by the first half of next year.

The "index of consumer sentiment has dropped below the low reached in the 1970 recession" and the decline this year "has been considerably more precipitious than in 1969–70," the Center said.

"Never before in the 25 years the Michigan surveys have been conducted has consumer pessimism been so widespread," it said.

They go on to say:

* * * the expected decline in consumer spending could be substantial and unless it is offset by considerable strength in business investment and Government spending "a recession by early next year must be regarded as quite possible, perhaps even probable."

Now, the two areas that it seems to me are most vulnerable here, we have discussed but not adequately, one is housing. In housing you have the very dangerous situation of two things. We have high interest rates and, as you know, mortgage rates are much more sticky than others and are likely to come down much more slowly and the evidence is something like 60 percent, close to two-thirds of our population, is priced out of conventional housing because payments are so high for new homes they cannot afford them.

And how about the Government-supported housing? We have been stopped cold on new approvals since January of this year. That lag effect is going to catch up with us next year. The housing, the credit crunch of 1969–70 was not very bad in homebuilding because the Government-subsidized housing program came along. We cannot count on that this time; in fact, we know it is going to be aborted to a very considerable extent. When you put that together with the impact housing has on not only the building but the things that go into the house, carpeting and appliances, and so forth, and then you take a look at automobiles, the other big consumer investment, and, as has been pointed out, you are going to have a situation where you are going to have several items that are going to make it more expensive, safety and antipollution equipment, and going to make new cars less efficient in gas mileage, if we put all of these things together the situation does not look at all promising for next year, and your forecasts, although I recognize that they are hedged, may be optimistic. How about that?

Mr. McCracken, you are from the University of Michigan, so I will put you on the spot first.

Mr. McCRACKEN. OK. I commented on the pessimism of consumers at the beginning of my prepared statement.

Senator PROXMIRE. At the beginning of your prepared statement.

Mr. McCRACKEN. So I need not comment further. I do attach significance to this. I do not think we can expect consumer spending to be one of the elements of strength next year, and I so indicated that in my statement. There is no question about what has happened to consumer sentiment and, in my judgment, the evidence does suggest this will have an ultimate impact on consumer spending.

Now, at the same time we do have certain other areas here which point the other way. We have a strong situation in capital spending. The inventory situation is certainly not suggestive of any significant liquidation next year. In fact, it is the other way around. And we also have a strong position in terms of our external trade.

Senator PROXMIRE. Before we get to external trade, I realize that is a clear bullish element and should help us.

Mr. McCRACKEN. Sure.

Senator PROXMIRE. But these others after all, business investment in business inventory depends upon consumer demand. As consumer demand begins to drop is there not a likelihood business investment in plant and equipment may diminish and it may have an effect also on their inventory replenishment?

Mr. McCracken. This is a possibility. There is not much evidence yet to suggest that that is happening.

In regard to your question about recession, if in fact monetary policy is still on the track that it was in the third quarter, then we will have a recession in 1974. I do not think there is any question about it. Fiscal policy cannot be turned around very rapidly, and a great deal now hinges on whether the easing of market conditions that we are seeing is simply a diminution of demand or whether monetary policy is becoming more expansionist.

Senator Proxmire. Apropos of monetary policy you say in your prepared statement: "We may have seen in recent weeks one of the best-timed turnabouts away from a restrictive monetary policy in the Federal Reserve's history."

Since you prepared that prepared statement, Mr. Burns has stated decisively that the Fed has not altered its monetary stance. In view of Mr. Burns' statement, would you like to alter your remarks about the beneficial effects of the so-called turnabout?

Mr. McCracken. That statement is not so easily interpreted. It may well be that the second quarter went above the target and the third quarter was a little bit below the intended path. In that case an unchanged target would look expansive relative to the third quarter. I do not know. I have no inside information about that. But I think the critical question here more than anything else hinges on what one's judgment is about monetary policy in the months ahead.

Senator Proxmire. Would you agree, Mr. Samuelson, with Mr. McCracken, that a 5 percent growth in the money supply would be an appropriate target for next year?

Mr. Samuelson. Before I answer I want to correct the record concerning a statement made earlier by one of the panelists. I have not endorsed 4 percent as the proper goal for the unemployment rate. Indeed, I was careful not to pronounce at all on this complex issue. But I did emphasize that a 4 percent real growth rate must be attained on the average over a long period of time or the rate of unemployment will have a rising trend. Now, to answer your question, Senator. I would not put as much store about any one monetary target as Mr. McCracken apparently does.

Mr. McCracken. That was hedged in my statement.

Mr. Samuelson. But I would not think that was a bad target.

Let me say that I agree with your emphasis that we might have a recession, and I will shock some members of your committee by saying that if the probability of recession was only one-quarter it ought to be treated as two quarters. You will say that economists speak with forked tongue; my answer is, "No," but if you had the proper sense of a loss function about how defensible it is to make an error on one side rather than another, you would weight it as I have. It is not that I really believe what happened in the money supply in the third quarter if extrapolated would surely bring on such a recession. I don't feel "restrictive" is in fact the proper word here because I want to remind us that from the beginning of August we have had one of the most rapid declines in short-term interest rates. It is only the people who are born in this world with one eye alone and can only watch one thing in the money sphere—namely, the rate of growth in the money supply—who can flatfootedly say this has been such a restrictive period.

But nevertheless, economic forecasting, because of the long and variable lags, is not so accurate that you can take the forecast of a growth recession as gospel and build all your policy around it. The minority view that there might be a real recession has to be given greater weight than its own intrinsic probability and I think you should take that into account in Congress.

Senator PROXMIRE. I would like to ask each of you gentlemen to respond as to what we should do about price and wage controls. We heard strong recommendations by people in the business community and Mr. Fellner, for example, that we ought to cut them out as soon as possible. Mr. Fellner was restrained enough at least to say by the end of the year but there has been a great deal of emphasis on this and, as you know, the law itself expires April 30, of next year. The date often mentioned for terminating it, though, is for the end of the year. Let me ask each of you this, would you regard it as appropriate that we end wage and price controls at the end of the year and if we do how would the end of wage and price controls in 1973 affect your forecasts for price performance for 1974, if at all?

Mr. Evans.

Mr. EVANS. First of all, let me say that I do think ending wage and price controls by the end of the year would be appropriate.

As far as the second part of your question, how it would affect the performance of 1974, I think it would have a rather small effect which I will quantify by saying less than 1 percent additional increment to price inflation.

Senator PROXMIRE. You think we would get up to 1 percent, not more than that?

Mr. EVANS. Yes, that is correct.

The reason I think that the result would be rather small is because we are entering a period of slackening demand, and so the demand pull inflation which we have been hearing about this morning will be tapering off. I think that the sources of inflation next year from wages would probably be about the same whether we had controls or not. In other words, I do not think that labor can be held down through controls in view of the rapid rate of inflation.

Senator PROXMIRE. Should it just be abandoned or be replaced? Mr. Burns has said and I quote: "Wage-price controls should be replaced by a review board with more limited powers to intervene in the economy," and he points out "where competition does not work with sufficient vigor, where it does not work well enough."

Do you support that concept or would you just cut wage-price controls out, and go back to what we had before the new economic program in August of 1971?

Mr. EVANS. Well, no, I support to a limited degree. I sometimes use the word, "superboard," as an overall review panel which would monitor what was going on, and in areas where very large wage or price increases were clearly out of line with market conditions, I think they should be cut back. One of the reasons we had such rapid inflation in 1970 was because a few unions in 1968 and 1969 asked for wage increases which were much larger than the average and a few firms raised their prices much more than the average needed to cover their costs or meet supply or anything of that sort. So I think this board should be retained, but I would caution that unfortunately these things occasionally have a habit of turning into sort of a political whipping boy, picking on industries which for one reason or another had acquired an unsavory reputation. So I would want to make a strong statement against that sort of thing. But I would be in favor of a limited review board.

Senator PROXMIRE. Mr. McCracken.

Mr. McCRACKEN. I think the present program ought to be terminated before April 30, but not with the date announced in advance. It would be much better to have it simply abruptly terminated.

As to having a review board or some such body as that with a monitoring function, I have no particularly strong feelings about that.

It might be a useful feature as to a way to exit out of the program. At the same time, I doubt if it would have any consequential effect. I do think we need to remember that the very area which a review board presumably would be presiding over has not been the focus of inflation in the last year. The nonfood commodity area as a whole has been rising at a rate of 4 or 5 percent this year.

Senator PROXMIRE. Mr. Evans gave us a numerical limit of the inflationary effect of ending wage and price controls. Would you care to give us an estimate? Do you think it would have any effect if it ends, say, by April 30, as you suggest?

Mr. McCRACKEN. The incremental effect of abandoning the program would be negligible. I would put it at not over a half a percent for next year.

Mr. SAMUELSON. I would think at the end of the year would be the earliest defensible date and, therefore, probably too early; and it would be defensible then only if the expected relaxation in overall demand between now and then in fact materialized with indications that it would continue into the future. That such an act would also only be defensible if it met with the approval of organized labor—and I do not mean the approval of organized labor in which organized labor is given release from wage control in return for agreeing to release from price control.

I would find it difficult to quantify the effects of a termination sometime between January 1 and April 30, because it would depend very crucially on whether it contributed in any degree to the end of the wage-price, collective-bargaining honeymoon. Most of the earlier forecasts which I saw as to what could be expected in the form of cost push, given the behavior in earlier years of demand pull, would suggest we would have had worse inflation if the normal cost-push pattern had asserted itself, and if the premature abandonment of price-wage control should be an important factor making the normal pattern reassert itself early, then I would think that 1 percent additional inflation would be a conservative estimate, and if we widen our time horizon to the full length to which the decision would apply that over a 2- or 3-year period it would be several times that magnitude in importance. It is a risky thing.

Senator PROXMIRE. Mr. Samuelson, there is a very puzzling contradiction in this whole thing. As you know, wage-price controls were put into effect when unemployment was higher and the demand was less. During most of their life we have had unemployment higher and demand less. Now we are getting into a situation where the economic situation is getting more likely to provoke inflation, and we are taking them off. Does that represent a contradiction?

Mr. SAMUELSON. You have to distinguish between whether the inflation in question is a demand-pull on "seller's" inflation. The country is not so much moving into demand-pull inflation, as into seller's and cost inflation. A good argument can therefore be made that if the country were not in some sense already tired of wage-price controls, that it is precisely in such a "stagflation," in the inflation part of the stagnation, that continued price controls could have a beneficial effect and could have a minimum of the harmful effect.

Mr. MCCRACKEN. Could I make a comment?

Senator PROXMIRE. Yes, indeed.

Mr. MCCRACKEN. I agree with it. It is a stagflation period. This kind of a program is apt to have its maximum effect in the situation that we had in 1971. That is when you do have a maximum opportunity to have any effect. I do not see in the current period here with strong demand pressures that we still have on markets, I do not see that kind of——

Senator PROXMIRE. I thought I detected, Mr. McCracken, in your analysis, maybe I did not, that we were going to have a falloff in growth, that we were going to have somewhat greater unemployment and we were going to have continued inflation next year.

Mr. MCCRACKEN. But at a slower——

Senator PROXMIRE. That is an indication of "stagflation," a period in which controls ought to be working as they did back in 1971?

Mr. MCCRACKEN. We have had an accumulation of a lot of distortions in this program. You alluded to one, this paper mill out there in Rhinelander, I think we just have reached the point where the diminishing effectiveness of the program has to be matched against the distortions which we now have.

Senator PROXMIRE. Mr. Burns indicated we ought to have a review board to take a look at continuing inflation on a longer basis. How about the successful program we have in the area of construction, health, and perhaps food? Do you think we ought to have something in those areas where we clearly have distinct shortages?

Mr. SAMUELSON. Yes, two out of the three areas you talked about happen to be the domain of Mr. John Dunlop, and the country has been grateful at the miracle in the construction industry and the health industry that was somehow perpetrated, and if it can be continued I think it ought to be. I believe there is some danger in terms of political consensus in getting wage agreements, if there are wage review boards at a time when there may be a jettisoning of price review boards on administered prices by large corporations, and I think that that particular asymmetry is the sort of thing that may end the wage honeymoon and ought to be watched very carefully.

Senator PROXMIRE. I just have a couple of more questions. One, I would like to—first, I would like to point out that, Mr. Evans, you have given me the impression that, which has been given by a lot of economists, and perhaps it is unfair and maybe I misinterpret what you say, but the impression that the vast bulk of the unemployed are unskilled teenagers from the ghetto, that just is not supported by the evidence. The majority of the unemployed are white adults with work experience, and I have the number of unemployed here broken down by category: Men, 20 years and over, 1.9 million; women, 20 years and over, 1.6 million; teenagers. 1.3 million; white unemployed, 3.9 million; with work experience, 3.1 million; without experience. 0.7 million. So it is clear that this is pretty much of a universal problem, and it is not one simply that can be solved by identifying it as a ghetto problem. On almost any basis we are still doing worse than almost any other industrial country in the world with the exception of Canada, which, of course, is very dependent on us.

Mr. EVANS. If I may make one brief comment there. I personally usually use another set of statistics, and I do not want to get into the statistics game, but I generally look at the people who have been unemployed 5 weeks or more. In other words, I believe the people who are unemployed 1 to 4 weeks are not of the same magnitude of problem; those are frictional unemployment and are not treated by overall policy. I do not have the figures here today to give effective rebuttal to those numbers if, in fact, it is warranted.

Senator PROXMIRE. I would like to get a rebuttal along that very line. If you can show the long-term unemployment is concentrated largely in people without work experience, minority groups, and young people, I would like to see it.

Mr. EVANS. OK, I certainly would be pleased to prepare those figures.

Senator PROXMIRE. The New York Times last Sunday carried an article which alludes to politicization of the Council of Economic Advisers. You are all eminent economists and, Mr. McCracken, you served very recently as the Chairman. It points out that Mr. Stein and Mr. Keyserling, one a Democrat and one a Republican, have been extraordinarily political; they waded into every fight around. Mr. Stein even gave speeches in support of President Nixon in the campaign. It is pointed out one of the great problems here is when you have the Chairman of the Council of Economic Advisers responding regularly to interpretation of the statistics that come out, and the feeling on the part of many that the interpretation is self-serving and partisan, and puts the best light, for example, on unemployment statistics or the best light on price statistics. The suggestion is made that the economic profession would be the best instrument to resolve this.

Perhaps some kind of study could be made, initiated at the convention of the American Economic Association to be held in December. Then recommendations might follow on how the Council should operate. Mr. Stein is an extraordinarily able man, and I am sure he has followed his conscience, as has Leon Keyserling and others, but if there could be some guideline permitting them, for example, to get into specific issues and give their view of particular legislation but not allow regular interpretation of statistics, this might be helpful. And perhaps a prestigious group of economists could flatly oppose political campaign speeches being given by members of the Council.

It is a very delicate area because we hesitate to offend anyone. I hope that you gentlemen could give me your reaction to the discipline that might be considered by the profession. Will you start off, Mr. Samuelson?

Mr. SAMUELSON. Yes. I have never been in that position so I can speak freely. The counsel which I would give to a President who asked me "How shall I use my Council of Economic Advisers, how shall I use the Chairman?" would be that that President will gain more in the long run from that Chairman of the Council of Economic Advisers if he does not use him in a primarily or purely political capacity. That any short-term gain that that President may think he will get by sending the Chairman of the Council of Economic Advisers to give a gloss on the latest unfriendly labor statistics handout will be lost in the lack of credibility which that Chairman will have in the long run, and I would advise that President to forbid the Chairman of the Council of Economic Advisers to speak in an election period before the Commonwealth Club or the Detroit Economic Club in favor of the candidacy of the party which the Chairman of the Council represents.

I would do this just in terms of maximizing the effectiveness of the administration and to the country of the Council of Economic Advisers.

Now, I have given the easy part of it, the hard parts are the marginal decisions.

Senator PROXMIRE. You say if you were advising a President on how to handle it you would tell or suggest to him that he might do this. I would hope for a little stronger framework because if you leave it up to the President he would say, of course, the economists say this and to hell with it. But I think if leading figures in the profession itself would take the position that the national interest would be best served by preserving the professionalism of the Council, it would be better than saying if the President wishes to do it this way let him go ahead and do it.

Mr. SAMUELSON. I did not wish to pronounce on that other aspect of the problem in the sentence which I earlier uttered but the reason I put it on the President was that there are many times, and with both political parties, I can give you instances where it is quite obvious that the Chairman of the Council of Economic Advisers was overruled by higher policy levels in the recommendations which he gave, and he had to be a good soldier in a certain sense in his public utterances with respect to those policies, and I cannot think of any charter prepared by the guild of, say, the American Economic Association which could remove the possibility of such occasions arising.

Senator PROXMIRE. You are absolutely correct. There is no question the President is and should be sovereign in this respect. He has the right, after all, this is his council of advisers, and he can use it anyway he wants.

I am just saying if the profession indicated the Nation would be best served and the President in the long run would best be served by a professional and objective analysis by the Council, this might be persuasive both with the President and with the Council.

Let me ask Mr. Evans to go next and Mr. McCracken, in view of his position, to be the cleanup man.

Mr. EVANS. Well, first, I should point out the obvious, which is that I am not particularly well qualified to answer this question having never served in these positions. But, very briefly, it seems to me that the Chairman of the Council's first responsibility obviously is to his President. He should meet with the President and the President should make known what his views are and what he would like to accomplish in terms of the economic scenario. The Chairman should they say, "OK, in my opinion, the best ways of going about this are to do such and such," and then do it. He cannot disagree with the President or he will be out of a job.

Senator PROXMIRE. I know he cannot. That is what we are trying to do here is to create a situation in which he will have a better chance for insulating his professionalism.

Mr. EVANS. With respect to the other part of the question, whether there should be a list drawn up by professional economists, I guess I do not really have a high opinion of that procedure and do not think it would work. The American Economic Association or some list like that, I would imagine, would have many reasons for choosing this list, very few of which, in my opinion, would be relevant to how well this man could serve the country.

Senator PROXMIRE. They have an objectivity, they have a very high competence. It seems to me they could give very helpful advice.

Mr. EVANS. In my opinion, their objectivity on this would be much lower than is commonly accepted.

Senator PROXMIRE. A bunch of Democrats. [Laughter.] I do not think so.

Mr. EVANS. Well, I guess if you polled the AEA constituency you would find they are heavily Democratic, but I think they would give a Democratic President just as much trouble as a Republican President.

Senator PROXMIRE. I think so, too. I think they are concerned with their profession and with the great importance of having the Council of Economic Advisers maintain its high professional quality and respect, would greatly outweigh any partisanship they may have and they realize the Presidency shifts back and forth and so they cannot serve their ideological preference by a recommendation that would help one party and not another.

Mr. EVANS. I am glad you have such an exalted opinion of the profession.

Senator PROXMIRE. I have often criticized the profession severely as I did in my opening statement this morning.

Mr. EVANS. That is true. I am afraid this selection process would not reach the high levels of objectivity which would be necessary and I would not be in favor of that.

Senator PROXMIRE. Mr. McCracken.

Mr. MCCRACKEN. When you first asked this question I thought for the first time in my career I was going to take a fifth amendment before a congressional committee.

Professor Samuelson gave some very good advice, as it were, to the President here. The Chairman of the Council has a rather indistinct part that he has to try to go along. No question but what the President has to consider him a member of the team. I believe it was Roy Blough who, after his tour of duty as a member, wrote that this is important because: "If this is not true then the three members of the Council would have approximately the same influence on policy as any other three economists with good publication facilities." I think that is correct.

On the other hand, the Chairman of the Council also has to conduct himself in this job in a way that maintains his professional credentials with his colleagues in the profession. I am sure that most of us who have been there have occasionally found ourselves straying over these boundaries. I certainly think of times when I did.

As to having the American Economic Association members draw up a charter or guidelines, I would not recommend that. I doubt if it would be very constructive. I think what it might be worthwhile doing would be possibly for the Joint Economic Committee to inquire into the whole structure as it was originally developed in the Employment Act at both ends of Pennsylvania Avenue. What have been the successes and failures? What have been the problems? We have accumulated now over 25 years of experience. This committee might want to review that.

Mr. SAMUELSON. I have an important addition to add to what I said before.

Senator PROXMIRE. Yes.

Mr. SAMUELSON. And that is, I think the finest moment of any Chairman of the Council of Economic Advisers might be the moment when he quit and quit with a public blast against policies which he thought were bad. That is always a personal, ethical problem of any team member, but this is the duty and obligation of any Council member responsible to the President. If he cannot go along with the policies he has his final last right to resign and give the reasons for his resignation. So I do not think the fear of losing your job should be a reason necessarily, for going along with the policy. At some point the job is not worth having and I think——

Senator PROXMIRE. You would institutionalize a farewell address by the Chairman of the Council?

Mr. SAMUELSON. Well, we would just have people leaving Government and they tell us, they have given us——

Senator PROXMIRE. That would tend to give greater tenure to whoever was the Chairman of the Council, and it would probably increase his influence. [Laughter.]

Well, gentlemen, thank you very, very much. You have made a most fascinating morning and have given us some extremely useful advice.

The committee will stand in recess until tomorrow morning at 10 o'clock when we convene in this room to hear three other distinguished economists.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, October 18, 1973.]

THE 1973 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, OCTOBER 18, 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: Senator Proxmire.

Also present: John R. Stark, executive director; Lucy A. Falcone, Jerry J. Jasinowski, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

This morning we have asked our witnesses to discuss the price outlook and the future of the phase IV inflation control program. At yesterday's hearings we received unanimous testimony that the economy is headed for a slowdown and a rising rate of unemployment. Our witnesses agreed that the economy is locked into this slow growth pattern for at least the next 9 months, almost regardless of the future course of economic policy.

What does this imply for the price outlook?

Unfortunately, slow growth and rising unemployment does not bring with it any promise of an end to inflation. Indeed, a slowdown could actually intensify inflationary pressures. Slower growth of output means lower productivity gains, which in turns means rising unit labor cost. Slower growth of output also means less overtime to be worked, more workers on part-time schedules, and more temporary layoffs. And is that not likely to result in many workers doing their best to seek higher hourly wage increases to maintain their real income? To the extent that labor costs are a source of price inflation, the difficult period lies ahead of us, not behind us.

Furthermore, there is as yet no assurance that the pressure of rising raw material prices will abate. The worst of the food price increase is hopefully behind us, but other raw material prices are continuing to rise. The wholesale price index for nonfood crude materials rose 3.3 percent in September alone. That was the largest monthly increase of any month so far this year.

Given this discouraging price-wage outlook, it is strange that there is so much talk of disbanding controls. Certainly we are in no position to declare a victory over inflation. Yet none of us can ignore the damaging effect which controls may be having on output, profits, and investment.

Are the controls so damaging that they should be abandoned? Or can the controls be restructured to deal more effectively with the inflationary pressures which lie ahead? Or can the controls be replaced with a less formal but perhaps equally effective incomes policy?

These are difficult questions. The expiration date of the Economic Stabilization Act next April 30 in a sense represents a deadline prior to which these questions must be decided. Congress is thus very much in need of expert advice on these questions. Fortunately, our panel this morning is extremely well-qualified to provide that advice.

Our first witness will be Marten Estey, professor of management and industrial relations at the Wharton School. Mr. Estey has just completed a study for the American Enterprise Institute entitled "Wage Stabilization Policy and the Nixon Administration." He also is the author of numerous other articles on wage policy, including one published by the Joint Economic Committee last year on "Union and Non-Union Wage Changes." Mr. Estey is also serving at the present time as a member of an advisory committee to the Cost of Living Council on wages in the food industry.

However, Mr. Estey is testifying on his own behalf this morning and not in his capacity as a member of the committee, and we have asked him to discuss the wage situation generally, not just in the food industry.

Our second witness will be Prof. Mary Hamilton, chairman of the department of finance at Loyola University of Chicago. Miss Hamilton served on the Price Commission during phase IV.

Our final witness is Arnold Weber, dean of the Graduate School of Industrial Administration at Carnegie-Mellon University. Mr. Weber was Assistant Secretary of Labor for Manpower from 1969 to 1970. He served as Executive Director of the Cost of Living Council in 1971 and then as a member of the Pay Board during phase II. Mr. Weber has just completed a history of phase I which is being published by the Brookings Institution, and I understand he is now at work on a history of phase II.

I would like to ask each of the witnesses to hold their statement to about 10 minutes.

Mr. Estey, please proceed.

STATEMENT OF MARTEN ESTEY, PROFESSOR OF MANAGEMENT AND INDUSTRIAL RELATIONS, WHARTON SCHOOL OF FINANCE, UNIVERSITY OF PENNSYLVANIA

Mr. Estey. Thank you, Senator Proxmire.

In discussing wage stabilization and incomes policy, I think the best thing to do is to start by reviewing briefly what has happened to wages during controls, and then follow that by taking a look at some of the factors that affect the prospects with respect to wages and labor costs in the future.

The major focus of interest, as well as the major impact of controls is on wages negotiated under collective wage bargaining. And the central fact, I think, is that the rate of increase in negotiated wages has fallen substantially during controls.

In the first quarter of 1973, at the end of phase II, negotiated wage changes in all industries registered the smallest gains since the first quarter of 1968, the first period for which quarterly data on average mean wage changes are available.

Put another way, the average first year adjustment in wages in the second quarter of 1973 was approximately half as large as in the third quarter of 1971. The average increase in wages over the life of the contract in 1973–II was slightly less than two-thirds as large as in the fourth quarter of 1971.

In construction, which has been subject to mandatory controls since March 1971, the slowdown in the rate of wage increase was even more pronounced, falling from approximately 18 percent in the quarter before controls began in that industry to a low of 4.3 percent in the fourth quarter of 1972.

As a further measure of the success of the Construction Industry Stabilization Committee, we have moved from a situation in which major construction settlements raised the average size of all major collective bargaining settlements to one in which construction lowered that average.

Now, to shift from negotiated wages to wages generally, we find the behavior of wages in the private nonfarm sector as a whole has been quite different from that of negotiated wages.

First, general measures of wages responded much more rapidly to controls than did negotiated wages. Perhaps I should amend that to say that they moved much more rapidly during controls than did negotiated wages. The various measures of general wages dropped so sharply that they registered their smallest gain during the whole control period in the fourth quarter of 1971, one-quarter after the control program was put into operation.

Second, and I am sure equally important, the rate of increase in general wage measures, that is, of average hourly compensation, and of average hourly earnings, has fallen less during controls than was the case of negotiated increases. This of course is partly because when the general pay standards were set, they were much closer to the rate of wage increase prevailing in the economy as a whole, than to the rates of increase an negotiated wage prevailing at that time.

In terms of the effect of controls, there is of course always an argument as to how much of the slowdown—which was sharper in the case of negotiated increases than of general wage increases—how much of this slowdown, if any, is due to controls. This is of course a matter of considerable controversy, as was the case with the wage price guideposts in 1962. Some people have noted this will give professional employment to economists for years to come, trying to reach a conclusion as to the overall impact of controls.

Although I can no longer claim to be an uninvolved spectator, I find it very hard to believe that the strenuous efforts of the Pay Board, the Construction Industry Stabilization Committee, and the Cost of Living Council have had no effect, even though they may have been aided and abetted by underlying economic forces.

And it is important to remember, in assessing the effectiveness of the wage stabilization program that although inflation control was one objective, in addition there were the objectives of maintaining equity and fairness, and of minimizing the disruption of normal market mechanisms such as collective bargaining.

Accordingly, the effectiveness of the control program in meeting these multiple objectives cannot be measured in terms of wage behavior alone.

Now, to look at the productivity situation, I think we should note that productivity gains made a major contribution to the reduction of inflationary pressures both in 1971 and in 1972. In both 1969 and 1970 the rates of productivity growth were low. In 1971 and 1972 the output per man-hour in the private nonfarm economy rose by 4.0 and 4.2 percent respectively.

This sharp productivity gain, combined with a reduction in the rate of increase in compensation per man-hour from 7.3 percent in 1970 to 6.9 percent in 1972, resulted in a 60-percent decrease in the rate of gain in unit labor costs in the private nonfarm sector, from 6.6 percent in 1970 to 2.6 percent for all 1972 (unit labor costs actually declined in 1972–II).

Thus by mid-1972, cost-push pressures, as reflected in the rate of increase in unit costs were noticeably less than they had been at the beginning of the controls program, although more of this improvement may have been due to productivity gains than to the reduction of gains in compensation or to the impact of controls on wages generally.

Now, as to future prospects. There are several major factors that I would refer to here: the collective bargaining schedule for 1974, the decline in real wages and its impact on demands for wage increases, and of course the prospect of a decline in the economic activity.

As far as the bargaining schedule of 1974 is concerned, I do not have the specific data, but I understand that the number of workers subject to negotiations in 1974 is smaller than in 1973, a factor which must be considered a plus in the fight against inflation, if only because it will narrow somewhat the impact of collective bargaining.

The key negotiations of 1974, of course, are those involving basic steel, and their related negotiations in the can and aluminum industries. An agreement has already been reached in basic steel which is designed to prevent a strike in 1974 by providing in advance for a 3-percent annual wage increase over the life of the agreement in exchange for arbitration in case of an impasse, and it is hoped that steel will follow the pattern set in autos this year, and thus extend the moderate wage increases of 1973 on into 1974.

I think we have to note that the steelworkers have already indicated that they may seek additional wage increases to make up for the erosion of real wages, so it remains to be seen how closely they follow the automobile industry pattern.

Perhaps the strongest pressure for increases in wages, I think, is the current decline in real wages brought on by the rapid increase in consumer prices.

All major wage measures reflect the erosion of real wages by the sharp price increases of 1973. When we look at these measures in terms of 1964 dollars, in order to adjust for price changes, we find that average hourly compensation fell in the second quarter of 1973.

The hourly earnings index for the private nonfarm employee fell in the first and second quarters of 1973.

Real spendable earnings fell in the first quarter of 1973 and the second quarter of 1973; and according to the most recent figures that I have, fell at an annual rate of 1.9 percent from July to August 1973.

Put another way, the gross average weekly earnings in current dollars for a worker with three dependents rose from $137.62 in August 1972 to $147.02 in August 1973, but his real spendable earnings fell from $97.25 to $95.22.

Now, I should put in a qualifier here, that about three-quarters of this drop in his real spendable earnings was due to increased social security deductions and Federal income-tax payments rather than higher prices. But the worker still feels this.

The erosion of real wages shown in these figures, it seems to me, is significant in two respects:

First, it suggests how great the pressure may be for wage increases which will reverse this trend, or at least keep up with the rate of increase in consumer prices and prevent further erosion of real wages.

Second, it suggests why organized labor is calling for the termination of controls, and how difficult it would be to continue wage stabilization with prices rising at present rates.

The third point deals with the question of a possible slowdown in the economy. Any appreciable slowdown in economic activity is likely to lead to a reduction in overtime, especially in the manufacturing industries. I think this is particularly significant because, although of course it has something to do with the auto workers' complaints about mandatory overtime, overtime has also served as a valuable buffer against inflation. A reduction of overtime would lead to reduction in both gross weekly earnings and in real spendable earnings, and add still further, as I see it, to the pressure for wage increases.

Of course, a slowdown in economic activity, I believe, would be accompanied by a slowdown in the rate of productivity growth. In fact, I might note that the productivity in the private nonfarm sector actually declined in the second quarter of 1973. Of course, if we have a slowdown in the rate of productivity growth, the tendency is to lead to a rise in unit labor cost.

Here again I note that the unit labor costs in the private nonfarm sector have accelerated now for four consecutive quarters. After declining in 1972, the second quarter, they had accelerated to a rate of 5.9 percent by the second quarter of 1973.

Thus we face a strong possibility of a simultaneous slowdown in the rate of productivity growth and an acceleration of increases in wages. Such a development would significantly reinforce the upward pressure on unit labor costs, and we would face the serious prospect of a resurgence of cost-push inflation.

If that analysis is correct, the need for some sort of restraint on wages and prices may well become greater than it is now.

But in discussing the future of controls, it is essential to distinguish between a potential need for continuation of controls and the feasibility of doing so in practice.

A crucial element in the present situation is the growing hostility toward controls, particularly from the parties most directly affected by them, labor and management.

George Meany, president of the AFL–CIO, as recently as last week called for an immediate end to wage and price controls. And last week both the U.S. Chamber of Commerce and the National Association of Manufacturers urged President Nixon to end the entire wage-price control program promptly.

The administration, too, has frequently expressed its desire to end the stabilization program. Secretary Shultz reported last week that the administration was trying to arrange a gradual, industry-by-industry approach to the termination of controls.

It has long been recognized, both here and abroad, that no stabilization program will work unless it has the support of labor and management and, we might add, of the executive branch of the Government. If that support has dissipated, as appears to be the case, continuation of controls becomes no longer practical.

So long as wage gains are outrun by increases in the Consumer Price Index, labor's resistance to continuation of wage stabilization will continue to rise, and understandably so.

Realistically, one would have to agree that without effective price stabilization, continuation of wage stabilization is unfair and inequitable.

We are faced with the prospect that today's demand-pull inflation may touch off tomorrow's cost-push inflation. And to compound the problem, today's demand-pull inflation is contributing to the strong pressures to dismantle the machinery for restraining cost-push inflation just when cost-push pressures appear to be rising.

In view of that prospect, and in view of a critical new variable in the equation—the unpredictable impact on the domestic economy of the war in the Middle East—I would hope that the pressure for the immediate termination of all controls would be resisted until all concerned have a clearer picture of the magnitude of those two threats to the return to economic stability.

I thank you.

[The prepared statement of Mr. Estey follows:]

Prepared Statement of Marten Estey [1]

Wage Stabilization: Record and Prospects

In discussing wage stabilization and incomes policy, it seems appropriate to start by reviewing what has happened to wages during controls and then to follow that by taking a look at some of the factors that affect the prospects with respect to wages and labor costs in the near future.

I. What Happened to Wages During Controls?

A. Wage Changes Under Collective Bargaining

The major focus of interest, as well as the major impact of controls, is on wages negotiated under collective bargaining. And we are concerned here with the *rates of increase* in wages, rather than with their *level* or amount in dollars and cents, for although wage levels seldom decline, their rates of increase may do so. Furthermore, it is wage increases, measured in percentage terms, that are pertinent to the problem of inflation, which is measured in terms of percentage increases in prices.

The central fact is that the rate of increase in negotiated wages has fallen substantially during controls.

In 1973–I, at the end of Phase II, negotiated wage changes in all industries together registered the smallest gains since 1968–I, the first period for which quarterly data on average (mean) wage changes are available.

This was true in the case of both first year adjustments and increases over the life of the contract, and for both wages and benefits and for wages alone.

The average first-year adjustment in wages in 1973–II was approximately half as large as in 1971–III.

[1] Professor of management and industrial relations, the Wharton School, University of Pennsylvania.

The average first-year adjustment in wages only fell from 13.5 percent in 1971–III to 6.1 percent in 1973–II, while in the case of wages and benefits, it fell from 15.0 percent in 1971–III to 7.6 percent in 1973–II.

The average increase in wages over the life of the contract in 1973–II was less than two-thirds as large as in 1971–IV.

The average increase in wages only over the life of the contract fell from 9.0 percent in 1971–IV to 5.7 percent in 1973–II, in the case of wages and benefits, it fell from 10.6 percent in 1971–IV to 6.6 percent in 1973–II.

In construction, which has been subject to mandatory wage controls since March 1971, some four and a half months longer than the rest of the economy, the slowdown in the rate of wage increase has been even more pronounced than in collective bargaining agreements generally, with the average first-year wage adjustment falling from 18.0 percent in 1971–I, the quarter before construction wage controls began, to a low of 4.3 percent in 1972–IV.

During the construction industry stabilization program, in fact, we have moved from a situation in which major construction settlements *raised* the average size of *all* major collective bargaining settlements to one in which construction *lowered* that average. Thus in 1970, the year before controls, first-year wage adjustments in major construction settlements were nearly double those in other industries, and *raised* the all-industry average for the year from 10.9 percent to 11.9 percent. In 1972–IV on the other hand, first-year construction settlements averaged 4.3 percent, and *lowered* the all-industry average from 6.5 to 6.4 percent.

B. General Wage Changes in the Private Non-farm Sector

The behavior of wages in the private non-farm sector as a whole has been quite different from that of negotiated wages.

General wage measures responded much more rapidly to controls than did negotiated wages. Increases in average hourly compensation, in average hourly earnings, and in the hourly earnings index (earnings adjusted for overtime in manufacturing and for interindustry shifts) each dropped so sharply that they registered their smallest gain during the whole control period in 1971–IV, the first quarter of Phase II.

The rate of increase in general wage measures has fallen less during controls than in the case of negotiated increases. In 1973–II, the rate of increase in average hourly compensation was approximately 25 percent smaller than in 1971–II, the quarter prior to controls, and the rates of increase in average hourly earnings, both gross and adjusted, were about 7 percent smaller than in 1971–II.

C. The Effect of Controls

It is evident that there has been a substantially greater slowdown in the rates of increase of negotiated wages than of wages generally, though both are lower now than at the outset of controls. Indeed, wages were spared from the freeze of June 13, 1973, because, as the President put it, wage settlements had become non-inflationary.

How much of this slowdown, if any, is due to controls is a matter of considerable controversy, as was the case with the voluntary wage-price guideposts set forth in 1962. And though I cannot claim to be an uninvolved spectator, I would find it hard in any event to believe that the strenuous efforts of the Pay Board, the Construction Industry Stabilization Committee, and the Cost of Living Council have had no effect, even though they may have been aided and abetted by underlying economic forces.

Furthermore, it is important to remember, in assessing the effectiveness of the wage stabilization program, that although the primary goal of the wage stabilization program was to combat inflation, it also sought to maintain equity and fairness and to minimize disruption of normal market mechanisms such as collective bargaining. Its effectiveness in meeting these multiple goals obviously cannot be measured in terms of wage behavior alone.

II. PRODUCTIVITY, COMPENSATION, AND UNIT LABOR COSTS UNDER CONTROLS

In addition to the substantial slowdown of negotiated wage increases during Phase I and Phase II, productivity gains have made a major contribution to the reduction of inflationary pressures in both 1971 and 1972.

Following two years of low productivity growth in 1969 and 1970, output per man hour in the private non-farm economy rose 4.0 percent in 1971 and 4.2 percent in 1972.

This sharp productivity gain, combined with a reduction in the rate of increase in compensation per man hour from 7.3 percent in 1970 to 6.9 percent in 1972, resulted in a sixty percent *decrease* in the rate of gain in unit labor costs in the private non-farm sector, from 6.6 percent in 1970 to 2.6 percent for all 1972 (unit labor costs actually declined in 1972–II).[2]

Thus by mid 1972, cost-push pressures, as reflected in the rate of increase in unit costs, were noticeably less than they had been at the beginning of the controls program, although more of this improvement may have been due to productivity gains than to the reduction of gains in compensation or to the impact of controls on wages generally.

III. PROSPECTS FOR THE FUTURE

In assessing the situation with respect to the future of wage-price controls, several major factors which have a bearing on the movement of wages and labor costs need to be considered—the collective bargaining schedule for 1974; the decline of real wages as a stimulus to larger wage increases; and the probability of a decline in the rate of productivity growth associated with a slowdown in economic activity.

A. The Bargaining Schedule for 1974

The number of workers subject to negotiations in 1974 is smaller than in 1973, a factor which must be considered a plus in the fight against inflation, if only because it will narrow somewhat the impact of collective bargaining.

The key negotiations of 1974, of course, are those involving basic steel, and their related negotiations in the can and aluminum industries. An agreement has already been reached in basic steel which is designed to prevent a strike in 1974 by providing in advance for a three-percent annual wage increase over the life of the agreement in exchange for arbitration in case of an impasse, and is hoped that steel will follow the pattern set in autos this year, and thus extend the moderate wage increases of 1973 on into 1974.

But the Steelworkers have already indicated that they would seek additional wage increases to make up for the erosion of real wages, so it remains to be seen how closely they follow the auto industry pattern.

B. The Decline in Real Wages

Perhaps the strongest pressure for increases in wages is the current decline in real wages brought on by the rapid increase in consumer prices.

All major wage measures reflect the erosion of real wages by the sharp price increases of 1973. When we look at changes in real wages—wages measured in 1967 dollars instead of current dollars, in order to correct for price changes—we find that:

Average hourly compensation of all employees in the private non-farm economy *fell* at an annual rate of 2.6 percent in 1973–II.

The hourly earnings index for the private non-farm economy, adjusted for overtime in manufacturing and for interindustry shifts, *fell* at an annual rate of 1.0 percent in 1973–I, and of 1.8 percent in 1973–II.

Real spendable earnings of workers with three dependents *fell* at an annual rate of 5.0 percent in 1973–I, 0.7 percent in 1973–I, and 1.9 percent from July to August 1973.

Or to put it another way, the gross average weekly earnings (in current dollars) of a worker with three dependents *rose* from $137.62 in August 1972 to $147.02 in August 1973. But his real spendable earnings (in 1967 dollars) *fell* from $97.25 to $95.22.

Although three-quarters of this drop in real spendable earnings was due to increased Social Security deductions and federal income tax payments, rather than to higher prices, the effect on the worker is the same—his real spendable earnings are down.

The erosion of real wages shown in these figures is significant in two respects:

It suggests how great the pressure may be for wage increases which will reverse this trend, or at least keep up with the rate of increase in consumer prices, and prevent further erosion of real wages.

It suggests why organized labor is calling for the termination of controls, and how difficult it would be to continue wage stabilization with prices rising at present rates.

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[2] *Productivity and Costs in the Private Economy,* Second Quarter 1973, Bureau of Labor Statistics, U.S. Dept. of Labor.

C. A Slowdown in the Economy

If, as many predict, there is a slowdown in the economy in the next six to twelve months, there would be significant implications with regard to inflation.

Any appreciable slowdown in economic activity is likely to lead to a reduction in overtime, especially in the manufacturing industries, which have been averaging 3.8 hours overtime per week in 1973. Although this overtime has been the source of the Auto Workers' complaints about mandatory overtime, it has also served as a valuable buffer against inflation—a reduction in overtime would lead to a decline in both gross weekly earnings and in real spendable earnings, aggravate an already deteriorating situation with respect to real wages, and add still further to the pressure for wage increases.

A general slowing of economic activity would doubtless be accompanied by a slowdown in the rate of productivity growth. The productivity gains in 1971 and 1972 were well above the long-term average of 3.0 percent, and are clearly not sustainable for a protracted period of time. In fact, as we have noted, productivity in the private non-farm sector actually declined in 1973–II—the first decline since 1970–IV, when the General Motors strike sharply reduced output.

But even a slowdown in the rate of productivity growth (an actual decline is not necessary) would result in any acceleration in unit labor costs. In fact, this pattern may have begun already, for after declining by 0.5 percent in 1972–II, unit labor costs in the private non-farm sector have accelerated for four consecutive quarters, to a rate of 5.9 percent in 1973–II.

D. Renewed Cost-push Inflation?

There is a strong possibility that we face a simultaneous slowdown in the rate of productivity growth and an acceleration of increases in wages. Such a development would significantly reinforce the upward pressure on unit labor costs that has already become evident in the private non-farm sector of the economy, and we would face the serious prospect of a resurgence of cost-push inflation, regardless of what happens to demand-pull inflation.

If that analysis is correct, the *need* for some sort of restraint on wages and prices may well become greater than it is now.

But in discussing the future of controls, it is essential to distinguish between a potential *need* for continuation of controls and the *feasibility* of doing so in practice.

A crucial element in the present situation is the growing hostility toward controls, particularly from the parties most directly affected by them, labor and management. George Meany, president of the AFL–CIO, as recently as last week called for an immediate end to wage and price controls. And last week both the United States Chamber of Commerce and the National Association of Manufacturers urged President Nixon to end the entire wage-price control program promptly.

The Administration, too, has frequently expressed its desire to end the stabilization program; Secretary Shultz reported last week that the Administration was trying to arrange a gradual, industry-by-industry approach to the termination of controls.

It has long been recognized, both here and abroad, that no stabilization program will work unless it has the support of labor and management and, we might add, of the Executive branch of the government. If that support has dissipated, as appears to be the case, continuation of controls becomes no longer practical.

So long as wage gains are outrun by increases in the consumer's price index, labor's resistance to continuation of wage stabilization will continue to rise, and understandably so.

Realistically, one would have to agree that without effective price stabilization, continuation of wage stabilization is unfair and inequitable.

THE DILEMMA

We are faced with the prospect that today's demand-pull inflation may touch off tomorrow's cost-push inflation. And to compound the problem, today's demand-pull inflation is contributing to the strong pressures to dismantle the machinery for restraining cost-push inflation just when cost-push pressures appear to be rising.

In view of that prospect, and in view of a critical new variable in the equation—the unpredictable impact on the domestic economy of the war in the Middle East—I would hope that the pressure for the immediate termination of all controls would be resisted until all concerned have a clearer picture of the magnitude of those two threats to the return to economic stability.

WAGE CHANGES DURING CONTROLS

[Quarter-to-quarter changes; percent change over previous quarter at annual rate]

Item	1971				1972				1973	
	I	II	III	IV	I	II	III	IV	I	II
Negotiated wages, 1st-year adjustments:										
Wages and benefits, 5,000 workers or more	10.6	11.5	15.0	12.7	9.7	8.1	8.7	7.3	7.3	7.6
Wages only, 1,000 workers or more, all industries	10.0	10.4	13.5	10.5	8.7	7.1	7.6	6.4	5.3	6.1
Wages only, construction	18.0	13.1	12.3	11.5	19.0	6.3	6.4	4.3	4.5	6.3
General wage measures, private nonfarm economy, seasonally adjusted:										
Average hourly compensation [1]		7.9	6.8	4.7	9.8	5.2	6.4	6.5	10.8	6.0
Hourly earnings index [2]		7.0	6.4	4.8	8.3	5.6	5.3	7.1	5.0	6.5
Real spendable earnings (worker and 3 dependents, 1967 dollars)		2.7	.7	3.0	9.4	3.7	1.3	2.2	−5.0	−.7

[1] Average hourly compensation, all employees, in current dollars.
[2] Adjusted for overtime (in manufacturing only) and for interindustry shifts, in current dollars.

Source: Wage and benefit decisions data from "Review of Productivity, Wages, Prices, and Employment" (2d quarter, 1973), Bureau of Labor Statistics release, Aug. 3, 1973, table 7, general wage measures, data from ibid., table 5.

Senator PROXMIRE. Miss Hamilton, please proceed.

STATEMENT OF MARY T. HAMILTON, CHAIRMAN, DEPARTMENT OF FINANCE, LOYOLA UNIVERSITY OF CHICAGO

Miss HAMILTON. In my view, the most critical factor in the price outlook is developments in the world economy; that is, the rate of expansion in foreign countries as well as our own.

Our main price difficulties appear to be in the areas of food, energy, and some raw materials such as nonferrous metals. Each of these areas is directly affected by world developments. Food problems resulting from short supplies due to natural causes have been aggravated by increased demand both at home and abroad. Also, the high levels of expansion in foreign countries have increased the competition for energy sources and raw materials.

A simultaneous worldwide expansion in output at rates above historical long term levels is not a usual occurrence. It is of some interest to note, however, that the period of rapid inflation in 1950 and early 1951 also took place in a climate of robust economic growth in Europe and Japan as well as in the United States.

I think it is difficult to assess the current price situation—even more so now than has been true in the past—in part because the basic price trends are obscured by the recent wide fluctuations.

Also, phase IV is still in its infancy and we have not felt the full impact of delayed price increases.

The performance of the major indexes in various phases of the stabilization program is well known. The seasonally adjusted annual rate of increase in the Consumer Price Index was 3.6 percent in phase II and 8.3 percent in the 5 months of phase III preceding the freeze. For the 3 months ending in August 1973, the annual rate of increase was 11.4 percent, reflecting the rapid upsurge of food prices. The food component increased at an annual rate of 6.5 percent in phase II, 20.3 percent January–June 1973, and 34.5 percent in the 3 months ending in August.

The increase in prices of commodities less food also escalated from an annual rate of 2.4 percent in phase II to 5.2 percent in 5 months of phase III. The rate of increase in the 3 months ending in August was held to 4.1 percent.

At the wholesale level, the annual rate of increase in the all-commodities index jumped from 6.9 percent in phase II to 24.4 percent in January–June 1973. An astounding increase in August, offset in part by actual declines in July and September, resulted in an annual rate of increase for the 3 months ending in September of 13.2 percent. The most dramatic increase was, of course, in the farm products and processed foods and feeds component.

In the first 5 months of phase III, these prices were rising at an annual rate of 49.8 percent as compared to 16.1 percent in phase II. The annual rate of increase for the 3 months ending in August 1973 soared to 104.4 percent, but declined to 35.9 percent for the 3 months ending in September. Price increases for industrial commodities also accelerated from an annual rate of 3.5 percent in phase II to 14.4 percent in January–June 1973. The rate of increase was held to 4.5 percent in the 3 months ending in September. This is equal to the rate of increase in the 8 months of 1971 before phase I.

The overall figures are illuminating but conceal some interesting trends that are pertinent to an assessment of the outlook.

The annual rate of increase in the Consumer Price Index declined from 8.6 percent in the first quarter of 1973 to 7.2 percent in the 3 months ending in June. This reflects a 50-percent drop in the rate of increase in food prices, offset in part by a rise of 35 percent in the rate of increase for commodities less food and 25 percent in that for services.

The reduced rate of increase for food prices was due to the slower rate of increase in meat prices after the imposition of ceilings on March 29. In spite of an increase in production, poultry prices declined only 0.3 percent as consumer demand for red meat alternatives increased sharply. Higher prices for fruits and vegetables were caused by reduced supplies as a result of weather conditions.

Increased prices in other foods were largely the effect of increases in the price of grains and animal feeds since mid-1972. Food price increases in July and August are accounted for largely by meats, poultry, fish, and dairy products.

In the nonfood area, important contributors to the overall rise in prices have been gasoline and fuel oil prices. The rate of price increases was accelerating in the last half of 1972 and, in the first 6 months of 1973, gasoline prices rose at a seasonally adjusted annual rate of 16.1 percent.

At the wholesale level, the increase was over 70 percent. Although the inadequacy of supplies of crude petroleum relative to demand for petroleum products was a major factor, there is some indication that normal seasonal patterns of production were affected by the stabilization program.

The normal shift from gasoline to fuel oil in refinery output appears to have been diminshed last fall. As a result, fuel oil was in short supply during the winter. Similarly, an increase in fuel oil prices early in phase III delayed the normal increase in gasoline output in the spring. Fuel oil and coal prices increased at a seasonally adjusted annual rate of 22 percent in the first 6 months of 1973.

Gasoline and motor oil, fuel oil and coal, and food have a combined relative importance of 26 percent in the Consumer Price Index. The estimated impact on the overall index of the increases in these three components for the 6 months ending in June is 5.45 percentage points, or 68 percent of the seasonally adjusted annual rate of increase in the Consumer Price Index. The estimated impact for the 6 months ending in December 1972 is 3.9 percentage points, or 42 percent of the overall increase in consumer prices.

I should add that the impact of changes in components is difficult to calculate precisely. This is an estimate based on procedures that give a pretty quick fix.

Price trends at the wholesale level have been swamped by changes in the prices of agricultural commodities. The price of farm products, processed foods, and feeds increased at an annual rate of 43.2 percent in the second quarter of 1973 as compared to 51.9 percent in the 3 months ending in March, again a slight decline from the first to the second quarter in the rate of increase.

Food seems to be the Achilles' heel of control programs and agricultural prices are affected significantly by world events and world markets. A major cause of our present dilemma is the decline in world production of grains and a shortage of protein meal. Crop losses in many countries, but particularly in Russia, China, and India, resulted in a decline of 36 million metric tons, or 3½ percent in world grain production in 1972. This is in sharp contrast to the average annual increase of 34 million tons in each of the 10 preceding years.

As a result of the 1972 shortfall, world grain reserves are now at a bare minimum. The problem has been aggravated by a shortage of protein meal due to losses in peanut crops and a reduced Peruvian anchovy catch.

I need not add that with rising incomes the demand for meat until 1973 had been increasing substantially. It actually has declined somewhat in 1973 in the United States.

Although U.S. agricultural policy has been significantly redirected toward expanded production, it takes time for this to affect supplies and, in the interim, devaluation has made our farm products cheaper to foreign countries. While an increase in agricultural exports is clearly desirable for our balance of payments, it does put short-run pressure on domestic prices.

Price changes in the commodity market were extremely erratic in the summer months. The huge increases in the prices of some commodities in August have been followed in many instances by substantial declines. As a result, the seasonally adjusted annual rate of increase for the 3 months ending in September was reduced to 35.9 percent.

The rate of increase in industrial commodities accelerated from 10.2 percent in the first quarter of 1973 to 14.9 percent in the second quarter. The increase for crude materials except food rose from 11.8 percent in the first quarter to 36 percent in the second quarter.

In some respects, increases in the Wholesale Price Index have been analogous to those in the Consumer Price Index. The combined relative importance of farm products, processed foods, and feeds and fuel and related power components is 36 percent. The estimated impact of increases in these components on the Wholesale Price Index for the year ending September 1973 is 12.8 percentage points or 77 percent of the total increase in the overall index.

Price behavior in phase III has important implications for the "success" of phase IV. Success is in quotation marks because, in contrast to earlier phases, there is no specific target rate of inflation. The basic objective is to spread the bulge in price increases while tight monetary policy and fiscal restraint do the job. While some will judge phase IV's performance in this context, others will give greater weight to the absolute magnitude of the impact on the price level.

For these reasons, it is important to put phase III in perspective. The food explosion would have occurred in any case. The roots were well established in the last 6 months of phase II. If one looks at what was happening to the food component of the CPI in phase II, it is clear that it was rising, and by December the rates of increase were considerable. Also, devaluation would have caused problems and explains in part the rise in prices of industrial products, particularly those using nonferrous metals. Unfortunately, these "explainable" price increases seem to have been accompanied by an increasing frequency of anticipatory price increases. Nevertheless, I think it is important not to overrate its predecessor, phase II. It was no better designed to cope with the basic problems of phase III than phase III itself. For the most part, market conditions—both domestic and international—were not at severe odds with the goal of price stabilization. This was not the case in 1973.

The major problems in phase IV will continue to be in areas where supplies are inadequate to meet demand at prevailing prices. These include energy needs, strategic materials, and food. Ironically, were it not for these areas where at least in the short run we can only hope to contain some price increases, we might not want a control program.

The food situation will continue to be bothersome into 1974. The USDA forecast made in August was that food prices for the year will average 18 to 22 percent above 1972. This may be on the top side now since there have been some marked declines at the wholesale level since that forecast was made, particularly in the prices of poultry, eggs, and pork. Also, beef prices have shown weakness in spite of the removal of ceilings. In addition, crop forecasts are optimistic.

On the other hand, crop reserves are currently at such a low level that supplies for wheat and corn may fall below those of last year. At present, we have 1.3 billion bushels of wheat committed to export. The USDA thinks this is high; a more likely figure may be 1.1 billion bushels.

Some have advocated export controls as a means of easing domestic pressures. However, a factor that cannot be overlooked is that while the United States has only 6 percent of the world's population, it produces 25 to 30 percent of the world's food, particularly grain. This, together with our need for imports of strategic materials, implies that attempts to operate in isolation and maintain a domestic price below world price levels for commodities traded in the world market are sheer folly.

On balance, the evidence suggests that we must anticipate fluctuations in food prices around higher levels than those to which we are accustomed, at least into 1974. This does not mean that all prices will be higher—for example, in the next few months, beef prices may ease further as a result of an increase in slaughtering. And in 1974, an increase in pork supply should remove some pressure in that area. Problems on the immediate horizon are milk, bakery products—especially those using wheat—canned goods, and soft drinks.

Price development in the nonfood area will depend importantly upon the course of economic activity both at home and abroad. While there are some indications of easing—and some have argued that we are already in the early stages of a recession—there are still many areas of strength in the economy.

The American Statistical Association fall survey of forecasts indicates a median forecast of a 2.6-percent rate of growth in the United States for 1974. That compares with an estimate of 6 percent for this year.

On the other hand, the OECD economic outlook published in August, while indicating some slowdown in rates of growth in Japan, Germany, and in other countries in Europe, also indicates that the other countries would still have rates of growth well above ours. That is around 7 percent, as compared to an estimated 2.6 percent in this country.

In addition to these signs of continuing strength there is evidence that major materials industries are operating very close to capacity. A recent Federal Reserve study indicates that capacity utilization in these industries was 94 percent in the second quarter of this year. This is the highest level since 1948, the first year for which data are available. The high level of capacity utilization reflects not only significant increases in output in 1972 and 1973, but also slow expansion in capacity. Where the industries concerned have made investments, they have been primarily for plant modernization or meeting pollution requirements. These are also industries that complain of low profitability, and as a result, failure to expand.

Given these pressures, I think phase IV is doing as well as can be expected. The dollar-for-dollar passthrough is tougher than phase II rules and, although it seems a bit redundant to me, the profit margin constraint has been retained.

I think one of the strongest things working for phase IV is the fact that the administration stated flatly that prices—and in particular food prices—would rise. Food prices are highly visible and, as a result, have a disproportionate impact on inflationary expectations. However, there seems to be an increased understanding on the part of the consumer of the food price problems. Unfortunately, consumers may not view price increases in the modified area with such generosity.

One of the problems with control programs is that people become very aware of price increases and fail to notice price decreases. Moreover, there is a strong tendency to assume that all price increases are inflationary. This view ignores the role of the price system in making possible adjustments to changing conditions of both supply and demand. Demand shifts may reflect increased income or merely a change in preferences.

One of the good things about phase III and phase IV—which is, incidentally, an outgrowth of the term limited pricing agreements in phase II—is regulations cast in terms of weighted average price increases. This permits some flexibility in relative pricing and, therefore, minimizes the distortion of resource allocation. Although price increases under phase IV must still be cost-justified, the flexibility permits individual prices to respond within a limited range to demand as well as cost pressures. Unfortunately, this concept is not easily grasped by the public.

There is also a need for greater awareness of tradeoffs in public policies and goals. Three obvious ones related to controls are the Russian détente, the balance of payments and devaluation, and ecology, conservation, and environmental considerations. All of these put pressure on the price system. It is all too easy to take a myopic view of price stabilization and ignore other fundamental considerations.

Thank you.

[The prepared statement of Miss Hamilton follows:]

PREPARED STATEMENT OF MARY T. HAMILTON

Mr. Chairman, and members of the Joint Economic Committee, I appreciate the opportunity to be here today for your discussions on the current outlook for inflation and phase IV. In my view, the most critical factor in the price outlook is developments in the world economy, that is, the rate of expansion in foreign countries as well as our own.

Our main price difficulties appear to be in the areas of food, energy, and some raw materials such as non-ferrous metals. Each of these areas is directly affected by world developments. Food problems resulting from short supplies due to natural causes have been aggravated by increased demand both at home and abroad. Also, the high levels of expansion in foreign countries have increased the competition for energy sources and raw materials. A simultaneous world-wide expansion and output at rates above historical long term levels is not a usual occurrence. It is of some interest to note, however, that the period of rapid inflation in 1950 and early 1951 also took place in a climate of robust economic growth in Europe and Japan as well as in the United States.[1]

My comments today fall under two general headings: (1) price trends in 1973; and (2) implications for Phase IV.

PRICE DEVELOPMENTS IN 1973

An assessment of the current price situation seems frought with even more uncertainty now than has been true in the past. In part, this is due to the wide fluctuations in price increases in recent months. Basic trends in price changes tend to be obscured by distortions resulting from the freeze. Also, Phase IV is still in its infancy and we have not felt the full impact of delayed price increases.

The performance of the major indexes in various phases of the stabilization program is well known. The seasonally adjusted annual rate of increase in the Consumer Price Index was 3.6 per cent in Phase II and 8.3 per cent in the five months of Phase III preceding the freeze. For the three months ending in August, 1973, the annual rate of increase was 11.4 per cent reflecting the rapid upsurge of food prices. The food component increased at an annual rate of 6.5 per cent in Phase II, 20.3 per cent January–June 1973, and 34.5 per cent in the three months ending in August. The increase in prices of commodities less food also escalated from an annual rate of 2.4 per cent in Phase II to 5.2 per cent in five months of Phase III. The rate of increase in the three months ending in August was held to 4.1 per cent. (See Tables 1 and 2.)

At the wholesale level, the annual rate of increase in the all commodities index jumped from 6.9 per cent in Phase II to 24.4 per cent in January–June 1973. An astounding increase in August, offset in part by actual declines in July and September, resulted in an annual rate of increase for the three months ending in September of 13.2 per cent. The most dramatic increase was, of course, in the farm products and processed foods and feeds component. In the first five months of Phase III, these prices were rising at an annual rate of 49.8 per cent as compared to 16.1 per cent in Phase II. The annual rate of increase for the three months ending in August 1973 soared to 104.4 per cent but declined to 35.9 per cent for the three months ending in September. Price increases for industrial com-

[1] The rate of inflation peaked early in 1951. The Wholesale Spot Market Price Index for 22 commodities in the first 3 months of 1951 averaged more than 50 percent above the June 1950 level. The food component of the CPI increased approximately 20 percent from June 1950 to June 1951.

modities also accelerated from an annual rate of 3.5 per cent in Phase II to 14.4 per cent in January–June 1973. The rate of increase was held to 4.5 per cent in the three months ending in September. This is equal to the rate of increase in the eight months of 1971 before Phase I.

The overall figures are illuminating but conceal some interesting trends that are pertinent to an assessment of the outlook. These are discussed in the sections below.

The Consumer Price Index

The annual rate of increase in the Consumer Price Index declined from 8.6 per cent in the first quarter of 1973 to 7.2 per cent in the three months ending in June. This reflects a 50 per cent drop in the rate of increase in food prices, offset in part by a rise of 35 per cent in the rate of increase for commodities less food and 25 per cent in that for services.

The reduced rate of increase for food prices was due to the slower rate of increase in meat prices after the imposition of ceilings on March 29. In spite of an increase in production, poultry prices declined only 0.3 per cent as consumer demand for red meat alternatives increased sharply. Higher prices for fruits and vegetables were caused by reduced supplies as a result of weather conditions. Increased prices in other foods were largely the effect of increases in the price of grains and animal feeds since mid-1972. Food price increases in July and August are accounted for largely by meats, poultry, fish and dairy products.

In the non-food area, important contributors to the overall rise in prices have been gasoline and fuel oil prices. The rate of price increases was accelerating in the last half of 1972 and in the first six months of 1973, gas prices rose at a seasonally adjusted annual rate of 16.1 per cent. At the wholesale level, the increase was over 70 per cent. Although the inadequacy of supplies of crude petroleum relative to demand for petroleum products was a major factor, there is some indication that normal seasonal patterns of production were affected by the stabilization program. The normal shift from gasoline to fuel oil in refinery output appears to have been diminished last fall. As a result, fuel oil was in short supply during the winter. Similarly, an increase in fuel oil prices early in Phase III delayed the normal increase in gasoline output in the Spring. Fuel oil and coal prices increased at a seasonally adjusted annual rate of 22 per cent in the first six months of 1973.

Gas and motor oil, fuel oil and coal, and food have a combined relative importance of 26 per cent in the Consumer Price Index. The estimated impact on the overall index of the increases in these three components for the six months ending in June is 5.45 percentage points or 68 per cent of the seasonally adjusted annual rate of increase in the Consumer Price Index. The estimated impact for the six months ending in December, 1972 is 3.9 percentage points or 42 per cent of the overall increase in consumer prices.[2]

The Wholesale Price Index

Price trends at the wholesale level have been swamped by changes in the prices of agricultural commodities. The price of farm products, processed foods, and feeds increased at an annual rate of 43.2 per cent in the second quarter of 1973 as compared to 51.9 per cent in the three months ending in March.

Food seems to be the Achilles Heel of control programs and agricultural prices are affected significantly by world events and world markets. A major cause of our present dilemma is the decline in world production of grains and a shortage of protein meal. Crop losses in many countries, but particularly in Russia, China and India, resulted in a decline of 36 million metric tons or 3½ per cent in world grain production in 1972. This is in sharp contrast to the average annual increase of 34 million tons in each of the 10 preceding years.[3] As a result of the 1972 shortfall, world grain reserves are now at a bare minimum. The problem has been aggravated by a shortage of protein meal due to losses in peanut crops and a reduced Peruvian anchovy catch.

The shortage of feed grain has been accompanied by a worldwide increase in the demand for meat. In the U.S. alone, meat consumption per capita has gone from 88 pounds in 1962 to 115 in 1973, an increase of about 30 per cent. Output expansion is affected significantly by feed prices.

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[2] It is difficult to calculate the precise impact, but the approximation is described in the note to Table 3.

[3] These estimates are based on data from Schnittker Associates, Washington, D.C.

Although United States' agricultural policy has been significantly redirected towards expanded production, it takes time for this to affect supplies and in the interim, devaluation has made our farm products cheaper to foreign countries. While an increase in agricultural exports is clearly desirable for our balance of payments, it does put short run pressure on domestic prices.

Price changes in the commodity market were extremely erratic in the Summer months. The huge increases in the prices of some commodities in August have been followed in many instances by substantial declines. As a result, the seasonally adjusted annual rate of increase for the three months ending in September was reduced to 35.9 per cent.

The rate of increase in industrial commodities accelerated from 10.2 per cent in the first quarter of 1973 to 14.9 per cent in the second quarter. The increase for crude materials except food rose from 11.8 per cent in the first quarter to 36.0 per cent in the second quarter.

In some aspects, increases in the Wholesale Price Index have been analogous to those in the Consumer Price Index. The combined relative importance of farm products, processed foods, and feeds and fuel and related power components is 36 per cent. The estimated impact of increases in these components on the Wholesale Price Index for the year ending September 1973 is 12.8 percentage points or 77 per cent of the total increase in the overall index. (See Table 3.)

IMPLICATIONS FOR PHASE IV

Price behavior in Phase III has important implications for the "success" of Phase IV. Success is in quotation marks because in contrast to earlier phases, there is no specific target rate of inflation. The basic objective is to spread the bulge in price increases while tight monetary policy and fiscal restraint do the job. While some will judge its performance in this context, others will give greater weight to the absolute magnitude of the impact on the price level.

For these reasons, it is important to put Phase III in perspective. The food explosion would have occurred in any case. The roots were well established in the last six months of Phase II. Also, devaluation would have caused problems and explains in part the rise in prices of industrial products, particularly those using non-ferrous metals. Unfortunately, these "explainable price increases seem to have been accompanied by an increasing frequency of anticipatory price increases. Nevertheless, I think it is important not to over-rate Phase II. It was no better designed to cope with the basic problems of Phase III than Phase III itself. For the most part, market conditions—both domestic and international—were not at severe odds with the goal of price stabilization. This was not the case in 1973.

The major problems in Phase IV will continue to be in areas where supplies are inadequate to meet demand at prevailing prices. These include energy needs, strategic materials, and food. Ironically, were it not for these areas where at least in the short run we can only hope to contain some price increases, we might not want a control program.

The food situation will continue to be bothersome into 1974. The USDA forecast made in August was that food prices for the year will average 18 to 22 per cent above 1972. The USDA forecasts have been notoriously bad this year and this time they have erred on the topside. Since that forecast was made, there have been some marked declines at the wholesale level, particularly in the prices of poultry, eggs, and pork. Also, beef prices have shown weaknesses in spite of the removal of ceilings. In addition, crop forecasts are optimistic.

On the other hand, crop reserves are currently at such a low level that supplies for wheat and corn may fall below those of last year. At present, we have 1.3 billion bushels of wheat committed to export. (The USDA thinks this is high: a more likely figure may be 1.1 billion bushels.)

Some have advocated export controls as a means of easing domestic pressures. However, a factor that cannot be overlooked is that while the United States is only 6 per cent of the world's population, it produces 25 to 30 per cent of the world's food, particularly grain. This, together with our need for imports of strategic materials implies that attempts to operate in isolation and maintain a domestic price below world pricelevels for commodities traded in the world market are sheer folly.

On balance, the evidence suggests that we must anticipate fluctuations in food prices around higher levels than those to which we are accustomed, at least into 1974. This does not mean that all prices will be higher—for example in the next few months, beef prices may ease further as a result of an increase in slaughtering. And in 1974, an increase in pork supply should remove some pressure in that area. Problems on the immediate horizon are milk, bakery products—especially those using wheat—canned goods, and soft drinks.

Price developments in the non-food area will depend importantly upon the course of economic activity both at home and abroad. While there are some indications of easing—and some have argued that we are already in the early stages of a recession—there are still many areas of strength in the economy. Also, there is evidence that major materials industries are operating very close to capacity. A recent Federal Reserve study indicates that capacity utilization in these industries was 94 per cent in the second quarter of this year. This is the highest level since 1948, the first year for which data are available. The high level of capacity utilization reflects not only significant increases in output in 1972 and 1973, but also slow expansion in capacity.[4]

Given these pressures, I think Phase IV is doing as well as can be expected. The dollar for dollar passthrough is tougher than Phase II rules and although it seems a bit redundant to me, the profit margin constraint has been retained. I think one of the strongest things working for Phase IV is the fact that the Administration stated flatly that prices—and in particular, food prices—would rise. Food prices are highly visible and as a result have disproportionate impact on inflationary expectations. However, there seems to be an increased understanding on the part of the consumer of the food price problems. Unfortunately, consumers may not view price increases in the non-food area with such generosity.

One of the problems with control programs is that people become very aware of price increases and fail to notice price decreases. Moreover, there is a strong tendency to assume that all price increases are inflationary. This view ignores the role of the price system in making possible adjustments to changing conditions of both supply and demand. Demand shifts may reflect increased income or merely a change in preferences.

One of the good things about Phase III and Phase IV—which is incidentally an outgrowth of the term limited pricing agreements in Phase II—is regulations cast in terms of weighted average price increases. This permits some flexibility and relative pricing and therefore minimizes the distortion of resource allocation. Although price increases under Phase IV must still be cost justified, the flexibility permits individual prices to respond within a limited range to demand as well as cost pressures. Unfortunately, this concept is not easily grasped by the public.

There is also a need for greater awareness of tradeoffs in public policies and goals. Three obvious ones related to controls are the Russian detente, the balance of payments and devaluation, and ecology, conservation and environmental considerations. All of these put pressure on the price system. It is all too easy to take a myopic view of price stabilization, and ignore other fundamental considerations.

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[4] "Capacity Utilization in Major Materials Industries," *Federal Reserve Bulletin*, August, 1973.

TABLE 1.—PERCENTAGE CHANGES IN CONSUMER AND WHOLESALE PRICE INDEXES, SELECTED PERIODS, 1969–73 (SEASONALLY ADJUSTED, COMPOUND ANNUAL RATES)

	12 mo, 1969, December 1968–December 1969	12 mo, 1970, December 1969–December 1970	8 mo, 1971, December 1970–August 1971	3 mo, phase I, August–November 1971	14 mo, phase II, November 1971–January 1973	5 mo, Phase III, January–June 1973	6 mo, phase III, January–July 1973
Consumer Price Index:							
All items	6.1	5.5	3.8	2.0	3.6	8.3	7.4
Food	7.2	2.2	4.8	1.7	6.5	20.3	17.8
Commodities less food	4.5	4.8	2.9	.3	2.4	5.2	4.5
Services [1]	7.4	8.2	4.5	3.1	3.5	4.3	4.0
Wholesale Price Index:							
All commodities	4.8	2.2	5.0	.3	6.9	24.4	16.6
Industrial commodities	3.9	3.6	4.5	−.1	3.5	14.4	12.0
Farm products, processed foods and feeds	7.5	−1.4	6.5	1.1	16.1	49.8	27.5
Consumer finished goods	4.9	1.4	3.8	.7	5.6	18.6	14.7
Foods	8.2	−2.5	6.7	2.1	10.6	25.4	18.8
Finished goods, excluding foods	2.9	4.0	2.2	0	2.3	14.6	11.7

[1] Not seasonaly adjusted; data contains almost no seasonal movements.

TABLE 2.—PERCENTAGE CHANGES IN CONSUMER PRICE INDEX AND SELECTED COMPONENTS, 3-MONTH SPANS, AUGUST 1972–AUGUST 1973 (SEASONALLY ADJUSTED, COMPOUND ANNUAL RATE)

	All items	Commodities less food	Food	Food at home	Food away from home	CPI-domestically produced farm foods [1]	CPI-selected beef cuts [1]	Gasoline and motor oil	Fuel oil and coal
From 3 months ending in:									
August 1972	3.2	2.7	5.3	5.4	4.0	9.7	21.1	4.9	−1.0
September	4.4	3.7	7.7	8.2	4.3	6.8	7.4	13.7	1.0
October	4.2	2.7	7.3	7.8	4.3	1.0	−7.9	8.4	1.7
November	4.3	2.0	8.3	9.5	4.3	1.6	−8.9	7.9	3.4
December	3.4	1.3	4.9	6.0	4.0	4.0	−4.6	1.1	3.4
January 1973	4.0	2.0	11.3	14.0	4.9	16.3	20.3	5.2	4.8
February	5.7	2.7	16.8	20.0	4.9	25.9	55.8	7.0	25.6
March	8.6	4.0	28.6	35.4	7.1	41.0	93.5	7.4	28.4
April	9.2	5.1	25.4	29.4	8.3	34.6	69.2	13.9	29.0
May	8.7	5.4	21.3	24.0	13.1	26.2	28.5	13.1	9.5
June	7.4	5.4	14.7	15.4	12.0	17.3	8.0	25.5	16.0
July	5.7	4.0	10.7	10.4	11.9	13.8	3.8	15.0	13.8
August	11.4	4.3	34.5	42.0	9.8	50.2	37.9	8.1	13.0

[1] Not seasonally adjusted.

TABLE 3.—CONSUMER PRICE INDEX: ESTIMATED IMPACT OF CHANGES IN FOOD AND FUEL COMPONENTS, SELECTED PERIODS 1972–73

		Estimated impact on CPI,[1] seasonally adjusted annual rates					
Component	Relative importance	June 1972–June 1973	August 1972–August 1973	June–December 1972	August 1972–February 1973	December 1972–June 1973	February–August 1973
Food	22.492	3.08	4.48	1.42	2.81	4.84	6.23
At home	17.494	2.75	4.08	1.24	2.55	4.37	5.72
Away from home	4.998	.34	.40	.21	.23	.47	.56
Gasoline and motor oil	2.902	.33	.26	.21	.23	.47	.30
Fuel and coal	.655	.08	.08	.01	.09	.14	.07
Addendum:							
Estimated total contribution of food and fuel to CPI		3.49	4.82	1.64	3.13	5.45	6.60
Percentage change in CPI		5.9	7.5	3.9	5.0	8.0	10.0
Estimated contribution as a percentage		59	61	42	63	68	66

[1] The estimated impact of a component is the adjusted actual percentage change, seasonally adjusted annual rate, multiplied by its weight in the total index.

Senator PROXMIRE. Mr. Weber, please proceed.

STATEMENT OF ARNOLD R. WEBER, DEAN, GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, CARNEGIE-MELLON UNIVERSITY

Mr. WEBER. Mr. Vice Chairman, thank you. My comments will focus generally on the economic stabilization program rather than the price and wage prospects specifically.

In a companion paper,[1] I have presented by views concerning the lessons afforded by experience with incomes policy in the United States since August 15, 1971, when wage and price controls were first imposed. In this statement, I will focus directly on the prospects for phase IV——

Senator PROXMIRE. I understand you have a statement and also a paper. Mr. Weber. Is that correct?

Mr. WEBER. Yes.

Senator PROXMIRE. Your paper will be printed in the record at the end of your oral statement. Your statement and your paper are both pertinent and relevant to this hearing; and also, the tables that Mr. Estey and Miss Hamilton presented will be included.

Mr. WEBER. Thank you, Mr. Vice Chairman.

I'm pleased to be here to review the economic stabilization program with you and the other members of the committee. In a companion paper, I have presented my views concerning the lessons afforded by experience with incomes policies in the United States since August 15, 1971, when wage and price controls were first imposed. In this statement, I will focus directly on the prospects for phase IV and subsequent stabilization measures. As you indicated, I was Executive Director of the Cost of Living Council during phase I and served as a public member of the Pay Board during phase II. However, I have had no direct involvement in the stabilization program since the dissolution of the Pay Board, and I will try strenuously to separate ego from analysis. In Dickensian terms, you might say that Miss Hamilton and I are the "spirit of phases past."

In my judgment, phase IV is a well-conceived effort to recoup the public credibility and program effectiveness that were lost during phase III. It would be misleading to assert that the price explosion that has taken place since January of this year was the sole consequence of the misadventures of phase III. The impact of international food shortages and the rising demand for world commodity markets on domestic price levels is widely known. And has been documented by Miss Hamilton. Nonetheless, it is also true that phase III created an administrative climate that permitted, and in some cases encouraged, businessmen to compensate for past restraint by initiating substantial increases in the prices charged for their goods and services. The second freeze and phase IV were not imposed because we have an unshaken confidence in the regulation of wages and prices, but because the public at large believed that phase III demonstrated how to fail in controls without trying. And I must say as a personal matter,

[1] See paper entitled "Inflation and Incomes Policy: Lessons From the U.S. Experience," beginning on p. 373.

I don't accept the explanation that what happened in the first part of this year is largely attributable to the fact that on January 11 we all woke up with an insatiable desire for protein which somehow wasn't satisfied. It is far more complex than that, and it also goes in fact to the nature of phase III.

Phase IV, in contrast, is tough and far reaching on the price side, and the Cost of Living Council has demonstrated the will to develop the necessary administrative apparatus and to enforce its regulations. If anything, the rules are probably too stringent to be uniformally enforced in a boom economy without harmful consequences to the allocation of resources. The Cost of Living Council has attempted to deal with this problem by devising special rules that are applicable to particular commodities where genuine shortages may threaten. At the same time, meritorious requests for price increases have been granted, but have been stretched out over a period of time to diminish the effect of these increases on both the price index and public confidence. If the major challenge of phase III was knowing when to be tough—that is, bringing the stick out of the closet—the overriding problem of phase IV is knowing when to be "flexible" and exercising this flexibility in such a manner that it does not undermine the credibility of the stabilization effort. Thus far, it seems to me, the administration has walked this line with considerable skill and agility.

As I indicated in my paper, controls, by themselves, cannot restrain inflation. However, if skillfully administered, they can make a positive contribution to price stability. With the expected slowdown in the rate of expansion in the economy, controls can help to shear off the peak of price movements and accelerate the adjustment to looser market conditions. Phase IV cannot produce rump roasts or rolled steel, but it can help insure that when these products are forthcoming, the producers will not exploit short term market conditions.

At this point, it is important that phase IV be given a chance to work without expecting the restoration of economic stability overnight. In this respect, Congress should guard against becoming a channel for special interests who may feel pinched by the stabilization program. This does not mean that the Congress should not carry out its oversight responsibilities, as it is doing here, but where Congress exerts pressure in specific cases, it becomes exceedingly difficult for the administrators to maintain that fragile balance between equity and economic stabilization that is essential to an effective program. The cause of sound administration was hardly served when many segments of Congress first pressed for a freeze on food prices in June and then called for a relaxation of the program when a chorus of protests resulted and some producers withheld supplies from the market. During phases I and II, the Price Commission and the Pay Board were permitted to administer the controls program on the merits of individual cases as they viewed them; as the controls program continues, the temptation to correct "inequities" through congressional intervention will inevitably increase.

Although phase IV in general has been well designed and implemented, in my judgment policies governing wages are deficient. That is, while the 5.5 percent standard is still formally in effect, it has little regulatory relevance. This judgment may seem anomalous in view of the fact that wage increases have been relatively moderate despite the prodigious price increases we have experienced in 1973. It is clear, however, that the pay standard has been breached in many recent collective bargaining situations such as railroads, rubber, electrical equipment, and automobiles. No public determinations of these cases have been forthcoming from the Cost of Living Council, presumably on the assumption that it is best to leave well enough alone. While this covert game of cat and mouse has been effective in dealing with the large unionized situations in 1973 it is troublesome on several counts.

First, no one really knows what the effective pay standard is under phase IV. To be sure, events have made the 5.5 yardstick obsolete, but what replaces it as an equitable basis for regulation? To what extent should the standard be modified to take account of the rise in the cost of living and the erosion of real earnings? In the large unionized situations, this notion of equity is apparently worked out in three-way discussions between the parties and the Cost of Living Council. In contrast, the 65 million employees in the nonunion cases presumably are still bound by the 5.5 percent standard and frequently lack the clout or cunning to get consideration of their equitable needs.

Second, it is probable that the labor market in 1974 will be characterized by increased slack and that cost-push pressures will pose an equal threat to price stability as demand-pull factions. Under these circumstances, what is the proper standard that will promote equity to the workers while minimizing the inflationary impact of increases in cost? This issue cannot be satisfactorily resolved through a series of ad hoc determinations, which appears to be the present approach. The need for a redefinition of the standard is particularly important in view of the 1974 bargaining round which will be dominated by negotiations in steel and related industries, construction, and coal mining.

In construction, few contracts contain cost-of-living clauses so that there will be great pressure to compensate for rising prices in immediate and substantial wage increases. It will be recalled, that the jump in construction wages contributed significantly to the sharp increase in general wage levels in 1970–71 despite a 6 percent unemployment rate in the economy as a whole. In steel, the parties are likely to act generously to afford internal political protection to the highly innovative no-strike agreement entered into by Big Steel and the Steel Workers Union. And in coal, a new, militant union leadership is certain to press for a sizable settlement to consolidate its position.

Each of these cases has its own merits. Nonetheless, unless a realistic pay standard is articulated by the Cost of Living Council the cumulative impact of these settlements may be to set a de facto standard that will have an unstabilizing effect on the economy in 1974. Accordingly, in my judgment, the pay standard should be revised by establishing an explicit catchup formula that will permit workers to exceed the 5.5 percent standard if their wage increases have not kept pace with the recent increases in the cost of living. This approach was taken during the early stages of phase II and was generally administered without difficulty. In addition—and this goes to the primary criticism of this point—the phase II experience indicates that the new, higher standard will not inevitably become a floor under wage settlements.

There is a need for the formulation of an explicit strategy for decontrol, although as Professor Estey said, I would agree that it is not a propitious time to decontrol effectively.

The gyrations in policy from phase I through phase IV clearly indicate that controls are not self-liquidating. Rather, they develop their own dynamics which create a "stop-go" pattern that makes for bad controls and unstable expectations on the part of businessmen, consumers, and workers. Thus, if we are to disengage from controls with a minimum shock to the economy a well-conceived and widely understood strategy to decontrol should be developed. This strategy could take shape at three levels. First, individual industries could be decontrolled when the rate of price increase subsided to a specified level. In effect, the term limit price formula used by the Price Commission during phase II constituted one approach to partial decontrol.

Second, a reasonable price goal for the economy as a whole may be reasserted. The price goal should be realistic and accept the probability that prices will rise for reasons outside of the grasp of the most assiduous controllers.

Third, it is probably true that after more than 2 years of direct controls it will be extremely difficult for the Government to fold its tent and disappear into the economic sunset. Therefore, some interim mechanism for reviewing and intervening in selective wage and price decisions should be established. In this respect, a Wage-Price Review Board has received the greatest attention. Through a process of analysis; public hearings, and reserve authority to modify individual actions, the public can be reassured that the Government is exercising continued surveillance over prices and wages and is willing to deal with situations where excessive market power is exercised by businessmen and unions. In addition, perhaps the most positive outcome of phases III and IV to date is to demonstrate dramatically that the Government can often have a powerful effect on prices by expanding supply in such areas as food, lumber, and metals.

Although controls impair the workings of a free market economy, paradoxically the stabilization program has afforded an opportunity to deal with various anticompetitive policies that have reinforced inflationary tendencies. Regardless of any judgment concerning the efficacy of controls, the historic reversal of agricultural and energy policies will have consequences that endure beyond phase IV. Similarly, a concern over rising construction wages caused a review and suspension of the Davis-Bacon Act, albeit for a short period of time.

Commentators as diverse as Arthur Burns and John Kenneth Galbraith have pointed to the need for "structural reform" in labor and product markets to help to deal with inflation. By giving high priority to price stability, the controls program has helped to give national attention to those arrangements that impair the efficient use of economic resources and sustain inflationary forces. The Congress in general, and this committee in particular, should seize this opportunity to examine those public policies that may contribute to inflation in various sectors of the economy. If steps are taken to identify and remedy these noncompetitive policies then the stabilization program will have had constructive consequences that extend beyond that last phase—whatever that might be—in the current effort to control inflation.

Thank you very much.

[The paper referred to in Mr. Weber's statement follows:]

Inflation and Incomes Policy: Lessons From the U.S. Experience

(By Arnold R. Weber*)

The United States has now completed two full years of experience with direct controls over wages and prices. As each phase of the stabilization program has been supplanted by the next the initial optimism of August 1971 has given way to a weary realism, if not disillusionment, over the efficacy of income policies and/or controls in restraining inflation. If Phases I and II were hailed as a "success" by most commentators, Phases III and IV have been vilified as "failures" with equal conviction. Like most victims of overindulgence, some economists and policy-makers are muttering "never again" while not quite certain that temperance can be regained.

Both characterizations oversimplify the results of the United States' current experiment with economic controls. The lessons of the last two years are more subtle and diverse than such flat judgments imply. These lessons relate to the capacity of incomes policy to deal with inflation, the problems of managing controls once they are initiated, and the relationships between controls and other economic policies. Strategic errors in management should not condemn the concept of controls; nor should a system of controls accept a burden it was not designed to bear.

THE LIMITATIONS OF CONTROLS

It is clear that controls, by themselves, cannot bring inflation to bay. To the sophisticated observer this may seem to be a truism. However, because the pressures for controls are essentially political rather than economic in nature, it is important to recognize that wage and price restraints will not remedy the deficiencies of fiscal and monetary policies or restore a balance of international trade accounts. Alchemical qualities were attributed to controls during Phases I and II when incomes policies overcame the burden the inertia of past government efforts to deal with inflation. The disappointment in the subsequent performance of Phases III and IV was at least proportionate to the exaggerated estimate of the powers of controls that had been engendered by the early experiences. As the economy shifted from one of excess capacity to a flat out boom in late 1972 and 1973 both the real and apparent effects of controls were dramatically altered.

Recognition of the limitations of controls should not justify the extreme view that controls have no salutary effects and are a placebo administered by cynical politicians to a gullible public. In fact, the record of the American experience indicates that controls can make a positive contribution to the battle against inflation in conjunction with other economic policies, and in the context of particular conditions in the labor and product markets.

Thus the forthright administration of controls can dampen the expectations that help to sustain inflation. With a rigorous set of incomes policies in place, unions may take pause before pressing for wage increases that are calculated to guard against the future erosion of earnings. At the same time, businessmen may not be as likely to raise prices in anticipation of increases in costs. Certainly, the dramatic announcement of Phase I and the bureaucratic muscle-flexing associated with Phase II helped to create a climate in which price stability became a reasonable assumption for economic decision-makers. By the same token, the announcement of a "permissive" Phase III precipitated a free-for-all as businessmen scurried to protect themselves against a new surge of inflationary expections. It is still questionable whether or not Phase IV will be able to repair this blow to confidence that the government is willing to deal aggressively with price inflation. Aside from the delicate (and unstable) effect on expectations, incomes policies can help to restrain wage and price movements that reflect market power as much as market forces. There is a quality of autohypnosis to contentions that wage and price movements universally mirror the shifts in supply and demand. Powerful unions in the labor market and oligopolies in the product market often exercise latitute beyond the limits contemplated by models of competition. Under these circumstances, controls can systematically, albeit temporarily, limit the exercise of such discretion in the absence of basic structural reforms. For example, controls have diminshed the rate of wage increases in the building construc-

*Dean, Graduate School of Industrial Administration, and Provost, Carnegie-Mellon University.

tion and transportation industries where trade unions enjoy considerable leverage. Similarly, the stabilization program has blocked petroleum and foodstuff producers from exploiting short-term market advantages. Indeed, there is substantial evidence that controls have been most effective in those sectors where market power is most manifest.

The impact of controls on expectations and market power implies that they can have a significant influence on the *timing* of changes in the movement of wages and prices. When the basic economic climate has been altered (through fiscal and monetary policies) but price and wage behavior still echoes past inflation, controls can accelerate the return to stability. Conversely, when demand factors put upward pressure on wages and prices, the timing of increases can be retarded and the cumulative upward movement reduced until the economic expansion has subsided. As a practical matter, it is easier to accelerate adjustments when market pressures are subsiding than to retard increases when the pot is boiling. Obviously, some of the "success" of Phases I and II can be attributed to the more felicitous economic environment that existed at that time while the problems that have beset Phases III and IV stem, in part from the batterings of a boom economy.

THE NEED FOR ADAPTATION

This particularist view of controls provides the text for another homey lesson of the recent U.S. experience. Economic controls are not homogeneous; rather, the specific design of the system must be tailored to the circumstances that prevail at the time that it is imposed. Moreover, the program must be continually refined in the light of changing conditions. A wage-price freeze, for example, is a relatively crude instrument of incomes policy and cannot be expected to deal with the technical difficulties of resource allocation in a complex economy. Instead, it is primarily useful in delivering a sharp blow to inflationary expectations before a more sophisticated system is put in place. On the other hand, a comprehensive, rigorous set of controls can press down on wages and prices without deleterious consequences when the economy is marked by excess capacity and inflationary pressures have been engendered by cost-push fatcors. Greater flexibility should be exercised during a period when the economy is suffused with high demand and a rigid system will result in major distortions in resource allocation.

In this manner, Phase I had a chilling effect on inflationary expectations even though the Nixon Administration did not have a credible, ongoing program of controls when it was imposed. The subsequent performance of Phase II reflected the fact that, unwittingly or otherwise. the design of the program was well-adapted to the economic circumstances. The controllers could wield a tough, wide-ranging set of control to limit the exercise of power and accelerate the adjustment to market conditions without causing major disruptions or major misallocations. On the other hand, the hapless Phase III used "flexibility" as the pretext for a general retreat from controls at a time when demand was beginning to crimp capacity. Consequently, the bureaucratic defenses against inflation were easily overwhelmed. Phase IV makes an earnest attempt at redemption but clearly the shock effect of the second freeze was diminished by repetition and confidence in controls is more difficult to restore when the economy is careening down the rapids. Phases III and IV have vividly demonstrated that economic controls cannot be viewed as a task of manipulating illusion, but must be given detailed attention in design and implementation.

THE ROLE OF INTERNATIONAL FACTORS

The vicissitudes of the later phases of the controls program further illustrate the paradoxical role played by international monetary and trade considerations in the rise and decline of incomes policies. In the U.S., as in many West European nations, international economic developments provided the basic motives for the resort to controls. In the summer of 1971, the U.S. was suffering from a substantial deficit in the balance of payments and great pressure was being exerted on the dollar in international money markets. At a distance, it is easy to forget that the initiation of controls was part of a comprehensive set of policy changes aimed primarily at improving the nation's position in the international economy. If there was any "classical" justification for the freeze it was that the various measures taken to improve the U.S. balance of payments would also relieve the competitive pressures on American producers. Hence, controls could protect against this added element of market insulation, particularly on the price side.

This strategy appeared to work and had the added virtue of supressing the political clamor for bold action to cope with *domestic* inflation and unemployment. Together, the controls program and the subsequent devaluation appeared to promote a rare confluence of economic expansion, relatively stable prices and an improving balance of payments.

These same winds from international markets acted to topple Phase III and to make Phase IV precarious. Although it is not the entire story, much of the explosion in prices that has taken place in 1973 has reflected developments in international markets that are beyond the reach of the most assiduous controller. Because of rising foreign demand for American products—particularly foodstuffs and other commodities—domestic prices for these goods have experienced startling increases and have caused severe secondary effects in the chain of prdouction and distribution. Thus while the demand for controls is linked to international trade considerations, their effectiveness as a domestic program is highly vulnerable to the vagaries of world markets. Paradoxically, the greater the dependence of a country on international trade, the greater the pressures for some form of incomes policy. At the same time, the probable effectiveness of the program is reduced by the fact that prices will be profoundly influenced by factors that are outside of the administrative grasp of the controllers.

THE DURABILITY OF CONTROLS

Despite the roller coaster pattern of prices in the U.S. over the last two years, the controls system has demonstrated a remarkable durabiilty. None of the participants in the momentous decisions of August 15, 1971 would have predicted that formal wage and price restraints would still be in place four phases and two years later. Indeed, the regulations of Phase IV cast a tighter net over prices than prevailed during any other period of the stabilization program outside of the two freezes.

This record of survival confounds the conventional wisdom that wage and price controls will quickly fall of their own weight in a market economy. The alleged fragility of controls arises from two factors. First, it asserted that a controls system will be undermined by the economic dislocations, i.e., shortages and black markets, that cumulate from efforts to substitute bureaucratic judgments for the wisdom of the market system. Second, here is a belief that in a political democtracy a system of controls contains the seeds of its own destruction. Wage and price controls are as much an exercise in equity as economics. Because it is difficult, if not impossible, to demonstrate that any set of decisions are "fair" (as contrasted to "efficient"), a stabilization program will build a stock of resentments that will cause the political leaders to abandon the system before the ill-will engulfs them. In this manner, every "fair" decision handed down by the controllers will engender one ingrate and at least two enemies. The ingrate is the beneficiary of the decision who feels that a just claim has been taridly recognized; the enemies are those businessmen and union leaders who believe that their more meritorious cases were not suitably recognized.

Although this belief in the self-liquidating properties of controls has had some credence in past experiences in the U.S. and abroad, the recent record indicates that there is nothing immutable about the process. On the one hand, the march from Phase I to Phase IV has gone forward during a period of powerful expansion in output and rapidly rising employment. As a practical matter, it is hard to equate the prodigious boom with the contention that controls have wreaked havoc with the finely-tuned market mechanisms necessary to promote economic growth. To be sure, there have been some short-term shortages in the food area; however, the remarkable fact is not that such transient shortages have taken place, but that they have been so limited despite the draconion nature of some of the regulations. Indeed, it is difficult to distinguish between the theatrics of trade association presidents and bona fide shortages. In fact, the administrators of the controls program generally have shown a sensitivity to the impact of their decisions on supply factors. When the controls program did threaten to dry up supplies of cement, lumber, and poultry and pork products, the rules were relaxed to avert a prolonged impact on production. Bureaucratic prestidigitation may not be a complete substitute for the invisible hand, but it is not the wanton force that some commentators suggest.

The equity problem has been dealt with through a combination of error and exceptions. An underlying reason for the sudden shift from Phase II to Phase III was a belief within the Administration that businessmen and labor leaders were becoming increasingly restive under governmental restraints. With the onset of Phase III, most businessmen and some union leaders had ample latitude to remedy past grievances—and protect against future injustices by moving up prices and wages at a rapid rate. In the nature of things, prices can be adjusted much more rapidly than wages so the sense of inequity created by Phase III was largely borne by labor. The Nixon Administration prudently moved to placate the trade unions by exempting wages from the freeze imposed in June, 1973. At the same time, the 5.5 percent wage standard has been flexibly, if not imaginatively, administerd, permitting wage gains to be generously supplemented by fringe benefits and increments arising from escalator clauses that automatically link wage changes to increases in the cost-of-living. Although the economic consequences of this series of adjustments have been less than desirable, the process preserved the consensus necessary to sustain a program of controls in a political democracy. The low level of strikes in the last two years and the absence of widespread instances of defiance indicate that the perceived inequities and limited inconveniences caused by controls can be overcome by adroit administration.

CONTROLS AND COMPETITION

Among economists, in particular, the discussion of wage and price controls often takes the form of a disquisition on the comparative benefits and costs of controls vs. the operation of a free market economy. This dichotomy, is a real one in many ways and policy-makers should give attention to the great issues embraced by competing notions of efficiency, freedom, and stability. However, the American experience also indicates that a system of controls and the precepts of a free market do not always stand in mortal antagonism. In many instances, the conduct of the controls program in the United States has abetted the restoration of free market conditions where they were negated by other government policies in the past. With the imposition of controls, the elimination of inflation became the dominant goal of national economic policy. As a result, the consequences for price stability of various government programs calculated to protect special interests became manifest. In other words, the controls program established a new policy framework in which the costs of less visible, anti-competitive policies have been assessed against a yardstick of national welfare and found to be unsupportable.

In addressing the members of the now defunct Pay Board and Price Commission, President Nixon stated that the sweeping revision of agricultural policy from one of restriction to one of maximum expansion output could not have taken place without the pressures generated by the stabilization effort. Similarly, the recommendations of a Cabinet Committee to relax oil import quotas had been quietly buried in 1970 but were resurrected when the impact of national petroleum policy on prices was vividly demonstrated in 1973. At the same time, the government sharply reduced stockpiles of metals and other commodities that were ostensibly maintained for "national defense" purposes but which more deviously had helped to prop up prices. In the labor market, the controls program has served as a vehicle to modify the application of the Davis-Bacon Act and state laws prescribing minimum wages for particular occupations. These laws traditionally have been used to strengthen anticompetitive forces in the labor market. In this manner, the recent American experience reveals that, perversely, controls can provide opportunities to restore competitive conditions in situations in which the government has been a handmaiden of restriction and monopoly. For many observers, these actions are perhaps the most important outcome of the stabilization program.

THE LOSS OF INNOCENCE

Overall, the lessons of the U. S. experience with controls have been mixed and probably are unsatisfying to dogmatists on both sides of the question. Wage and price restraints, by themselves, have not been an adequate weapon to slay the inflationary dragon but they can facilitate other measures to achieve stability. At the same time, it does not appear that Phase I was a giant step on the road to serfdom nor a prelude to massive economic dislocations. And the distraught consumer has learned the truth of Justice Brandeis' dictum to his granddaughter that life is hard and the sooner this is understood, the easier it will be.

It is probable that governmental intervention in wage and price decisions will be an important element of anti-inflation policies for a long time. But innocence has been lost in the U. S. and this is all to the good so that we can get on with the

job of devising that combination of remedies that will best approach that elusive goal of economic growth with price stability.

Senator PROXMIRE. Thank all three of you for your statements this morning. They have been extraordinarily factual. And they had in them a lot of material that I didn't know and didn't appreciate, and which I think the other Members of the Congress and the public don't appreciate either.

None of you think that controls should be expected to work miracles, but I gather that all of you may feel, or do feel, that incomes policy does have a useful and important role to play.

Since we will soon be faced with the question of a possible replacement for phase IV, I would like to try to develop with you the principles that an effective income policy should meet.

First, let me ask you this: Should price-wage policy be directed primarily at the concentrated power of business and organized labor, or should it also attempt to deal with the shortage situations of the kind we have in health, perhaps, lumber, food, and different kinds of power confrontation situations such as in construction? Should we broaden it to include these areas, too?

Mr. Estey.

Mr. ESTEY. Senator Proxmire, I think incomes policy, as the term is generally used, is concerned with the general problem of wage-price relationships and it is customarily thought of as concentrating on, or emphasizing, large business organizations and union settlements primarily because these are the areas in which decisionmakers are believed to have discretion, where they have some alternatives as to where to set their wage levels or where to set their prices, so that incomes policy has a tendency to focus on these areas.

Now, this is not to say that there shouldn't be mechanisms for dealing with shortage problems. But I think this is outside of and in addition to and separate from income policy as such.

Senator PROXMIRE. Let me just say that I think that is right.

Phase IV can be and should be followed by what Arthur Burns has proposed as an incomes policy in the way that you have described it. What I am trying to get at is, what should we do? Mr. Weber has just indicated that a phaseout by industry is a part of the solution at least. And I am trying to elicit from you how we do that. Do we do it on the basis of price performance, which, as I understand it, is at least one criteria that Mr. Weber suggests, or do we do it on the basis of also recognizing the shortages within the industry and the power problems that you have in something like the construction industry?

Mr. ESTEY. My own feeling would be that rather than to necessarily move to a wage-price review board, I perhaps would lean more in the direction that the administration has already taken in some respects and is suggesting, and that is what you might call selective decontrol.

I see no reason why you couldn't continue to maintain controls on particular industries which are regarded as potential problem spots, or industries in which the wage-price problem is particularly pressing. This is a little different than the shortage question. It seems to me that there is something to be said for continuing the present program in modified form rather than setting up a new mechanism for the wage-price review board, or something like that.

Senator PROXMIRE. Miss Hamilton.

Miss HAMILTON. Mr. Vice Chairman, the first comment I would like to make is that I think you clarified what I was concerned about—I really don't think that incomes policy has a long run important role to play in this economy. I do think we need very much what Mr. Weber referred to, a strategy of decontrols.

Senator PROXMIRE. You say you think an incomes policy does not have a long-term role?

Miss HAMILTON. Not a long-term role in the U.S. economy.

I think we can return to a freer market system.

However, I certainly do agree that we need a strategy of decontrol. And I think there are various ways this could be done—it seems to me there are two choices, a complete decontrol, everyone all at once, or rules of the game spelled out ahead of time whereby you could have selective decontrol.

Apparently it is working well in the lumber industry—now this was a real problem area in phase II—and yet the administration felt they could decontrol it at the present time.

If you wanted to go to the price route as a means of decontrol, as Mr. Weber mentioned in the pricing agreement, it is conceivable that you could just say, you cannot increase our weighted price more than x percent, with x percent something probably below the general economic standard. I say below because with the weighted average price increase you always run the danger that companies will exploit the high elasticity—the inelasticities and raise prices on products people will keep on buying.

However, I think that type of decontrol strategy is a possibility. If you wanted to decontrol you might be able to make tradeoffs with the TLP. In return, for, say, a zero increase, or a price reduction; where your weighted average price actually declined, a firm could be removed from, say, the profit margin constraint. I think there are broad areas for trade. I don't think there should be trades on an individual basis—I think there should be rules of the game for trading.

There are other criteria which I think are important for decontrol. And I mentioned one, the shortage situation. That is a problem, and I think, should be a reason for decontrol if decontrol would increase plant capacity. The problem is that industries will often argue on a vested interested basis, claiming that the control program is why they have low profitability. And that may or may not be the case. Low profitability may be the reason for lack of expansion, but it is not necessarily caused by the control program per se. So that does have some problems.

In my view I think we should be thinking about decontrol. We ought to have a strategy. I think decontrol has to come with some element of surprise. But I think it is important to have a decontrol policy; if we don't have it, I am afraid we might get into the kind of situation that exists now in Great Britain, where so many things are written into the legislation that the controllers and the administrators of the control program have a very difficult time operating within this cast iron legislation.

Senator PROXMIRE. Have you given any thought to how we go about this?

This is the middle of October. We are going to be absorbed in other matters, probably, in the next 2 or 3 months. By April 30 we have to make a decision on whether to continue the stabilization act as is, or whether we can refine it and limit it. There is going to be a strong effort on the part of labor and the part of business, too, to kill it. There is a growing sentiment, as you know, in the country and the Congress to drop it. So we might have to compromise it out some way. If we continued it, then, of course, we would simply permit this kind of adjustment on the part of the President, he could then decontrol it as time goes on. I take it that you imply at least that we are unlikely to be in a position where we could consummate the decontrol by April 30 of next year——

Miss HAMILTON. I wouldn't say that is impossible. I think that it may be possible. I am concerned now about the rate of expansion abroad. In this morning's Journal of Commerce there is indication that Germany's restrictive policy is having very important impacts, and perhaps the OECD forecast which I cited is overoptimistic. I don't think we really have a good handle on what the effect on U.S. price levels may be of even a moderate decline abroad. My point was that even a moderate decline means we are living in a world economy with countries that are expanding faster than we are.

Senator PROXMIRE. I note that Mr. Weber said in concluding his remarks at one point that when you have Arthur Burns on one side and Kenneth Galbraith on the other side that you have pretty much the limits of ideological thought and economic thought. But I see, however, that you are to the right of Arthur Burns at least on income policy.

Miss HAMILTON. I'm not so sure.

Senator PROXMIRE. He does seem to recognize that we are likely to have a very long-term situation, and we should recognize that. We should not overlook the oligopolistic and monopolistic pricing power of both union and management, and therefore we need an income policy in recognizing that we cannot get back as you suggest to a free market in automobiles, steel, and many other areas, we are just not going to do it.

Under those circumstances don't we need some mechanism that is going to stay on top of this on monthly basis perhaps and keep informing both the President and the Congress as to what we should do and be in a position for rollbacks in the event that we do have these power units taking advantage of the situation to increase prices or wages unwisely?

Miss HAMILTON. I think there are two separate issues, Mr. Vice Chairman, although they could be handled together, I suppose. One is, as you mentioned, the attack on centers of power, the concentrations of power, which I would put under the category of antitrust policy, or trying to remove market stickiness, that kind of thing. I am not sure that is the same issue as having a review type of operation. If you wanted to have a review policy you wouldn't even necessarily need a wage-price review board, you could have an agency. Supposing you wanted to monitor for 6 months after the determination of a stabilization program, you could continue——

Senator PROXMIRE. We could debate the means. But what I am saying is, some kind of income policy in the sense that you have some mechanism—it may be an agency or a review board or whatever—

that does recognize the economic impact of buying concentrations of industry and labor.

Miss HAMILTON. I find myself with an ideological problem here.

Senator PROXMIRE. Let me go on to Mr. Weber, and we will come back to you later.

Mr. Weber, two problems: One, the income policy; and the second, decontrol.

Mr. WEBER. To begin from the same premise that I think probably we all share, other things being equal, it would be desirable if we had less government interference rather than more. Other things aren't equal. And it is clear that there is a great public appetite and demand for government actions that would deal constructively with significant pressures on prices.

Now, given this situation, it seems to me the question devolves into one of determining what mechanisms will be the most effective in doing the job. And second, how do you avoid some of the unfortunate consequences or distortions that often flow from controls?

Now, my feeling at this point, as I indicated, is that phase IV is a constructive step, the administration was soft before, and it has to be hard now.

Now, the longer run problem essentially involves a transition back to an uncontrolled economy. I assume that next year we will start to get some pretty good numbers, and that is really the best way to start moving out of controls. That is, the rate of price increase will start to subside.

Now, if that happens, how do you roll out? Your point was that we should have a mechanism to continue to look at concentrations of power, particularly over this interim period. I would agree with that. And I think a wage-price board could have an effective impact perversely by serving as the dog in the manger. That is, because there is a program calling for this scrutiny of wage and price decisions and strong political pressures do things that I would consider economically to be more mischievous may be dissipated.

The third point you raise is, should this review mechanism deal with shortage situations? My answer is "Yes."

I noted that you had before you yesterday Paul Samuelson, who I had for a course in economics at MIT. I remember almost 20 years ago when, in class he asked if Bing Crosby would sing better—that dates both of us.

Senator PROXMIRE. He is still singing——

Mr. WEBER. If he got $200,000 a song instead of $100,000 a song?

The answer was, he probably wouldn't sing any better, and certainly not twice as well.

Similarly, there are instances where you have a short-term inelasticity of supply in the market: for example, petroleum now.

Senator PROXMIRE. He might sing twice as much.

Mr. WEBER. He might sing more. But we are talking about petroleum now. You could say, let the price mechanism work. But the basic problems with the short-term supply of oil are assoicated with very dramatic foreign policy events. If demand is increasing and the supply is relatively fixed, the price per barrel could go up to $10 a barrel. But it is unlikely that in a short term you are going to get a very significant increase in supply. So under those circumstances it seems to me the Government can play a reasonably constructive role by identifying those situations where price increases are necessary to develop long-term increases in capacity and production versus those price increases which constitute an exploitation of short-term market advantages.

Senator PROXMIRE. You make a very convincing case to me for having an income policy. But if you can't sell labor on it—and it is hard to sell them—and you can't sell business—and it is hard to sell them—if you can't sell anybody who is as knowing and informed as Miss Hamilton is on this, how are you going to go about developing this policy so that we can enact it and get it signed into law? And even if we could do that, how are we going to get the cooperation of these various groups? Will they agree to work with it, work on the board? Will they cooperate?

Mr. WEBER. Of course, that is a question that I think none of us here are any more qualified than anybody else to answer in terms of assessing the intentions and willingness to commit on the part of management and labor. But I would like to make a few more general comments.

It is a great anomoly to me, Senator, that when we were in phase I and phase II, everybody supported the program—the Sidlinger poll showed that 76 percent of the people supported the program. And you don't get 76 percent of the people to support many things in this country. And yet we had a relatively permissive program. And now in phase IV around 50 percent of the people support the program. The labor-management advisory committee——

Senator PROXMIRE. I am not talking about the people, I am talking about the industry.

Mr. WEBER. I say, it is part of the general point about getting public support, because you are quite right, control programs can't work unless they do sustain public support. But the point I was trying to make was that there is an anomoly which perhaps will dilute the notion that people really mean what they say. Many people, as I indicated, now say they don't support controls. The Labor-Management Advisory Committee unanimously called for a phaseout of controls by the end of the year. And yet here we are with a control situation, that makes phase II look positively permissive. I must say, I am hardpressed to understand that. What happened, I think is that labor always had a grievance, the way phase I and phase II worked, although during phase II in 1972 you had to distinguish between the mimeographed statements from the AFL-CIO headquarters and how labor was behaving. Generally, they were very cooperative. Then you started to have this terrific increase in prices which took place in 1973, and the attempt to restore credibility through phase IV.

Now management is calling for the end of controls. So what you see, it seems to me, is a normal expression of self-interest at the political level, but which really isn't demonstrated, particularly on the management side, by what is happening to them in terms of profits, and prices, and general economic performance.

So I think my general conclusions are: One, to agree that you need public support; and second, to present a certain set of facts and observations which in my judgment minimizes the notion that these people wouldn't really support a continuing program.

Senator PROXMIRE. In order to get the public and congressional support don't you have to have the program administered in a way that can maintain public support? In some ways this program has been administered in a way that would alienate public support and discredit the program.

Mr. WEBER. How is that, sir?

Senator PROXMIRE. The decision on beef, for example, this seems to be an extraordinary illogical position to many Americans. The decision on gasoline is one that, of course, alienated tens of thousands of gasoline dealers and many of their customers. It doesn't seem to have any justification behind it, the inability to have a cost passthrough—for example, on beef.

Mr. WEBER. I saw the action on beef as rational decision. What they were saying is that if you maintain a ceiling on beef during the freeze, it would not impair the future production of beef since there is an 18-month production cycle in this commodity.

Senator PROXMIRE. You had a situation where there were very serious shortages, and you have had such a concern on the part of Congress that the Tower amendment passed in the Senate something like 89 to 5; there was practically no opposition. The Tower amendment just wiped out the beef price freeze. What I am saying is that whether that is right or wrong—you may be completely right on the basis of the facts and the theory and something that would be workable. But you have to get something also that Congress will accept, and the public in general will understand and accept. How do you go about that? Aren't we in a position now where people were enthusiastically for price support, and Congress overwhelmingly supported that, and wanted controls. But now we have had the worst inflation that we have had at any time in many, many years under phase IV, under controls, and I think that many people feel that maybe controls don't work so well after all, that this is worse than what the country had before we had any controls, and they want something that will work. Controls are not working. And under these circumstances, are we in a realistic position to go on with them?

Mr. WEBER. I agree with you. And that is really for you to assess—I think all three of us have indicated that we think controls can have a salutory effect in dealing with concentrations of power, in terms of accelerating the adjustment to changing market conditions—I certainly agree with Mr. Estey that controls had the effect on the wage side. What you are saying is that there is an acute political problem of persuading people that if the rate of price increase is 8 percent, in the absence of controls it would be 10 percent. Therefore, they are relatively better off. And that isn't easy, I certainly agree with you.

Your notion about beef and gasoline, when I was in the Office of Management and Budget, George Shultz used to say: "The budget is a battle of the parts against the whole, and the parts almost always win."

Well, it is similar in controls. During phase I we used to get what we called the universal form letter, Senator. The first paragraph always began: "We want to congratulate the President on his forthright actions in imposing controls, we really need them."

Paragraph two was: "You should realize that we are different."

Now, how many cases like beef, gasoline, and cement do you have to have before the controls program is undermined as an administrative matter?

Senator PROXMIRE. The trouble with the beef situation was that that was singled out as special treatment. That was the only area where there was no passthrough.

Mr. WEBER. At the beginning——

Senator PROXMIRE. So that was given the 1 percent treatment—and so the beef farmers seemed to have a legitimate complaint. Why shouldn't they be treated like everybody else?

Mr. WEBER. That, it seems to me, is because phase IV was coming around from the other direction; it was trying to restore credibility. There was the perception that it would cause shortages in the food area, and that it would have effects outside the freeze. This would be particularly true in those products for which there was a short production cycle such as pork and poultry. So they relaxed controls on these commodities. But they retained controls on meat, where the long-run economic consequences would tend to be minimal.

Now, I agree that if I were a beef farmer I would probably have been outraged. But the problem in controls is the need for balancing these political and economic issues.

Senator PROXMIRE. You see, we are going to have that same problem politically as we go along——

Mr. WEBER. Sure.

Senator PROXMIRE. Because you suggest that we decontrol industry by industry. Well, labor is going to react, and business the same way; treat us all alike. George Meany says, put us under controls, and we will support it. But if you are going to make these exceptions, no. Of course, that is not logical. That doesn't make any sense at a time when you have some areas that are competitive, and the price behavior has been well within the guidelines, and where you don't have the shortages. But at the same time, as I say, it is going to be very hard to single out industries and stick it to them in the kind of political system you have and make it work. But you all agree that that is what we ought to do, as I understand, and I think you are right.

Mr. ESTEY. Senator Proxmire, I would like to raise one point here. And in doing this I am really relying on an article that Mr. Weber had in the Wall Street Journal last year—he made a very important point here.

Senator PROXMIRE. What paper?

Mr. ESTEY. The Wall Street Journal.

Senator PROXMIRE. I thought you said the Milwaukee Journal.

Mr. ESTEY. It involved viewing the whole process as a form of national economic bargaining. And I was reading the comments there today that the same day that the National Association of Manufacturers and the U.S. Chamber of Commerce came out in favor of immediate decontrol, George Meany was also quoted as saying, we ought to get rid of it all, even if we have temporary chaos.

But the thing that impressed me more in Meany's statement—and I don't know how seriously to take it—was that he used the word "unless" in his comments—that "unless" something is done about wage standards, and so on, and so forth, we ought to end wage controls now. So to me, maybe I am overreacting in this—but that seems to be the key word. I think, as Mr. Weber said a few minutes ago, that the AFL–CIO may be asking for changing and modifying the pay standard to take into consideration what has happened to prices.

To push the point a bit further, it seems to me quite possible to view the statements of the Chamber of Commerce, the NAM, and the AFL-CIO as part of a negotiating posture, and that, in fact, there is room for maneuver here.

Senator PROXMIRE. Let's see what there is on that basis that you mentioned. I think that is an interesting suggestion.

If you are going to change the wage standard—and I can understand John Dunlop, with all his experience and considerable success as an arbitrator, doesn't have to have a standard, it is always easier to work if you have more flexibility. Suppose you take the increase in the cost of living as one ingredient to it, and the other being productivity increases. Since August of last year we have had an increase in consumer's prices of 7½ percent, almost a 20-percent increase in food prices, which is the most visible, and which workers are most conscious of.

You take the 7½ percent as part of your wage guideline: and you add to that a 3-percent productivity increase, and you end up with a 10½ percent guideline formula for inflation. If you have that much of a guideline you might as well have nothing, you have a situation that is so bad, so inflationary, so sure to upset our economic system, that nobody would support it.

On the other hand, if you are going to cut below that, you are going to have, it seems to me, a fight with labor, because they have a strong argument. The cost of living ought to be in it, and also productivity ought to be in it.

Mr. WEBER. But, Senator, when we did this in phase II we used a longer time period; we used 3 years. So that if you hadn't gotten 21 percent over 3 years, you could go up to 7.

Senator PROXMIRE. Do you think that organized labor is in a mood to accept that longer time period when they see what has been happening to their paychecks, when they already have, as the Wall Street Journal pointed out yesterday in their analysis, they already have a dimunition in their real pay over the past year that is rather sharp, around 3 percent, in their real income, allowing, of course, for inflation.

Mr. WEBER. I agree with that.

But my comments in my statements were that what I find objectionable is the notion that the standard is reached by this form of arbitrage, because there isn't a standard in collective bargaining.

But 65 million workers are not covered by collective bargaining.

Senator PROXMIRE. What do you suggest?

Mr. WEBER. I suggest that there be an explicit amendment.

Senator PROXMIRE. Just throw out a figure as a standard, not 5½?

Mr. WEBER. It has got to be 5.5 plus "*x*." And in collective bargaining the pattern has been in the area of 7 percent. That is, in effect, what we do have now. And if you will look at what is happening to average compensation per hour in the last quarter, I guess it has been up around 6.8 percent. If you look at some of these settlements, you see that not everybody will get 7 percent——

Senator PROXMIRE. That is the trouble, once you get that 7 percent, then, don't you move toward a ceiling of 7 percent, and doesn't the average become——

Mr. WEBER. It didn't happen during phase II, and it won't happen in my judgment in 1974, because you are going to get some increase in unemployment. And what you tend to do is shift the direction, you shift the median, but you don't reduce the dispersion. And I think that was really one of the most surprising outcomes of phase II. But it can help deal with this symbolic equity insofar as the labor movement is concerned. What I am particularly concerned about is that we really have a doube standard, 5.5 for those who don't know where 20th and M Streets are, and 5.5 plus also for those who do know where the streets are, which, as you know, is a characteristic of most regulatory systems.

Senator PROXMIRE. You have the conflict, then, between whether you want justice or price stability. The injustice tends to give you more price stability than the justice would.

Mr. WEBER. If I have to choose, I would choose justice. But I think it relates to what Miss Hamilton said, that there is some balancing room. Not all the 65 million nonunion workers are going to get 7 percent, but there are some circumstances where, given their labor market conditions, they would have a rightful claim. And it is very tough for them to get in when the regulations still say 5.5. And we used to think on the wage board that our regulations were the picture of simplicity, but they were very complicated, and after 2 years, they really constituted a legal system.

Senator PROXMIRE. Do you and Mr. Estey—because, Mr. Weber, you emphasize this so much in your prepared statement—agree that it is pretty inevitable that labor is going to have to insist on a stronger increase because of the slowdown which we foresee, if there is such a slowdown? In the event you do have less overtime, and shorter hours, and more layoffs, a drop in labor income that way, will there be a drive to try to make this up in your view?

Mr. ESTEY. Senator Proxmire, at this point I am going to take the liberty of differing with Mr. Weber on this.

I think there is no question that organized labor will press for higher settlements. And I wouldn't disagree with him on the fact that we are coming close to 7 percent.

Let's look for the moment at the construction industry situation.

Here is an industry which has been under control the longest of any under this particular program, starting in March 1971. And I think I am right that the construction industry stabilization committee never adopted a formal numerical pay standard like 5½ percent, and in fact in their negotiations with the Pay Board they refused to adopt it. And yet here is the industry in which the wage settlements have declined the most, because they started at the highest level, but they are down late in 1972 to 4.3 percent.

Senator PROXMIRE. So you think it would be unwise to try to establish——

Mr. ESTEY. I hedge on it, I simply say that it is possible to run it without a change in the pay standard.

Mr. WEBER. If I might respond to the construction industry example, which justifiably is used as an example of good practice and good stabilization. The conditions there were so unique that it seems to me it would be perilous to use that case and approach, and apply them to the economy as a whole.

First of all, the Construction case dealt with the unionized sector. Second, the international union presidents were in favor of it because it gave them a vehicle to exercise some control in decisionmaking and discipline over the locals.

And, third, the wage increases were running in 1970 at 20 percent on top of $7 of wages, or $6.50 averages.

Fourth, the major discipline, in addition to John Dunlop's prodigious abilities and skills that made the system go, was the threat of nonunion competition in the commercial and industrial sector, which was really growing at a rapid rate. I am told the two largest contractors in the country are both nonunion.

So you had a whole set of conditions which promoted stabilization. In addition, the administration had shown a great concern when it suspended the Davis-Bacon Act, which as far as the construction unions are concerned, is a basic protection.

Now, try and use that in other situations which don't enjoy the same sense of discipline on the industry side and the management side, it seems to me that it is inappropriate and probably will not succeed.

Senator PROXMIRE. If you want justice for labor, I wonder if you would get it, though, by establishing a different guideline?

Let's take a look at what it is likely to be next year. These are the predictions made by the economists yesterday.

If unemployment increases from the present level of 4.8 to 5.5 or 6 percent, between 600,000 and 1 million more people will be out of work. Wouldn't that be likely under all the circumstances you have given us today, to result in a greater pressure on the part of organized labor, that has the clout and the capacity, to try to recoup their real wages with higher settlements, and at the same time a less ability on the part of unorganized people so that their wages would tend to fall? You would get a greater inequity, a greater injustice. And I just don't see how a guideline would have much effect on that. We had the experience on the guideline before that there were long periods when the unorganized people didn't get up to the guideline.

Mr. WEBER. I think that is a fair question. But my testimony permits the retention of a 5.5, and the reinstitution of a catchup provision. You could leave the standard alone—what we are saying is not that all wages should rise 7 percent, but in those circumstances where there is a combination of factors associated with labor market conditions, the productivity of the firm, and the need for catchup, that 7 percent would be permissible.

Now, even during phase II, not all unions got 5.5 The unions that were relatively weak, or industries that were economically depressed, got less than 5.5.

Senator PROXMIRE. They are in the position of workers who are not organized, 65 million people.

Mr. WEBER. That is right. Some got over 5.5.

You know, one of our big problems, Senator, during phase II, were the claims for comparative equity on the part of the white-collar, nonorganized people who worked for large firms where the blue-collar workers were organized, and we generally permitted that. So what I am saying is not that we change the standard—and I understand the problem that you indicate explicitly——

Senator PROXMIRE. Let me just ask you, as a matter of information, during phase II, the Pay Board collected some data on union versus nonunion wages. What does it show?

Mr. WEBER. That the approvals for workers in unionized situations were about 1½ percent higher than for those in nonunion situations.

Senator PROXMIRE. What is it today?

Mr. WEBER. Under controls, they did better——

Senator PROXMIRE. Is that the reason they did better, or was it because of the economic situation?

Mr. WEBER. Well, there are a lot of reasons.

I just wanted to amplify how they did better. They did better in terms of the average of the approval, but they did worse in the sense that there was the sharpest drop from what they were getting immediately before controls. And I think that is what Professor Estey said, so that they were still higher, but as the controls program pressed down, it pressed down relatively harder on the union cases.

And the reason they got more was really two or three reasons. One, they had the greatest catchup argument. Remember, unions tend to be under 3-year contracts. The nonunion people have continuous adjustments. So as prices rose through 1970 and 1971, they got a lot of the increases which reflected what the economic environment would have provided for: 5 and 6 percent. But under some union contracts, the workers were getting only 3 and 4 percent as deferred increases. This was a very important distinction.

And, secondly, unions are much more expert at mobilizing arguments in equity. So some of the major settlements that the Pay Board approved really had nothing to do with general economic circumstances. In coal, where it was dealing with the problem of pension plan funding, the Pay Board approved 16 percent. So, in a way, the unions did better, but they fared worse, which is a paradox—but I think it is basically true.

Senator PROXMIRE. Miss Hamilton, you came down pretty hard against putting any restraint or limits on agricultural exports, if I understood you. And it seems to me that if we have a continued shortage of food—we may or may not have it—if we have, because of our devaluations and the immense world demand for our food, we will have an extraordinary wrenching of our pricing system and an impact on the consumers and on labor. Their reaction might be strongly inflationary. So a temporary policy of modifying, restraining the increase in our exports so that we can begin to rebuild our reserves, and be in a position to protect ourselves in the event we have bad wheather conditions, drought, or something of that kind, makes sense.

Miss HAMILTON. Senator, in answer to that, the statement in my testimony was really aimed at people who just flatly say, let's put on export controls. I think the present reporting system is critical—it is too bad be didn't have it last year. And I think exports should be watched carefully. I would hate to see us repeat a soybean-type situation in any other commodity. I think that is the worst that can happen.

Senator PROXMIRE. Wasn't a great deal of the inflation that we had caused by, not the Russian wheat thing alone, although that was one element, a modest element, but on top of that we have had two devaluations, so that we have had in effect a teriffic price cut for many countries, 20 to 30 to 40 percent in American food, and they are affluent, and they began to buy far larger amounts than they did in the past. That had the effect of giving us almost $5 wheat, and a fantastic increase in corn prices and soybean prices. Now that is bound to have a big effect on the price of meat, beacuse of the substitutability of food, the spreadout throughout the food area. This was the guts of our inflation problem last summer—in August 80 percent of the rise in the cost of living was in food.

So it seems to me that in order for us to recognize—and I do say you are absolutely right in your implication that this can have a devastating effect on other countries as well as an adverse effect in the long-range trade that we have, their reliance on American food. Nevertheless, it seems to me that we should put ourselves in a position to restrain exports on a temporary basis.

Miss HAMILTON. I think if this becomes necessary, you would have to do it. I am saying that I would not advocate policies of export controls just blithely, saying: "Let's protect ourselves first." I do think the reporting requirements are terribly important now. And I do think the situation should be watched. Actually, I think we are at a great disadvantage with respect to other countries. We publish so many crop statistics, research statistics, and many other countries don't. And everybody seems to know a lot more about us than we do about them.

But I agree with you, I think the situation has to be watched very carefully.

Senator PROXMIRE. Mr. Weber, you made a persuasive argument that we should take advantage of the situation to eliminate our structural difficulties which really are at the root of much of our inflation. These structural weaknesses include our discrimination in employing women and minority groups, for example, and our import policy, our procurement policy, and so on. We talk about this in our committee. And you talked about it very well and properly, but in general terms. Could you be a little more specific and give us some priorities, some indication of what you think Congress can do and should do about this? Even the President talks about it sometimes. But they never seem to come down with a comprehensive program. And the Congress itself doesn't come up with anything that really meets what is the fundamental problem that would help us prevent inflation in the long pull.

Mr. WEBER. I am not sure that that is my comparative advantage, Senator. The areas where there are these structural problems are obvious in the labor market there are various forms of discrimination with respect to the employment of women and minorities.

Senator PROXMIRE. And they argue that they are so much worse, they say if Mr. Fellner goes in he is going to be our next Chairman of the Council of Economic Advisers, and he testifies that he favors 5 percent as our full employment target rather than 4 percent. This would reflect in all kinds of ways in our budget policy and our revenue policy as well as on the well-being of several hundred thousand Americans who will be out of work under those policies.

Mr. WEBER. And there are also other areas, as you are aware, where there is great political sensitivity—in Davis-Bacon, for example. There are four studies that I am aware of that have been done by economists that all show that the impact of Davis-Bacon is to raise wages significantly above the level that otherwise would have prevailed. So that is one thing.

The whole area of the regulated industries, such as transportation, for example, requires attention. The process of regulation has served to abet price increases rather than control them in many cases.

Senator PROXMIRE. You are doing some awfully good work in the area of controls with Brookings—you have written a history of phase I, and you are working on phase II now. Has Brookings or any other group outside of government done any work in this area that would suggest the structural remedies that we might work on that would provide this? You suggested Davis-Bacon, and now you suggest a couple of others.

Mr. WEBER. I am saying that these are the things you should look at, I will not prejudge what should be done in each case. There obviously is a lot more to be done in agriculture; in agriculture and energy policy. There is a lot to be done in housing. I don't know whether that is within the reach of Federal jurisdiction. But one of the sharpest increasing components over the last 5 or 10 years in the cost of living has been housing, and then again medical care as well. In the housing area there are building codes, there are limitations on the use of land, and there are also limitations on labor, and what have you. In the medical care situation, the consumer price index component dealing with medical care over the last 10 years increased much greater than the overall rate. Well, what are we doing to improve this situation?

Senator PROXMIRE. I think that is one area that responded pretty well to control systems——

Mr. WEBER. They did. And that is an excellent case in point. The original point I was making is that if you let prices rise, does it expand the supply? And the answer was, it wasn't expanding the supply, because the supply was basically set by the supply of medical services. which is controlled by the medical schools, and through this, the market.

Senator PROXMIRE. It had moderated quite a bit in the last couple of years.

Mr. WEBER. But that is a terrific case in point of dealing with shortages; to permit prices to rise would not increase the supply over the short term. But those are the areas we are concerned with—it seems to me agricultural policy is obviously another one. But here the turnaround has been historic. The President himself said that 2 years ago you couldn't have thought of doing the things that have subsequently been done by the Congress or as a matter of administrative action. But I think it is a great opportunity to identify these things that we have done in many instances for meritorious reasons which are no longer applicable or for which the costs are too great in terms of price stability.

Senator PROXMIRE. I just have a couple of more questions.

You have been very patient, and very helpful.

In a recent press conference Mr. Stein suggested that the consumers are really not as bad off as they think. And he argued that the Consumer Price Index, which is something we rely on for our policy, and all of us use as a basis for judging how bad off labor or the consumer is—the Consumer Price Index, the most widely used measure of inflation, he said, is out of date. He said the CPI probably overstates to a significant degree what has happened. He claims that food has become a smaller part of the consumer budget since the CPI rates were last changed.

How about that?

Miss Hamilton, do you think that the consumer price index is out of date, that we have been misjudging the effect on the consumer?

Miss HAMILTON. Certainly, Senator, if you compare the Consumer Price Index with the GNP deflator, the Consumer Price Index being the price of goods consumed weighted in some fashion, it has tended to show a higher rate of price increase than the deflator.

Senator PROXMIRE. That may be. But as far as the consumer is concerned, he doesn't know what the deflator is——

Miss HAMILTON. That is true.

Senator PROXMIRE. Let me put it this way. Don't you think it significantly overstates the impact of inflation? Is it that much out of date?

Miss HAMILTON. I really haven't analyzed it to know how much it is out of date. It is true that the percentage of income spent on food has declined since the weights were last changed. But whether or not that would make the index look much lower——

Senator PROXMIRE. How do you know that? Is that true right up to date? Is it true that they have gone up?

Miss HAMILTON. Yes, Senator, the percentage has gone up in 1973, but it has gone up marginally. It still would show a historic downtrend, but an increase in 1973.

Senator PROXMIRE. Yesterday Mr. Evans predicted that consumer prices would rise about 3.7 percent in 1974 compared to 4.7 increase in the implicit price inflator. He poses, as I understand it, a 1 percent increase in the price of food. How do you react to that? Do you suggest that that is about right?

Miss HAMILTON. That is a hard one to guess—I would not like to put myself in the spot of the USDA. Is he measuring the year-to-year level?

Senator PROXMIRE. I think he was. He said for the year, yes.

Miss HAMILTON. Although prices have already gone up a lot, I would guess that it would be higher than that. But I certainly wouldn't anticipate anything such as we have seen this year. I would expect that perhaps beef may be in somewhat shorter supply in December or January, and the prices might go up some, assuming that we don't have any bad harvests, and so forth. Part of the problem is that some of the nonagricultural component costs such as packaging costs have not been passed through. And we haven't really seen the impact of that. So it is hard to see exactly what food prices will be at the end of the year. I certainly think we have seen the worst of it. But 1 percent I find low.

Senator PROXMIRE. How about his overall estimate of that of prices?

Miss HAMILTON. Of 3.8?

Senator PROXMIRE. 3.7.

Miss HAMILTON. 3.7; I think it is low.

Senator PROXMIRE. Do you want to give me a ballpark figure?

Miss HAMILTON. I would put a range on it. It could be as low as 3.7, and I would think it could also be as high as maybe 6.

Senator PROXMIRE. What was it that Arthur Burns said the other day, that it would be no lower than, what, 5? He didn't say how high it would be, but he said it would be no lower than 5.

Mr. ESTEY. This is really not my area.

Senator PROXMIRE. The reason I am doing this, I am not doing it just for fun, the reason I am doing it is my last question is going to relate to, what are we going to do with our price and wage question, and it has a lot to do with what we can expect.

Mr. ESTEY. My first reaction is that the rise is too low.

I would like to make one comment, and that is, I recall very vividly—showing my age even more than the remarks about Bing Crosby—in World War II, when the cost-of-living index was a major factor in the wage policies of the War Labor Board, it showed very clearly that whenever the consumers price index becomes a guide to wage stabilization policy, it comes under great criticism. And there is great question about its accuracy and reliability, and so on. And I simply point out that this has been the case before—and obviously when it becomes a critical role measure, obviously the weaknesses that any measure has become evident. And I would say again roughly I would be surprised to see a price increase as small as Mike Evans predicted.

Senator PROXMIRE. I realize it is kind of foolish to ask for a prediction when there are so many changes in the world, and nobody predicted what would happen to prices this year—certainly nobody predicted that food prices would go up 20 percent, but they did.

Let me ask you this. Yesterday Mr. Evans said that the difference between having any price control system and having none would be no more than 1 percent. In other words, the price controls aren't going to give you any more of an advantage as far as inflation is concerned than 1 percent.

Paul McCracken spoke next, and he said it would be less than one-half of 1 percent.

Both of those gentlemen favored ending price controls by the end of the year, as do labor and management, and as you know, many, many others.

I think that the kind of judgment that you experts have on this may have some influence on what Congress does with wage and price controls. Suppose we start with you, Mr. Weber.

Mr. WEBER. The specific question——

Senator PROXMIRE. The specific question is: What if any difference in the rate of consumer prices in the next year will it make whether we have a wage-price control system after January 1, or do not have it?

Mr. WEBER. I think the 1 percent figure, 1, 1½, is a reasonable percentage.

Senator PROXMIRE. You would go as high as 1½?

Mr. WEBER. One, or one and a half.

It depends in part on market conditions. If there is a softening of demand, which everybody has rejected, and the problem is dampening the rate of increase to adjust to the market——

Senator PROXMIRE. As you know, in 1970 we had a real softening in incomes, and a recession, and yet prices went up sharply.

Mr. WEBER. That is what I am saying, and that was reflected in the cost-push phenomenon. And what I am saying is that under those circumstances I would expect the effect to be greater than, say, in a period such as 1973, because it does have this effect——

Senator PROXMIRE. Controls can do a much better job when you have cost-push than when you have demand-pull.

Mr. WEBER. Yes, sir, in my judgment. And when you have looser markets, price movements and wage movements are more likely to reflect institutional power as well as supply and demand.

Having said that, I must confess that I view this as a very partial assessment of controls. If you do away with controls, does that mean that we are going to have a 12-percent interest rate on short-term money, and a reduction in the rate of increase in the money supply to 2 percent? Does it mean that we must have a budget surplus of $10 billion in order to bring about stability? What I am saying is that the existence of incomes policy creates a situation where the mix of fiscal and monetary policy can be different, because there is a notion that some of the burden is being borne by controls. And I think this is really what Arthur Burns was talking about when he indicated the desirability of an ongoing form of incomes policy.

Senator PROXMIRE. What you are saying is that you might have about the same price level, but you might have a far lower level or substantially lower level of unemployment, and you might be able to have more revenue or lower taxes, either one, and you would have a more acceptable fiscal policy.

Mr. WEBER. That is what I am suggesting, that income policy takes the heat off some of the other policies which otherwise would bear the whole burden and have a different set of economic consequences.

Senator PROXMIRE. Miss Hamilton.

Miss HAMILTON. I would agree with that in part, Senator Proxmire.

In terms of the estimate, the 1 percent to 1½ or something in there, I think that is probably true, depending upon how successful phase IV is. If a lot of the price increases are shifted into 1974, that would tend to make the gap closer perhaps. So it all depends on what happens in phase IV.

I think Mr. Weber has a good point, that controls do take some of the heat off, in that they certainly help buy some time in terms of adjusting other policies. You don't have to keep changing policies so rapidly.

But you were mentioning that your witnesses yesterday wanted to take controls off immediately. If you apply that same question, what would the difference in the price level, between say, now and the end of the year with or without controls, I would say the difference would be quite a bit more than 1 percent.

Senator PROXMIRE. The third witness, Mr. Samuelson, said that April 30 would be the earliest we should take it off, and we might phase it out by the end of the termination by April 30.

Miss HAMILTON. I would agree with that.

I think right now phase IV has just gotten started.

Senator PROXMIRE. In view of your testimony, I didn't get the impression that you would agree with it. I thought that you felt, as Mr. Weber and Mr. Estey, that we would decontrol by industry, and that there would be some industries that should be under this beyond

April 30 of next year—we are not going to settle the shortages in the health area and maybe in the food area and some other areas by April 30.

Miss HAMILTON. I didn't specify whether some things might go beyond April 30. But I am not putting myself in the position of saying we should have a longrun incomes policy. And I think in part the thing that Mr. Weber was talking about as incomes policy, I was thinking of as a decontrol strategy.

Senator PROXMIRE. I understand that all of us would agree that there were some areas that we could decontrol promptly, maybe in the next month or so, or even more quickly. But as I understand Mr. Weber's view, we shouldn't just end the control system until it was clear that in each of these industries the control system could no longer contribute. And that might be quite a while. You are saying now that it is not necessary to phase price and wage controls out by April 30, the whole thing?

Miss HAMILTON. I am not sure we would be much worse off if we did—I am really concerned about some of the distortions we may be building in and the whole relative price problem.

Mr. ESTEY. I would like to support Mr. Weber's point here about the favorable impact that the income policy has on fiscal policy and monetary policy. The point you raised about the prediction that maybe eliminating price controls would mean only a 1-percent faster rate of price increase than if we had them, or even as little as a half a percent, raises a very interesting question. And while I have really no way of evaluating those figures, I think there is obviously some point at which you say, if you were sure that price controls gained you only half a percentage point on prices or less than that, perhaps, some place you say at that point the complexities and distortions, the aggravations and complications of controls were not worth that much savings in prices. I don't say that that is the figure, however.

Senator PROXMIRE. It is fascinating to reflect on this, though, because, after all, the 1 percent—what you are saying is that you are going to save the American consumer about $6 billion. And a $6 billion tax wouldn't be very proper. If you put it to a referendum, does the public want taxes increased by $6 billion, or do they want controls. I think you would get a pretty overwhelming vote against the taxes.

Mr. ESTEY. Let me say again that I shy again very carefully from saying what the figure would be.

There is obviously some point when you say, when the gains from controls get sufficiently small, the cost becomes enough to justify taking them off. I am not sure that we have reached that point.

Senator PROXMIRE. Thank you very, very much.

It has been most helpful. You have given us a lot of information, as I have said, that we didn't have before. And I am deeply indebted to you.

Thank you.

The committee stands adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

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