FINANCIAL ASPECTS OF THE BUDGET DEFICIT

730

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

FIRST SESSION

APRIL 24, 1975

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FINANCIAL ASPECTS OF THE BUDGET DEFICIT

THURSDAY, APRIL 24, 1975

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

The committee met, pursuant to notice, at 10:11 a.m., in room 1114, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Kennedy, Javits, and Taft; and Representatives Hamilton, Long, and Heckler.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, William A. Cox, Lucy A. Falcone, Jerry J. Jasinowski, L. Douglas Lee, and Carl V. Sears, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. We thank our witnesses for again taking their valuable time to join us and share with us their insights into some of the economic problems that are confronting our country.

This morning we will be discussing a very vital subject, namely, the financing of the budget deficit and of course the refinancing of the Federal debt; and we are very fortunate in having three distinguished experts with us to discuss these problems.

I called this hearing, at this particular time, because of my very great concern that the financial aspects of the budget deficit are so little understood in the Congress and, I must say, by the general public. Let me put it just a little more directly and strongly. They are not only little understood, but the budget deficit is frequently misunderstood. In part, the financial aspects of the budget deficit are misunderstood because of the flood of rhetoric from administration sources, regarding crowding out and the vicious competition for credit.

This rhetoric has of course been picked up by the press and the other media and has been drummed into all of our minds. I make no pretension to be a financial expert. However, I have taken the liberty with the cooperation of our excellent staff of the Joint Economic Committee to write a number of experts asking for their analysis of this problem of crowding out the private sector from the money market, because of the financing problems facing the Federal Government.

I also have written to the Secretary of the Treasury, and the Chairman of the Federal Reserve Board of Governors asking for information which will help us analyze this question. I have called this hearing

this morning for us to examine here orally some of the dimensions of the financing of the deficit. I must say that I place considerable emphasis upon what they call "deficit financing" because it seems to be at the heart of some of the emotional problems about the current economic situation.

I want to digress for a moment to say that yesterday I met with the Acting Secretary of the Treasury, Mr. Gardner, and we had a good discussion about putting together a task force of staff people from Treasury, the Joint Economic Committee, and hopefully from the Federal Reserve Board, to take a good, hard look at what the real problems are in budget deficit financing and what, if anything, can be done to make it seem a little less hazardous than has been pictured thus far. It is an effort to try to lower the dimensions or the threshold of the rhetoric on the one hand, come to some basic agreements as to factual information on the other, and search out certain options that can be made available in public financing as well as private financing during this critical period.

I want to begin today by saying that one does not have to be a financial expert to understand certain very important basic elements in the current economic situation. What one does need is a certain amount of plain common sense and a little bit of elementary economics.

Let me just lay out the situation as I see it from my common sense point of view, if I can qualify for that.

The economy is still very weak. While I agree with those that anticipate output will stop falling soon this does not lead me to the conclusion that all of our problems are over. We have been falling rapidly down a very steep mountain. We are almost at the bottom. When we get to the bottom we have to turn around, battered to be sure, and bruised as we may be, and begin the long climb up. There will be many obstacles along the way.

This is just another way of saying that it is hopeful now that the recession is bottoming out but I still think that we are going to see some more alarming figures in the field of unemployment.

The very large deficits that we are facing stem virtually in their entirety from the high level of unemployment and the low level of production. It is the falloff in tax receipts and the increase in the cost of unemployment compensation and other benefits which are creating the deficit. The only way to get rid of the deficit is as I see it is to get back to full employment.

The responsibility of fiscal and monetary policy is to give enough support to the economy to move us rapidly back towards full employment, thereby rapidly narrowing the budget deficit. Fiscal and monetary policy must make sure that we keep moving steadily upon our climb back up this economic mountain that we have been sliding down.

The question we ought to ask is are the fiscal and monetary policies providing enough support for the economy? It is most unfortunate as I see it that so many people have relegated that question to second place and have attached exaggerated importance to the secondary question of the impact of the deficit on financial markets.

To a large extent this credit market question takes care of itself. Private demands for credit go down when unemployment is high. This makes room in the credit market for Government demand which goes up. The process also works in the reverse. When the economy recovers,

private demands do go up and government demands go down. If the economy recovers as we hope and expect, the largest deficits we will face are occurring right now in the second quarter of 1975. No spending decision that the Congress makes on next year's budget is going to influence the size of this current quarter deficit.

This deficit has to be financed. There is no other choice. Therefore the proper question to be asked about the deficit is not "Can it be financed?" If we don't finance it the whole house comes tumbling down. The question to be asked is "How can it be financed with a minimum disruption of private credit flows?" In other words, what kind of monetary and debt management policy should we have right now and in the year ahead?

In my opinion a policy of issuing long-term debt at this time or in the immediate future would be highly ill-advised. The statements which Secretary Simon has made regarding the "vicious competition for credit" have also been ill-advised, and, I regret to say, downright irresponsible.

Our monetary policy is far from adequately accommodating. Monetary policy is not helping us climb the mountain, it may actually be holding us back. Those, of course, are my own nonexpert views. I have asked our witnesses this morning to discuss both the monetary and debt management policy of the United States and I am looking forward to your testimony.

I wrote to Mr. Burns asking that he share with the Congress the Federal Reserve's projections of expected credit flows this year and next and will include my letter and Mr. Burn's reply at the end of my opening statement.

I regret that he has sent me a rather unresponsive reply. I am going to take just a minute to read the substance of the reply. Might I add here that I have had a private conversation last evening with Mr. Burns and I am hopeful that we will have more information. I guess what I am trying to say here, for those that are concerned, is we are not interested in having a fight over this business of our budget deficit financing. We are interested in finding some answers.

Mr. Burns said this, and I quote, "The projections to which you refer are internal working documents. These projections are highly speculative, past experience has indicated that they are subject to huge margins of error. Since projections of that character could easily be misused or misinterpreted it would be inappropriate to put them into the public domain."

Let me just ask about these projections, are they so highly speculative? Then how can Mr. Burns and the Federal Reserve or anyone else know what the credit market situation will be and how serious may be the problem of crowding out? I do not find it at all reassuring that monetary policy may be being made on the basis of projections which are so highly speculative that it would be dangerous to let the Congress look at them.

I wonder if these projections are any more speculative and uncertain than projections of the economic outlook or future budget totals? I point out to Mr. Burns that budget projections and projections of the economic outlook are made available to the Congress and to the public. I believe Congress is quite aware of the inevitable uncertainties

which surround these projections but it is essential that Congress be able to operate from the same information base as does everyone else. Here is the problem, we get a certain amount of information from the Office of Management and Budget, and we get a certain amount of information from the Council of Economic Advisors, and we have difficulty getting information of similar character or related to the same problems from the Federal Reserve.

We simply can't operate now on that kind of a lack of cooperation. Mr. Burns' letter does go on to say that he recognizes the needs of Congress for "guidance" and he is therefore providing a "qualitative description of the Federal Reserve staff's projections of financial flows through the end of fiscal 1976."

That qualitative description consists of exactly four sentences as follows:

> The aggregate flow of credit to private borrowers is expected to turn up in the latter half of 1975, if an economic recovery gets underway at that time. A further strengthening of private credit demands would very probably occur in the first half of 1976. Such a revival of private needs for loanable funds would be occurring at a time of enormous demands for credit by the Treasury to finance a deficit that may exceed $100 billion if Federal expenditures are not kept under good control. By the first half of 1976, we might easily find that the aggregate volume of borrowings by the Treasury, municipal governments, businesses, and consumers was well above the highest annual rate for any six-month period in our history.

I must say, Mr. Burns, I did not need a Federal Reserve staff to tell me that the aggregate flow of credit to private borrowers will turn up if an economic recovery gets underway, that is automatic.

I have that much common sense.

As for the point that the deficit may exceed $100 billion if Federal expenditures are not kept under good control, I think that is pure scare tactics. If the Federal Reserve's flow of funds estimates are based on the assumption that the fiscal 1976 deficit will be $100 billion, then they are worse than highly speculative. The spending totals presently being discussed in Congress would produce a deficit in the neighborhood of $70 to $75 billion. There is no basis in fact or expectation for assuming that these limits will not be taken seriously by both the Congress and the administration.

Let me say at this point that our Budget Committees of the House and Senate have even been doing monumental work, they have been hard at it, and I believe that they are entitled to the commendation of all of us for their effort to get a handle on and some sense of control over the budget.

Mr. Burns' letter in no way represents a qualitative description of the Federal Reserve staff's projections of financial flows. I said I had a pleasant discussion with Mr. Burns about it. I hope that we will have more information. Congress needs an information base on which to make good decisions about the economy, and I will be in further touch with the Federal Reserve Board and its chairman, to see what we can work out in the way of the provision of information which will be genuinely helpful to the Congress.

To put it straight to you, how can the Congress of the United States be asked to act responsibly in the matter of debt management, in the matter of fiscal discipline and responsibility, if we have no really specific information as to what will happen in monetary policy?

Now, let me turn to my letter to Secretary of the Treasury Simon.

Again I have not received all the information which I have requested. However, Secretary Simon has been out of the country and Acting Secretary Stephen S. Gardner has, I believe, done his best to supply me with that information which could be made available quickly. I am going to place my letter to Secretary Simon and also the reply, which I received yesterday from Deputy Secretary Gardner, in the record at the end of my opening statement.

In this letter Mr. Gardner stressed the very large volume of new and renewal financing which the Treasury must inevitably undertake this year and next. The word I want to stress is "inevitably."

Decisions Congress is likely to make on spending will have a relatively minor impact on the total volume of financing. The question which really begs to be discussed is the technical question of how best to handle this enormous volume of financing and what kind of accompanying monetary policy is necessary.

As I told you, I met with Mr. Gardner yesterday and we agreed this question should be pursued in some depth at a staff level between the Treasury and the Joint Economic Committee. I sincerely hope the Federal Reserve can also be brought into these discussions and that these discussions will lead to agreement among the branches of Government as to how these debt management and monetary management problems can be resolved.

The chances of a strong economic recovery will be greatly enhanced if the public can be reassured that these technical problems will be handled in a way which will not unduly disrupt private credit flows.

I regret that Mr. Gardner did not feel able to respond to my request for an updated administration estimate of the fiscal 1976 budget deficit.

The $60 billion figure which the administration is currently quoting is not at all realistic. I must say for the record here that the first responsibility in fiscal matters is to provide the most accurate and up to date figures possible on revenues and expenditures. And that means budget deficits in this instance.

If we had a realistic estimate we would see that the administration estimate is not very far from the specific deficits that are being now recommended by the House and the Senate Budget committees. Much of the discussion of the different deficit estimates is a tempest in a teapot because the different programs are not very far apart.

There are enough real issues to be faced without wasting time on artificial ones. Now, I apologize to our witnesses for this lengthy statement, but I wanted to get this material in the record.

[The letters from Chairman Humphrey to Mr. Burns and Secretary Simon and the replies thereto follow:]

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., April 10, 1975.

HON. ARTHUR F. BURNS,
Chairman, Board of Governors,
Federal Reserve System,
Washington, D.C.

DEAR MR. CHAIRMAN: During the next few weeks Congress will be debating the budget resolutions which will establish fiscal 1976 targets for Federal receipts, outlays and the budget deficit. A key issue in this debate will be the impact of the deficit on financial markets. No one wants to see a deficit so large that Federal financing demands will impinge on necessary private borrowing and pre-

vent a strong economic recovery. On the other hand, it would be unfortunate if exaggerated fears about the financial consequences of a large deficit were to deter Congress from providing adequate fiscal stimulus.

In this situation, the Congress needs additional factual information and expert analysis of the probable situation in financial markets. It is my understanding that the staff of the Federal Reserve Board of Governors regularly prepares projections of expected flows of funds. I would like to request that you supply the Joint Economic Committee with your most recent projections. Please supply them on a quarterly basis through the end of calendar 1976, showing the expected demand for and supply of funds according to the usual sectoral breakdown, including Treasury issues, Federal agency issues, and State and local government securities. Please also supply the assumptions with respect to the Federal deficit on which these projections are based.

In order to make this information available to Congress prior to the upcoming floor debate on the budget resolutions, I hope that you can respond to this request no later than April 18th. If you have any questions concerning this request, please contact Ms. Courtenay Slater of the Committee staff.

Thank you for your cooperation in this matter.

Best wishes.

Sincerely,

HUBERT H. HUMPHREY, *Chairman.*

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., April 18, 1975.

Hon. HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I am writing in response to your letter of April 10, requesting Federal Reserve staff projections of flows of funds.

The projections to which you refer are internal working documents that are not made available to anyone outside the Federal Reserve. These projections are highly speculative; past experience has indicated that they are subject to huge margins of error. Since projections of that character could easily be misused or misinterpreted, it would be inappropriate to put them in the public domain.

I fully understand, however, the needs of Congress for guidance concerning the financial problems that might be created by large deficits.

Let me therefore provide you with a qualitative description of the Federal Reserve staff's projections of financial flows through the end of fiscal 1976. The aggregate flow of credit to private borrowers is expected to turn up in the latter half of 1975—if an economic recovery gets underway at that time. A further strengthening of private credit demands would very probably occur in the first half of 1976. Such a revival of private needs for loanable funds would be occurring at a time of enormous demands for credit by the Treasury to finance a deficit that may exceed $100 billion if Federal expenditures are not kept under good control. By the first half of 1976, we might easily find that the aggregate volume of borrowings by the Treasury, municipal governments, businesses, and consumers was well above the highest annual rate for any six-month period in our history.

The effects of huge Federal financing demands on financial markets are potentially very damaging, and I hope the Joint Economic Committee will use its good offices to work for fiscal discipline in the Congress.

Sincerely yours,

ARTHUR F. BURNS.

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., April 19, 1975.

Hon. WILLIAM SIMON,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: In testimony before the Joint Economic Committee and in numerous other public statements you have expressed your concern regarding the credit market effects of a large Federal deficit. This question is also of con-

cern to me and to other Members of Congress. We do face large deficits in fiscal 1975 and 1976. They are the inevitable result of high unemployment and of the tax cut already enacted.

As I see it, we in the government have two responsibilities with respect to these deficits. The first, and most basic, is to be sure that a vigorous economic recovery gets underway and is sustained. A rapid return to higher levels of employment and income is the only way of ultimately eliminating these large deficits.

The government's second responsibility is to see that the large deficit which is occurring at the present time and which will inevitably continue for some months is financed skillfully, with the least possible disruption of private credit flows. This is a joint responsibility of the Treasury and the Federal Reserve. Congress has oversight responsibility to see that this task is properly carried out. To assist us in carrying out this responsibility I would appreciate your answers to the following:

Under reasonable assumptions about economic conditions and future Federal spending, the largest quarterly deficit (seasonally adjusted) which the government will experience during the period under discussion will apparently be in the 2nd quarter of 1975, that is, in the current quarter. The deficit will continue to be quite large in the third quarter.

In light of the current spread between long and short term interest rates and the heavy private demand for longer term borrowing, this appears to be a particularly inappropriate time for the Treasury to engage in longer term borrowing. I would like to know whether you share this view and whether the Treasury will refrain from further longer term borrowing for so long as private financing demands remain so heavily concentrated in the longer term debt market and the interest rate spread remains so unusually large.

Would you agree with me that economic recovery must take priority over lengthening the maturity structure of the public debt? Would it be helpful to you to have a sense of Congress resolution expressing support for short term Treasury financing for the remainder of this year? Would a Congressionally imposed one-year limitation on longer term financing be helpful in assuring the bond markets that the Treasury will stick to short-term financing?

You have repeatedly expressed concern that heavy government credit demands will drive interest rates up. What monetary policy assumptions do you use in drawing your conclusions about interest rates? What steps is the Treasury taking to minimize any unfavorable effect of Federal financing needs on private borrowing? What efforts are you undertaking to be sure that debt financing operations and monetary policy are appropriately coordinated?

To assist the Congress in making wise decision on next year's budget, please also supply the factual information listed in the attachment to this letter. I feel it is essential that Congress have this information prior to the upcoming floor debate on the budget resolutions. Therefore, I ask that you respond to this request no later than April 18th. If you have any questions concerning this request, please contact Ms. Courtenay Slater of the Committee staff.

Thank you for your assistance in this matter.

Best wishes.

Sincerely,

HUBERT H. HUMPHREY, *Chairman.*

Enclosure.

INFORMATION REQUESTED BY THE JOINT ECONOMIC COMMITTEE, APRIL 10, 1975

1. Please provide the Administration's current estimate of the size of the deficit this year and next. Please provide also an estimate based on the assumption that the outlay totals recommended by the House Committee on the Budget are adopted and that the major provisions of the recently enacted tax bill (other than the rebate and the special credit for home purchases) are extended through 1976. Please provide estimates both on a unified budget basis for fiscal years 1975 and 1976 and on a National Income Account basis by quarters through the end of calendar 1976. Please provide the income, price and unemployment assumptions on which these estimates are based.

2. Based on these estimates, what will Treasury borrowing requirements be through the end of calendar 1976? Please provide this information by quarters or, if that is not possible, by half-years.

3. Based on these same assumptions regarding the deficit please supply estimates of the demand for and supply of funds in the U.S. credit markets through the end of 1976. Please give these estimates by sector, including Treasury issues, Federal agency issues and State and local government borrowing as well as the major categories of private borrowing and lending. It is my understanding that the only estimates of this type yet released by the office of Debt Analysis are based on the Federal spending and receipt assumptions contained in the President's February budget. The rapid course of developments in the past few months makes these estimates out-of-date. In light of the importance of the financial aspects of the deficit, it is essential that Congress have updated and realistic estimates of probable credit flows.

4. Please supply a break-down of new marketable Treasury issues since January 1 by maturity date with the yield at the issue on each maturity.

THE SECRETARY OF THE TREASURY,
Washington, D.C., April 23, 1975.

Hon. HUBERT H. HUMPHREY,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: In addition to our telephone conversation and the meeting we will have later today, I want to formally acknowledge and thank you for your letter of April 10, 1975, to Secretary Simon concerning the effect of large Federal deficits on the credit markets.

As you know, when your letter was received, I communicated with Secretary Simon who was in New Delhi following his visit to the Soviet Union. He is now attending the Asian Development Bank meetings in Manila. The Secretary's immediate cable response instructed me to tell you that he wanted to talk directly to you as soon as he returned to the United States and that he would like an opportunity to express his views to the Joint Economic Committee. I am sure you will understand how important it is to have the Secretary participate in the discussions concerning the fundamental issues commented on in your letter.

This is underlined by the fact that there must be added to any estimate of deficit financing the $106.7 billion ($156.2 billion in gross debt) of publicly held marketable debt that matures within the next twelve months. I am enclosing a series of tables showing considerable detail on our borrowing patterns over the past few years and our plans for 1975 and 1976.

As the attached tables show very clearly, the Treasury debt is already overwhelmingly top-heavy in very short maturities, and the average maturity has been shortening continuously. Furthermore, with the enormous volume of new borrowing requirements plus the refinancing that will have to be done this fiscal year and next, it is inevitable that our financing will be done predominantly in short maturities and that the present maturity structure will be shortened further.

The trends evident in the enclosed charts of average length of the marketable debt raise concerns that amplify those expressed in your letter. Even the small portion of the Federal debt that is characterized as intermediate, medium and long term averages only four years eight months. We already have a situation that inevitably contributes to the volatility in interest rates. For these reasons alone, the debt financing operations are frequently and thoroughly coordinated with the Federal Reserve. Not only do the Secretary and Chairman meet with each other frequently—at least weekly—they are in touch by phone repeatedly. In addition, the Treasury staff and the Federal Reserve engage in regular weekly consultations and are continually in communication by telephone. In addition, there is a formal structure of Treasury Advisory Committees consisting of experts from the private sector organized to provide the essential market advice necessary to the managers of the Federal debt.

I hope the attached charts and tables will be useful to the committee in responding to the substance of the concerns that are expressed in your letter.

The quarterly budget, economic and flow-of-funds forecasts that you requested are not circulated outside of the Administration. Our latest budget deficit expectations for this fiscal year and next—about $45 billion and $60 billion respectively—have been widely discussed. Our general expectations for the economy have changed surprisingly little since the Budget and Economic Report were published, and we will be pleased to discuss these with you in a qualitative way in our meeting with you today.

I hope I have made it clear why we cannot share your view that this is an appropriate time for the Treasury to refrain entirely from borrowing in the long term market or adjust the extremely sensitive and carefully planned policies that are necessary to responsible debt management.

I earnestly hope you will give the Secretary every opportunity to augment this letter both in person and with additional factual analyses of the problems we face in the months ahead.

Sincerely,

STEPHEN S. GARDNER,
Acting Secretary.

Enclosures.

TABLE 1.—NEW MONEY RAISED IN MARKETABLE TREASURY OBLIGATIONS, JAN. 1–APR. 30, 1975

[Amounts in billions of dollars]

Maturity	Amount	Percent of total
2 yr or less	[1] 18.2	[1] 75.2
13–26-week bills	[1] 8.1	[1] 33.4
Miscellaneous bills	2.3	−9.5
52-week bills	1.2	5.0
Short coupons, 1 to 2 yr	11.2	46.3
2 to 7 yr	4.6	19.0
2 to 3 yr		
3 to 5 yr	[2] 2.3	[2] 9.5
5 to 7 yr	[2] 2.3	[2] 9.5
7 to 20 yr	1.2	5.0
7 to 10 yr		
10 to 20 yr	1.2	5.0
Over 20 yr	[2] .2	[2] .8
Total	[1] 24.2	[1] 100.0

[1] Includes assumed $800,000,000 in addition to weekly bills for settlement on Apr. 24.
[2] Includes pro rata share of new money raised in February refunding.

TABLE 2.—MATURITY DISTRIBUTION OF PRIVATELY-HELD MARKETABLE TREASURY OBLIGATIONS OUTSTANDING, APR. 30, 1975

[Dollar amounts in billions]

Maturity	Apr. 30, 1975 (estimated)		Apr. 30, 1974		Apr. 30, 1973		Apr. 30, 1972	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
2 yr or less	$142.1	69.4	$111.7	66.	$107.3	62.3	$98.8	57.4
Under 6 mo	91.1		72.8		67.8		71.8	
6 mo to 1 yr	20.4		14.9		8.9		10.8	
1 to 2 yr	30.6		24.0		30.6		16.2	
2 to 7 yr	46.1	22.5	40.9	24.2	47.6	27.6	55.2	32.1
2 to 3 yr	15.1		14.8		16.0		21.4	
3 to 5 yr	18.3		15.0		21.7		22.7	
5 to 7 yr	12.7		11.2		9.9		11.1	
7 to 20 yr	12.6	6.1	12.4	7.3	13.3	7.7	11.1	6.4
7 to 10 yr	2.2		3.2		3.3		4.7	
10 to 20 yr	10.4		9.1		10.0		6.4	
Over 20 yr	4.1	2.0	4.2	2.5	4.1	2.4	7.1	4.1
Total	204.9	100.0	169.2	100.0	172.3	100.0	172.2	100.0

TABLE 3.—NEW OFFERINGS OF MARKETABLE OBLIGATIONS[1]

[Dollar amounts in billions]

	Under 2 yr		2 to 7 yr		7 to 20 yr		Over 20 yr	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1973:								
1st quarter	$1.1	11	$5.5	25			$0.6	46
2d quarter	−.4	−4	7.3	34			.7	54
3d quarter	1.7	16	4.7	22	$0.9	69		
4th quarter	8.0	77	4.0	19	.4	31		
Total	10.4	100	21.5	100	1.3	100	1.3	100
1974:								
1st quarter	5.6	18	4.4	16	.6	100		
2d quarter	2.2	7	5.2	19			.6	25
3d quarter	9.6	30	9.6	35			.9	37
4th quarter	14.4	45	8.5	30			.9	38
Total	31.8	100	27.7	100	.6	100	2.4	100
1975:								
1st quarter	12.5	68	9.1	100			.9	100
April	5.8	32			1.2	100		
Total	18.3	100	9.1	100	1.2	100	9	100

[1] Gross new offerings of notes and bonds; net new offerings for bills.

TABLE 4a.—BORROWING FROM THE PUBLIC[1], TOTAL NEW MONEY

[In billions of dollars]

	January to June	June to December	Calendar year
Actual:			
1971	3	22	25
1972	−2	17	15
1973	2	6	8
1974	3	15	12
Estimated based on President's budget and current enactments:			
1975	40	41	81
1976	33	36	69
Based on House Budget Committee outlay total and extension of major tax provisions:			
1975	40	49	89
1976	42	42	84

[1] Includes FR system.

TABLE 4b.—BORROWING FROM THE PUBLIC[1], MARKETABLE OBLIGATIONS[2]

[In billions of dollars]

	January to June	June to December	Calendar year
Actual:			
1971—Gross new issues	25.5	31.5	57.0
To refund maturing issues[3]	15.2	13.0	28.2
To raise new cash	10.3	18.5	28.8
1972—Gross new issues	11.8	24.5	36.3
To refund maturing issues[3]	5.8	9.4	15.2
To raise new cash	6.0	15.1	21.1
1973—Gross new issues	7.3	17.8	25.1
To refund maturing issues[3]	2.3	6.1	8.4
To raise new cash	5.0	11.7	16.7
1974—Gross new issues	16.1	34.3	51.4
To refund maturing issues[3]	8.3	12.6	21.9
To raise new cash	7.8	21.7	29.5
Estimated, based on President's budget and current enactments:			
1975—Gross new issues	54.0	61.1	115.1
To refund maturing issues[4]	14.5	10.6	25.1
To raise new cash	39.5	50.5	90.0
1976—Gross new issues	54.7		
To refund maturing issues[4]	14.2		
To raise new cash	40.5		

[1] Excludes FR system.
[2] Excluding regular bill rollovers.
[3] Privately-held excludes FR system holdings.
[4] Includes presently outstanding privately-held issues.

Source: Office of the Secretary of the Treasury, Office of Debt Analysis.

Table 5

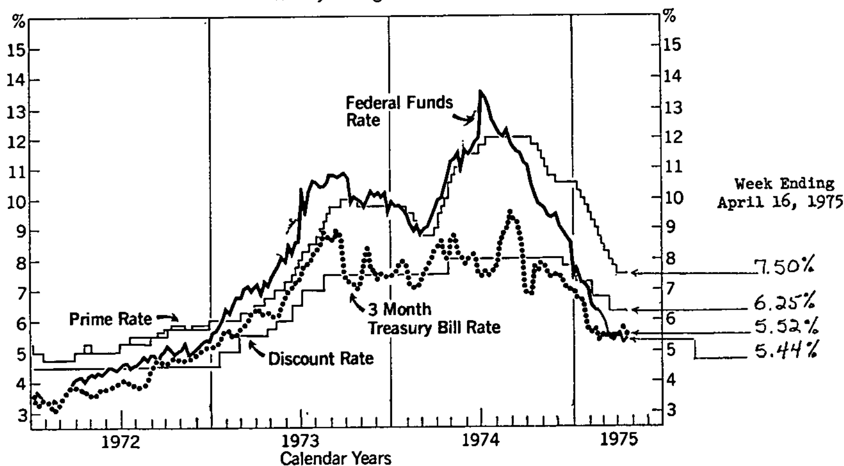

Table 6

AVERAGE LENGTH OF THE MARKETABLE DEBT

Privately Held

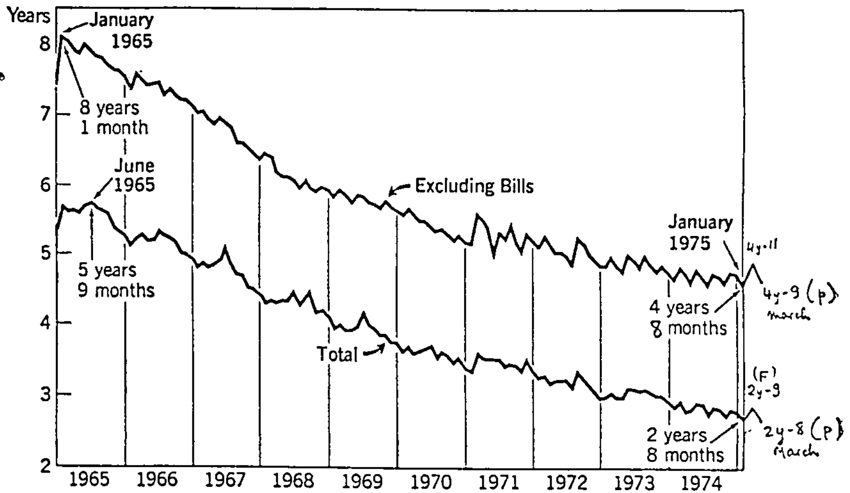

TABLE 7.—ORIGINAL MATURITY OF MATURING SECURITIES OTHER THAN REGULAR AND TAX ANTICIPATION BILLS AND EXCHANGE NOTES

[In billions of dollars]

Maturity date	Maturing issue (percent)	Issue date	Original amount issued	Outstanding at maturity			Length of issue	
				Total	Federal and GA.	Private	Years	Months
Feb. 15, 1973	(N)6½	Aug. 16, 1971	2.5	2.5	0.2	2.3	1	6
	(N)4⅞	Nov. 15, 1971	4.3	4.3	1.8	2.5	1	3
May 15, 1973	(N)7¾	Oct. 1, 1969	1.2	5.8	2.6	3.2	3	7½
	(N)4¾	May 15, 1972	3.8	3.8	2.6	1.2	1	0
Aug. 15, 1973	(N)8⅛	Feb. 15, 1970	1.8	1.8	.3	1.5	3	6
	(B)4	Sept. 15, 1963	3.9	3.9	.7	3.2	9	11
Nov. 15, 1973	(B)4⅛	July 22, 1964	4.4	4.3	.5	3.8	9	4
Feb. 15, 1974	(N)7¾	Aug. 15, 1970	2.3	3.0	.4	2.6	3	6
	(B)4⅛	Jan. 15, 1965	3.1	2.5	.6	1.9	9	1
May 15, 1974	(N)7¼	Nov. 15, 1970	4.5	4.3	1.0	3.3	3	6
	(B)4¼	May 15, 1964	2.1	2.8	.5	2.3	10	0
Aug. 15, 1974	(N)5⅝	Aug. 15, 1968	10.3	10.3	5.9	4.4	6	0
Sept. 30, 1974	(N)6	Oct. 19, 1972	2.1	2.1	.2	1.9	1	11½
Nov. 15, 1974	(N)5¾	Nov. 15, 1967	1.7	5.4	2.2	3.2	7	0
	(B)3⅞	Dec. 2, 1957	.7	1.2	.1	1.1	16	11½
Dec. 31, 1974	(N)5⅞	Dec. 28, 1972	2.1	2.1	.1	2.0	2	0
Feb. 15, 1975	(N)5¾	Feb. 15, 1968	5.1	4.0	1.5	2.5	7	0
	(N)5⅞	Oct. 22, 1961	2.0	1.2	.1	1.1	3	4
Mar. 31, 1975	(FF)8.094	July 30, 1974	1.5	1.5	.3	1.2	0	8

Chairman HUMPHREY. Let me say I initiated these discussions on my own because I am deeply concerned over what I consider to be the scare tactics that are flooding the financial markets about our inability or the lack of ability to finance the Federal debt on the one hand, and the current deficits on the other.

How, in the name of common sense, you can get economic recovery when you scare people half to death is beyond me. If there is something here that tells us that we are in an unbelievable predicament, then we need to know the facts. We need to know what the sickness is, what the problem is, and what we need to know about its dimensions. How-

ever, if we just have ourself an ideological battle going here, with an exchange of rhetoric, then we ought to recognize it for what it is.

Now, let me introduce the first witness, Mr. Andrew Brimmer, professor at the Harvard Business School. Mr. Brimmer served with distinction as a member of the Federal Reserve Board of Governors until last August. He speaks to us as a real expert in both the theory of monetary policy, and its practical application, and I have recently read with great interest an interview with Mr. Brimmer which appeared in "Financial World Magazines," and I will place that in the Congressional Record.

Now we have other witnesses and I will introduce them as they come along but I would suggest now that we start with Mr. Brimmer and then we shall proceed.

STATEMENT OF ANDREW BRIMMER, PROFESSOR, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Mr. BRIMMER. Mr. Chairman, members of the committee, I am delighted to respond to the committee's invitation to give my views on financing the Federal debt. I would wish, then, Mr. Chairman, after my oral statement, to place in the record the statement I prepared in response to the specific questions put to me by the committee.

Chairman HUMPHREY. Please proceed, as you wish.

Mr. BRIMMER. I would like to point out some of the highlights of my prepared statement. I will not go into the economic framework within which I discuss the questions of financing the deficit, and the appropriateness of monetary policy. I have such comments in the paper, but your own summary Mr. Chairman, serves as the background for my comments.

Let me say I am also handicapped by lack of information over the estimates of credit flows prepared by the Federal Reserve, and I am more handicapped than the committee, obviously, with respect to the prospective size of the debt.

However, I accept as given the prospect of the Treasury having to borrow net, not gross, at least $45 billion in this fiscal year and $70 to $75 billion in the next fiscal year—net financing from the public markets.

That being the case, I have tried to examine the appropriate role which the Congress and the public might expect the Federal Reserve to perform, and given my own background, Mr. Chairman, I would prefer to concentrate on that side of the issue.

The paper is organized as follows: I look essentially at the question of prospective competition for funds in the market. I am handicapped because I have no systematic projection of sources and uses of funds for the economy as a whole for 1975 and for 1976. However, projections made earlier in the year by Solomon Bros.—and I include a summary of their projections which I put together from their published document—and that projection appears in tables 1 and 2 of my prepared statement.[1]

Mr. Chairman, I do not want to get stuck with the individual numbers. These projections were made early in February. Clearly the situa-

[1] See tables 1 and 2, p. 24.

tion has changed since then, but the basic approach is what I would like to stress.

It is absolutely necessary that we look at both the demand side of the credit markets and the supply side. It is absolutely necessary that we do this in a systematic way.

I have tried to reconstruct the Solomon Bros. data which would permit me to look at sources and uses of funds for 1973 and 1974 and projections for 1975, by the principal sectors of the economy—household sector, the business sector, the Government sector, and the foreign sector.

Having done that, several things stand out. It is clear that the household sector in 1975—these are calendar years—will scale down substantially its net demands for funds.

According to these best estimates there would be an actual drop in the net volume of funds raised. That is important. It makes room in the money market. Second, it is clear that the business sector—despite the enormous growth in the demand for funds in the long-term debt sector of the market, it is clear that the short-term business demand for funds in 1975 will be substantially less than was the case in 1974.

One reason, of course, is the sharp reduction in the demand for funds to finance inventories.

Chairman HUMPHREY. To finance inventories?

Mr. BRIMMER. To finance inventories. Yes. I think we must remember why exactly it was in 1974 that the demand for funds by the business sector took such an enormous jump over 1973. It is no mystery as to why that occurred. One of the principal reasons was the need to finance the rise in inventories which in turn had been propelled upward by inflation.

Now with the actual liquidation of business inventories in 1975—and of course that is proceeding—and with a moderation in the pace of inflation business needs for working capital will be much less.

It is also clear that businesses will be repaying bank loans during the first part of this year. Through March there had been a net repayment of over $5½ billion. Let me repeat—businesses repaying credit. As the year goes on, I would expect bank loans to turn around. I would expect business demand for bank loans to grow somewhat.

But again, let me repeat, the main pressure of the business sector on financial markets in 1975 will be in the long-term market as more and more firms attempt to reconstruct their liquidity positions and attempt to move some of the short-term debt off their balance sheets and refinance with long-term debt.

Now I must say, Mr. Chairman, that it would be unwise for us to expect all business firms who want to do that to be able to do so in 1975. I think some of those in line will have to stand aside.

I will discuss that point further if the committee wishes. The other point I would want to make based on these data is that the Federal Government will have an enormous demand for funds in the market—but it is the direct debt of the Treasury, not the agencies.

The agencies ought to be borrowing substantially less in 1975 then they did in 1974. They are government, too, and much of their activities are out of the budget: But they put pressure on the private markets.

The agencies would be net repayers of debt. Some other sectors will expand more slowly. I would leave that and say that the next question,

Mr. Chairman, which interested me was the record of the Federal Reserve in the financing of the public debt.

I apologize for not having had time to pursue this thoroughly, but I did go back and look at the record for the last decade. I asked myself this question: When the Treasury has found it necessary to finance a large increase in the public debt, what has been the role of the Federal Reserve?

To answer this question, I focused on the growth of the debt during periods of business cycles although there were some other periods not identified by the National Bureau of Economic Research as business cycles during which the debt rose substantially.

I found the following—and here there is an appendix table attached to my prepared statement in which I set out these statistics. I would simply summarize it. What I found is the following: That during each principal period when the debt rose substantially—mainly because of the weakness in the economy—the Federal Reserve has taken—in the secondary market—a sizable share of the growth of that debt.

Let me repeat, the Federal Reserve has taken a sizable share. The proportion has run anywhere from the neighborhood of one-quarter to two-fifths. This is not just in some few periods, but in every period.

Some cases showed the proportion to be even higher. Now this points directly to the core of the question: To what extent will the Federal Reserve support—through the secondary market—the acquisition of enough of the government debt to sustain the growth of money and credit which the economy requires?

That is a crucial question. My hunch is that if the Fed fails to do that, and if it fails to perform that role, through 1975, at least, there will, in fact, be backing up of interest rates; there will, in fact, be crowding out in the sense which the Treasury and the Federal Reserve and outside observers have mentioned.

I will come back to that if the committee wishes. Finally, Mr. Chairman, I have made an effort to see what in fact has been happening to Federal Reserve policy. Answering your specific question, is the Federal Reserve sufficiently accommodating to the needs of the economy, my answer is they have been hesitant. They have finally begun to move in the right direction. But as of now, it looks as though the Federal Reserve is hesitating again.

I have some statistics in tables 3 and 4 of my prepared statement,[1] which sumarize the recent growth of the monetary aggregates. These are the kinds of statistics the Federal Reserve watches in the conduct of monetary policy. I have also included in table 4 [2] the recent record of selected interest rates.

I could go into more detail if the committee wishes, but let me summarize. Having decided to shift from a policy of monetary restraint to one of ease last October, the Federal Reserve wasted a great deal of time in getting on with the task. It was only in the last couple of months that the Federal Reserve succeeded in achieving growth in the monetary aggregates.

I don't want to be stuck with any measure of the money supply. I mentioned three or four of them here. Pick any one you wish. The Federal Reserve did not succeed until the last couple of months in

[1] See tables 3 and 4, p. 25.
[2] See table 4, p. 25.

getting growth rates in monetary aggregates in the range which the Federal Reserve itself has set as a policy. Now it is true they got interest rates down rather rapidly. But because of the weakness in the economy and the weakness in the demand for funds, the money supply and bank credit grew rather slowly.

The Federal Reserve appeared to have been reluctant to provide the reserves which the banks could have used to buy securities and thus drive down interest rates if they could not have lent money to business and other borrowers.

Let me repeat, in the last couple months they have been making some headway. The question is now whether they will continue on that appropriate track—and I am concerned about that. If you look at the record, you will notice that beginning last December, early this year and later on—roughly every 4 weeks—the Federal Reserve cut the discount rate from 8 percent, and it is now down to the neighborhood of 6¼ percent.

But it has been there for almost 2 months. There has not been another rate change despite the weakness of demand since that time. The Federal funds rate has been stuck in the neighborhood of 5¼ to 5½ percent for 3 or 4 weeks.

And—based on my checking around the money and credit markets—I can report to the committee that a number of outsiders and participants in those markets tell me that they are now convinced the Federal Reserve has stopped its easing policy for the time being.

If that is so, I think there will be a backing up of interest rates as increased demand for funds flows into the market, and the vigor and persistency of this recovery will be in question. So I think it is appropriate for the Federal Reserve to accelerate for several more months the growth of money and credit. And one index of that I think would be for the Federal Reserve to get the Federal funds rate down to 5 percent rather than leave that rate where it is now.

I leave it to the Fed whether to change the discount rate.

Mr. Chairman, you asked me about Treasury debt management. I have little to say about that. I appreciate the fact that the Treasury does want to lengthen the maturity of the debt.

Chairman HUMPHREY. Does what, sir?

Mr. BRIMMER. Does want to lengthen, stretch out.

Chairman HUMPHREY. Yes, of course. By the way, let me interrupt to note, that since 1965, the maturity of the debt has been falling all the time, from an average of a little over 5 years down to about 2½ years.

Mr. BRIMMER. That is right.

Chairman HUMPHREY. So that there is a constant pressure upon the Treasury for refinancing more rapidly and really at a more rapid rate than in the past.

Mr. BRIMMER. I agree, Mr. Chairman. And I have a paragraph in here with those figures. But I think it is an unwise policy during a period of recession and the strong demand for funds especially in the long end of the market for the Treasury to put that objective so high up on its agenda.

I think the Treasury ought to settle for financing most of this debt in the short-term market where—as I said earlier—there is substantial easing in the overall demand for funds. The business sector is scaling down its demands in the short end.

They are reducing outstanding short term and, for example, repaying bank loans. Consequently, the Treasury ought to move on out of the long end and let the private sector have that part of the market for the time being.

Now also, Mr. Chairman, I note that the Treasury and the Federal Reserve keep in close touch with the market. But as I checked around for the past couple weeks, I find that a number of market participants feel there is not sufficient orchestration of the flotation of issues.

For example, I know the Treasury has borrowing committees and before it comes to markets it consults with the banking community. And the Federal Reserve keeps in touch. But I think it would be much better for the Treasury—and more likely the Federal Reserve in behalf of the Treasury—to institute now a more systematic program of consultation with investment bankers who are anxious to bring to market companies that have been waiting as well as State and local governments that have been waiting.

But I think we ought to look with a great deal of disappointment on the fact that in later March the Treasury came to market with $1.25 billion of 15-year debt on the same day that the largest private industrial financing issue—$600 million—came to market. The Treasury knew it was coming. There was no reason for that kind of confrontation in the marketplace, and the effects on the rest of the market were disastrous—and there was no reason for it.

I think we can do better by having more systematic consultations. So in summary, Mr. Chairman, debt management can be improved. One main objective should be to focus on the short end of the market, rather than the long. The Federal Reserve does need to provide more support through the summer in my judgment for the overall money and credit needs of the economy.

Finally, Mr. Chairman, late in the year, the Federal Reserve—to avoid restimulating inflation—will have to start moderating the pace at which it increases money and credit. Now the implications of that are serious, and I hope we would have a chance to talke about it.

Thank you very much, Mr. Chairman.

Chairman HUMPHREY. Thank you very much, Mr. Brimmer, for your very lucid explanation of some complicated matters. We of course will include your prepared statement in the record and we thank you very much for it.

[The prepared statement of Mr. Brimmer follows:]

PREPARED STATEMENT OF ANDREW F. BRIMMER[1]

MONETARY POLICY AND DEBT FINANCING

I. Introduction

I am delighted to respond to this Committee's invitation to give my views on "Financing the Deficit." Specifically, I was asked to address myself to the following questions:

1. Can the financial markets handle Federal deficits of $45 to $50 billion in fiscal 1975 and approximately $75 billion in fiscal 1976 without seriously interfering with private demands for credit or forcing interest rates to levels which will prevent an economic recovery?

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[1] Mr. Brimmer is Thomas Henry Carroll Ford Foundation Visiting Professor in the Graduate School of Business Administration at Harvard University. From March 1966 through August 1974, he was a Member of the Board of Governors of the Federal Reserve System.

2. Faced with the inevitability of very large deficits in the current quarter and for the next several quarters, what is the most appropriate monetary policy for the Federal Reserve to pursue? Is present policy adequately accommodative?

3. Do [I] feel that the Treasury should restrict itself to short-term borrowing during this period in which business demand for credit is so heavily concentrated in the bond market and the interest rate spread between long- and short-term rates is so large?

I will respond to each of these questions. In Section II of the statement, prospective competition for funds in the capital market is assessed. In Section III, I examine the role of the Federal Reserve in Federal Government debt financing during the last two decades. The Treasury's approach to debt management in recent months is commented on in Section IV. In Section V, the recent trend of Federal Reserve monetary policy is appraised. Finally, in Section VI, I give my views on the appropriate course for monetary policy during the remainder of this year.

II. Prospective Competition for Funds

As noted above, the inordinate amount of concern that has been generated over the uncertain impact of prospective Federal Government borrowing on the capital markets in 1975 and 1976 is unwarranted. A number of observers have tried to place the greatly enlarged borrowing in proper perspective, but evidently they have had little success.

Official estimates of the Federal Government's budget deficit during fiscal year 1975 (ending next June 30) are still undergoing revision, but they cluster in the neighborhood of $45 billion. The deficit for FY 1976 (beginning next July 1) may be as high as $80 billion.[2] It should be noted that these estimates do not take into account the impact of the President's energy program—which is still being debated in Congress. Nor do they allow for the fact that Congress is likely to make permanent some of the one-year tax reductions included in the tax bill signed by the President last month.

The factors underlying the ballooning deficit are widely recognized—and, hopefully, understood. At this juncture, the Federal Government is expecting to spend about $324 billion in FY 1975, and receipts are anticipated at $279 billion—yielding the estimated deficit of $45 billion. In FY 1976, spending is expected to climb to $372 billion while receipts may advance to $297 billion—yielding a deficit of $75 billion. The explanation of the widening gap between Federal Government receipts and outlays is straightforward: the rapidly deteriorating economy has necessitated a sharp rise in spending to cushion the effects of growing unemployment while declining economic activity is a drag on Government revenues. The $22.8 billion tax cut (which Congress wisely enacted as a stimulus to economic activity) will add to the deficit in the first round.

To finance these deficits, the U.S. Treasury may have to tap the capital market for as much as $125 billion in FY 1975 and 1976. The specific timing of this borrowing (as well as the specific amount) remains uncertain, but it is clear that the Treasury will have to borrow almost continuously. It should be recalled that in FY 1974, the Treasury had net borrowings of $3½ billion. In the first half of the current fiscal year (last half of calendar 1974), net borrowing totaled about $11 billion. As of now it appears that the Treasury will have to raise approximately $33 billion net of refundings during the first six months of calendar year 1975. Net borrowing requirements for the last six months of this calendar year may approach $40 billion.

The prospect of greatly enlarged borrowing by the Treasury has given rise to a fear that private borrowers and State and local governments will be "crowded out" of the capital market. In the process, it is argued, the down trend in interest rates will be halted; savings institutions will have difficulty competing for funds, and the revival of housing starts (which now look uncertain in any case) will be aborted.

This concern about "crowding out" other borrowers should be given far less weight than it is apparently getting. It overlooks the fact that several of the strong demands for funds recorded last year will moderate significantly during 1975. A number of imponderables (including Federal Government borrowing) make it difficult to construct a detailed forecast of sources and uses of funds for the current year. However, the efforts which have been made suggest that one should expect the demand for money and capital market accommodation by

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[2] These estimates were stated publicly by Secretary of the Treasury William Simon on Mar. 17, 1975.

borrowers other than the Federal Government to place little or no strain on the ability of these markets to perform. For example, one forecast prepared early in February,[3] estimates that total funds to be raised in 1975 may amount to about $163 billion, a decrease of $9 billion from the year earlier total (Table 1). Last year, the total declined by $13 billion compared with the 1973 volume.

(If this forecast was being made today, it would undoubtedly be revised. However, the main reason for the revision would be the greatly enlarged volume of Federal Government borrowing. The private demands for funds (aside from corporate bond financing) probably would have to be changed very little.)

Among the major borrowers, the business sector is expected to shave appreciably its demands for external financing. Business net claims on the capital market may amount to $72 billion this year—a drop of $27 billion from the 1973 level. In particular, the need to finance a large overhang of unwanted inventories will be greatly lessened, and many businesses will be able to economize on cash requirements as output and sales fall off. Reflecting these developments, the net increase in business loans in 1975 may come to roughly $12 billion compared with a rise of $34 billion last year. Viewed in terms of the impact of such borrowing in the money market, this represents a $22 billion lessening in business demand for fund. (In passing, it should be noted that the contra-seasonal decline of about $5.6 billion in business loans at the nation's commercial banks in January–March period suggests that the moderation in demand is already well underway.) Moreover, the volume of commercial paper outstanding may rise by about $10 billion in 1975—in contrast to a gain of $17 billion last year.

On the other hand, corporations will undoubtedly attempt to raise a larger volume of funds in 1975 through the sale of bonds in the capital market than they were able to obtain last year. In the Salomon estimate, flotations may amount to $31 billion this year vs. $25 billion in 1974. However, in light of the heavy corporate bond flotations thus far (a record $4.6 billion was issued in March alone), the total may amount to as much as $36 billion in 1975—a gain of $11 billion; or roughly the same as the $12 billion increase registered in 1974. Business-type real estate mortgages may rise by $19 billion in 1975—thus registering another year of decline in their share of total credit flows.

The continued pressure on corporations to raise external funds during 1975 can be traced in part to an expected sharp reversal in corporate profits. Before allowing for taxes and inventory valuation adjustment (IVA), corporate profits might total $79 billion in 1975 vs. $110 billion in 1974. However, after adjusting for IVA, and adding repatriated foreign profits and depreciation—and after subtracting Federal tax payments and dividends—corporate cash flow from internal sources may amount to $88.8 billion in 1975 vs. $81.4 billion in 1974. But with total corporate sources projected to decline to $140.8 billion in 1975 from $163.5 billion in 1974, internal sources may represent 60 percent of the total this year compared with 54 percent a year ago. Even so, the proportion of total funds raised internally would barely be restored to the 1969 ratio. Thus, the need to help reverse the deterioration in corporate liquidity that has been underway for the last five yeas is another reason why a liberal monetary policy is desirable for the rest of this year.

The household sector may raise about $32 billion in 1975—a decrease of $10 billion from the 1973 level—which also saw a sharp decline in the net amount raised. The rise in consumer credit in 1974 (partly a reflection of the sharp decline in automobile sales but also partly a reflection of sluggishness in consumer spending generally) amounted to only $10 billion: this was less than half of the $23 billion rise posted a year earlier. In the current year, the increase may amount to $4 billion. Residential mortgages may climb by $26 billion in 1975. However, this amount would be $4 billion less than that recorded in 1974—which in turn was $15 billion below that for 1973. State and local governments may raise about $15 billion, virtually the same as the $16 billion raised in 1974.

In addition, Federal Government credit agencies (particularly those devoted to the raising of funds to be rechanneled into home financing) may have net borrowings of $10 billion this year vs. $20 billion recorded a year earlier. Finally, the volume of foreign bonds outstanding in the United States may expand by $3 billion in 1975 vs. $2 billion in 1974.

With respect to sources of funds, the crucial factor for 1975 is the outlook for nonbank investing institutions. In 1974, as shown in Table 2, these institutions as a group supplied 57 percent of the total funds raised—vs. 61 percent in 1973.

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[3] Solomon Brothers, "Supply and Demand for Credit in 1975," Feb. 10, 1975.

Specifically, in 1974, savings and loan associations (S & L's) supplied about $23 billion to the market—virtually all of which went to home buyers. This was roughly $6 billion less than they supplied in 1973. For mutual savings banks, the figures were $2.7 billion vs. $5.3 billion. For 1975, it appears that S & L's may advance net about $27 billion and mutual savings banks about $6.6 billion.

In the case of commercial banks, net lending in 1975 may approximate $65 billion versus $54 billion recorded last year. If this volume materializes, it would represent a gain of $11 billion—in contrast to a shrinkage of $24 bilion in net credit extension in 1974 compared to the 1973 level (which amounted to $78 billion). Life insurance companies and noninsured corporate pension funds may also have slightly more funds available in 1975 than was the case last year. On the other hand. State and local government retirement funds may expand their net lending to a lesser degree than they did in 1974. Federal lending agencies (partly reflecting the improved position of S & L's) will probably advance a much smaller volume of funds in 1975 than they did a year earlier. Nonfinancial corporations may also cut back appreciably the amount of credit extended (perhaps to $3 billion vs. $9 billion) as the backlog of receivables is worked down.

Real estate investment trusts (REITS) may continue to provide a declining volume of net financing of properties as they continue to struggle with their own liquidity problems. Mutual funds and fire and casualty companies may also expand slightly the volume of funds supplied to the market on a net basis. Foreign investors (especially the owners of petroleum revenues) may lift their net supply of funds to the United States capital market by $3.5 billion, raising the level to $10.5 billion in 1975 vs. $7.0 billion last year. In 1973, the figure was only $2 billion. Finally, individual investors may cut back significantly on the net volume of funds supplied to the money and capital markets directly. As market yields decline, they will most likely find more attractive the interest rates (along with greater liquidity and in some cases safety as well) offered by savings institutions. Reflecting this expected behavior, individuals may supply about $20 billion to the money and capital markets in 1975 vs. $39 billion supplied in 1974. In 1973, the figure came to $25 billion.

But, in the projected flow of funds, the most dramatic change is the greatly stepped-up borrowing by the Federal Government during the current year. In the projection outlined above, it was estimated that the Federal Government (excluding Federal credit agencies) would raise net about $41 billion in calendar year 1975. This represents an increase of $30 billion from the 1974 level. In 1973, Federal net borrowing declined by $2 billion. These projections were made after the drastic upward revision of official estimates of the Federal budget deficit. Yet, given the uncertain outlook with respect to spending, net Federal Government borrowing might be raised appreciably to the neighborhood of $70 billion in calendar 1975.

III. The Federal Reserve and Debt Financing: The Record

Given the very large increase in the Federal Government deficit over the next two years, it is clear that the Federal Reserve System will have to acquire a fairly large proportion of the net increase in the public debt in the secondary market. The record of Federal Reserve behavior in previous years during which Federal Government borrowing rose appreciably should lead both Congress and the public to expect the System to do just that. For the purpose of these hearings, I have drawn together selected statistics on Federal Government borrowing, changes in Federal Reserve ownership of Government securities, the money stock, and short-term interest rates. The figures, covering the calendar years 1955 through 1974, are shown in the Appendix Table attached to this statement.

Several points stand out in these data: On the average, during each of the last three post-World War II recessions, the Federal Reserve has absorbed roughly one-fifth to two-fifths of the increase in Federal Government net borrowing from the public.[4] For example, in 1958, the Federal Reserve's share in net borrowings was 27 per cent; in 1961 and 1962, the proportions were 22 per cent and 30 per cent, respectively. Although 1967 was not a full-blown recession year, the economic slowdown during the first quarter of that year, did produce a substantially enlarged Federal budget deficit and much higher Government borrowing from the public. In that year, the Federal Reserve absorbed about three-fifths of the net rise in the national debt. In 1970 and 1971, the Federal budget regis-

[4] Since these data are on a calendar year basis, they do not coincide precisely with the reference dates for recession and recovery as defined by the National Bureau of Economic Research.

tered extremely large deficits, and the Federal Reserve's share of net borrowing by the Treasury was two-fifths and one-third, respectively.

These data also suggest that the Federal Reserve plays a vital intermediary role between the Federal Government and private credit markets. By definition, the larger the proportion of an increase in the debt which the Federal Reserve absorbs the smaller is the share which must be raised in private credit markets. When the debt has grown substantially—and as the Treasury has been forced to compete with private borrowers—interest rates have risen noticeably, and the growth rate of the money supply has slackened. This tendency is clear whether one traces the relationship by reference to the narrowly defined money stock (M_1) or the more broadly based measure (M_2). It also holds for both the Federal funds rate and the yields on three-month Treasury bills.

Let me repeat, these figures are suggestive rather than definitive. A much more detailed and systematic analysis would need to be undertaken before the relationship among Federal Government borrowing, Federal Reserve support, and money and interest rates can be established with greater certainty. However, the general outline sketched here does lead to a clear task for the Federal Reserve: Unless the System is prepared to absorb a sizable share of the net rise in the Federal debt in 1975 (not necessarily as large a proportion as in 1970 and 1971—when the fraction averaged just under 40 percent), an unduly large percentage of the borrowing by the Government will have to come out of household savings. Such a course would assure that the recession—despite the stimulus of the tax cut enacted by the Congress earlier this year—would drag on through most of this year—with a concomitant waste of the nation's human and material resources.

IV. The U.S. Treasury and Debt Management

Given the size of Federal borrowing that must be undertaken, it is clear that the Treasury must finance the vast bulk of the debt in the short-term money market. It is clearly doing this—for the most part. Yet, on one or two occasions (and above all in light of what Treasury officials are saying), the Treasury's venture into the long-term capital market has exerted unnecessary and disruptive pressure in the securities markets. The outstanding example occurred late last month. On the same day that an industrial firm floated $600 million of long-term corporate bonds (a record for a nonpublic utility issue), the Treasury offered $1.25 billion of 15-year bonds. The Treasury issue attracted bids of $2.9 billion. The adverse impact of the Treasury flotation was felt in all sectors of the securities markets. Since the Treasury knew well in advance that the Corporate Calendar would be extremely crowded, it could have tailored its own more expertly.

I am not unfamiliar with the Treasury's desire to moderate the persistent tendency for the debt to become shorter. For example, over the last decade, the average length of the debt has shrunk steadily—from five years and four months in 1965 to only three years in 1974. As a matter of fact, in December last year, the average was down to two years and eleven months. Thus, the Treasury does feel pressed to check further attrition in the debt's average maturity.

But I would give less weight to this objective than Treasury officials give it. Unlike some of them (at least according to press reports), I do see a reason why the Treasury should limit its access to the long-term bond market. The reason is to lessen pressure on long-term interest rates and thus enhance the opportunity for the corporate sector to restore its badly depleted liquidity.

I know that the Treasury keeps in close touch with investment bankers as well as with commercial banks, so it is fully abreast of conditions in the money and capital market. The Federal Reserve Banks (which act as the Treasury's fiscal agents) are in even closer touch with the market. This is especially true of the Federal Reserve Bank of New York. Nevertheless, I believe that more systematic consultation by the Treasury (or by the Federal Reserve on Treasury's behalf) with market participants about the prospective flow of corporate and municipal securities onto the market would ease the task of timing new issues for everyone.

V. Trend of Federal Reserve Monetary Policy

Since last October, the Federal Reserve has sought to encourage a more rapid growth of the monetary aggregates. That objective was spelled out in the Policy Record of the FOMC's October 1975 meeting and reiterated in subsequent public statements. The evidence suggests, however, that the System only recently has been making progress toward this goal. This conclusion is supported by the

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statistics presented in Tables 3 and 4. Table 3 shows the growth rates for several of the principal monetary and reserve aggregates during specified periods over the last year. Table 4 presents figures on selected interest rates.

Even a cursory review of the data in Table 3 leads to a significant conclusion: during the last two months, the Federal Reserve made some headway in its efforts to accelerate the growth of money and credit—while it had lost ground during the preceding four months as the economy slipped more deeply into recession. This fact stands out no matter which reserve, monetary, or credit aggregate is used to trace the trend of monetary policy.

For example, during the four weeks ending April 16, 1975, the average volume of reserves available to support private deposits (RPD's) rose at a seasonally adjusted annual rate (SAAR) of 3.6%. The same measure shrank at a 16% SAAR over the last 16 weeks, and it had been shrinking for nearly a full year. Nonborrowed reserves (i.e., reserves supplied at the initiative of the Federal Reserve) grew by 8% over the last month. But here, also, in the last three months, such reserves declined at a SAAR of 18%. In the last six months, the net expansion was only 2.3% (SAAR). Federal Reserve credit (perhaps the best summary measure of the System's net impact on the money and capital markets) rose at a SAAR of nearly 14% in the eight weeks ending April 16. Here, too, the pace of expansion had lagged noticeably over the preceding four months—compared with publicly stated Federal Reserve general objectives.

In the case of the monetary aggregates, a similar pattern can be traced. The narrowly defined money stock (M_1—demand deposits and currency in the hands of the public) rose 9% (SAAR) in the four weeks ending April 9, 1975. An increase of 11% occurred during the eight-week period; and over the thirteen-week period, there was a net increase of 6% (SAAR). Until the last two months, M_1 had been actually shrinking. The more broadly based money stock (M_2—which includes M_1 plus commercial bank time and savings deposits other than large-denomination CD's) and commercial bank credit (as measured by the adjusted bank credit proxy) registered positive gains over the entire period under review.

As one can see in Table 4, short-term interest rates have fallen significantly since last fall. The decrease was led by the Federal funds rate—which dropped by over 8⅛ percentage points since September (from 10.78% to about 5⅜% on April 21). The Federal Reserve discount rate has been reduced in three steps: from 8.0% to 6.25%. Other short-term rates show the same profile. The most widely quoted prime rate (which commercial banks charge their best customers) is in the neighborhood of 7½% at most banks. Since the cost of money to the banks (measured roughly by ther ates they offer on large denomination certificates of deposit (CD's)) is approximately 6¼%, they are enjoying a rate spread of about 1¼%. (Last winter, the spread had been as much as 2½%—the widest on record.)

Long-term rates have fallen also, but the decline has been proportionately far less. The more modest declines in the long end of the capital market partly reflect a continuing strong demand for funds by corporations and State and local governments—as well as some borrowing by the Federal Government in this segment of the market.

Actually, short-term and intermediate-term interest rates have been backing up in recent weeks. Again, the reason seems to be renewed hesitation on the part of the Federal Reserve with respect to the proper course of monetary policy. While Federal Reserve officials *say* they are committed to the use of monetary policy to assure economic recovery, their actions give the impression of being more tentative. For example, the Federal Reserve discount rate was lowered at roughly four-week intervals beginning in early December (when it was reduced to 7.75% from the 8.00 set last July) through early March when the rate was set at 6.25%. Now it appears to have come to rest (at least for the time being) at that level. Moreover, the Federal funds rate seems to have gotten stuck in the neighborhood of 5⅜%—where it has been for several weeks. So, while the Federal Reserve continues to enter the market regularly to supply (or absorb) reserves, many market participants are getting the impression that the Federal Reserve has about come to the end of its credit-easing actions as far as the present recession-recovery phase is concerned.

VI. Concluding Observations

From the foregoing discussion, I reach the following conclusion: Unless the Federal Reserve System acts to prevent it, the competition for funds in the nation's capital market in 1975 might produce a level and structure of interest. rates that could delay the timing and dampen the vigor of the recovery which national economic policy is designed to achieve. The assessment of the outlook presented here assumes that (in addition to a stimulated fiscal policy and the absence of wage and price controls) the course of monetary policy during 1975 will be accommodative. Specifically, it is assumed that, in carrying out this policy, the Federal Reserve will supply bank reserves in a generous fashion and that open market operations would be employed aggressively (i.e., to make large net purchases of outstanding Federal Government securities.) The basic question, however, is whether the Federal Reserve will be vigorous enough in its efforts to expand the availability—and reduce the costs—of credit in a still depressed economy.

Given the supply and demand for funds outlined above—along with some improvement in investor expectations in the face of moderation in the rate of inflation—the monetary policy followed by the Federal Reserve so far may lead to the following pattern of interest rates. Short-term rates may move down somewhat further through mid-1975, but the decline may be very slight compared with levels currently prevailing. The heavy borrowing by the Federal Government in the short-term market (along with continued sizable needs of the business sector) may well limit the magnitude of the reduction in short-term rates. In the latter part of the year, as the expected economic recovery gets under way—and particularly after the liquidation of unwanted inventories has been completed and stocks are being accumulated again—business loan demand is expected to become stronger. Under those circumstances, renewed upward pressure on short-term rates should be anticipated. In the long-term capital market, interest rates may decline moderately below present levels. These modest reductions will reflect the expected record level of corporate bond flotations and near-record borrowing by State and local governments. Moreover, interest rates on bonds issued by firms with less than the highest credit ratings may show little or no decline. Because of the strong inflow of funds to savings intermediaries—in face of sluggish demand for houses—interest rates on home mortages may decline somewhat further as the year unfolds. Corporate bond yields may start climbing again in the closing months of 1975—depending on the timing and strength of the recovery. Finally, toward the end of this year, some long-term investors (especially if they fail to note the large backlog of excess capacity in American industry) may begin to worry again about the prospect of renewed inflation in 1976, and this change in expectations could also give a boost to long-term rates.

Thus, a fundamental conclusion should be re-emphasized: the Federal Reserve System will have to expand the volume of bank reserves at a fairly high rate through most of 1975—if the credit needs of the economy are to be met. If the System fails to do this, the greatly enlarged Federal budget deficits will have to be financed out of private savings, and private borrowers will be "crowded out" of the market place. The consequences of such a development must not be underestimated: interest rates would back up; savings intermediatries would mobilize a smaller volume of funds; the revival of housing starts would be anaemic well into next year; corporate liquidity will remain strained, and the overall pace of economic recovery in 1975 would be less sure and more feeble.

Given this prospect, I am personally convinced that the Federal Reserve will sustain the growth of money and credit at rates close to those currently prevailing. Moreover, it will have to sustain the higher rates of expansion through most of the current year. However, the impact would be registered—at least during virtually all of 1975—as a stimulus to increased output, and very little would show up in the form of higher prices. As the year wore on, the increment in prices relative to the increment in production would become somewhat larger. Yet, because of the large backlog of excess capacity and the high—and rising—rate of unemployment, there is little likelihood that the provision of a greater volume of bank reserves by the Federal Reserve System would rekindle underlying inflationary forces during the current year.

TABLE 1.—NET DEMAND FOR CREDIT, 1973–75

[Annual net increases in amounts outstanding; billions of dollars]

Category	1973 Amount	1973 Percent of total	1974[1] Amount	1974[1] Percent of total	1975[2] Amount	1975[2] Percent of total
Household sector:						
Consumer credit	$22.9	12.4	$9.9	5.8	$3.5	2.2
Mortgages: Total	45.6	24.6	30.0	17.5	25.8	15.8
1 to 4 family residential	(41.0)	(22.2)	(27.6)	(16.1)	(24.4)	(14.9)
Other mortgages	(4.6)	(2.4)	(2.4)	(1.4)	(1.4)	(.9)
Security credit	−4.4	−2.4	−1.1	−.6	1.0	.6
Other consumer loans	5.3	2.9	2.7	1.6	2.0	1.2
Subtotal	69.4	37.5	41.5	24.3	32.3	19.8
Business sector:						
Business loans	38.4	20.7	34.3	20.0	12.1	7.4
Open market paper	8.4	4.5	16.9	9.8	9.6	5.9
Corporate bonds	12.7	6.9	24.7	14.4	31.3	19.2
Mortgages: Total	28.9	15.7	22.7	13.2	19.1	11.7
Multifamily residential	(8.8)	(4.8)	(5.7)	(3.3)	(5.3)	(3.2)
Commercial mortgages	(16.2)	(8.8)	(12.8)	(7.5)	(8.8)	(5.4)
Farm mortgages	(3.9)	(2.1)	(4.2)	(2.4)	(5.0)	3.1
Subtotal	88.4	47.8	98.6	57.4	72.1	44.2
Government sector:						
State and local governments	14.5	7.8	15.5	9.0	15.0	9.2
Federal Government	19.4	10.5	30.7	17.8	50.7	31.0
U.S. Treasury (privately held debt)	(−2.1)	(−1.1)	(10.7)	(6.2)	(41.0)	(25.1)
Federal agencies (privately held debt)	(21.5)	(11.6)	(20.0)	(11.6)	(9.7)	(5.9)
Subtotal	33.9	18.3	46.2	26.8	65.7	40.2
Other domestic credit	−7.6	−4.1	−16.7	−9.7	−9.9	−6.1
Foreign bonds (domestically held)	1.0	.5	2.2	1.2	3.1	1.9
Total: Net demand for credit	185.1	100.0	171.8	100.0	163.3	100.0

[1] Estimated.
[2] Projected.

Source: Salomon Brothers, "Supply and Demand for Credit in 1975," Feb. 10, 1975.

TABLE 2.—NET SUPPLY[1] OF CREDIT, 1973–75

[Annual net increases in amounts outstanding; billions of dollars]

Category	1973 Amount	1973 Percent of total	1974[2] Amount	1974[2] Percent of total	1975[3] Amount	1975[3] Percent of total
Nonbank investing institutions:						
Mutual savings banks	$5.3	2.9	$2.7	1.6	$6.6	4.0
Savings and loan associations	29.3	15.8	23.3	13.6	26.5	16.2
Credit unions	2.9	1.6	3.2	1.9	3.5	2.1
Life insurance companies	9.6	5.2	10.9	6.3	12.5	7.7
Fire and casualty companies	3.5	1.9	3.7	2.2	2 9	1.8
Private noninsured pension funds	2.1	1.1	5.4	3.1	5.0	3.1
State and local government retirement funds	3.7	2.0	5.7	3.3	6.7	4.1
Open-end mutual funds	−.2	−.1	.9	.5	−.2	−.1
Real estate investment trusts	4.5	2.4	1.2	.7	.2	.1
Subtotal	60.7	32.8	57.0	33.2	63.7	39.0
Commercial banks[4]	77.6	41.9	53.6	31.2	65.0	39.8
Finance companies	10.2	5.5	4.9	2.9	1.4	.9
Business corporations	5.4	2.9	8.0	4.7	5.7	3.5
State and local governments	4.5	2.4	2.4	1.4	−3.0	−1.8
Foreign sources	2.0	1.1	7.0	4.1	10.5	6.4
Subtotal	99.7	53.9	75.9	44.2	79.6	48.7
All institutions	160.4	86.7	132.9	77.4	143.3	87.8
Residual: Individual and miscellaneous	24.7	13.3	38.9	22.6	20.0	12.2
Total: Net supply of credit	185.1	100.0	171.8	100.0	163.3	100.0

[1] Excludes funds for equities, cash and miscellaneous demands not tabulated in table 3.
[2] Estimated.
[3] Projected.
[4] Includes nonoperating holding and other bank related companies.

Source: Salomon Brothers, "Supply and Demand for Credit in 1975," Feb. 10, 1975.

TABLE 3.—MONETARY AND RESERVE AGGREGATES, RECENT GROWTH RATES—PERCENT[1]

[Seasonally adjusted annual rates]

Category	Last month	Last 8 weeks	Last 13 weeks	Last 26 weeks	Last 52 weeks
Monetary aggregates, as of Apr. 9, 1975:					
M_1	8.5	11.2	5.5	4.5	4.2
M_2	10.1	12.0	9.5	8.1	7.2
Adjusted bank credit proxy	8.7	6.1	4.0	4.7	8.1
Reserve aggregates, as of Apr. 16, 1975:					
Nonborrowed reserves	8.3	−18.7	−17.0	2.3	3.1
RPD's	3.6	−16.5	−16.2	−10.8	−.7
Monetary base	10.0	10.5	7.3	7.3	7.6
Federal Reserve credit	13.7	13.1	7.7	6.7	8.8

[1] Percent change, simple annual rates, 4-week average, ending on date indicated from 4-week average, ending at the earlier period.

Source: Computed at Data Resources, Inc., from Federal Reserve Board figures.

TABLE 4.—SELECTED INTEREST RATES

[In percent]

Category	Monthly average		Weekly average—1974			
	September 1973	February 1974	July 3	Sept. 4	Dec. 28	Apr 21, 1975
FR Bank discount rate	7.50	7.50	8.00	8.00	7.75	6.25
Federal funds	10.78	8.97	13.55	11.64	8.75	5.25
U.S. Treasury bills, 90-day	8.29	7.12	7.45	9.18	7.01	5.66
Commercial paper, 90- to 119-day	10.31	8.00	11.95	11.94	9.28	6.00
CD's (new issue, New York City), 90- to 119-day	10.50	7.97	11.75	12.00	8.62	6.15
Corporate bonds (Aaa utility), recently offered	7.99	8.23	9.79	10.27	8.90	8.84
Municipal (bond buyer)	5.10	5.20	6.64	6.88	6.70	6.95
U.S. Government (10-yr constant maturity)	7.09	6.96	7.68	8.12	6.77	7.25
FNMA auction yields	9.32	8.48	9.65		9.47	8.30

Source: Federal Reserve Board

APPENDIX TABLE

SELECTED STATISTICS ON FEDERAL GOVERNMENT BORROWING, MONETARY AGGREGATES, AND SHORT-TERM INTEREST RATES, CALENDAR YEARS 1955–74

[Amounts in millions of dollars unless otherwise noted]

Year	Federal Government budget surplus or deficit (−)[1]	Net borrowing from the public (include Federal Reserve)[1]	Net change in Federal Reserve holdings of U.S. Government securities[2]	Net demand on private credit markets[3-4]	Federal Reserve share of net borrowing from public (percent)[4÷3]	Money stock (M_1)		Money stock (M_2)		Short-term interest rate	
						Level (billions)[3]	Percent change[4]	Level (billions)[3]	Percent change[4]	Federal funds[5]	3-mo Treasury bills[6]
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
1955	−729	448	−148	596	NA	132.2		185.4		1.78	1.753
1956	5,525	−5,911	130	−6,041	NA	136.9	1.3	189.0	1.9	2.73	2.658
1957	1,191	−1,168	−677	−491	NA	135.9	−.7	193.4	2.3	3.11	3.267
1958	−7,287	7,762	2,108	5,654	27.2	141.1	3.8	206.7	6.9	1.57	1.839
1959	−8,006	8,580	302	8,278	3.5	143.4	1.6	210.9	2.0	3.30	3.405
1960	3,593	−2,670	736	−3,406	NA	144.2	.6	217.1	2.9	3.22	2.928
1961	−6,816	6,762	1,497	5,265	22.1	148.7	3.1	228.6	5.3	1.96	2.378
1962	−5,668	6,560	1,939	4,621	29.6	150.9	1.5	242.8	6.2	2.68	2.778
1963	−4,579	4,255	2,773	1,482	65.2	156.5	3.7	258.9	6.6	3.18	3.157
1964	−5,241	5,780	3,451	2,329	59.7	163.7	4.6	277.1	7.3	3.50	3.549
1965	−4,543	2,872	3,724	−852	129.7	171.3	4.6	301.3	8.7	4.07	3.954
1966	−5,730	4,788	3,514	1,274	73.4	175.4	2.4	317.8	5.5	5.11	4.881
1967	−7,272	7,822	4,830	2,992	61.7	186.9	6.6	349.6	10.0	4.22	4.321
1968	−16,123	15,299	3,825	11,474	25.0	201.7	7.9	382.3	9.4	5.66	5.339
1969	5,430	−2,559	4,217	−6,776	NA	208.7	3.5	392.2	2.6	8.21	6.677
1970	−11,737	11,842	4,988	6,854	42.1	221.4	6.1	425.3	8.4	7.17	6.458
1971	−24,789	24,747	8,662	16,085	35.0	235.3	6.3	473.1	11.2	4.67	4.348
1972	−17,375	15,272	426	14,864	2.8	255.8	8.7	525.7	11.1	4.44	4.071
1973	−7,890	7,903	9,265	−1,362	117.2	271.5	6.1	572.2	8.8	8.74	7.041
1974	−10,944	11,790	5,219	6,571	44.3	[7] 283.8	4.5	[7] 613.9	7.3	10.51	7.886

[1] For calendar years shown. Source: Federal Reserve Bulletin, Summary of Federal Fiscal Operations.

[2] For calendar years shown. Source: Flow of Funds Accounts—Sector Statements of Savings and Investment.

[3] Money stock figures are seasonally adjusted averages of daily figures for December of years shown. Source: Economic Report of the President, February 1975 (except data on M_2 prior to 1959).

[4] Percentage changes of the money stock defined as follows: $Change_t = M_t / M_{t-1} - 1$.

[5] Based on 7-day averages for weeks ending Wednesday. Source: Economic Report of the President, February 1975.

[6] Average rate on new issues during period. Source: Economic Report of the President, February 1975.

[7] Projected.

Chairman HUMPHREY. Now, our next witness is a gentleman who has been with us before. I understand—if I am not mistaken—he has most recently been elected president of the Economics Association.

Am I correct in that?

Mr. MODIGLIANI. President-elect.

Chairman HUMPHREY. President-elect. Well, having aspired to that high office many times I would settle for that any day. [Laughter.]

Mr. Modigliani is professor of economics at Massachusetts Institute of Technology, along with his many other honors and we surely welcome you once again.

I can't tell you how much we appreciate your willingness to advise and counsel us at considerable expense to yourself and to your time.

Would you proceed with your testimony, please.

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. MODIGLIANI. Thank you, Senator.

Indeed, it was a profitable undertaking to testify here. I think we get $25 a day, and that's a pretty high estimate of what our time is worth.

Chairman HUMPHREY. You mean to tell me we're overpaying you at such——

Mr. MODIGLIANI. I think you are, yes. In face of the huge deficit.

Chairman HUMPHREY. I better take this up; I always believed in a good, fair wage. So we will see what we can do about that.

Mr. MODIGLIANI. Now, Senator, I have decided to pitch my presentation here today at the more fundamental level of the basic economics issues involved. In fact, I may have to apologize to you, because the level of my presentation might be the kind that I would give to an intermediate economics class. I apologize to you, but I figure that in any event I am not just talking to you. Hopefully, I am talking to Mr. Simon, and I think he does need that kind of economics. [Laughter.]

We have finally gotten through the Congress with administration cooperation a tax cut bill. It's been painful; it's taken a long time. As you know, Mr. Chairman, I advocated this tax cut in November of last year.

Chairman HUMPHREY. Yes; yes.

Mr. MODIGLIANI. I had recommended a $20 billion tax cut then. By the time we got around to it, I felt that the $20 billion you passed was inadequate. I now feel this more than ever. Our projections indicate that with this tax cut and even with a permissive monetary policy our economy will recover very slowly. In fact, our projections indicate that by the end of 1976 unemployment rates will hover around 8 percent, perhaps a little more, perhaps a little less depending on what happens to productivity. But we will not be out of the woods by any means. In fact, they indicate that it will only be in the third quarter of 1976 that we will get back to where we were at the end of 1973.

So it will take us 2 full years just to be getting back there.

Mr. TOBIN. In production.

Mr. Modigliani. In production. Unemployment will be far higher. In the meantime, population has grown, we will have, of course, that much higher unemployment. That is why we will have 8 or 8.5 percent instead of 5 percent as we had then.

Chairman Humphery. May I just interrupt to say that I think it is important to make note that as we talk about the recovery and production we do not always get the same results in employment.

Mr. Modigliani. Absolutely. And unemployment will be high, 8 percent; and production will only recover weakly.

Chairman Humphrey. I know you are a very wise economist because you agree with me on the tax cut.

Mr. Modigliani. I wanted to mention that, that you picked up my suggestion, or I picked up yours. But we agree and that's the important point.

Chairman Humphrey. Yes.

Mr. Modigliani. But before even the tax cut had been approved, the Treasury had been using scare tactics saying it's going to be terribly difficult to finance that huge deficit that comes out of the tax cut, let alone any higher deficit that could come out of a more aggressive fiscal policy either from the revenue side or from the expenditure side.

The question is whether there is any validity to the arguments that are being advanced. Let me first indicate, in agreement with what you said, that one should put the size of this debt in perspective. First of all, $70 billion is what we've been told and that these are figures of the same dimension we had during the Second World War. True. In money terms they are, but you cannot make that comparison at all. In fact, I was impressed when you quoted Mr. Burns saying the flows next year would be the highest ever. What Mr. Burns doesn't mention is that if the economy is growing, every year's flow should be higher the previous year, on the order of 5 percent. If it isn't, there is something sick.

So it's surprising he would use that argument.

As you pointed out, the overwhelming proportion of this deficit is the result of our weak economy. By and large, if we were back to full employment we would have no deficit even though the deficit is now running at something like $50 billion. So that's generally agreed. Most of it comes from weakness and it isn't that large considering the fact that the economy's output is some $1½ trillion.

So we are talking about figures that can only be taken in relation to a proper base.

Now, the arguments that there would be tragic consequences from this large deficit are essentially about crowding out effects of this huge debt.

I would like to distinguish between two kinds of arguments. One is what I call the naive populist argument, the argument that is so impressive when you first hear it and which is thoroughly and completely wrong from the economic point of view.

Then I move on to the second argument, from the financial community, which is much harder to understand to the layman; it's a technical argument which makes some sense economically but only on the principle that the financial community doesn't understand what is going on. That is, if they don't understand what is going on then they might be speaking sense. But this must be taken into account and I will come to it later.

Now, what is the naive argument? Well, it goes something like this: The deficit is so huge that there just aren't enough savings around to absorb that Government deficit without displacing all kinds of other private expenditure, without displacing investment. That means, first, that if you do displace investment you will not get much of an increase in aggregate output; and, secondly, that we will be displacing most important kinds of expenditures which should be providing capacity important in years to come.

The only way in which that deficit could be absorbed, since there is not enough savings, is for the Federal Reserve to print money, and with this newly printed money buy that debt. But don't we all know that that's unsound? Whenever the Federal Reserve prints money to buy the Government debt the result is a new round of inflation.

Now, is there any validity to this argument? The answer is absolutely not. There are a number of considerations to support this assertion. First, any person trained in economics knows that there always is enough savings to absorb or finance the investment and the deficit that the economy produced, because the deficit produces its own savings. So there always is enough, in the aggregate.

Let me illustrate this point with a couple of examples. Case one, suppose the Government cuts taxes $20 billion and suppose that the public refused, to spend it, to buy anything—they all put it away in their socks; what happens then? The deficit of the Treasury would be $20 billion. But the public is saving $20 billion more, exactly as much as the increased deficit.

Case two. The public responds. Because it gets $20 billion more, it responds modestly and it spends $10 billion more in consumption. Because of this higher consumption, there will be $10 billion additional income because the consumption of goods produced are income to other people who produced them. So the income received would increase by $30 billion. Suppose further on that the $10 billion they received for production of goods is taxed at 40 percent, which is roughly the American marginal tax rate. So they end up with $26 billion additional disposable income. Since by assumption they only consume $10 billion they have then saved $16 billion. How much is the deficit? It was $20 billion, but the Government collected $4 billion more in taxes; therefore, the deficit is $16 billion; $16 billion more deficit, $16 billion more savings.

The reason I give you these figures is that I will use them again later. So let me consider one more case in which the public responds by increasing consumption by $20 billion, and on top of that, you suppose that there are additional investments of $10 billion. You can work out that in this case income would rise by $30 billion; the taxes would rise by $12 billion and you would have a deficit down to $8 billion. The savings would be up to $18 billion of which $10 billion would be needed to finance the investment, leaving precisely $8 billion available to finance the deficit.

These examples are meant to give an idea of the mechanisms behind this relationship, between saving, investment and deficit, which must always hold since it is the result of an accounting identity.

Now, the fact that there is always enough savings to absorb the deficit means that there are no difficulties in financing it. It does not mean that any deficit is good enough, though. It would be a very ignorant person who would understand me to say that; therefore, the

Government can go ahead and have any deficit it wants. Of course, not. Because all the arguments I have given you are valid whether or not there is slack in resources. However, if there is no slack in resources, prices would rise by the full amount of the additional expenditure; so the additional expenditures would result in more inflation but no additional output.

If, however, there is slack in the economy, and I don't know anybody willing to say there isn't slack in the economy, then the effect of the higher expenditure will show up essentially in higher production of goods and higher employment.

However, we have to be careful. The fact that in a slack economy the higher deficit need not crowd out private investment does not imply that it may not. Indeed it may, but only if the Federal Reserve so wants.

And let's be quite clear what happens here. When the lower taxes produce a larger expenditure on consumption and, possibly, investment, through so-called acceleration effects, then income tends to rise. That is exactly what we are trying to accomplish.

When income rises it will take a larger money supply to transact that income, keeping interest rates constant. If we do not keep interest rates constant we will indeed crowd out investment, but because of the interest rate rise, not because of higher deficits. If we are to keep interest constant, the money supply must rise. That means that, together with the additional deficit, normally you would also require an expansion of the money supply. But it's not that the increase in money supply is needed to buy that additional deficit—there is hardly any relation between the two.

In fact the following is true: The larger the additional deficit to finance as a result of a tax cut, the smaller is the needed expansion in money supply.

Consider my first case—the case in which there was no response by the public. In that case the $20 billion tax cut lead to a $20 billion deficit. But since output did not rise, there would be no significant need to increase the money supply at all. Even though you have a $20 billion deficit to finance no additional money is needed.

Take my last case in which the deficit is only $8 billion because income rose $30 billion and therefore taxes rose by $12 billion. In this case you will have to expand the money supply by a number which is related to the $30 billion. In this country it would be something like one-fifth, or 6 billion, the velocity of circulation being $5 billion—something like that would be needed.

So, you can see you need extra money in order to be sure that the fiscal policy does what it was meant to do; not in order to absorb the deficit.

I also conclude from this that the increase in the money supply which is needed to maintain interest rates constant is something which the Federal Reserve must undertake if it is going to execute the will of Congress. The will of Congress was that the tax cut was designed to increase output, not to increase interest rates. If the Federal Reserve is to execute the will of Congress, it must be sure that interest rates are constant until the recovery is well underway. I agree with Mr. Brimmer that later on we will need higher interest rates and lower growth of money supply, but in the initial phase if it is not doing

that it is thwarting what you have asked the Reserve to do. So it is important to watch them to be sure that interest rates stay stable for an initial period.

Senator HUMPHREY. Would you repeat that again, because I think I understood it clearly but maybe somehow that message will penetrate these walls here, hopefully. [Laughter.]

Mr. MODIGLIANI. All right.

Chairman HUMPHREY. And it will hopefully flow out.

Mr. MODIGLIANI. To repeat my words for you, sort of encapsulating them.

I understand that Congress has cut taxes not for the purpose of having no deficit; not for the purpose of crowding out investment; not for the purpose of raising interest rates, but for the explicit purpose of expanding real and money income. Real and money income can not expand properly unless money supply grows with it.

Chairman HUMPHREY. Right.

Mr. MODIGLIANI. Otherwise you will have higher interest rates and you will have crowded out other things.

Therefore, if the Federal Reserve is to respect the will of the Congress it must make sure that in the initial phase, as the tax cut has its effect on aggregate demands, interest rates are kept constant and the money supply is increased as needed to maintain interest rates constant.

Chairman HUMPHREY. I instruct the staff to extract this part from our testimony and send it over to the Federal Reserve Board. The reason I do that is that the Federal Reserve Board is a creature of the Congress and it is entitled to hear what you have had to say in the specific terms that you have used to say it. I wish we could have put in some of the gestures along with it, but we can't do that. [Laughter.]

Mr. MODIGLIANI. I would like to point out that I would like to remain good friends with Mr. Burns; but I am willing to pay that price if this must be done.

To make this point clear: For the Federal Reserve not to expand the money supply as income responds to the tax cut is very much like a person that gets into his car to go home. He starts the motor and puts the car in gear, presses the accelerator, and at the same time puts the hand brake on. He might go somewhere but he won't go far.

If the Federal Reserve doesn't let the money supply rise, it's like putting on the brake. *You* have put it in gear and *you* have given gas to accelerate, and then *they* put the brake on.

It will take in our view a substantial growth of the money supply to keep interest rates constant. We figure that at least in the next quarter, actually in the next two quarters, third and fourth, the money supply will have to rise in the two-digit range in order to keep interest rates constant. And perhaps into some of the next year it will have to be quite close to that, somewhere around 10 percent still.

Chairman HUMPHREY. You are talking about 10 percent or above?

Mr. MODIGLIANI. Yes, that's it. Certainly for the next two quarters and probably for the next four quarters. This rate of growth will be needed to just accomplish what you meant to accomplish, and it still will lead to a large unemployment.

Next, let me observe that there is nothing wrong with the money supply growing at this rate when there is plenty of slack. Let me quickly give a few points on this. First of all, the money supply is now way below what it should be. If we had a full employment economy and if the Federal Reserve had not pursued the foolish policy last year of extremely tight expansion of money supply, the stock of money would now be much higher. That is what it should be. So we need to get back there, and you can not get back there unless for a while you go faster.

Second, let me observe that we are dealing with a recovery from deep recession—and this is a recession of the dimension of the Great Depression because we are back to the levels of the 1940–41 period, not 1933, thanks to God; but still we are at those levels.

Every fast recovery has always been accompanied by a very fast expansion of money supply and little growth of prices. During 1933 to 1937 the economy grew by something like 33 percent in 3 years and the money supply grew by something like 50 percent. Prices grew very little from 1934 to 1937, something like 1.5 percent per year.

So when there is lots of slack there is no reason to be concerned that a fast expansion of the money supply will be accompanied by inflation. In fact, all our projections are that inflation is being licked—slowly, but it is being licked. As long as unemployment does not go below a dangerous level, say certainly as long as it's above 6 percent you can be quite sure—and our projections confirm it—that inflation will be in the 6 percent versus the 11-percent area of last year. So we are making progress, and this will continue; and the suggested growth of the money supply will not interfere with that progress.

Now I come to the second argument which is the sophisticated argument. It's a kind of an anomolous one. It comes from the financial community. Sometimes you can hear it in Mr. Simon's speeches, but mostly it has been articulated in a speech given 2 weeks ago by Mr. James McKeon of Salomon Brothers to a group of security analysts. The argument runs like this; surely the Federal Reserve can, by sufficient expansion of the money supply, hold down short term interest rates. But if the financial community sees the money supply growing at the faster rate it will conclude that inflation is around the corner and if it concludes that, there will be a serious problem of increasing spread between short term and long term interest rates.

Essentially, economists know and agree that long-term rates incorporate in them an expectation of future inflation. If the financial community interprets this behavior of the money supply as one that will lead to growing inflation, then it will decide that future interest rates will be higher than the present ones and will demand a high yield in order to buy long-term bonds.

Hence, there will be an escalation of long-term interest rates even if the Federal Reserve is generous in expanding the money supply. The financial community's fear of inflation might be allayed if the Treasury chose to finance through medium and long-term issues. But this would produce congestion in these markets and lead again to escalation of long rates. And escalation of long-term interest rates will crowd out investments of the private sector.

Now what can one say to this argument? First of all, you have to notice that this argument, to be valid, requires that the financial community does not understand economics; that the financial community has been brainwashed by the monetarists into believing that a

fast growth of the money supply, no matter what—whether you are in a hole as deep as the earth or whether you are at the peak of a wild orgy of inflation—a fast growth of the supply of money always means inflation.

I don't know whether the financial community is that ignorant—I question it. But it takes more than that. The financial community has to be ignorant; whereas, the business community must not be ignorant, so they do not believe there would be inflation. If they also believe there would be inflation they would be glad to borrow at high interest rates.

So it takes the asymmetry of the ignorant financial community and a very wise business community. Now is that true? God knows, I wouldn't want to bet anything on this until we get there.

But, suppose for a moment that this tragic scenario occurs? What is to be done about it?

Notice first that something has to be done about it, because if you don't, that means you have to accept the following policy: You must do absolutely nothing to reduce unemployment, because, no matter what you do you are always into a deeper hole.

So the only thing you can do is accept Mr. Friedman's recommendation—stay put. Let the money supply grow slowly, and in the next 10 or 15 years we will get back to full employment. Don't ask when, but it will take a lot of time. Money wage demands are slow in responding to unemployment, or if such demands are made, it might take a long time, though eventually we will get there.

This is not acceptable to me, and I hope it is not to you as our representatives in Congress. So something has to be done about this McKeon dilemma, if it is a true situation.

Now, what can be done?

Well, there are a number of answers, which, by the way, interact with your questions about debt management.

Clearly, the first thing to do is to keep the Treasury out of the long end. You want to keep the Treasury in the short end unless conditions suggest that the longer end can absorb issues without widening the spread. Then you may divide your financing but stay primarily in the short end.

Beyond that, you can force the hand in this contest: If the spreads widen because of expectation of inflation, what you do is lower the short term rate even more because then, for a given spread, you get the long rate down.

There is a danger in this course because this requires an even greater expansion of the money supply. So you might find as a result a yet wider spread. This can become dangerous unless it is carefully explained. It is a strategy carrying some risk.

The other thing that can be done is for the Federal Reserve to engage in open market purchases of long-term issues to support the long-term market. This is a policy which has some chance of success but should not be overrated because after all the outstanding stock of long-term debt is large, relative to what the Federal Reserve can buy. So, unless it also succeeds in persuading some people that long rates should not be higher, just purchase alone may not be sufficient. But this leads me to the final point. That is, that I think the most useful thing that can be done is education: educating the financial community to the fact that they are wrong. Educating them now, before it happens,

to the fact that over the next year the money supply should, must, and will grow fast, so that when it occurs it is not taken as an indication that things are out of control. We would tell them in advance that it isn't coming yet, but it may come in 2, 3, or even 6 months; so look out for it; be happy when it comes, because that means the economy is recovering. And indicate that we are ready to take whatever actions are needed to prevent long-term rates from rising.

The difficulty with this approach is that the people who are supposed to impart the education seem to be willing to take the Friedman approach—use the next 10 years to get back to full employment.

I really question whether the administration and the Federal Reserve Board really want us to get back to full employment in 2 years—and I say 2 years as a target. It seems to me that is the only way to explain what they are doing.

But if that is the case, they are not going to be willing to do anything that will make it easier for this course to be followed.

To begin with, I think Mr. Simon should stop making his scare speeches. That is the best way to make it impossible for the Treasury to finance its deficit without creating commotion in the capital markets and without raising long-term rates.

Somehow we ought to smoke out of Mr. Simon and smoke out of Mr. Burns what kind of targets they have for real employment, and this is I believe what Mr. Tobin is going to tell you about, so I should not cut into this part.

I think there was only one other point of the questions that you raised.

You raise the question about current policy: Is current policy satisfactory?

I would say that it is really impossible to tell. I mean, as I think Mr. Brimmer has said, that over the past 2 months, things have improved, interest rates have been steady although they have risen a little, which disturbs me, but those little wiggles should not be permitted to assume exaggerated importance, to be regarded as establishing a trend; perhaps in the last month or so, perhaps in the last week or so, I have no complaint. But a week or a month is too short a time to establish a record and I think that the real test will come in the months to come.

Chairman HUMPHREY. Thank you. Thank you very much.

We will proceed now to Mr. Tobin, and we welcome you, doctor, and I wanted to thank you once again for the time that you accorded me on my visit to Yale. I thought it was a most productive hour or so that we had together and we certainly welcome your testimony around the subject matter that was laid before you in our letter.

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

Mr. TOBIN. Thank you, Senator Humphrey, and come back and visit us.

Chairman HUMPHREY. Thank you. I enjoyed it.

Mr. TOBIN. We certainly enjoyed it, sir.

Coming with a name that begins with a "T," late in the alphabet, I often find either that the preceding speakers have so agreed with me

that they have left me nothing to say, or they have disagreed with me to the extent that I don't have enough time to correct their errors.

In this case it's the former.

There really is substantial agreement among the three of us on major points, I believe.

All this business about crowding out has reminded me that in the 1930's, in the Great Depression, there was a famous parliamentary hearing on the economic crisis. The Treasurer of the British Government testified before the McMillan committee that nothing could be done in the way of fiscal policy—government spending or tax reduction—to alleviate the problem of unemployment in Britain at that time. Everyone knew, as a principle of economics, that such measures would crowd out private expenditures and private investment.

Also, I can tell you, that in 1932, all of the members of the Yale economics department, with the exception of a couple of people including the great Irving Fisher—and I would like to say I was not a member of the department at that time—all of them signed a manifesto saying that our Federal Government should not undertake public works financed by borrowing because that would crowd out private investment.

Both those statements came at a time of substantial unemployment and slack in the economy. They were ridiculous. They were examples of what a famous philosopher, Alfred North Whitehead, called "The fallacy of misplaced concreteness." That is, you take a principle which is good under some circumstances and apply it in the wrong circumstances.

I will state one clear general principle: There is never any significant financial problem of "crowding out" unless there is a significant resource problem of crowding out. What I mean by a resource problem is a shortage of labor and capacity to produce goods and services.

If the economy is at full employment, then it is clear that additional Government expenditures or tax cuts will create new demands on resources. Other uses of resources will have to give way if the new spending is going to be accommodated. In 1966, the Vietnam war was financed without tax increases. Expenditures for military purposes were thrown into an economy that already had full employment. There was "crowding out" in the commodity, labor, and also in financial markets. But the financial "crowding out" was just a reflection of the excess demands for real resources.

We are not in that situation now. We were not in that situation in 1932 either here or in Britain. Applying the principles appropriate for full employment and full utilization of capacity to a situation of immense unemployment and excess capacity—could cause a disastrous misunderstanding.

The economy is there to produce goods and services; it is not the purpose of policy to make the life easier for Treasury debt managers or for financial markets.

The financial markets can accommodate to the real situation unless policy prevents them from doing so.

Secretary Simon, for example, advocated—and he was to some degree quite correct in advocating—the position that private financial markets were capable of handling the complicated job of recycling

petrodollars from the OPEC exporters of oil into the Western financial markets. He may have exaggerated the adaptability and flexibility of the financial markets, but it's true they did a good job, or have done so far.

It is a mystery to me as to why he thinks those same financial markets are so unadaptable and inflexible when it comes to a much more simple problem which is accommodating the demands for financing Federal debt and private funding of the debt.

On the first question which you posed, which was whether financial markets can handle the deficit in prospect, I would say yes, they can. The deficit need not "crowd out" private uses of credit or force interest rates to levels which prevent or impede economic recovery.

The larger part of these deficits, for example, this calendar year 1975, $40 billion of the $67 billion we can expect in the national income account, is the result of the recession itself. The tight money policy and the recession generated by tight money policy have drastically reduced private demands for saving over the last 18 months. In fact, residential investment is down 42 percent in constant dollar volume from the fourth quarter of 1973.

Nonresidential fixed investment is down 10 percent.

Chairman HUMPHREY. Might I interrupt to say that some of our colleagues are leaving because of the roll call vote. I have urged them to come back. We have this problem as you know, Mr. Tobin, and it will appear to be an act of discourtesy but let me assure you, it is an act of Congressional necessity.

Mr. TOBIN. I understand that completely, sir.

In the current prices, the reductions in residential and nonresidential investment which have occurred amount to $43 billion in this recession; and the true shortfalls of such investment are much larger if one takes into account the normal growth that one would expect in a healthy economy.

Now, what happened to the savings that was not absorbed by those investments?

A large part of that savings simply vanished into unemployment, excess capacity, and lost production.

Chairman HUMPHREY. Excuse me, and would you please go slow while I am gone, because I want to get all that you have to say. We have to go vote.

So we can proceed and Congressman Long will preside.

[Congressman Long assumes the Chair.]

Mr. TOBIN. Shall I continue, then?

Representative LONG. Yes; if you would, Mr. Tobin.

Mr. TOBIN. Well, a large part of the savings that was not absorbed by those investments I was speaking of simply vanished in unemployment, excess capacity and lost production. As corporate profits and personal income declined, so did the retained earnings of business, and the savings of households.

But part of the saving released by the decline in private investment demand is finding an outlet in the Federal deficit, and that is a good thing, too, because otherwise income and employment would have to fall still further to cut saving down to the amounts now demanded for private investment.

That is just another way of saying that maintenance of Federal

spending during recession, while tax revenues fall, keeps recessions from being worse.

If the Federal Government should behave like the Hoover administration, or like the State and local governments today—that is, raising taxes and cutting outlays in a losing battle to balance budgets—if the Federal Government behaved that way now, our economy would be even more unstable, much more unstable than it is.

So those recession-induced deficits are not "crowding out" private credit demands. The deficits are there because private investment is weak, and private investment is weak because of tight money policies and recession itself crowding it out.

Nor are these deficits a cause of high interest rates. The same recession which produced the Federal deficits has brought large declines in interest rates and for the same reason, the weakness of private investment and credit demands.

Now, Congress, by the tax bills enacted and other fiscal stimuli contemplated in the budget resolutions, is giving a much-needed boost to the economy. This is especially true of the congressional budget as compared to the recommendations of the President's budget message, which involve virtually no stimulus at all.

Thanks to the expansionary fiscal measures of Congress, we can now have much more reason to hope that the disasterous decline in economic activity will come to an end sometime this year.

I don't think that is assured, but we have more reason to hope that it is true. But that is by no means the end of our problem. When we reach the trough unemployment and excess capacity will be extremely high, higher than they have ever been in the postwar period, and the spending needed for a sustained and substantial recovery will not be in sight.

Representative LONG. Mr. Tobin, if I may interrupt just for 1 moment because this brings specifically into point the position that the President has taken on a number of times. Mr. Simon has made the point that the effect of the Congress moving as far as it has moved in that regard might well be to cause an inflationary effect—and consequently the resulting depression in 2 or 3 years might be even more substantial and more serious than the one that we find ourselves either in or bordering on at the present time.

I interpret your remarks to say in effect that you do not believe that there is any real danger in that regard.

Mr. TOBIN. No; I think there is no real danger that the present policies of the Congress with respect to the budget are dangerously inflationary. Far from that, I think they are together with the monetary policy that we have, they are really inadequate so far to do the job of getting us a sustained and strong recovery.

As Professor Modigliani said, I don't believe that recovery itself is going to make the inflation problem worse unless it is allowed to overshoot, and we are far from the rates of unemployment and capacity use which would be overshooting. I would place them down at 5.5 to 5.0-percent unemployment.

We are so far from that that there is a long time, a lot of production to recover, a lot of employment to recover, before we come to that point. I will come back to that.

Representative LONG. May I ask you another question in that regard, again with respect to something happening at the present time? I noticed in the press recently that the British Government in what might be interpreted as being contrary to the usual pattern, has been trying to bring down interest rates at the same time that inflation is accelerating.

Now, as I say, this seems to me to be an unconventional policy, and I wondered if you would comment on that, in that if we pursued that governmental policy, would that raise the interest rates when we wanted to better control inflation?

Can we really turn this economic practice around that has been followed in the past? What do you think the effect of that might be?

Mr. TOBIN. You mean to raise interest rates, or lower them?

Representative LONG. Bring interest rates down while at the same time there has been inflation and acceleration of inflation?

Mr. TOBIN. I think that if you were in a tight capacity situation, with low unemployment and with danger of excess demand inflation, you certainly would not want to do that. You would not want to be lowering interest rates then, but rather raising them to restrain demand from overshooting.

Representative LONG. But you do not find this as——

Mr. TOBIN. This is not the situation in the United States.

Representative LONG. You don't see that to be the situation in the United States?

Mr. TOBIN. No, it is not the situation in the United States today.

Representative LONG. Thank God. I apologize for the interruption.

Mr. TOBIN. That is all right. I see it as a costly resolution for this country to assume that once the recession bottoms out as the jargon goes, that full recovery is automatic. It won't happen automatically. It requires policy, it requires support.

How will the deficits due to congressional initiatives be financed? Looking at finance in the broadest economy-wide sense, we can list several sources.

First, there is an additional saving which would come directly or indirectly to buy Government securities from the beneficiaries of tax reductions, tax rebates, and additional transfer payments of subsidies. They save part of their proceeds, repaying old debts, depositing funds in financial institutions, or buying securities.

Of course, to the extent that they do that with their tax rebates, or tax reductions, there is no further stimulus to the economy. But neither is there any problem of finding the savings to meet the deficit to that extent.

Now, second, as Mr. Modigliani pointed out, there would be additional corporate and household saving generated from increases in corporate profits and personal incomes resulting from the fiscal stimulus if it is allowed to increase production and income.

Third, there would be additional tax revenues as a result of those same increases in profits, incomes and sales and production. Some of those taxes would go to the Federal Treasury itself, some to State and local treasuries, and reduce their demands on capital markets.

Now, another source is imports. Imports may increase relative to exports as a result of the economic expansion driven by fiscal measures. Borrowing from foreigners to pay for oil and other imports augments the flow of funds into financial markets. The extent to which

recovery will deteriorate our trade balance and bring foreign funds into our capital markets is not entirely under our control. If foreign countries pursued expansionary policies or allowed their currencies to appreciate in dollar value, then these effects will not be very important.

Now, finally, interest rates may rise and "crowd out" some private investments. That is another source of financing of increased deficits.

But, on the other hand, expansion and recovery themselves are favorable to both residential and nonresidential investment.

The extent of "crowding out" depends in these circumstances, let me emphasize this, wholly on the monetary and credit policies of the Federal Reserve. There should be no illusions on this point. The Federal Reserve policy is the decisive factor.

On the one hand the Fed could cancel entirely the stimulative effects of congressional fiscal policy; that is, they could tighten credit and raise interest rates so much that private homebuilding and business fixed investment would fall by just as much as Government and taxpayer spending increases.

The economy would then be stopped dead. Production and employment would not be allowed to grow and unemployment would rise.

On the other hand, the Fed could hold interest rates constant, at present levels, or even lower. Expansionary fiscal measures would then be allowed to work and there would be no crowding out.

Interest rates will not go to levels that prevent recovery unless the Fed wants them to. There is nothing intrinsic in Federal deficits which would bring high interest rates. The real question is whether the Fed regards recovery per se, or the pace of recovery that Federal fiscal measures might promote as dangerous and inflationary.

If this is their view, then they would resist equally stubbornly any recovery whether it is generated by Federal fiscal policy and deficits, or by miraculous revival of private investment and demand for credit.

In any case, they would produce congestion and crowding out.

Now, the second question in your letter was about the appropriate monetary policy in view of the large deficits expected in the next several quarters, and the question was, "Is present policy adequately accommodative?"

My answer is the following: The Federal Reserve should accommodate the economy, assure an early end of recession, and actively promote a vigorous and lasting recovery.

To that end, I would like to see a dramatic reduction in short term rates right away, bringing the Federal funds right down close to zero.

Banks and savings institutions would then become very liquid, and very hungry for business loans, mortgage borrowers, and for long-term securities. There would be downward pressure on the prime rate, on long-term bond rates, and on mortgage rates.

There would be, so far as this is an important factor, upward pressure on stock prices in the equity markets. All of these developments would greatly improve the financial climate for business investment and residential construction.

Now, it is true, once recovery is well underway, the Fed should lean against the wind and allow interest rates to rise in response to the reviving demands for money and credit, and slow down the growth of monetary aggregates.

In my view, if the Fed were to adopt my scenario, Chairman Burns should explain publicly just what his policy is and what he intends, and let the financial markets and the whole world in on what he is trying to do. Then the market would understand that the low interest rates and high rates of monetary expansion appropriate in recession and early recovery will not be continued indefinitely, that brakes will be gradually and firmly applied in time to prevent the recovery from overshooting into the zone of accelerated inflation.

I think that would be the answer, a statement like that, clearly telling everybody what the policy is, to the problem that Mr. Modigliani and I were discussing, the problem of perverse expectations in the financial markets.

On the general point, if I could pursue some of the motor car analogy here, I think that much of the discussion of policy toward recovery is of the following nature: Suppose you started out on a motor trip on an interstate highway from Washington to New York, and as you got onto the interstate, it suddenly occurred to you that there is a stoplight in New York, N.Y., around Times Square somewhere, and you figure, "Well, gee, I better be prepared to stop there so I won't be able to go over 10 or 15 miles an hour from here to New York City."

Now, that is about what the level of policymaking in regard to the recovery is when it is said, "We cannot have a recovery policy because some day we may have to have an anti-inflationary policy."

Now, the point of my recommendations for monetary policy is not to accommodate the Federal debt managers, but to accommodate the Nation. Indeed, if Congress had not taken the stimulative fiscal measures which temporarily will increase the deficit, the need for easier monetary policy would be more acute, not less acute.

If there are Members of Congress and of the public who wish to avoid, for some reason, large increases of Federal debt, they should be pressing the Federal Reserve for expansionary monetary policies, because that is the only way to escape the deficits which continued recession and anemic recovery will inevitably bring, or to avoid the necessity, and I hope the political pressure, for further fiscal measures to bring about satisfactory recovery.

Now, I return to the point that the basic issue is the shape of the recovery which macroeconomic policy, both fiscal and monetary policy, should try to bring about.

How far and how fast should production and employment grow in 1976, 1977, and 1978? How far and how fast should fiscal and monetary policy aim to reduce unemployment?

I myself think we should certainly seek to reduce unemployment by three points during the 2 years 1976–77. Since we will probably end this year with nearly 9-percent unemployment, such recovery would bring the rate of unemployment a bit below 6 percent at the beginning of 1978.

Surely, that is a modest goal.

But even that will require average growths in production of 9 percent per year during the 2 years 1976–77. That is the average. For obvious reasons it would be best to begin at a higher speed and taper off.

The recovery would not be completed in those 2 years, and during 1978 it should reduce unemployment still further, I would say to about 5 percent.

It is not asking too much that we regain, in 3 or 3½ years from now, the ground that we have lost in 1 year.

I think this is the kind of recovery that this committee recommended in its recent report. I congratulate the committee and the staff both for that recommendation, and for the procedure of stating the objectives of policy in these concrete and economically meaningful terms.

I think that this committee should insist that the administration and the Federal Reserve do likewise. They should state the recovery pattern which their policies and their recommendations are designed to achieve. The only clue we have to that is the 5-year stagnation projection which was published in the budget message.

Now, I understand that the administration now says that those projections do not represent their policy.

I certainly hope they do not, but you and the public have a right to know then what paths of production and employment they are aiming at if not the ones that were published in the budget message, and if their targets diverge from the targets of Congress and of this committee, for example, then we can debate the differences as to whether we want a slow recovery or fast recovery, whether we want to take the rest of the decade for 10 years to get back to 5- and 6-percent unemployment, or whether we want to do it in 2 or 3 years.

If the targets are agreed, then we can debate whether the policies are appropriate to them. Such discussions would be much more meaningful than talk about deficits, interest rates, and monetary growth rates in vacuo.

I say that because there are no absolutes about those instruments, those variables, whether deficits should be high or low, whether monetary growth rates should be high or low, whether interest rates should be high or low. Those are questions that don't have any answers that are independent of the circumstances of the economy at the time, and the objectives of policy.

They depend on where the economy stands and where you want it to go.

It is particularly important that the Federal Reserve state the path of recovery on which its policy is designed, and will be designed to bring about the path of recovery in production, in employment, and unemployment.

If that path differs widely from the path desired by Congress or by the administration, you need to know that. If the Federal Reserve policy is premised on the belief that recovery of any magnitude is, per se, dangerously inflationary and only a very slow and limited decline in unemployment can be tolerated, you need to know that, the country needs to know that, the Congress needs to know that.

My advice to you is not to debate with Arthur Burns about numbers for interest rates or numbers for monetary growth rates until you have explicit clarity on the more basic question of the desirability path and strength and duration of recovery.

Once he provides that, then it is time to consider what combinations of fiscal and monetary policies will do the desired job and choose among those.

Now, in my opinion, the present path in fiscal and monetary policies is not strong enough medicine for the recovery which I, and I think this committee, would like to see.

That is why I was recommending a few minutes ago a dramatic shift to an easier monetary policy right now. If that does not happen, then we will need more fiscal stimulus than is now in prospect.

I do think that it is desirable to gear fiscal policy in the long run, say the budget for fiscal 1977, to a balance, a rough balance of the budget calculated with revenues from a 5-percent unemployment economy. I think your budget is still in that ball park, clearly.

The reason I make that recommendation is because as I said before, there is truth to the "crowding-out" argument in an economy which is operating at the high levels of employment and capacity utilization.

The argument is misplaced, it is premature now because there is so much slack in the economy.

Now, additional demands can be met from additional production rather than displacing other demands. But, when recovery is complete, the Federal deficit then would in fact reduce the resources available for private investment and for that reason I would suggest that any additional stimulative fiscal pressures taken, for example, a proposal which I favor very much, special supplementary recession grants to State and local government, measures of that kind should be legislated to phase themselves out as the recovery progresses.

That would leave us with a very prudent, I do think, and responsible fiscal policy, if the budget were to be, in the long run, in a balanced position when the economy is operating at, let us say, around 5-percent unemployment.

Now, I turn to question three which refers to the more technical matters of debt management and congestion in the long term bond market.

I have tried to indicate before that I regard this question as really subsidiary to the big issue, and the big issue is not what is going on in financial markets, but what is going on in the economy.

The financial markets can adapt, or can by proper policy, be made to adapt, to the needs of the economy. But, yes, the Treasury should avoid throwing its bonds into the segments of the financial market where private borrowing is concentrated. It should be emphasized that the business borrowing in the long term market is not now, to a large degree, a net demand for saving. It is refinancing; it is largely the funding of short term debt.

So it is not absorbing any saving. If business firms were in there doing a lot of long term borrowing to finance investment in real facilities, plants, equipment and so on, then we wouldn't be having the recession problem of the severity that we have.

What they are doing is largely refunding their debt, repaying short debt and trying to fund it into long debt. So it seems obvious to me that the Treasury should take advantage of the relative weakness of demands for short term funds and concentrate its borrowings at the short end. In addition, the Federal Reserve could help to relieve any congestion in long maturities by concentrating its open market purchases for the purposes of expanding its reserves in long maturities.

But I would add this does not mean I favor the rise in short term rates. To the contrary. As I stated before, I think that they should be brought down. This will happen if the Treasury borrows heavily in the short end of the market. This will happen if the Federal Reserve injects just enough reserves into the banking system regardless of which market they throw the reserves into, long or short.

So that the twist operations that we are talking about here, I recommend as a means of accelerating the needed fall in long term interest rates but not as replacement for the basic thrust of an easier monetary policy.

Thank you.

Chairman HUMPHREY. Thank you, Mr. Tobin. I apologize for having to be absent during part of your testimony. Your prepared statement will be included in the hearing record.

[The prepared statement of Mr. Tobin follows:]

PREPARED STATEMENT OF JAMES TOBIN

Question 1. Can the financial markets handle Federal deficits of $45 to $50 billion in fiscal 1975 and approximately $75 billion in fiscal 1976 without seriously interfering with private demands for credit or forcing interest rates to levels which will prevent an economic recovery?

Answer. Yes, the financial markets can handle the Federal deficits in prospect. These deficits need not crowd out private uses of credit or force interest rates to levels which prevent or impede economic recovery.

There are two central points I should like to emphasize.

First, the larger part of these deficits—for example, $40 of the $67 billion deficit on NI account estimated for calendar 1975—is the result of the recession itself. Tight money policy and the recession it generated have drastically reduced private demands for savings over the past 18 months. Residential investment is down to 42% in constant-dollar volume, and non-residential fixed investment is down 10%. In prices of this year, these declines amount to $43 billion, and the true shortfalls are much larger if normal growth is taken into account.

What happened to the saving which was not absorbed by these investments? A large part of it simply vanished into unemployment, excess capacity, lost production. As corporate profits and personal incomes declined, so did the retained earnings of business and the saving of households. Part of the saving released by the decline in private investment demand is finding an outlet in the federal deficit. A good thing too—otherwise income and employment would have to fall still further to cut saving down to the depressed amounts demanded for private investment. That is just another way of saying that the maintenance of federal spending during recession while tax revenues fall keeps recessions from being worse. If the Federal government behaved like the Hoover Administration or like state and local governments today—raising taxes and cutting outlays in a losing battle to balance budgets in recession—our economy would be even more unstable, much more unstable, than it is.

These recession-induced deficits are not crowding out private credit demands. The deficits are there because private investment is weak. Nor are these deficits a cause of high interest rates. The same recession which produced the deficits has brought large declines in interest rates, and for the same reason—the weakness of private investment and credit demands.

Second, the Congress, by the tax cuts already enacted and by other fiscal stimuli contemplated in the budget resolutions, is giving a much needed boost to our economy. This is especially true if the Congressional budget is compared to the recommendation of the President's budget message, which involved virtually no fiscal stimulus at all.

Thanks to the expansionary fiscal measures of the Congress, we can now have much more reason to hope that the disastrous decline in economic activity will come to an end some time this year. But that is by no means the end of our problem. When we reach the trough, unemployment and excess capacity will be extremely high, and the spending needed for a sustained and substantial recovery will not be in sight. It is a great illusion, potentially very costly to this nation, to assume that once the economy "bottoms out" full recovery is automatically guaranteed.

How will the deficits due to Congressional initiative be financed? Looking at "finance" in the broadest economy-wide sense, we can list the sources:

(*i*) Additional saving, which will be available directly or indirectly to buy government securities, can arise in two ways:

(*a*) Beneficiaries, corporate and personal, of tax rebates, tax cuts, and additional transfer payments or subsidies save part of the proceeds. They may repay old debts, deposit funds in financial institutions, or buy securities.

To the extent that they do so, there is no stimulus to the economy, but neither is there any problem of finding saving to meet the deficit.

(*b*) Additional corporate and household saving will be generated from the increases in corporate profits and personal incomes which result from the fiscal stimulus.

(*ii*) Additional tax revenues as a result of those same increases in profits, other incomes, sales, and production. Some of these taxes go to the federal Treasury itself and diminish the deficit from its initial level. Some go to state and local governments and reduce their demands on capital markets.

(*iii*) Imports may increase relative to exports as a result of economic expansion driven by fiscal measures. Borrowing from foreigners (to pay for oil and other imports) augments the flow of funds into the financial markets. The extent to which recovery will deteriorate our trade balance and bring foreign funds into our capital markets is not entirely in our control. If foreign countries also pursue expansionary policies or if they allow their currencies to appreciate in dollar value, this effect will not be very important.

(*iv*) Interest rates may rise and crowd out some private investments. On the other hand, expansion and recovery themselves are favorable to both residential and non-residential investment.

The extent of "crowding out" depends on the monetary and credit policies of the Federal Reserve. There should be no illusions on this point. The Fed's policy is the decisive factor.

On the one hand, the Fed could cancel out the stimulative effects of Congressional fiscal policy, tightening credit and raising interest rates so much that private home building and business fixed investment fall by as much as government and taxpayer spending rise. The economy would be stopped dead, production and employment would not be allowed to grow, and unemployment would rise. On the other hand, the Fed could hold interest rates constant, at present levels or even lower. Expansionary fiscal measures would be allowed to work, and there would be no crowding out.

Question 2. Faced with the inevitability of very large deficits in the current quarter and for the next several quarters, what is the most appropriate monetary policy for the Federal Reserve to pursue? Is present policy adequately accommodative?

Answer. The Federal Reserve should, in my opinion, accommodate the economy, assure an early end of recession, and actively promote a vigorous and lasting recovery, I would like to see a dramatic reduction of short-term rates right away, bringing the Federal Funds rate close to zero. Banks and savings institutions would become very liquid and very hungry for business loan customers, mortgage borrowers, and long term securities. Downward pressure would be put on the prime rate, long term bond rates, and mortgage rates. Equity prices could be expected to rise in sympathy. These developments would greatly improve the financial climate for business investment and residential construction.

Of course, once recovery is well underway, the Fed should lean against the wind, allowing interest rates to rise in response to reviving demands for money and credit, and slowing the growth of monetary aggregates. In my view, if the Fed were to adopt my scenario, its Chairman should explain publicly just what the policy is. Then the market would understand that the low interest rates and high rates of monetary expansion appropriate in recession and early recovery will not be continued. The brakes will be applied gradually and firmly in time to prevent the recovery from over-shooting into a zone of accelerating inflation.

But don't apply brakes too soon.

The point of my recommendation is not to accommodate the federal debt managers but to accommodate the nation. Indeed, if Congress had not taken stimulative fiscal measures which temporarily increase deficits, the need for easier monetary policy would be more acute, not less. Members of Congress and other citizens who wish to avoid large increases of federal debt should be pressing the Fed for expansionary monetary policy—both to escape the deficits which continued recession and anemic recovery will inevitably bring and to avoid the necessity for further fiscal measures to bring about satisfactory recovery.

I return to the point that the basic issue is the shape of the recovery at which macroeconomic policy—both fiscal and monetary policy—should aim. How far and fast should production and employment grow in 1976, 1977, 1978? How far and fast should fiscal and monetary policy aim to reduce unemployment? I myself think that we should certainly seek to reduce unempoyment rates by three points during the two years 1976–77. Since we will probably end this year with

nearly 9% unemployment, such a recovery would bring the rate down a bit below 6% at the beginning of 1978. Surely this is a modest goal. But it will require average growth in production of 9% per year. That is the average—for obvious reasons it would be best to begin at higher speed and taper off. The recovery would not be completed in these two years, and during 1978 we should reduce unemployment further, to about 5%. It is not asking too much that we regain 3 or 3½ years from now the ground we have lost in one year.

I think this is the kind of recovery the JEC recommended in its recent report. I congratulate the Committee and staff for that, and for stating the objectives of policy in these concrete and meaningful terms. I think the Committee should insist that the Administration and the Federal Reserve do likewise. They should state the recovery pattern which their policies are designed to achieve. The only clue we have is the 5-year stagnation projection used in the Budget message. The Administration, I understand, says that these projections do not represent policy. I hope they do not. But you have a right to know, then, what paths of production and employment they are aiming at. If they diverge from the JEC targets, then we can all debate the differences. If the targets are agreed, then we can debate whether the policies are adequate.

Such discussion would be much more meaningful than discussing deficits, interest rates, monetary growth rates in vacuum. There are no absolutes about those instruments. Whether they should be high or low, separately or in combination, depends on where the economy stands and where you want it to go.

It is particularly important that the Fed state the path of recovery which its policy is and will be designed to bring about. If this differs widely from the path desired by Congress, or by the Administration, you need to know that. If the Fed's policy is premised on the belief that recovery is per se dangerously inflationary, that only a very slow and limited decline in unemployment can be tolerated you need to know that. Do not debate with Arthur Burns about interest rates and monetary growth rates until you have explicit clarity on the more basic question of the desirable recovery path. Once he provides that, then it is time to consider what combinations of fiscal and monetary policies will do the desired job, and to choose among them.

In my opinion, the present package of fiscal and monetary policy is not strong enough medicine for the recovery which I, and I think this Committee, would like to see. That is why I was recommending a dramatic shift to easier monetary policy right now.

If this does not happen, we will need more fiscal stimulus than is now in prospect. I do think it is desirable to gear fiscal policy in the long run—in fiscal 1977 or 1978—to a budget that would be roughly in balance at 5% unemployment. This is because there is truth to the crowding out argument in an economy operating at high levels of employment and capacity utilization. The argument is misplaced and premature now, because there is so much slack in the economy that additional demands can be met from additional production rather than by displacing other demands.

The principle is clear. There is never a significant problem of "crowding out" in financial markets unless there is a problem of "crowding out" in commodity and labor markets. Additional government spending in a period like 1966 occurred in a fully employed economy. Government demands could be met only by diverting resources from other uses, i.e., by "crowding out." This was done by high interest rates and by inflation. There was no slack capacity in the economy to satisfy added demands for goods and services and labor. But 1975–1976, 1977 too—are different. Today there is no need for a crowding out problem, and if it occurs it is brought about by Fed policy.

But when recovery is complete, a federal deficit would in fact reduce the resources available for private investment. For this reason, I would suggest that any additional stimulative fiscal measures—e.g. recession grants to state and local governments—be phased out as recovery progresses.

Question 3. Do you feel that the Treasury should restrict itself to short-term borrowing during this period in which business demand for credit is so heavily concentrated in the bond market and the interest rate spread between long and short term rates is so large?

Answer. Yes, the Treasury should avoid throwing its bonds into segments of the market where private borrowing is concentrated. It should be emphasized that this private borrowing is not a net demand for saving. It is largely the funding of short term debt. The Treasury therefore should take advantage of the relative weakness of demands for short term funds. Indeed, the Federal Re-

serve could also help to relieve financial congestion in long maturities by concentrating the open market purchases by which it expands bank reserves in those maturities.

Our financial markets themselves will accomplish a great part of the necessary task of matching the maturities and terms private and government borrowers desire with the preferences of lenders. As the term structure of interest rates adjusts, borrowers and lenders move from one type of security to another. As Secretary Simon has pointed out, the market was very efficient in "recycling petro-dollars." It is strange that he does not credit it with equal efficiency for handling the much less complex job of financing Treasury borrowing.

This does not mean that I favor a rise in short term interest rates. To the contrary, as I stated before, I think they should be brought down. This will happen if the Fed injects sufficient reserves, regardless of which market they use to put them in. The "twist" operations recommended are designed to accelerate the needed fall in long-term interest rates.

Chairman HUMPHREY. I have a couple of questions to ask of a general nature and then we will, of course, rotate our questions here under our 10-minute rule for the members of the committee and we will work on the basis of who is here first just like we have in the past.

Now, on long-term debt financing, there were comments here from each of you on it, but I thought we would try to pin it down in some specificity. You see, what we have tried to do in these hearings is to extract the general thrust of your testimony and we publish it in what we call the Joint Economic Committee letter that circulates approximately once a week among the Members of Congress, to State legislators, Governors, other public officials, and to those private persons that ask for it or want it.

We do not editorialize. The purpose of the news letter is to merely state what you have stated and obviously we get conflicting testimony, but we present it as best we can and as objectively as we can to our readers.

The next issue will concentrate upon your testimony.

Now, many persons have been very critical of the Treasury for its recent issue of long-term debt at a time when so much of the private credit demand is concentrated, as has been indicated here, in the long-term market.

From what I have heard today, you feel that this criticism of the Treasury's action is justified.

Now, yesterday, as I mentioned, I met with Treasury officials and the Treasury presented us with material showing that the average maturity of the Federal debt has been dropping for some time and will continue to do so. I alluded to that earlier today. The Treasury seemed to view this as evidence that they simply must finance on a long-term basis whenever they get the chance. However, I wonder how much difference it would make if the average maturity of the debt were to drop just a little more than it would anyway because the Treasury agreed to stay out of the long-term market for a while? Would that have any adverse effects upon Government debt management policy? Is this something that is tolerable?

Second, would it have a calming influence on the bond market if the Treasury announced that it would abstain from long-term financing for a period. Would this be a good thing for the Treasury to do?

Let me start out here with Mr. Brimmer. You were the first to comment. Why don't we go to you?

Mr. BRIMMER. I agree with those sentiments, Mr. Chairman. It would be a very good thing for the Treasury to keep out of the long-term end of the market, and it would be helpful if they were to say so.

I take that view because, as I said earlier, in my checking around the financial community, I have identified hundreds of millions of dollars of issues of the moderately rated corporations—and I am not talking about the triple A's, for example, I am talking about BAA and so on—of firms that need to come into the market. When the Treasury goes to the long end of the market, it clearly has to put coupons on those issues and offer them in the market at a yield only slightly below the yield which would have to be on the best rated private debt.

Look at the interest rate spread between the Treasury issue recently marketed and the General Motors issue. It was very narrow. That simply swept up investers who turned away at the margin from other private issues to get the Treasury issue.

I agree with Mr. Tobin and Mr. Modigliani. This is a technical matter, but in the Treasury and the rest of the bond markets over the near term, it is consideration of these kinds of technical matters which is disrupting the ability of the markets to accommodate the long-term financing of business. So, I think it is highly important they do so.

Mr. Chairman, I made a specific suggestion at the end of my comments, and it is spelled out in my paper. I think it is desirable for the Treasury and the Federal Reserve to institute consultation procedures so that they can have a better feel for the projected flow of private sector financing.

Chairman HUMPHREY. Absolutely.

Mr. BRIMMER. And the Treasury can be guided by that. I think it is important the Treasury do that.

Chairman HUMPHREY. I have talked to Treasury about this and it seems to me this is within the realm of possibility and a reasonable suggestion.

As I gather so far from the testimony, what the business community is doing is liquidating its short-term indebtedness now, paying back debt to the banks, and attempting to go more into long-term financing.

Therefore, it is your judgment that the Treasury ought to cooperate with this and stay pretty much within the short-term financing and leaving the long-term as much as possible for the corporate and the private communities.

Is that correct, Mr. Brimmer?

Mr. BRIMMER. That is correct, Mr. Chairman.

Chairman HUMPHREY. Mr. Modigliani, what do you think about this?

Mr. MODIGLIANI. I think I fundamentally agree with the propositions you read and Mr. Brimmer's position. I would like to amplify only a little.

The only reason why the Treasury gains from its debt being longer-term is that it has to make less trips to the market. It doesn't have to be there all the time.

Now, that first of all is not, I think, a very important gain. There is some advantage. But I would urge that, to the extent that this is really an important advantage, the Treasury can manage to satisfy it-

self and not disturb the long-term market by a device which has now been used by corporations already in this country and it has been used elsewhere, namely, the issue of long-term debt with floating interest, essentially indexed on short-term interest rates.

I think these kinds of issues would keep them out of the market and I think would not interfere with private long-term issues.

This is, by the way, a kind of instrument which should be encouraged in this country—also for private corporations, because at times of uncertainty about future inflation, the problem of expectations of inflation to which I referred earlier—the best way to hedge against uncertain inflation is precisely to issue an instrument that pays the current short term. If inflation comes, the issuer will pay higher rates, but if it doesn't come, he won't.

So I think the Treasury ought to give consideration to some innovations, if this is a pressing point, over the next few years.

Mr. Tobin. I agree with both of those comments and in general that the Treasury should stay out of the long-term market for a while and say that they are going to stay out of it.

Chairman Humphrey. Do you think that would have a calming influence?

Mr. Tobin. Yes; I think that would have a calming influence and I think that the Federal Reserve should use opportunities to conduct its operations in long-terms when it is buying securities to add reserves to the banking system. That would help, also.

I think the Treasury officials and the Government in general should stop saying how difficult it is to finance the deficit.

Chairman Humphrey. Now, gentlemen. that last point, it is your judgment as I understand your testimony—and you correct me if I am in error—that, as you see it now, with the projected deficit for the balance of fiscal 1975, and for fiscal 1976—it is entirely possible for the Treasury to finance that rollover of debt and the deficit as well; without crowding out of the money market the private borrowers and without increasing or putting pressure on interest rates?

Do you wish to make any comment about that assertion of what I believe is the summary of your testimony?

Mr. Tobin.

Mr. Tobin. Well, the proviso for that is that it requires the Federal Reserve's cooperation in monetary policy to bring the result about. If the Federal Reserve wants crowding out to occur, it will occur.

If they pursue a tight policy and do not provide the additional bank reserves and credit and money supply that an expanding economy needs, then the by-product of that will be crowding out.

It would be unnecessary, and not intrinsic to the situation, and would occur simply because the Fed would not agree with the policy of having a recovery.

Chairman Humphrey. And that goes back to your fundamental question, the one you believe we ought to ask Mr. Burns, not to argue about what the rate of the money supply is or interest rates, but rather, what is your prescription for economic recovery, Mr. Burns?

Mr. Tobin. That is correct.

Chairman Humphrey. And what is your time frame, Mr. Burns?

Mr. Tobin. That is correct.

Mr. BRIMMER. Mr. Chairman, I agree with that, but I would also like to stress that if the Federal Reserve were not to take a good part of this debt at this time that would be a new policy for the Federal Reserve—on the record over the last 20 years.

Let me repeat—on the record over the past 20 years, the Federal Reserve has, in fact, absorbed a sizable share of the net rise in the debt during recessions.

Chairman HUMPHREY. You gave us a table on that.[1]

Mr. BRIMMER. Yes. So the question should be put to the Reserve: Why is it the Fed feels it cannot proceed in the same way this time? Why would it want to introduce a new policy with respect to debt management and debt financing in 1975–76 different from what it has done in the past?

Mr. TOBIN. Senator, I think while you were out, I made one point that I would like to repeat, a point on which I agree with what my friend Franco Modigliani said earlier, "It is not because there is a Federal deficit that I advocate an expansionary monetary policy; it is not to accommodate the Treasury or to make it easier for them to sell bonds."

That is not the reason for it. The reason for expansionary monetary policy is to accommodate the economy, the needs of recovery. Actually the more expansionary monetary policy we have, the less deficit we will need to get the same recovery.

Chairman HUMPHREY. Mr. Modigliani?

Mr. MODLIGLIANI. Yes. I would say there would be no crowding out unless the Federal Reserve adopts a policy which makes the recovery impossible. Provided the Federal Reserve accommodates the economy, there will be no crowding out.

Chairman HUMPHREY. Do you gentlemen visit Secretary Simon?

Mr. MODIGLIANI. Not Secretary Simon. I think our relations are not the friendliest. I know people on his staff and I think they do seem to understand this. That is why I always find it very hard to know whether Mr. Simon or Mr. Burns, for that matter, really say what they believe to be the technical facts or whether in reality they really want 9 percent unemployment for a long time and are using a variety of arguments to assure that we cannot do otherwise.

Chairman HUMPHREY. Because of their fear of inflation?

Mr. MODIGLIANI. That is right. I think their view is that we must punish ourselves for having done wrong things in the past and there is but one way to atone for that and that is a long time of high unemployment. That is the only way I can understand their position. But particularly at the present time it is really an incredible position because I think the evidence is very clear that inflation is abating and will continue to abate at levels of unemployment much lower than at present.

Chairman HUMPHREY. What worries me about the scare words "crowding out" is that it becomes a self-fulfilling prophecy.

Mr. TOBIN. Sure.

Mr. MODIGLIANI. Yes.

Chairman HUMPHREY. I was overseas during the Easter recess and I kept hearing high U.S. officials telling us, with what happened in

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[1] See appendix table, p. 26.

Vietnam and our unwillingness to pour in more resources, that this meant others would feel we could no longer be relied upon for our commitments. I did not find anybody in Europe feeling that way, but we kept reading that is what was going to happen.

When I got back, I told some people in the State Department and the White House that the only persons I heard talking that way were Americans; and I thought it was again a kind of a self-fulfilling prophecy. Now, here again, is the instance of money. I had a chance to talk with people in the Federal Republic of Germany while I was there, and they have done fairly well about money, and it was about the same matters, about the financing that was required both for recovery, as you have indicated on the one hand, and debt management on the other. They didn't have these fears that I kept reading about, that were being expressed in the highest council of Government.

My time has run out. I just want you somewhere along the line before we leave to tell us how we reeducate the financial community. I have been talking to them, and when I mention things like you are telling us, first declaring I am not an expert and professing my sincere innocence in all of these matters, why, it seems as if I have come in and it is sort of like trying to have initiated sex education in the most conservative community in America. They practically want to throw you out in the hall. Once in the hall, or the cloakroom, you see some of them who admit, "I think you are right." [Laughter.]

Chairman HUMPHREY. But not often.

Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Two things have been striking me: One, that there is variance in degrees, but there is much unanimity in all of your approaches to this problem. I know, Mr. Tobin, your statement about the trip from here to New York—and knowing there was a place where we had to stop in New York, and we better not go more than 10 or 15 miles an hour to get to New York because you have got to stop, or turn right, or left, when you get there, or at least make some alteration in the direction in which you are going—is perhaps casting aspersions. But putting us back into the age, to use the current terminology, of the model T Ford rather than some of the others that we have had, and that we are being overly cautious in this regard to the degree which you all unanimously, within degrees, adopted. This has been reassuring to me because of the fact that at the time that the Joint Economic Committee was making its analysis some months ago, a number of people thought we were going off the deep end in that regard. At least one of you here has voiced the opinion that perhaps even there we did not go quite far enough in that regard.

The second thing that has been reassuring to me is—and I have had more experience in the business world and political world than in the academic world—that you are not worried about our falling in this "peaks and valleys" situation if we do take the steps that are required, and the instruments that are available to us for regulation.

Both of these have been reassuring points to me.

I was not on this committee last year, Mr. Modigliani, but while you were here, some of the staff was telling me prior to the convening of this session today that in answer to a question that Senator Proxmire asked you last year—he asked you if there was one recommendation

that you could make as to what might get the economy going, and if you reduced it to one, taking everything out of all this talk, reduce it to one, what would it be. You unhesitatingly said, "Impeach the President." That was somewhere about a year ago. [Laughter.]

Representative LONG. Then Senator Proxmire decided that perhaps the danger of that was that we would increase the uncertainty that was in existence in the world at the time, not only in the economic world but in the political world, and you made the political prognosis that if he were impeached we wouldn't have to worry about spending a great deal of time trying him because, to use your remark, "The coattails are going to be awfully hard to find once he gets impeached."

Now, that has turned out to be a very good political prognosis, and projection as to what was going to happen because coattails did turn out to be extremely difficult to find.

But it hasn't turned out to be a very good economic projection as to what would be the one thing that we could do. It might have been the best. I don't know. Things could have perhaps been a great deal worse. But if I asked you the same question today that Senator Proxmire asked you earlier—what would you say is the one thing, particularly with respect to the leadership that we have, that we could do that would help the economic situation?

Mr. MODIGLIANI. Well, you have somewhat exaggerated my position. I did indeed indicate that impeaching the President would help, and, as I think over the judgment, I feel it was fundamentally sound.

I think things, bad as they are, would have been even worse if we still were fighting with the uncertainties of Watergate.

I must say that very shortly after I was here, the Federal Reserve went in a frenzy and produced the incredible credit squeeze which lasted from May to September. I was here at the end of March, and, therefore, could not foresee that additional factor. I think we did remove one source of trouble, but then the Federal Reserve threw in a new one.

Representative LONG. Right.

Mr. MODIGLIANI. Now, I think seriously, looking at the future, what you can do is fundamentally along the lines that Mr. Tobin has indicated. You now have a new budget committee, and an excellent, first-rate staff. I happen to know many of them. I think you have made excellent choices.

I believe what you need to do is to start with your own program in real terms—what is it that we should look forward to in terms of output and employment over the next 2 years.

You should then smoke out the administration to come out with its projections and targets, compare yours and theirs, and fight over the issue of what targets should finally be adopted—not over the details of monetary and debt management. In this respect I want to emphasize what Mr. Brimmer and Mr. Tobin have said. When it comes to the Federal Reserve, and I have said this before, my view is that the Fed should be given a task of bringing about a certain level of employment and output given the fiscal policy which you people have given.

You should establish the fiscal policy, you should give them the projections and target, and say, "It is your business to enforce those targets. If there is contradiction in those targets for example your target is 5-percent inflation and 7-percent unemployment, and there is

inconsistency between them—come back to us, tell us what it is, and we will work out a new program, and you enforce it."

What we must not do is let the Fed both technically pursue the targets and establish its own targets, which targets they will not tell you about because that is an internal document.

Representative LONG. Then the leadership has not outlined that policy to us from the standpoint of their leadership in the administration. They have not provided at least their views as to what that policy ought to be, and what that program ought to be.

I think we could condition what our actions are in that regard if we could get the additional information from the Federal Reserve, because most of the other information is available. There is much we could do if we could get the information from the Federal Reserve, if we had a program set forth with respect to what they really wanted to accomplish in the way of recovery.

Mr. MODIGLIANI. Mr. Long, don't you feel you can produce your own program and you can have a Sense of Congress Resolution that says, "We want the administration to pursue this target?"

Representative LONG. Yes, we can.

Mr. MODIGLIANI. Then they will have to come out and say they don't agree, or whatever, and then the fight will develop on how much unemployment, and how much output, rather than how much money, or how much credit flows, which is a side issue.

I am confident the Federal Reserve knows how to pursue targets. Of course nobody is perfect. However, if they have the targets, they would know they have the task and responsibility to pursue them. The problem is that now they are free to select their own target, and as of now I don't know whether where we are now is a bad mistake or is instead exactly the target they had aimed for.

For all I know, we are here because they were magnificant as technicians, and they got us exactly where they wanted us. We don't know that. But you have the power now to smoke them out, and from now on this country ought to have every year an explicit target coming out of a dialog with the administration—a public discussion of whether the target is reasonable or unreasonable, what the dangers are, and so on. Then the Fed should be instructed to pursue those targets and come back and explain why they failed—if they failed.

Representative LONG. I think we are doing this, and what we have been attempting to do, and I think we are making progress on it.

Mr. MODIGLIANI. I think you are, and I congratulate you on it. I think that is good for today and for many years to come.

Mr. TOBIN. May I say, you cannot avoid doing that now that the new budget procedure has been instituted.

Representative LONG. Right.

Mr. TOBIN. Because you cannot make budget policy without connecting it to overall economic policy, and that means connecting it to monetary policy.

Now, these estimates of budget deficits that come out of the Treasury and elsewhere are always conditional on some particular assumptions about GNP, corporate profits and personal income. These are the sources of taxes that are used to calculate the deficits. If, when the Treasury looks at actions of Congress, they take their previous

budget deficit estimate and simply add the initial effects of the actions of Congress—the tax cut of $25 billion, for example— they had the economic assumptions constant, they give no credit at all to the fiscal stimulus for collecting additional taxes. If that is what they are doing, then you certainly have a right to know it. Perhaps they are assuming a restrictive monetary policy, which will not allow an increase in GNP as a result of congressional fiscal measures.

Chairman HUMPHREY. I have to go catch another vote, and Congresswoman Heckler wants to ask questions, and I hope she will hold you here until I get back.

Let me say just quickly that we are feeling our way on the budget process, as you know, and I think it is coming very well, and I thank you for what you have had to say about it. I know that the respective chairmen of these budget committees and their members will be pleased.

But there is still the feeling in the Congress that somehow the Federal Reserve is untouchable, that it ought to be left alone over there. There still is not the realization that once the goals and targets and the priorities are set in terms of the fiscal or budget policies, and even assuming you can get the executive branch to agree with it, there is still the feeling that the Federal Reserve Board must be left on its own, that somehow or another—I say this in the presence of you, Mr. Brimmer—that they are wiser than wise men.

Mr. BRIMMER. Mr. Chairman, I know you have to leave, but before you do, I would like to say I recommend strongly to this committee, to the Banking and Currency committees in the Senate and House, that you do with respect to monetary policy precisely what you have done with respect to budget policy.

You created a technical office to serve all of you. You ought to do the same with respect to monetary policy. In that interview you mentioned, I spelled it out a little more fully. I think until you do that you will not be able to cope with the Federal Reserve—because as I said in that interview, they are just going to outgun you every time technically.

Chairman HUMPHREY. Don't run away, I leave you in the best of hands, not only the intelligent but charming Mrs. Heckler.

Representative HECKLER. I want congratulate you on your presentations. I must say that unfortunately we can never escape the constraints of time here. Since I live in the other part of the world—that is, the House side—there are added difficulties in traveling back and forth.

However, I would say that you have all touched upon the crux of the problem: Which should be our priority, the attack on recession or the attack on inflation. I represent an area in Massachusetts, with a high unemployment rate now at presently 14 percent, so, obviously the problems of the recession dominate my thinking. But there are many in Government, such as at the Federal Reserve Board, who are more concerned with the problem of inflation.

Therefore, the question is whether we can pursue a policy which will attack both problems at the same time and if we can't do both, which should be done first and to what extent and for how long?

Mr. Modigliani, I was encouraged by your statement relating to the growth of inflation. You projected, I think, a figure of 6 percent this year versus 11 percent last year.

Mr. Modigliani. Yes.

Representative Heckler. Would you say that the Federal Reserve has done something right, or if not, how has this been achieved? What caused this reduction in the inflationary growth?

Mr. Modigliani. Mrs. Heckler, I think the answer is largely no. Let me put it this way; a major force behind the rise and fall of inflation in these 2 years comes from things which have little to do with the unemployment rate. In some cases, the unemployment rate effect was even perverse.

You have first of all the substantial increase in raw materials prices, oil, and the like, which is completely unrelated to the employment situation; and it not only increases prices but, because people tend to respond by insisting on higher wages and tend to receive those higher wages, results in an inflation of costs which inflates prices again.

But that type of inflation is largely independent of the rate of unemployment unless, perhaps, you have 30 percent; but within say, the 9 to 16-percent range it is rather insensitive to the unemployment.

On top of that, you have a problem which is only partly understood, a sharp decline in productivity. It is the first time in the history of this country, or at least for a long time, that we have had such a dramatic decline in productivity.

Some of it is due to the very policy of reducing employment. We know that when output declines the initial impact is to reduce productivity because firms wait to fire peeople, they tend to hang on to them, they have trained them, and it is costly to fire them; so initially you get less output with the same employment and therefore you have low productivity and high costs. Some of the decline in productivity perhaps is due to dislocation due to the energy crisis. Some of it we don't quite understand and we don't know if it is permanent or temporary.

This year, if we have recovery we can look forward to rising productivity at least from the cyclical point of view, picking up what we lost coming down, and perhaps some recovery of the lost ground. Now that alone makes a considerable change in the picture.

So once you put these two together, I think you will find that the high unemployment would no way explain a difference of the order of the 11 percent last year versus 6 percent this year. Let's say perhaps of that difference, 1 percent may be due to the difference in unemployment, no more. It is quite insensitive.

Representative Heckler. What is that relationship between this decrease in the growth of inflation and the policies of the Fed?

Mr. Modigliani. The only effect that it could see—the only positive effect is that higher unemployment does tend to dampen wages but very moderately in the short run.

The negative effect is that a policy of contraction of output increases unit cost and therefore raises prices. So, on the whole, the contribution, I think, if you try to size it up, probably was more harmful than beneficial to inflation, but I would say that to a first approximation, the two effects cancel.

So I would think it contributed very little. Now, perhaps there might have been a somewhat higher contribution if you go to a different higher level; namely, the depression in this country by creating a world depression may have contributed to reducing raw material prices.

That is a very hard thing to tell because there is also exchange rates movement in between. But it may be that there is a little bit more that came from that direction and it is possible that, in the very beginning, there was some gain from breaking what looked like a very vicious spiral. But certainly it would not justify in any way, or any sense, a policy which leads to a 9-percent unemployment. So I would say I would give them very little credit. On balance, it may be a little positive or a little negative but it is hard to say.

Representative HECKLER. I would like to have all three of you gentlemen comment on the question of the effect of our deficits and also the effect of interest rates policy currently pursued by the Fed on the housing industry.

This is of major concern to me because obviously when we all know that when the economy gets a cold, housing gets pneumonia. These swings are so predictable as to be very elementary and yet we never write a remedy into the law. Perhaps it is impossible to do so—but it seems to me we don't even debate what protection we might give that sector of the economy which always seems to suffer disproportionately to its own size.

Now is there a way which we can protect housing? Is there a policy that you could suggest to the Congress which would equalize the burden on all sectors of the economy so that housing does not suffer unduly as it has in the past?

Would you like to start, Mr. Brimmer?

Mr. BRIMMER. Well, Mrs. Heckler, this is welcomed by me. Years ago, almost 5 years ago this month, I proposed a scheme which would have required the Federal Reserve to set differentiated reserve requirements on assets in such a way as to moderate the adverse effects of monetary restraint on housing.

In 1971, hearings took place before the Banking Committee in the Senate in which the Chairman of the Federal Reserve, speaking for the Board, came out against it, and I defended it. Subsequently, that proposal has been debated off and on, most recently again in February of this year.

I think some kind of systematic attempt by the Federal Reserve to moderate the adverse effects of monetary restraint on housing is still needed and I think it will come——

Representative HECKLER. When will it come, sir?

Mr. BRIMMER. I think it will come when this Congress impresses sufficiently on the Federal Reserve that it ought to be responsible for its own actions. I repeat: the Federal Reserve knows in advance the principal sectors of the economy which will be adversely affected.

The recession in housing which preceded the recession in the rest of the economy is due not entirely but almost entirely to the interruption of availability of funds at the mortgage financing agencies.

But something has happened in the meantime, Mrs. Heckler. The housing industry has been so decimated in 1973–74 that we should not expect a vigorous and early revival of housing as the lending institutions regain funds.

They are already regaining funds, but the level of housing starts is low and will remain low throughout most of 1975. I do not think the public should look forward to a 2 million housing starts year again until late 1976—at an annual rate—if then.

Now housing prices in relationship to real incomes, of course, have risen substantially, and that is one of the reasons. With the actual drop in real incomes and the uncertainty about real incomes over the long haul, I think housing demand will be depressed for a long time.

But I don't think we should lose sight of the fact that the entrepreneurs who—over the past few years—have been responsible for much of the net increase in housing starts, are now in serious condition.

Many of them have gone out of the business and probably will not come back soon. Many of the financing institutions—with real estate investment trusts being the most obvious ones—are in a very serious bind. So housing will not revive vigorously, and it will not be a major source of strength for the recovery of the economy.

I think the Congress must now give its attention as far as housing is concerned to issues other than of cost and availability of credit. There are other things which must be done to bring down the average price of a house—or at least to keep it from rising so much—into closer proximity to the ability of the average family to sustain such a very large purchase.

These are matters that go well beyond the Federal Reserve. But in the meantime, we should keep our eyes on the Federal Reserve to assure that current policies will assure an increased availability of money for housing and mortgage rates will go down some.

But the expected revival of housing on which many people are counting will not come about until very late—for the reasons I have mentioned.

Representative HECKLER. Of course, the fears and the rumors generated by the lack of clarity as to the intentions of the Federal Reserve in terms of control of the money supply in the near future, the next 12 months, has produced a number of rumors circulated around Capitol Hill and elsewhere, especially in real estate circles, predicting a very strict money policy.

We should have learned from the last few years the consequences in housing as a result of the tight money policy.

It seems to me that with a commodity as basic to the lives of all Americans as housing and shelter is, there is a justification for a public policy that really responds to the needs of that particular sector of the economy.

Now, I have felt that housing is so vitally affected by Federal Reserve decisions that one of the members of the Federal Board should be from the housing sector. Housing should have an advocate on the Board.

I have suggested this to Mr. Burns, and he is not unsympathetic. However, he has not made a decision.

Mr. BRIMMER. On that last point, with an impending vacancy on the Federal Reserve Board as of June 1, since Governor Sheehan has announced he is retiring from the Board, that issue can be put into sharper focus, I am sure.

Representative HECKLER. I shall do that, you can be assured of that. Mr. Modigliani.

Mr. MODIGLIANI. I have been working with a group of colleagues at MIT on the problem of how to handle the housing industry, not just for today but from the longrun point of view.

The proceedings of that study are coming out. They are being published by the Federal Reserve Bank of Boston, and we have been testifying before various committees about this. In essence, what we see in the long run is a combination of two things. On the one hand we need to reform the mortgage instrument so that it allows for so-called low-start payments. That is, payments which are based on so-called real interest rates; that is, rates which are free of the effect of inflation and then the payments will right in time, and there are a variety of mechanisms.

They can be made to rise with the cost of living, they can be made to rise with other indicators, but that would make the initial cost of buying a house not move all over the place depending on inflationary conditions.

That is one terrible effect of the present design of the mortgage, an instrument designed for a world of stable prices which is unsuited for a world of uncertain and high inflation.

Second, this new instrument should be made available both to thrift institutions and to pension funds and to insurance companies so that you would be attracting that kind of funds to the mortgage market. But there should be also a deliberate action with respect to the savings institutions to eliminate interest ceilings, because the problems housing faces is in part the problem of ceilings. To eliminate ceilings you will have to face the problem of how to liquidate the portfolio that the S. & L.'s hold now which, in part, is a low yield portfolio.

I feel a good place that public money could be spent is in salvaging these institutions which are in their predicament in part because of the will of Congress—because of the legislation and regulations relating to S. & L.'s which has caused them to have no other assets but mortgages, financed by short term deposits.

They did not choose to gamble on the structure of interest rates. We made them. So I feel that this is essentially an important topic which should be addressed now, while the monetary situation is somewhat easier, so that with the next round of tightening, we are prepared. And I feel that instead of spending money in subsidizing housing, in times of high interest rates giving subsidies to relatively well-to-do people because at the beginning of life they have difficulties to meet a high initial annual payment, we should use that money to put the S. & L. in the position to pay high interest rates which would go largely to poor people because the depositors are relatively lower income people.

In short, I think we would be shifting the subsidy to where it belongs, at the same time enabling the market to work. I think that the longrun solution is in this direction.

Representative HECKLER. Mr. Tobin, would you like to comment?

Mr. TOBIN. I think also that the longrun solution of the structural problem of the vulnerability of housing to restrictive monetary policy is in the direction indicated. That is, to reform thrift institutions, to add to the range of mortgage instruments and other financial instruments available, to get rid of regulation Q and deposit interest rate ceilings and permit small savers to enjoy the same interest rates that large operators get. The discrimination between them is an undesirable and regressive policy.

In the immediate situation, I think the important thing is to put monetary pressure on long term rates.

Now, there has been considerable reflow of funds into the thrift institutions as a result of the decline in interest rates that has occurred in recent months. But there has not been a great revival of mortgage lending on that account. This is partly because the thrift institutions have thought that repaying their previous debts or buying bonds with higher yields than mortgages was a better way to use the funds. That is another reason why the Fed should keep the pressure on long term interest rates through having low short term rates and through having the banks be exceedingly liquid.

Mr. BRIMMER. Mrs. Heckler, may I focus on a recent action of the Congress?

Representative HECKLER. Certainly.

Mr. BRIMMER. An action which struck some of us outside as not contributing to the longrun solution of the housing problem, and it cost probably a lot of money. That is the provision in the recently enacted tax bill which gave rebates to homebuilders.

Representative HECKLER. Oh.

Mr. BRIMMER. I just thought you and other members ought to hear at least some of the reaction. We know everybody did not vote for it, and reactions would be different, but this is my judgment. That action will make it extremely difficult to promote the kinds of actions Mr. Modigliani and I mentioned, and some of the objectives I made earlier.

As I get around, I hear substantial criticism of that. I share that criticism. I think it was using public money to subsidize a cleanup of inventories which in other industries the stockholders were asked to bear.

I just wanted to register that.

Representative HECKLER. Mr. Brimmer, I am entirely in agreement with your provision. As you recall that amendment was added by the other body and we did not have the opportunity to vote on its rejection on the House floor. As a matter of fact, it did virtually nothing for Massachusetts which was my main interest, since my State does not have that much new housing stock available.

I was extremely disappointed and I hardly consider that an approach to the problems of housing. In fact I would be hard pressed to cite a specific piece of legislation that addressed that problem in this Congress.

Our so called housing legislation is generally legislation for the unemployed, and while I thoroughly support it, it is misguided to claim that it is legislation for the entire housing sector.

Mr. Modigliani, I was amused by your statements about the financial community because in Boston I hear that side also, and I do wish you well in terms of acquainting them with the logic of your point of view. They are striving mightily to acquaint economists with their own point of view and they hope to make the same kind of conversion that you do.

Now I would like to have you comment on the adage that seems to be accepted in the financial community about the market being 6 months ahead of the economy, therefore, since the market has rallied and is hopefully continuing to rally there is no need for the Congress

to take on an aggressive policy because the economy has bottomed out and the market will revive of its own strength and what we would be doing in terms of piling up the deficit we would be fueling new inflation.

Mr. MODIGLIANI. Well, Mrs. Heckler, first of all I think that what you said about the Boston community is interesting and I wish you would take the initiative of convening a small round table of a few economists and a few members of the community. When they talk to me they refer to other people as holding those beliefs.

Representative HECKLER. They are inclined to do that.

Mr. MODIGLIANI. They understand it quite well but the rest don't. If you could locate a few people, this would be enlightening for us. The Boston community is one of the important financial centers and it would be an important contribution.

Now your next question was about——

Representative HECKLER. About the idea of the market being 6 months ahead of the economy.

Mr. MODIGLIANI. Well, I think we should not take that very literally. All you can say is that there is a tremendous need for additional action because the market is only 800, and anybody in the market knows that if things were normal the market should be 1200. So I think the conclusion from that is, yes, we all agree that there is going to be a recovery. Mr. Tobin is somewhat uncertain but I would put the odds at 90 percent, that within the next quarter probably, we will have some rebound. But it will be a rebound which will be only moderately consoling to anybody who has any stock at all.

It was nice to see the market move to 800 but I don't know. Even though I do believe that the stock market does tend to lead the economy to some extent—there is, yes, some evidence of that—I also think the stock market is full of neurotic reactions. I mean, when it went 600, or whatever it was, there was nothing that would justify that.

It seems to me that the recent rally is consistent with the fact that we are slightly improving, but there is still a lot of need for more action. I certainly would not say—I don't think anybody would tell you—that 800 is where the Dow Jones should be.

Representative HECKLER. No, I think that their point is—and I am not an expert, I merely listen to all these different points of view and then try to sort them out—their point is that since the market is rallying this is an indication of the recovery and therefore the Congress should not indulge in heavy deficit spending and the $70 billion projection has privately been increased by many Members of Congress to $80, $90, or $100 million this year. And there are those who assert that the rally is being accomplished either through past policies or because of a vitality of the economy, hidden vitality of the economy itself, and therefore the Congress should not engage in heavy deficit spending which will rekindle inflation which was the beginning of the problem, and so forth.

Mr. MODIGLIANI. Did you inquire whether these people feel this is due to the tax bill passed?

Representative HECKLER. They deplore it.

Mr. MODIGLIANI. But the market did not go down after that, it went up.

Representative HECKLER. That is right. So I would be happy to set up this little round table, at least to even begin, because one of my constant, should I say, adversaries—Mr. David Babson, you know Mr. Babson, Babson Institute and Babson Reports.

Mr. MODIGLIANI. Yes, yes.

Representative HECKLER. He is also my constituent in Wellesley; and David is extremely knowledgeable——

Mr. MODIGLIANI. Yes.

Representative HECKLER. And I will start with the two of you and if you gentlemen wish to join them, fine, we will be glad to do this.

Mr. MODIGLIANI. Yes.

Representative HECKLER. I could go on, because I have enjoyed this, but I believe something is happening on the other side.

Chairman HUMPHREY. Yes; and we will have to call it to a conclusion. I have a question to put to you and it will just take a minute. As you know the House and Senate committees, budget committees, have slightly different recommendations on budgets.

The House has recommended $368 billion, the Senate $365 billion. As has been indicated here this has been the result of some very meticulous hard work. There are those of us, however, that believe that the Senate resolution, I speak of our side, does not provide all the temporary economic stimulus that the economy needs at this point.

My colleague, Senator Mondale, who is on the Senate Budget Committee, has been talking with me about this and we are contemplating cosponsoring an amendment that would provide for $9 billion additional outlays. Senator Javits is also a cosponsor. This would provide $9 billion in additional outlays if and only if unemployment continues to average above 8.5 percent for the next 3 months.

Now in our amendment we would hope to offset some of that outlay by one or two modest tax reforms that we think would have some acceptance such as for example the elimination of the DISC program, which is just one. Allowing for an estimated increase in receipts due to a higher level of economic activity, we would add to the budget deficit say between $3½ to $5 billion. So you maybe would have a $73 billion budget deficit. Now I know you have not had a chance to study this amendment but I would like to ask these questions. Would it be helpful to add this temporary additional stimulus to the budget knowing that all programs would phase out as unemployment came down below the 8.5 percent figure? Would this extra, whatever the amount is, added to the deficit be a strain on the credit markets about which we should worry?

Let's start with you, doctor.

Mr. MODIGLIANI. Without having seen the amendment I would say that in principle I would be favorable to it. I do think we need additional stimuli. Now, if I had the power of deciding which stimuli, I would prefer a more aggressive monetary policy—an even more aggressive one than the one recommended, not just keeping interest rates constant—rather than having additional fiscal stimuli.

But since I see no hope—no chance of that, I would be in favor of this amendment as you have read it to us which is conditional on developments in the next few months.

Mr. BRIMMER. Well, Mr. Chairman, again since I have not seen it I must speak with some circumspection. But frankly I am more con-

cerned with what you do with the money than I am with adding it to the budget.

An additional expenditure of that order of magnitude used to pinpoint assistance, to unemployment——

Chairman HUMPHREY. Part of this would be for the counter-cyclical payments to State and local governments for example.

Mr. BRIMMER. Well, fine, but again I would not want simply to see the money go for general budget support.

Chairman HUMPHREY. No.

Mr. BRIMMER. As I look down the road, I see an economy generating an insufficient number of jobs for the next 2 or 3 years. So those marginal groups in the labor force are going to carry the burden of unemployment—the blacks, the women, and so on. I would prefer to see Congress appropriate money to deal explicitly with jobs for either public service or move in some other way to deal with those who are left behind as the economy expands in terms of output—but as the labor force grows more rapidly and thus we end up with continuing high levels of unemployment.

So again the amount of money concerns me less than the use of the money. I frankly do not think you need generalized additional stimulation over the next year or so. I think the Federal Reserve will respond, too, so I expect the monetary stimulus to come about.

So I would be reluctant just to add money. I would want to pinpoint it. If it is used for the purposes I suggested, I would support the idea of including it.

Chairman HUMPHREY. Very good. Mr. Tobin.

Mr. TOBIN. As I stated in my main testimony I very much favor recession grants to State and local governments. I think it has been a disastrous thing and counterproductive for all these State and local governments to be scrambling around reducing expenditures and increasing taxes during recession. I think the economy can stand the additional stimulus that you have mentioned. It is a prudent thing to do, since I don't think the package that we now have, taking monetary and fiscal policy together, is strong enough.

Chairman HUMPHREY. There is a difference between the administration's estimates of borrowing needs in the second half of calendar 1976 and the estimated program of the Congress. The Treasury gave us an estimate of borrowing needs under the President's program of $36 billion in the second half of 1976. Under the outlay total recommended by the House budget borrowing needs would be $42 billion. This is a $6 billion difference.

My question is, is this a matter that ought to cause any grave concern? Is this difference going to have any significant impact on the money markets? In determining the outlay ceiling for fiscal 1976, should Congress have a major concern with holding down financing requirements or should our first concern be whether that $6 billion is needed to finance public programs and support the recovery program?

Mr. MODIGLIANI. It should be the latter.

Chairman HUMPHREY. The latter?

Mr. MODIGLIANI. Absolutely.

Mr. BRIMMER. Yes.

Mr. TOBIN. Yes.

Chairman HUMPHREY. You agree?

Mr. Brimmer. Yes, in my prepared statement I estimated the Treasury net borrowing in the last 6 months of this calendar year in the neighborhood of $40 billion and concluded it would put no additional strains on the market.

The smaller increment you describe in my judgment could be accommodated equally well.

Chairman Humphrey. Just to run through these quickly because these are questions posed to us by Members of Congress, Mr. Brimmer, I noted with great interest that you said in your interview in the Financial World which we have included in the testimony here, that you felt the Federal Reserve should be more forthcoming with projections of long range targets.

Mr. Brimmer. Yes.

Chairman Humphrey. You said for example that you definitely feel that at least once a year that the general strategy and monetary policy should be laid out.

Could you elaborate a bit on this?

As you probably know, Mr. Burns is appearing before the Banking Committee next week to discuss this question under the resolution of Senator Proxmire, which was introduced and passed. As I said in my opening statement, the Fed has just refused to provide us their projection of the flow of funds. I don't want to put you on the spot but would you care to give us an opinion as to whether it is proper to withhold this information from Congress?

Is there some middle ground we might reach between getting all the details and getting nothing at all?

In my conversation with Deputy Secretary Gardner, I was given the impression that the Federal Reserve does not share that information with the Treasury either. I was assured that Treasury fully informs the Federal Reserve with respect to its debt financing plans; however, I was told there was no flow of information coming the other way. The Federal Reserve does not tell Treasury what its monetary targets are.

Is that the way it worked in your experience, Mr. Brimmer?

Mr. Brimmer. Well, I——

Chairman Humphrey. Do you think it would be helpful for the Treasury to have this information and would it be helpful for us to have this information?

Ms. Brimmer. Mr. Chairman, first let me say, on the historical question, there is no flow of information from the Federal Reserve to the Treasury on the detailed projections.

There is no flow of information setting forth 6 months to a year ahead what the Fed believes the other financial requirements of the economy will turn out to be. There is none.

There is informal consultation. The Treasury staff meets with the Fed staff; the Chairman of the Federal Reserve consults with the Secretary of the Treasury, but the sharing of statistical information you focus on does not occur in consultations.

Is there a middle ground? Yes.

What I had in mind in that interview was as follows: First, the Federal Reserve staff does prepare, several times a year, a general projection of the economy out for 12 months. Paralleling that is a fairly detailed projection for flow of funds. That is staff work—and

notice how I put this—those are projections; they are not operating targets.

Chairman HUMPHREY. I understand.

Mr. BRIMMER. I would want to make a distinction between the committee setting out in detail 6 months to a year ahead the detailed projections it thinks ought to be followed. What I had here in mind was to make more readily available the staff assessment—and for which the Board provides no direct input—of flows of funds in the economy as they see it.

Mr. Chairman, this is no mystery. Everybody does it. I have here the Data Resources projections. Virtually every large banking institution and insurance company does it.

I think the time has come for this Congress to do it.

Chairman HUMPHREY. It seems to me to be very necessary for us. I think we operate, frankly, with one eye closed, so to speak, around here as we deal with overall economic policy.

Mr. BRIMMER. Mr. Chairman, the establishment of an office to support the economic policy committees, the Joint Economic Committee, the Banking and Currency committees, in this Congress paralleling the Budget office ought to be done, and you ought to assign to that staff, that separate office, this responsibility.

Chairman HUMPHREY. You think we could do that under the mantle of the Joint Economic Committee by a subsection of our staff working on that with appropriate staff? I know it requires special expertise.

Mr. BRIMMER. I think you could. And you need to get people out of the Federal Reserve and other places who are the experts in economics here exactly the way banks and other participants in the money markets have done. They know pretty much Federal Reserve techniques of operation; they have the arrangements which provide the flow of raw data; they can, in fact, run a shadow Federal Reserve System with the projections and kinds of considerations going into these; and they benefit by it.

Mr. Chairman, if you might permit me on the question of information and so on—and I spend a good bit of my time in the financial community as well as in the industrial community these days—the Federal Reserve speaks not simply with information but with authority.

Chairman HUMPHREY. That's for sure.

Mr. BRIMMER. And there is virtually no one else speaking with authority. And the counterpart of that authority has to come out of the Congress. It is the only body under the Constitution with the oversight responsibilities vis-a-vis the Federal Reserve.

I would hope the Congress would organize itself to provide that oversight function so it can also speak with authority.

Chairman HUMPHREY. What is worrying me, and I will conclude this hearing on this note, is this. We are making a very determined effort here at what we call fiscal responsibility under the new budget committees together with the work of the Joint Economic Committee. We are working in close coordination and spending many hours of time on it. And the Congress is going to be judged in a real sense by the electorate by what is the effectiveness of the programs that we authorize, and that we fund.

In other words, that is, and let's assume that we have an overall budget outlay of $368 billion which is what the House has, or $365

billion from the Senate side, or any figure like, say, $370 billion. That is supposed to be able to meet certain goals, certain targets. We ought not be engaged in just spending money. We ought to have a reason for the expenditure of this money. To what purpose is it targeted? What are the objectives that we seek to accomplish? But our problem is that even if we give the most meticulous attention to these matters, unless we have some idea of how the Federal Reserve Board is going to cooperate, we cannot possibly realize those targets except possibly by accident. I think, Mr. Tobin, what you have said here, namely, that we have to ask the Federal Reserve Board not just about M-1 and the money supply and interest rates and all; we have to ask them: What is your program? What are your projections? What do you think should be the rate of unemployment at the end of calendar year 1976? What do you think should be the rate of economic growth at the end of calendar year 1976? And what money policy are you willing to pursue to accomplish it in light of what we establish as a fiscal policy here?

Mr. TOBIN. Exactly. That is what you should do. That is the most rational way to make policy in this area.

Chairman HUMPHREY. If we could get this thinking going among our Members, gentlemen. I sit in Democratic Caucus and in there, I regret to tell you, that many times the economic conservatism that caucus has is really alarming. Not so much the conservatism but the lack of understanding of this interplay which you gentlemen have so brilliantly outlined for us here today.

I know the hour is late, and I don't want to keep you any longer, but——

Mr. MODIGLIANI. May I make one point first, before you close?

Chairman HUMPHREY. Yes.

Mr. MODIGLIANI. You shouldn't just ask them what their targets are, but you should have your own targets set and tell them this should be your targets and then let them argue and come back and say why not, if not. Otherwise they could pick whatever they wanted.

Chairman HUMPHREY. But it would be interesting to find out for a change just whether or not they have any targets. And after we found that out, we can say, "Well, well and good, but here are the elected representatives of the American people and the target they have put up."

Mr. MODIGLIANI. Right. And which you are responsible for.

Mr. TOBIN. There is one more point, Senator.

Another question is this: How clear in advance should the Federal Reserve be about what it is doing and what its policy is in the markets and in the economy generally. Now other central banks are not in the practice of playing things as close to the vest as our Federal Reserve. I know the German Bundesbank really has announced what its policy will be for the year.

Chairman HUMPHREY. Yes.

Mr. TOBIN. From their point of view, it helps them achieve their objective if they let the market know what it is.

I don't know why our Federal Reserve has always thought they could achieve their objectives better by keeping everybody in the dark.

Chairman HUMPHREY. I met with a group of German industrialists and brought up this very point and they looked at me and said, "Well,

how would you expect us to plan our investments, Senator, how would you expect us to plan our operations if we didn't know what the central bank was going to do. They are a partner with us. They have more to say about what happens to us than almost anybody else."

Yet, in this community, in our economic community, we, in the Congress, don't know what the Reserve Board has in mind, and I don't imagine that many of the large industries of our country have any real understanding of it, either. They have guesses, estimates, hopes.

Thank you very, very much, gentlemen, for your interminable patience here today.

The committee stands adjourned.

[Whereupon, at 1:10 p.m., the committee adjourned, subject to the call of the Chair.]