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# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

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## HEARINGS

BEFORE THE

## JOINT ECONOMIC COMMITTEE

## CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

FIRST SESSION

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JULY 23, 24, 25, 29, 30, AND 31, 1975

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WEDNESDAY, JULY 23, 1975

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

The committee met, pursuant to notice, at 10:12 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Proxmire, Kennedy, Javits, and Taft.

Also present: John R. Stark, executive director, John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Sarah Jackson, Jerry J. Jasinowski, and George R. Tyler, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

## OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. We are continuing our midyear economic review and, as has been indicated in the past, it is the plan of the committee and the staff to publish a report of the midyear economic situation.

Today the Joint Economic Committee continues its midyear review of the economic situation and outlook. While the economy appears to be poised for recovery, the strength and duration of that recovery is still very much in doubt. A few signs point to a bottoming out of the recession and these signs are surely welcome and encouraging. Real GNP declined only three-tenths of 1 percent in the second quarter compared to an 11.4 percent decline in the first quarter. That is a tremendous change. Industrial production increased in June after having declined for 8 consecutive months. New orders for durable goods, which is one of the more important indicators, have increased in the last 2 months.

But there are many other signs that raise doubts about a healthy and a sustained recovery and I wish to emphasize those words, strong, healthy, sustained recovery. Housing starts have come back only slightly after rockbottom levels this past year. After increasing to 1,100,000 units in May, housing starts declined by a percent in June. Given the recent rises in the money market rates, the brief respite in mortgage interest costs may already be over, raising serious doubts about any adequate pickup in housing.

We had, last week, the Secretary of Housing and Urban Development here, Carla Hills, and we went over the matter of the housing program in considerable detail. Investment plans of business remain, according to the reports that we have received, very weak. The latest plant and equipment survey shows that business expects to increase dollar expenditures for capital equipment only 1.4 percent in 1975. When corrected for inflation, plant and equipment spending will decline about 10 percent. And finally, the personal consumption factor; a recent survey conducted by the Wall Street Journal concluded that, "American shoppers have turned into conspicuous nonconsumers." In short, some of the experts believe consumers will play an apathetic role in the Nation's economic recovery and perhaps even slow that recovery.

Apparently many consumers are saving their tax rebates rather than spending them as we had hoped. There is evidence that they are either putting them on deposit or are picking up old bills. A vice president of Manufacturers Hanover Trust said, and I quote: "Consumers are still trying to restructure their balance sheets. They are not likely to break out and start spending at any time in the near future." I suppose this is the sort of statement that underlines what we call the consumer confidence survey that was given to us by the University of Michigan or Michigan State University giving this rather bleak picture in the major sectors of the economy such as personal consumption, business investment, and housing.

The President and the Congress, I believe, should be reassessing current economic policies asking, are they enough? are we on the right track? what needs to be done? None of us would disagree that the American economy has reached what appears to be the bottom of the chasm. The question is, are we going to move out of that chasm quickly and is the Federal Government going to play a significant part in that recovery? Someone said earlier this year that we needed a Moses sector in the economy to lead us into the promised land of prosperity. So far that Moses sector has failed to materialize. I think he is still out in the wilderness some place rather than on top of Mount Sinai handing down the tablets. What has materialized is an impending sharp rise in the price of domestic reproduced energy which could well abort an already weak recovery and this is why some of us have looked with considerable disfavor upon proposals to increase the cost of that energy.

I hope that this midyear review of the outlook has prompted a reappraisal of the administration's economic policies. Now, we will be talking to you about that.

This morning we welcome an old friend who has cooperated with this committee so well, Mr. Alan Greenspan, Chairman of the Council of Economic Advisers and two new members of the Council who are appearing before the joint committee for the first time. Mr. Greenspan, I suppose you have forewarned these men of what a jungle they are walking into here, the unbelievable hazards that they are about to encounter. Mr. Paul McAvoy was a distinguished professor at MIT before joining this Council. Mr. Malkiel was a professor of economics at Princeton University and is considered an authority on financial markets and the structure of interest rates.

Gentlemen, your areas of specialization make you uniquely qualified to deal with the problems facing the American economy today. We would hope that we get a good prescription from you. It is not always possible to get the patient to take it but at least we would like the prescription. It is a pleasure to welcome you on behalf of the committee and we will now hear from Alan Greenspan, Chairman of the Council of Economic Advisers.

Senator PROXMIRE. Would you yield, please, Mr. Chairman?

Chairman HUMPHREY. Yes.

Senator PROXMIRE. Mr. Chairman, all three of the men came before the Senate Banking Committee for their confirmation. I think Chairman Greenspan knows that he and I differed very strongly on issues. I have great admiration, respect, and affection for him. He is a fine man and a very able man and a very fair and honest person but we disagree on a number of issues.

Mr. McAvoy came before the committee as an expert in energy and a man with a fine background, as the chairman has said, at MIT and I was very, very much impressed, as were other members of the committee with Mr. McAvoy's fine record and the kind of contribution he can make to economic policy, and heaven knows we need it. Mr. Malkiel appeared before the committee only a few days ago and was confirmed yesterday. And again, I was deeply impressed. Here is a man, Mr. Chairman, who has been at Harvard and Princeton, he skipped Yale somehow.

Chairman HUMPHREY. You are prejudiced about that.

Senator PROXMIRE. Well, I do not like that, that is right, but he was an assistant professor at Princeton and then in record time became associate professor. Within a couple of years he became a full professor, and shortly after that he was awarded one of the most coveted chairs that Princeton can provide, indicating that his colleagues think very highly of him. And after grilling him for 2 hours before the Senate Banking Committee, I can see why. He is extraordinarily articulate, he understands monetary policy as few people who has served on the Council of Economic Advisers have. And while again I think there are areas on which we can disagree, I think he will make a fine contribution.

The reason I raise this point is because I think it is so important that men of this quality have an opportunity to contribute for Congress and the public as much as possible. We have some outstanding Governors in the Federal Reserve System but somehow the press and the public and the Congress have focused almost entirely on Mr. Arthur Burns of the Federal Reserve Board and ignored all the Governors and focused on Chairman Greenspan, who does a good job for the President given that viewpoint as the Chairman of the Council of Economic Advisers, and I am afraid they are going to ignore these men. I hope they do not. I hope we can find a way to put them to good use.

Chairman HUMPHREY. One of the ways we can see you and not ignore you is to get into a fight with you. But we shall not try to precipitate that kind of a situation. But I do want to thank you very much for your cooperation.

Senator Javits, do you have any comments?

Senator JAVITS. Like all of my colleagues I am delighted to see the new team. We look forward to your cooperation and intelligent appraisal of our situation from you. I noted with great interest, the new figures which indicated a consumer price increase in June, a fact the chairman has already noted. This is very alarming. But I believe that if we take that as a signal to rethink our efforts, to increase production, to increase business activity, and to deal boldly with our situation we can deal effectively with the problem. I say that because I fear we will too soon leap to the conclusion that we are in for another burst of inflation.

I would hope very much that the Council of Economic Advisers would apply their thinking to a better control over the price system. We are overconsumers, a fact we have known for many, many years. We are able to apply discipline as we showed in January 1975, even with respect to gasoline. In addition, we are fantastic producers and all I can say is we need to emphasize the positive, not to run for cover because 1 month shows an increased price level. This administration is, in my judgment, overly sensitive to the indications of a renewed inflation.

Thank you, Mr. Chairman.

Chairman HUMPHREY. Senator Taft, do you have any comments?

Senator TAFT. Thank you, Mr. Chairman.

I just want to welcome these gentlemen here and I look forward to hearing their views.

Chairman HUMPHREY. Thank you.

All right, Mr. Greenspan, let us hear what you have to say.

## STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY PAUL McAVOY AND BURTON MALKIEL, MEMBERS

Mr. GREENSPAN. Mr. Chairman, speaking for my colleagues, I would say we very much appreciate your comments. I might say it is a great pleasure for us to appear before this committee today. The newly constituted Council of Economic Advisers is looking forward to a useful and cooperative relationship with the Joint Economic Committee in the difficult period that lies ahead.

I would like to begin this morning with a brief summation of our thinking on the economic outlook and to follow up with some discussion of the interaction between the economy and our overall economic and energy policies.

As you pointed out, Mr. Chairman, the figures released by the Commerce Department last week tend to confirm the message contained in the monthly statistics of the past several months. The sharp decline in economic activity appears to have halted during the second quarter. Production is now rising and real gross national product during June was undoubtedly above the second quarter average, presaging a significant rise for the current quarter. During the second quarter, however, real gross national product is estimated to have declined at an annual rate of approximately 0.3 percent. In real terms, final sales, which net out movements in inventories, rose at a 3.3-percent annual rate. The rate of inflation, as measured by the implicit price deflator, declined to a 5.1-percent rate during the second quarter, sharply below the 8.4-percent rate of the first quarter and the 14.4-percent rate of the fourth quarter of last year.

The extraordinary inventory movements continued to dominate the second quarter figures. The decline in business inventories at an annual rate of nearly $34 billion in current dollars was even more rapid than during the first quarter of the year. During the past two quarters the real stock of nonfarm inventories has dropped by 3.6 percent. By the second quarter, inventory liquidation had pushed production 2.4 percent below final demand in the economy as a whole. In other words, if the level of real gross national product were to rise to the level of final demand the unemployment rate would be about 8.2 percent instead of the basic 8.9 percent of the past 3 months. The ratio of real nonfarm stocks to GNP declined very sharply in the second quarter of the year and, of course, the ratio will decline even more sharply as GNP starts upward in the third quarter. This will indicate that the bulk of the excess inventory overhang with which the year began has been worked off.

The liquidation will almost surely slow in the months ahead. A dramatic turn in the inventory cycle is going to force production upward closer to the level of final demand. As is typical in inventory cycles, the inventory liquidation has been coupled with a sharp shortening of leadtimes on deliveries. As soon as companies are forced to meet current sales out of current production instead of out of stocks, purchasing agents must increase their orders for goods and materials all along the production chain. This process will itself produce a bunching up of orders and some stretching out of delivery times. Purchasing agents, no longer being able to purchase from suppliers on a hand-to-mouth basis, will attempt to increase their supplies of goods and materials on hand. This, in turn, will accelerate the new order rates and the recovery in production and employment. The swing from inventory liquidation to accumulation is going to be a major factor in the speed of the recovery which we see in front of us.

Real personal consumption expenditures rose at a 6.2-percent annual rate during the second quarter, more rapidly than we had anticipated earlier. The weekly statistics for early July indicate that the second quarter increase is continuing. Only a very small part of the increase in retail sales to date appears to have been due to the tax cuts and the resulting sharp rise in disposable personal income. Personal income, quite aside from the tax reductions, is now rising in a quite encouraging manner. Rising employment and wage gains have lifted the wage and salary component of personal income by about $5 billion at an annual rate in each of the past 2 months.

The much-improved price performance has also been an important factor helping retail sales. So far this year the consumer price index has risen at a 6.6-percent annual rate, and that I might add includes the June figure, far less than the 12-percent rate of last year. The lower rate of price increase has contributed to consumer purchasing power and helped to dispell the uncertainty and the sharp decline in consumer confidence which became so pronounced late last year.

It appears that only a small portion of the eventual impact of the fiscal stimulus applied through the tax reductions has yet been reflected in consumer purchases. The gradual effect of these rebates upon consumer outlays, together with improving confidence and incomes, should induce a fairly rapid and sustained increase in consumer purchasing during the balance of the year and into 1976.

Business fixed investment in real terms declined in the second quarter, but the drop was much less than in the previous two quarters. It is still quite difficult to form a judgment regarding the rate of business capital outlays over the next year. The large amount of excess capacity and the recession-squeezed profit margins are likely to produce some further moderate downdrift in fixed investment over the balance of this year. But the bulk of the decline in investment appears to be behind us. Capital good order backlogs, though declining, are still adequate in some areas, the sharp decline in the inflow of new orders for capital goods has been halted, and, indeed, orders for capital goods in June were almost 8 percent above the March low. The longer leadtimes required, together with the lagging patterns of business investment during earlier recovery periods, suggest that capital outlays are unlikely to turn upward before 1976; this is in real terms.

As we have discussed on earlier appearances before this committee, our projections incorporate an expectation for a recovery in housing starts to annual rates of about 1.5 million by late this year. The May figures were quite encouraging, with the rate of starts up 15 percent. We had expected another slight increase in June, but, instead, starts declined slightly. It is difficult to interpret these numbers, however, in view of the fact that the decline was in the large multifamily category, which tends to be particularly erratic from month to month. Building permits for new units were being authorized in June at rates which implied a rate of starts in excess of the June level. This, I might add, actually reflects the fact that in permit issuing areas starts were significantly below the permit levels themselves. The financial factors continued to be quite favorable with continued large inflows into the savings and loan associations in June reflecting in part, of course, the tax rebates. We hold to the view that the pickup in starts has been delayed only temporarily. Our expectation that starts will be in the 1.5 million annual rate area by late this year hardly represents a boom, but it does represent a significant increase from current levels and it will be an important factor in the recovery.

Price developments this year have been highly encouraging even though the Consumer Price Index in June rose by 0.8 percent. Several factors, however, suggest the need for a continued note of caution in our evaluation. The downward price pressures of the recession and the intense inventory liquidation pressures will be easing as the recovery gets underway. Developments in energy policy may also leave some mark on the price indexes in the months ahead. And finally, although inflation has subsided significantly, we still have a high rate of inflation, both in relation to past standards and in relation to our objective of restoring a greater measure of stability to the economy.

We believe that the developments of the first half of the year have set the stage for recovery and, taken together, they indicate a somewhat stronger pickup in production and employment in the second half of this year than we had generally been anticipating.

There have been a number of recent analyses that suggest that an increase in oil prices this autumn from oil price decontrol or from OPEC price increases would seriously dampen or even abort the forces of recovery. There is no question that sharp energy price increases can have an adverse effect upon the level of economic activity and employment. This general proposition is itself well recognized. It has been referred to by a number of observers, including the Congressional Budget Office in a recent study. The size and duration of these effects, however, are quite difficult to estimate.

Although the analytic procedures differ from study to study, the general procedure has been to estimate the changes in the prices of oil, coal, natural gas, and other fuels and then to input these into one or more of the large econometric models in order to trace through the effect upon prices, production, and employment. While it is impossible to evaluate all of the variations and differences in approach, we should like to discuss some of the reasons why our conclusions as to the economic effects of different energy policies differ quite considerably from some of the other estimates.

Our estimates incorporate allowance for developments which are going to occur anyway regardless of the policy alternatives being considered. We make allowance for the fact that U.S. energy prices are going to move upward by some amount even without decontrol or any further increase in OPEC prices. Imports will rise more rapidly without decontrol and the higher priced imports will pull up average U.S. prices and the fuel bill in any event. Moreover, the lower controlled prices of domestic oil will curtail domestic production and maintain consumption at artificially high levels. This will mean a more rapid expansion in the domestic use of the higher priced foreign oil.

Another difference in approach is that we do not believe that there will be any significant "sympathetic" or induced price rises for coal or natural gas resulting from the higher oil prices. In the case of coal, this is based in part on the fact that residual fuel oil is the principal competitive substitute for coal, and residual prices are currently near the import or the world price level and will change little as a result of decontrol. It is not even clear that a rise in residual fuel prices, which might occur as the result of OPEC oil prices, would have much effect upon coal prices since demand is running below capacity.

Natural gas prices will rise, but not as a consequence of changes in oil prices. The demand for unregulated gas will continue to grow and push up this price. Rigidities in production processes, however, suggest that the short-run substitution from oil to natural gas will be minimal. The average regulated price will also rise as the new supplies that come on the market are sold at the now-higher wellhead prices allowed by the Federal Power Commission.

There is an additional difference. Most outside studies also include a further markup or ripple effect as the increase in prices is assumed to generate a secondary round of wage increases, which, in turn, work through an additional cycle of induced price increases. These additional sequences of secondary wage and price markups further depress purchasing power, production, and employment and, as a consequence, create, at least from the models calculated, additional unemployment.

This approach generally assumes that wage earners will attempt to restore their real wage. We may debate the technical adequacy of the wage-price equations which underlie these models. But we must also recognize that the President's energy program specifies a full rebate to consumers of the induced loss in purchasing power from the energy price increase. It would eliminate the loss in purchasing power and, perhaps, at the risk of oversimplifying expectational and other factors, certainly dampen, if not completely short-circuit, any wage-price spiral pressures. The cost of living escalators, in those wage contracts which contain them, would have only a very small impact upon the overall wage level. As a consequence, our estimates of the price increase exceed the direct effects of full cost passthrough only by a small amount. The rebate mechanism largely neutralizes the macroeconomic ripple effects of the changes in the fuel bill.

We may illustrate these differences and others by considering, as an example, the estimates of the increase in energy prices and in the fuel bill presented in the study by the Congressional Budget Office. Its study estimates the effects of a $2.25 OPEC price increase, together with the 2-year phased decontrol of "old" oil as originally proposed by the administration. Its calculations point to a $40 billion increase in the fuel bill by December 1976. Increased oil expenditures account for $33 billion while sympathetic or induced price increases for coal and natural gas account for an additional $7 billion. Under the comparable CBO assumption we would conclude that phased decontrol and a $2.25 OPEC price increase would increase the fuel bill by about $22 billion, or almost half of the CBO estimate.

In assessing the direct effect of the CBO assumptions upon the average price of oil consumed in the United States we estimate an increase of $3.69 per barrel by December 1976, compared with the CBO estimated increase of $5.50 per barrel. There are three major reasons for this discrepancy. First, we believe that a $2.25 OPEC price increase, should it occur, will cause an increase of less than $2 per barrel in the price of U.S. imports. This is because such a price increase seems likely to result in a reshuffling of the OPEC price differentials in such a manner as to cause a less than equivalent increase in the U.S. import price.

The second source of divergence is that the CBO study includes in its estimate the effect upon domestic prices of the June 1 increase of $1 in the oil import fee. While this was appropriate at the time the study was completed, the price effect is now already largely included in the domestic price and in the fuel bill. Failing to recognize this today is equivalent to overstating the increase in the average price of petroleum consumed in the United States because of phased decontrol and the assumed OPEC action by about 50 cents per barrel.

The most important source of divergence, however, results from the assumed pattern of phased decontrol. The CBO assumes that the pattern of decontrol is logarithmic, that is the percentage decline is against the most recent month, whereas the administration has proposed a linear pattern of decontrol, that is a constant percent from the original base. The consequence is that under the CBO assumption, around 80 percent of "old" oil would have been decontrolled by December 1976, while calculations based upon the administration approach would indicate that about 64 percent would be decontrolled by that time. Adjusting the CBO numbers to a linear decontrol pattern, which is actually what is being proposed, would reduce the price increase in December 1976 by about 63 cents per barrel. Allowance for these factors would reduce the estimated increase in the fuel bill under the CBO assumptions by about $8 billion. A number of other less important differences, including the change assumed in the relationship between the world price of oil and the domestic price for uncontrolled oil account for the remaining divergence between our estimates.

In summary, therefore, our assessment is that the economic impact of the President's phased decontrol proposals is considerably less than many studies estimate. Although the President prefers the phased, gradual decontrol of old oil prices, we believe that even immediate decontrol can be handled through the rebate mechanism without significant disruptive effects upon our recovery. In any event, decontrol, whether phased or immediate, is far preferable to doing nothing in our crucial need for energy independence.

Thank you very much, Mr. Chairman.

Chairman HUMPHREY. Thank you very much, Mr. Greenspan. You have given us a good deal to think about and I must say a good deal to argue about and discuss.

A good deal of your presentation today was on the matter of the decontrol program of the administration. I think it indicates that the administration has reason to be very concerned about decontrol. And, while your explanations are helpful, I do not think they really get at the nub of the matter; namely, the real impact of decontrol on the economy, an economy that is currently rather fragile.

We tend to agree that the recession has bottomed out. But the fact is that any kind of disruption could lead to either an increase in inflation or a substantial downturn in production and a rise in unemployment.

We see a very nervous money market, for example. We see fluctuations in mortgage interest rates, we see an uncertain pattern in the housing area.

There are many things that indicate that while the economy is reaching out for a degree of new health that it is very much like a patient that has had a serious illness, and that the impact upon that patient of any outside force could cause a relapse.

Now, the administration has proposed as part of its energy program that windfall profits, accruing to petroleum companies if decontrol takes place, be taxed; and, that rebates be given to consumers to restore a part of their lost purchasing power. I might add in the beginning that that sounds better than it works. It is sort of like rebates that the courts order after the utility has overcharged. You have a little trouble finding the folks. You occasionally have to go to the cemetery. And there are no checking accounts in either heaven or hell. So that you have a little problem getting the economic impact.

Now, after we get through all of these explanations, I think it is important that we get some simplified and yet reasonably accurate estimates as to what the net drain of purchasing power on consumers would be. After you get all of these adjustments that you have described to get a windfall profits tax, as the administration has proposed, could you quantify for us the amount that you estimate the windfall profits tax would collect and the amounts which would be rebated to consumers each year between now and 1980? And, very importantly, what the net drain on the purchasing power of the consumers would be because of oil decontrol? That is what we are really talking about.

Mr. GREENSPAN. First, Mr. Chairman, let me say that the President's program is not a partial rebate, but an attempt to restore, as closely as we can estimate, the full loss in purchasing power of consumers that would occur because of the rise in oil prices consequent upon decontrol.

This objective can be achieved in a number of ways and we have considered a number of different variations in the particular procedures. Whether it is done by rebating the proceeds of windfall profits taxes, excise taxes, or other means, is not terribly material in the context of restoring consumer purchasing power.

I think I might say, Mr. Chairman, as I indicated in my testimony, that one of the reasons why our estimates differ from many of the estimates of the impact of higher oil prices which have been discussed in recent weeks is that the econometric models, which build in a very substantial inflationary effect, which is not offset adequately by the rebate mechanism.

I cannot give you a specific set of numbers or procedures by which the estimated amounts required would be refunded. We have a number of alternate estimates because this gets down to the specific question of the particular form of windfall profits or excise tax and the particular form of the rebate mechanism.

As economists, we are largely interested in the feasibility of the approach but it can be handled in any number of ways. The specific tax structure and the specific form of rebates, I think will be determined largely by the Congress, in conjunction with the Administration.

Chairman HUMPHREY. Our staff has made some evaluations. The FEA estimates that the President's program would add, for example, only one-tenth of 1 percent to the unemployment rate in 1977.

The staff of this committee shows in its analysis that even with a full refund to consumers of the administration's proposed excise tax and the $2 tariff on imported oil, the unemployment rate would be up about 0.8 of 1 percent. That means that about 750,000 more people would be unemployed than if controls are continued.

According to this staff's analysis, consumer prices would be about 2 percent higher in 1977. And lost GNP would exceed $50 billion as a result of the President's proposal. The decontrol program would add about $600 to the cost of running the average American family.

Further, I have here the analysis of the President's program to decontrol domestic oil by the House Committee on Interstate and

Foreign Commerce. And it shows the following: 800,000 more unemployed, consumer prices up an additional 2 percent, real GNP down $26 billion, a decrease of 2.8 percent, housing starts down by 268,000, automobile sales down by 1 million.

Now, this is the staff of the House Subcommittee on Energy and Power that has had the assistance of the Data Resources, Inc., whose model was used in formulating the macroeconomic analysis presented by the administration.

So we see many divergent points of view. I think what is needed, Mr. Chairman, is for the Council of Economic Advisers to take these different studies, put them side by side, explaining the areas where you agree with them, and those where you disagree. I would like to see the different areas of the Government come to some agreement on these statistics.

Mr. GREENSPAN. Let me just say, with respect to that, Mr. Chairman, we would be most delighted to do so and cooperate with you in any respect that you think would be useful.

Chairman HUMPHREY. I do not get much comfort over constant argument about these conflicting estimates. I think like most people, we are discouraged and dismayed over the failure to come to any agreement on energy policy. And, while it makes a good argument and a good debating point and it is nice to appear on television and radio and go after the other guy and show him that you have got more information that he has, it does not help the public.

Now, in the instance of the Joint Economic Committee, we incorporated no markups of crude oil, price boost by processors or distributors. Our price increase was linear.

Contrary to what has been said, the June $1 tariff continues to work its way through the economy as price boosts are often delayed 1 month or more.

We did include the OPEC price boost of $1.57 versus the Congressional Budget Office of $2.25. This accounts for about one-fourth to one-fifth of our price and unemployment effects.

One thing I noticed you had to say about decontrol is that you did not think it necessitated any adjustment in prices for natural gas or coal. Let me just say that the argument in the Congress is this: How can you expect people to produce natural gas when the price of oil has gone up and the price of coal has gone up. You have got to let the price of natural gas come up. The argument is that you will penalize somebody if you keep controls on one group and do not have them on another group. The proponents of decontrol in the Congress argue that you have got to let these prices come up to what other sources of energy are, and, indeed, what the world price is.

It is all related to British thermal units. It is all related to the amount of energy that truly comes from a particular agreed upon unit of fuel.

My 10 minutes are up. But we will be back to see you a little bit later, because I want to ask you whether this administration is going to recommend a continuation of a tax decrease or the continuation of some form of tax cut into the next year.

It is my understanding that some of these tax reductions that we made will be coming off in the coming year. And a failure to extend the tax cuts means that tax withholding will go up again in the beginning of next year.

Do you have any estimate as to what you are going to do? Do you feel the economy has recovered enough to go back to the old tax schedule? Or should we have a continuation of reduction of withholding?

Mr. GREENSPAN. Mr. Chairman, I think it is too early to make such a decision. The reason is that an actual determination in a legislative sense does not have to be made for many months and it is difficult enough to forecast what is going to happen in the next few months. By September, October, or November, we will have a far greater insight into what sort of recovery is going on in the economy as of that point. And I think we should have as much information as we can conceivably have before that judgment is made. It really serves no useful purpose in my view to make a premature judgment. But clearly, that judgment will be made when the time comes.

Chairman HUMPHREY. You see, this is the basic disagreement between us. I would think that as a businessman or a corporate board looking at investment or projecting sales, which indeed relates to their projection of investment, they would like to know what the ground rules are going to be for more than just the next 6 months. This is why I felt that, for example, even the 1-year extension of the investment tax credit was less than desirable.

This is a weakness of the administration policy. Nobody ever really knows what is coming up. Why do we not give this economy some assurance of a tax program, an investment program, a fiscal policy, and a monetary policy long enough so they can catch their breath?

Mr. GREENSPAN. Let me just say, Mr. Chairman, that I would certainly agree that reducing uncertainty is something of value. But in our judgment, balancing that definitely desirable issue which you point out quite eloquently, does not in our judgment overweigh the importance of having additional information.

Mr. Chairman, I would like one of my colleagues to take over for just a minute. Do you have a comment?

Mr. MALKIEL. I wondered if perhaps, Senator Humphrey, I could shed some light on your understandable confusion that different models are giving you different answers as to the effect of the increase in the price of energy. Believe me, in a sense it is as confusing to economists as it is to people on the outside. But in general I think it is fair to say that models often differ in the different weight that they assign to money and fiscal effects and the particular model, so if it is the DRI model that your staff used, it gives particularly heavy weight to monetary policy and relatively little weight to fiscal policy.

Now, as a consequence, only in that kind of model will you then not be able to make a fiscal offset that would totally restore purchasing power and get you back to where you were before. In that case you would also need an appropriate monetary offset. And all I am suggesting is that to the extent your model emphasizes the monetary or fiscal effects you will tend to get different answers and you will tend to get different appropriate responses to fully offset.

But certainly I think again I would emphasize that in everything we have done, we as much as you, want to insure that we have a vigorous recovery in the economy and when we talk about an offset we are talking about a complete offset to any effect, any deleterious effect, that may come from higher energy prices. And that is the basis on which our planning would be made.

Chairman HUMPHREY. Just as a point of correction, our model was not the DRI; ours was the Wharton model which has a different emphasis as I recollect. The House Budget Committee and the Congressional Budget Office, I think, used the DRI. But again, these are all technical things that Mr. John Q. Citizen does not understand. What he understands is one simple thing: how much is it going to cost me? What is going to happen to the price of fuel oil? What is going to happen to the price of gasoline?

Senator Javits.

Senator JAVITS. Thank you. Thank you, Mr. Chairman.

I would like to pursue some of these questions with you briefly. Yesterday we had rather dismaying news of an upsurge in the consumer price index. Do you gentlemen expect this kind of performance for the rest of the year? Is this a precursor of price behavior for the rest of the year? What signals shall we read from this news?

Mr. GREENSPAN. Well, first of all, Senator, I think that 0.8 itself is clearly above any underlying trend that we see at this particular point. A very big part of that came from a very sharp increase in meat prices and vegetable prices which we do not expect to continue. The previous month's figure of 0.4 we always conceived of as being abnormally low. I would say that I personally will be quite surprised if the figures over the next several months are not below the June rate of increase.

Senator JAVITS. So we have no reason to suppose, it is your conclusion, that this signals some new burst of inflation threatening the recovery?

Mr. GREENSPAN. No, I would say that it does suggest that the base or underlying rate of inflation is probably above the 3 to 4 percent annual rate range. Although inflation probably will not subside further in any substantial sense over the next several quarters. I would certainly not interpret the June increase as a new burst of inflation as you would put it, Senator.

Senator JAVITS. So the general expectation that inflation this year would run somewhere between 6 and 8 percent, I gather that has been a widely discussed figure, persists?

Mr. GREENSPAN. I would say yes, sir.

Senator JAVITS. Could we have the views of your new colleagues since this matter is so important, Mr. Chairman?

Mr. GREENSPAN. Yes, I would like to hear them myself.

Mr. MCAVOY. The increase of 0.8 that Alan Greenspan described for the month of June was high. The increase was led by food price changes which occurred at the 1.5 seasonally adjusted average rate. So that a good part of it was food, both because the weight is high and the rate of increase was very high. Our work on forecasting agricultural prices and food product prices indicates to us that it is likely that the most important component of the increase in the meat area is going to soften, that we are not going to experience additional large rates of increase for meat products. The grain products and vegetable products seem to be leveling off. There seems to be nothing in the horizon that would affect those prices significantly.

I am impressed by the smaller rate of increase in wholesale prices and particularly in the crude materials and the intermediate products wholesale prices which are increasing at a very low rate. Again I would affirm that the June increase is off the forecast and we are not likely to return to lower forecast levels than otherwise.

Senator JAVITS. Thank you.

Mr. Malkiel.

Mr. GREENSPAN. Before my other colleague gives his view, just let me, however, make one caveat with respect to that. We estimate that farm product prices in the wholesale price index for the month of July, seasonally adjusted, will be up largely because of the recent rapid rise in grain prices. As a consequence, the wholesale price index in total for the month of July is likely to increase. I do not want to put a specific number on it, but we should expect a definite increase to be reported which may seem to suggest a bursting of inflation. But I think that would be quite deceptive, Senator.

Senator JAVITS. Mr. Malkiel.

Mr. MALKIEL. Senator, I would have to say first of all that it is very clear to me that inflation is going to be a very stubborn problem and I think it is also an extraordinarily serious, long-run problem. One of the things that concerns me is whether we will run into the kind of capacity bottlenecks that could rekindle the inflation problem long before we reach acceptable levels of unemployment as we reflate the economy, as I believe we definitely should and must, to get ourselves down to a significantly lower level of unemployment.

Now, I would not for a moment tell you that we have any capacity problem now. We have loads of excess capacity in this economy. But I think many of the studies I have seen suggest to me that we are going to run into capacity bottlenecks long before we get down to a level of unemployment which I think all of us would consider acceptable. And therefore, I think we have also got to think in the long run about a program of encouraging capital formation as being one of the best ways I know to fight this long-run inflation problem. And at the same time, create the capacity that we need to employ all of our labor force.

Senator JAVITS. I thoroughly agree with you. That is why I said what I did at the opening about emphasizing the positive. I do not think that our Government, including we in the Congress, thought nearly enough about pragmatics. Concerning the investment tax credit, and depreciation schedules, have we done enough? If you do not do something about financing mechanisms for small business and housing, will our actions prove adequate? Have we done what we need to do in terms of a recovery?

Would you care to comment on that and in this way perhaps we can get into these matters.

Carla Hills was here the other day. Senator Humphrey referred to her. She took us rather by the ears with one proposition which we found very provocative and very discouraging. She felt that housing would follow a recovery. We felt—and I think it was practically unanimous that a bold push forward in the housing field is vital to engender a recovery. What we are discussing now moves somewhat along the same lines. Could we have your comment on that, Mr. Greenspan?

Mr. GREENSPAN. In a great deal of the general analyses of business cycles, people almost always conclude that housing should lead the recovery, and that is based upon historical relationships between housing starts and interest rates. As you know when the economy softens, interest rates tend to fall, and since housing tends to run partly countercyclical, historically it tends to lead the, turning points in economic recovery.

It is clear that while housing starts did bottom in advance of the recovery and general economic activity this time, the bottom was at an exceptionally low level, and even though we anticipate a housing recovery, and the evidence indicates that it is getting underway there is just no question that it is moving in a turgid and rather slow way.

But nonetheless one has to be impressed with the fact that an increase in starts from approximately 1 million units a year seasonally adjusted at present to about 1½ million annual rates by late this year would represent a 50 percent increase. This will be a very large increase and it will have a very marked impact on economic recovery. I think there are basically two issues.

One is an analysis of the adequacy of the absolute level of housing activity and the second is the change in the level. The impact upon the recovery in overall economic activity is largely determined by the latter and not the former.

Senator JAVITS. All right, do I gather then that you are perfectly content with this rate of anticipated increase, and you do not believe any special measures should be taken to try to gear it up higher, especially in the vein of Mr. Malkiel's assertion that we will find we are short of capacity despite our currently high level of unused capacity?

Mr. GREENSPAN. Well, obviously in one sense residential construction is a competitor for the capital and other resources required to construct capacity. But, obviously, we would like to see housing starts rise as fast as is feasible, and I think it has been our experience that by far the most important element which would generate the substantial and buoyant recovery in the housing market, as I have said here on many occasions, a meaningful and a sustained reduction in mortgage interest rates and the improved availability of mortgage financing.

And we are now experiencing very large flows of savings into the S. & L.'s. The commitments for mortgages are high.

I must say I share the chairman's view that mortgage rates have been sticky, and we would like to see them moving down further. But we must remember that a very substantial part of the level of mortgage rates represents inflation premiums in that rate structure. Because mortgage financing competes, so far as rates are con-concerned, with medium quality corporate issues, the same factors which would get long-term interest rates down in general—namely, the lowering of inflationary expectations—will also be the major factors which will get mortgage interest rates down and hence accelerate a buoyant recovery in housing.

Senator JAVITS. My time is up, Mr. Chairman. I will be back.

Chairman HUMPHREY. Yes, sir.

Senator Proxmire.

Senator PROXMIRE. Mr. Greespan, I think the main difference between the administration on the one hand and the Congress on the other is the difference as to whether or not the recovery will be vigorous enough. Many of us feel it will not be. It will be weak, so weak that it requires a dramatic change in policy to give us what we need.

I would like to call your attention to the recent estimates by the Organization for Economic Cooperation and Development, an international organization obviously with no particular bias and high professional competency. They estimate in this country in the second half of this year the growth will be only 5 percent, and in the first half of 1976 5½ percent. This coming year it will be 5½ percent.

Now, Business Week, in one of the most recent issues, July 21, contends that this is pretty much the consensus of private economists in this country. They say growth by the middle of this coming year will be less than 6 percent or close to it.

Now, what bothers me particularly about the OECD estimate, they say that for all other free countries, all other OECD countries, the growth in the second half of this year will be only 2½ percent, and the first half of 1976 only 3½ percent, and they conclude this—and I quote one short sentence from it: "Near-term recovery will be so weak that there is some doubt that whether on the basis of present policies it will prove self-sustaining."

Now, it seems to me this is the issue, and I have not heard any argument from the administration that would seem at all logical that a substantial stimulation by monetary policy or by fiscal policy would have such infllationary effects that we would not be able to control them by reducing the stimulation with plenty of opportunity to do so. What is your response to that conclusion?

Mr. GREENSPAN. First, Senator, as you know, the Council of Economic Advisers chairs the U.S. economic delegation to the Economic Policy Council of the OECD, and we are of course in quite constant discussion with that organization and its staff. We have seen their estimates and, in fact, participated in meetings with them in regard to those estimates. We respect their technical capability, but I must say in all candor, we think the numbers are just too low.

I think those estimates were made prior to an understanding of the size of the inventory liquidation that was occurring in the second quarter, and that in and of itself——

Senator PROXMIRE. It is not true that the OECD did a more accurate job of forecasting the recession than the administration's economists did?

Mr. GREENSPAN. As I recall, the OECD estimate for early this year indicated a real GNP decline for the United States for calendar 1975 in excess of 4 percent. As you recall, in January our estimate was 3.3 percent. Our estimate has actually not significantly changed from our January figure. All I can say, Senator, is that our estimate included a very severe decline in the first quarter of this year, not as much as actually occurred, but pretty close to it, and I believe that both the OECD and ourselves projected pretty much the same decline in the first half.

We did and we still do differ on the extent of the strength of the recovery. At this stage, without having the specific numbers on hand, I think it is probably safe to say they have understimated the inventory swing, as I think most economists have both with respect to the second quarter and what we think will occur in the third and fourth quarters.

Senator PROXMIRE. My rejoiner would only be that No. 1, you seem to be in a minority. At least, as I said, the American economists, the international economists all seem to feel that the recovery is going to be weak, and No. 2, I do not see any evidence that a more stimulative policy would not be desirable.

Let me give you some figures. The Congressional Budget Office said that if we have the 7-percent growth in the money supply, which is about what Mr. Burns indicated we would have, between 5½ and 7½ percent that gross national product would be cut by $25 billion below what it would be if we had 8½ percent growth in the money supply, that the unemployment would increase by 300,000. There would be a crowding out because of the unavailability of capital, but particularly—and this was the clincher for me—that there would be an increase in prices because of the increase in interest rates which would communicate itself in higher prices without any relief from that kind of a policy.

On the other hand, if we had a 10-percent increase in the money supply under these circumstances, just for the rest of this year, that the effect would be to reduce the deficit by $8 billion. It would cut unemployment by almost 300,000–280,000—and it would reduce inflation because interest rates would tend to fall and of course they are a component in costs.

Now, what is your response to that kind of a recommendation of a very vigorous monetary policy, and I would like to ask Mr. Malkiel because he testified before the Senate Banking Committee when he was confirmed that he thought we might have a fairly restrained fiscal policy, but he would like to see expansion in the monetary area.

Mr. GREENSPAN. Let me answer you first. I think the consensus of what is going on in the second half is changing. I think you will find it is changing fairly rapidly, especially with the release of the second quarter GNP figures. We had a meeting of outside economists last week, in fact on the same day that the second quarter data were released.

Without quoting specific individuals—but they are men of very significant national reputation—I would not describe their discussion of the consensus for the U.S. economy during the next four quarters in the terms that the OECD is currently using. But you know this gets down to who says what, and I think that this is on the record. We are all going to look back and see whether or not we are embarrassed or not.

Senator PROXMIRE. Mr. Malkiel.

Mr. MALKIEL. In answer to your specific question about the monetary policy, I think you will recall that at that hearing what I was referring to was a question in the long run of thinking very hard about changing the mix of our monetary and fiscal policies. That is with the same degree of stimulation I said that I would prefer to have that stimulation come somewhat more from monetary policy and somewhat less from fiscal policy. That is to say that we would have lower deficits and presumably, lower interest rates.

This would help the capital formation problem and the housing problem because that is exactly——

Senator PROXMIRE. I could not agree with you more, but you see the point I am trying to make is we need stimulation, and if we have 7 percent or even 8½ percent increase in the money supply, and we can rely on the monetary policy stimulation, it appears that that just will not be enough.

Furthermore, that that kind of increase in the money supply is not likely to be inflationary if it is within a reasonably abbreviated period.

Let me point this out, Mr. Greenspan, something that troubles me particularly. This 5½- or 6-percent growth should be put in perspective. The average recovery in the first quarter of recovery in the five previous recessions we have had since World War II, the average was 11 percent. We had a 14-percent recovery, 14½ in 1949, so this would be an anemic recovery. This would mean that more than 8 percent of the work force out of work throughout 1976. It just is feeble.

I would like to have you tell me why, if you are right, your diagnosis is correct, that we are going to have a better than 5 or 6 percent recovery, why would it not be a good idea to go a little stronger and have an 11-percent recovery at this time or 12 percent recovery. What is wrong with that? Why is that not good? Reduce the deficit, as well as put people to work.

Mr. GREENSPAN. First of all, Senator, remember when we are making economic estimates we are making point estimates. We could be off quite considerably; that is, this recovery could accelerate much faster than we expect. It happens—and it happens quite often—that we tend to underestimate the extent of the decline, and we tend to underestimate the extent of the recovery.

One the difficulties that you have—and I grant you it is a very difficult set of judgments to make—is that once you embark upon a highly expansionary policy which may in subsequent times appear to have been ill-advised it is very difficult to reverse that policy or to put it back in the box. In other words, if you cannot reverse policy in a timely and effective way you tend to create very severe inflationary and, subeqeuently, very sharp recessionary forces. And, considering the tragedy we have just been through, this extraordinary decline in economic activity and this monumental rise in unemployment, I think it is encumbent upon us to follow a policy which gets the economy back to a balanced, long-term growth path in a manner which will not recreate this type of instability. In our judgment, the particular stance of fiscal and monetary policies as we see it at this moment is adequate to the needs of the recovery.

Senator PROXMIRE. I could not agree more that we certainly want a kind of recovery we can sustain. But I call your attention to the fact that when we come out of the recession in the beginning of the sixties, we had the longest recovery in our history. It was a sharp recovery, much sharper than being predicted by most economists here. I believe perhaps sharper than you predict and it was sustained. It lasted throughout the decade of the 1960's.

And then, of course, we had the Vietnam war and other disruptions that contributed to the dilemma we are in now. But that recovery was a recovery of some 9 years without recession.

Mr. GREENSPAN. Remember, Senator, that came off of a stable, noninflationary economic base with no inflation expectations built in to the system.

Senator PROXMIRE. It came off the situation where unemployment is lower than it is now.

Mr. GREENSPAN. That is correct.

Senator PROXMIRE. It is a sharper recovery than you are expecting now. We have a much lower level of capacity utilization now. We have far more space to move in.

Mr. GREENSPAN. Let me just say this. I would certainly just reiterate what I mentioned to Senator Javits. I do not consider the June consumer price index rise as indicative of a new burst of inflation.

I should, however, add that nonetheless we are starting from a base rate of inflation which is significantly above where it was in 1960 and 1961. Although there are considerable differences here I should point out that our recovery, even though it starts, granted from a very low base, is scarcely what I would describe as slow.

I think if you merely look at the extraordinary swings in inventories which one can forecast with some degree of confidence, you can get a fairly rapid acceleration in economic activity. And I think that at this stage I would say that the recovery is ahead of schedule and the nature and the direction of our revisions as we do them on a continuous basis now is up and not down.

Senator PROXMIRE. My time is up.

Chairman HUMPHREY. Yes.

Senator Kennedy.

Senator KENNEDY. Thank you. I also want to exented a word of welcome to Mr. McAvoy and Mr. Malkiel before the committee.

To carry on the point on the rate of recovery, I think there are many of us on this committee and many across the country who desire a real recovery from the recession, not just a rebound. It certainly appears that the economy may have bottomed out, but all we have so far is a rebound, not a genuine recovery. Certainly, no recovery is underway yet with regards to unemployment. Hundreds of thousands of people are unemployed in my part of the country, New England, and millions are unemployed in many other sections of the country. Your comments here on the state of the economy and your reservations about urging the administration to move more vigorously in the area of a new tax reduction or an extension of the 1975 tax reduction for next year, are an indication that the administration is still waging a single-minded war against inflation and failing to address the problems of recession and unemployment.

By your failure to support the tax cut extension for next year, plus an extra reduction because of the withholding rates set for 1975, are we not really telling the American people that they are going to face a tax increase in January, a tax increase of approximately $15 billion?

Mr. GREENSPAN. It is a little under $12 billion, net withholding. I might say that even if there is a direct extension we will get some increase in withholding largely because we bunched the reduction in withholding into a period of less than a year. So that automatically, even if there were a direct extension of the tax cut, we would get a slight increase.

Let me say that I have not stated that I am either for or against a renewal of the 1975 act. All I suggested was that the adminstration thought it was premature to make that judgment and I would not take that either as evidence that the administration is for or against the extension. I think an evaluation of this situation and a discussion by the President on this issue will inevitably occur as the economy evolves in the next several months.

Senator KENNEDY. Your position is that you are openminded on this issue. But is that enough? I would have to draw the conclusion that, in spite of the unemployment we are facing now in this country and the sluggishness of the recovery, you are still undecided about whether the country can afford a tax increase in January. Now, that is the conclusion that I would certainly draw.

Mr. GREENSPAN. Yes, that is correct because I do not think that a decision has to be made. The law, as you know, does not expire until December 31 and today is July 23. I think that we can have considerable more time to watch events evolve before that critical decision—and it is a critical decision—should be made.

Senator KENNEDY. Last fall, we saw the admnistration advocating a tax increase, just as the economy was plunging into the current day recession. Later, the administration switched its position and supported a tax cut. Now we have a similar situation. In spite of the recession, the administration is signaling the American people that a tax increase may be on the horizon next January. Yet, the report of the Budget Committee of the Senate, indicates that with a continuation of the tax cut for next year plus an additional $15 billion tax cut, which would be a total cut of about $25 billion, would provide a more vigorous recovery without any danger of renewed inflation. Unquestionably, it would have a dramatic and important impact on the problem of unemployment. Nonetheless the principal adviser to the President says, "Go slow, let us wait and see, we can afford to wait a while longer."

In effect, you are saying to great numbers of people who are unemployed that their problems are just going to have to wait and see, because the administration is not yet prepared to adopt a policy of genuine recovery.

Mr. GREENSPAN. Senator, let me just reiterate that this tax cut is in place. We have just mailed out $8 billion in rebates. The tax cut is going to be in place until the end of the year and our view basically is that we want to be careful not to induce a situation which creates a reignition of inflationary forces in late 1976 or 1977 which would eventually induce another dramatic decline of economic activity.

Now with respect to the various types of forecasts which you have cited, I do not particularly relish getting into the guts of these econometric models upon which the bulk of these forecasts are based.

But I will say to you that there is a great deal of technical dispute with respect to the formulations of the various equations that go into these models and the rather automatic conclusions which result, which specify that if you have a certain amount of fiscal stimulus or a monetary stimulus you will get a certain price behavior.

I would really like to suggest that our experience in forecasting prices with these models in recent years has been something short of dismal. And I would not particularly want to count on our technical capability of making these very critical and subtle forecasts by these types of means. I think it is critical and important that we use judgment and evaluate the various risks involved in being right or wrong on these sorts of things. I do not wish to denigrate these models. They are exceptionally useful and they serve, for our purposes as everybody else's, a very important role.

But, I think to presume that they are descriptive in any subtle way of the way our economy is functioning at this moment is just false.

Senator KENNEDY. To get back to the point that the chairman, Senator Humphrey, was makng on the energy issue, why is it we cannot get agreement even on the statistics and facts. We find that on the issue of decontrol, the administration uses figures about what it is going to cost per gallon of gasoline, or what it is going to cost the average family. They talk about 7 cents a gallon for gasoline. Most of the experts that we have heard have put the figure closer to 12 cents.

The administration estimates $200 per family or so in terms of the cost. Yet others tell us that the cost may be up to $900 for a family of four. What can the American consumer believe? How can they be sure you are not presenting the statistics that put your proposal in the most favorable light, or that the other side is exaggerating these figures? Why can't we get some figures which reflect what the real facts are?

Mr. GREENSPAN. Chairman Humphrey has proposed that we analyze these various different types of oil decontrol impact estimates and we will endeavor to comply as quickly as we can. We will give our evaluation and, frankly, if you would like, we would be more than willing to have our staff and the members meet with whomever you would like to meet with until we hammer out the facts and the differences. Clearly there is agreement across a broad area here; there were no disagreements. There are differences. And let us let the facts fall whre they may. I do not think there is any vested interest in having a particular position. If, in fact, we are wrong, I think we should recognize it. And I think there is no particular reason why anyone would want to embark upon a particular set of estimates, and base policies upon those estimates, if they are wrong. Now, we believe our numbers are right, but this is one way to find out what sets of data are correct; and if we cannot agree, at least we can narrow the differences, and we certainly intend to do that.

Senator KENNEDY. I think that would be very helpful, Mr. Greenspan.

Mr. GREENSPAN. And may I just say just parenthetically, Senator, about these types of estimates of the effects of decontrol, there is one thing that has not been discussed. Now, I do not want to make too much of it; I think it is a fact that we should be aware of. Namely, it is that there are world prices for petroleum products out there and for example, in July, or several weeks ago, we have made some rough estimates which indicate that the landed price of regular gasoline in New York from Rotterdam is about 6.5 cents a gallon above the domestic price currently in place. Now, to be sure, there is a question of whether or not the Rotterdam prices are in fact depressed because of refinery margins being depressed in Europe. Nonetheless, I think we should recognize when we get some outlandish numbers on the impact of decontrol, we do have a competitive market out there. And if, for some reason you should begin to get price increases, for example, in the area of 15 cents a gallon, I think that rise would be sharply curtailed by a flow of competitive products moving into the United States. So there is a market out there and this is not a situation where an open-ended series of price increases is very likely.

Chairman HUMPHREY. Mr. Greenspan, you have been able to ascertain today the honest differences of viewpoint and philosophy that prevail. I think Senator Proxmire put it very concisely and in understandable terms. We are basically concerned about the rate of stimulus, the rate of recovery, not only in terms of the GNP or the profits or the sales, but also in terms of lowering the levels of unemployment, because we have to ask ourselves what is a tolerable level of unemployment without great social or economic costs. Too often these hearings never concentrate on what it costs to have 8, 9 million people without work.

What are the costs to the individual family income? What are the costs in terms of morale and spirit? Also, what are the costs to local government in terms of the reduced revenues and increased costs that have to be faced for payments, welfare? What are the costs to the Treasury in terms of lost revenue, in terms of unemployment compensation?

And it seems to me that we are not coming to grips with the fundamental structural problems that continue in the employment area by relying only on unemployment compensation to deal with these problems. Unemployment compensation can only hope to serve the function of lessening immediate suffering, it cannot solve structional problems. And I am hopeful that the Council of Economic Advisers will be looking ahead to see what is really at fault in this economy. Even if we get a major recovery, and that is very probable, a recovery in profits, a recovery in sales, a recovery in GNP even 7, 8, 9 percent, how come we will still have 2 years from now according to all estimates, 7 percent unemployment, 8 percent unemployment or even 6 percent unemployment? And I do not think anyone has given us any assurance that at any rate of recovery over the next 2 years we will get much below 7 percent unemployment.

So this, to me, is a necessity that goes far beyond any contemporary discussion that we as individuals have, because members of the CEA come and go, as Members of Congress come and go. This economy needs to be looked at in a very objective manner, over the long range to see why even if we project high rates of economic growth, we still have continuing high rates of unemployment.

I think this is where we have got to move. Now, I am not unaware of these inflation problems, and I intend to find myself in some agreement with you that we started from a much different base this time than in previous recessions. There is not any doubt about that. But also, if that is the case, then we have to be looking at what kind of mechanisms or tools we use to get at the problems.

For example, you said today that you place great emphasis on the enormous inventory swing, and you noted that the inventories are being drawn down, the oversupply of inventories is on the way out. It is correct that the completion of the inventory runoff cannot help but cause a short-run GNP upturn. I do not think anybody can deny that. But my point is, what are the underlying forces that will keep a sustained recovery going? Because inventory swings, according to all past evidence, are very short run. And we get right down again to what are those solid structural frameworks on which you build for a sustained recovery? Because just as you can have a temporary dip in inflation, you can also have a sudden increase in inflation. You can also get a temporary growth in GNP with your inventory swings, and then all at once it is all over. What is the outlook, Mr. Greenspan, for consumption, long term; for investment, long term; for exports, long term?

Mr. GREENSPAN. Well, first, let me suggest that another way of viewing the problem of capital requirements, which Mr. Malkiel was referring to earlier, is that it means a huge demand for investment goods in this economy. In fact, the other side of the question of the adequacy of savings or incentives, to meet this extraordinary rise in investment is there is a huge amount of potential effective demand in the long run, coming from the investment sector. As you know Mr. Chairman, this is one of the very critical elements in sustaining long-term economic growth.

I would also say that we do not envisage that the rise in housing starts will stop at the 1.5 million annual rate which we are projecting by the end of this year. The normal demand for housing in this country is approximately 2 million, and we fully expect that the recovery will eventually carry us back to that level.

I would say with respect to export demand, that is not an easy estimate to make because the complex international trade factors are not easily forecast. But I would suggest that the levels of capital goods, private investment demand, and housing, in and of themselves, are enough to add a solid and a significant underpinning for the longer term. We may not have sort of a short-term Moses factor, but if I were to put that label on anything, I would say it is capital investment in the long term.

So far as consumption is concerned, that, in our experience over the years, tends to be what we call largely dependent; that is, that it will grow as consumer incomes grow. And consumer incomes will grow, and quite significantly, with the restoration of our basic investment in capital goods and housing.

Chairman HUMPHREY. Thus far, despite the fact that your own testimony shows that consumer income has been growing and savings may be growing—and much of that may be the tax rebate that went into savings—there is a considerable amount of evidence that consumer confidence is not growing, that all of the reports show a very high degree of uncertainty which is portrayed, in a sense, by the amount of savings. The money is not being put into the economy through the purchase of goods. It is my judgment that the Congressional Budget Office staff, the Joint Economic Committee staff, and the Council of Economic Advisers, should get together on these projections relating to decontrol. We are prepared to cooperate, and I will ask Mr. Stark, our staff director, to get in touch with your people and we will see if we cannot do something here that will be helpful and constructive for all of us, because it is getting a little boring just to debate these figures. And I do not think it helps.

Now, the Congressional Budget Office is not in the business of making recommendations on policy; that is not its function. But your office is supposed to make recommendations on economic policy, and I wonder if you have discussed with the President the possible merits of a more stimulative program in light of the sluggishness of recovery.

Do you have underway and active examination of policies which might be adopted as the recovery shows signs of faltering? In other words, what are your backup proposals?

Mr. GREENSPAN. Well, Mr. Chairman, I think in response to that I would merely indicate that economic policy is, as it should be, always under constant review; but we do not have in our files all sorts of specific contingency plans. And the reason we do not is that the economy is changing so rapidly all of the time that any particular plan, if you want to put it in those terms, becomes obsolete very quickly.

I think the appropriate procedure in this type of endeavor is to audit what is going on very closely on and be prepared, should untoward events occur, to come up with immediate evaluations. I think in large measure what is required as a continuing ongoing review and evaluation so that within a very short leadtime we can create specific policy recommendations. And that is more the approach that we take, rather than compiling a catalog or inventory of particular backup plans in the event of unforeseen events.

Chairman HUMPHREY. One of the arguments that has impressed me over the years is the necessity of what we call "confidence" in the business world on policies of government as well as confidence in ourselves and in the economy. I think there is a great hidden power that can be realized called "faith and confidence" that things are on the upbeat. It is what we call in politics "hope."

But here is my argument with the administration. It is a very serious one and a very sincere point of view. I think the characteristics of the administration policy, as I have seen them, over the last 5 or 6 years is first of all, hesitancy to act and act competently. The Federal Reserve Board, for example, was unduly late in recognizing that there was a recession in terms of its monetary policy. So was the administration.

As Senator Kennedy has pointed out, the President was talking about a tax increase up until Christmas in 1974.

Second, timidity, always a little worried that you are going to do too much.

And third, which I think is even more serious, uncertainty. The public never knows, for example, again on the tax cut, the point has been made here that if you do not continue the tax cut, it is in effect a tax increase.

That is why I believe it is important to give some long-term signals—where are we going, not just that we are leaving port, not just that we are going to go out and look at the icebergs, but that we have got a place that we would like to land. What is our goal?

So I think what is really needed is a sense of steadiness, of certainty of policy, a sense of continuity. What can you depend on next year? What can the consumer depend on? When you buy a car, Mr. Chairman, you buy it with 36 months of payments. Now, if you are going to get a tax reduction for 12 months, and you bought the car because you wanted to get the stimulative effect, you know, for 12 months, then what do you get for the next 24? A depression, at least a depressing effect.

On the one hand you are taking those uppers for 12 months, and you are giving downers for 24 months. You have got them on two kinds of dope.

Now, I want some continuity, and I am deadly serious about it. I think what is wrong here in the policy is there is an unwillingness to face up to the fact that we have got some very serious long-term problems, that is going to be much slower recovery than we had hoped, and the unemployment problem is exceedingly difficult. I do not think anybody around here has the full answer to this unemployment problem. Some of us want to get it more quickly than others, but even the most generous estimates indicate that 6 percent unemployment is the lowest we can hope for in the near future.

Well, I came to this Government when we were talking about full employment being 3 percent, and I go to other countries, and I find that full employment is 2 percent unemployed, and we are conditioning ourselves for unemployment at 6 percent.

Now, just as surely as I am looking at you and you are out there, we have come up in the last 20 years from 3 percent to 6 percent, and trying to condition ourselves into believing that that is all right. Now, if that is the case, then we had better start telling the American public that we are going to have to pay for it, not only in terms of lost income and lost revenues, but also of lost hope for millions and millions of people, if we are going to have a sizable segment of our country that is on the dole.

And I repeat to you what I have said at 101 of these meetings: I am a work guy, w-o-r-k, and I think that this administration has become really much more permissive than I ever thought an administration of this kind could ever be. I thought the Republicans were for work, and that some of us do-good, bleeding-heart Democrats were not, but I find out it is turning around. We got you a good program called unemployment compensation and food stamps, which they fought against for a while, and then they said, well, you know, that is pretty good. That kind of bails us out, instead of getting people out here to fix up the railroads, to take care of the parks, to move in to provide for the kind of facilities that our country needs.

Now, I will give you one-third equal time.

Mr. GREENSPAN. I will use up most of it being speechless.

Senator, I think we are all most concerned about the state of the American economy, both currently and in the future. We do not believe that the unemployment rate has got some magic number below which it cannot go. I think that is a notion which makes no economic sense whatsoever.

Chairman HUMPHREY. Let me interrupt you there. I will not deny that, but what are you going to do with it? Are you willing to put him to work, or do you want him to decide to develop an appetite for no work?

Mr. GREENSPAN. I think that basically we have gotten off the track in recent years onto a zigzag policy. We have created a period of chronic inflation followed by high unemployment and high instability. I think this has created great uncertainty for the American people and for American business. I very much subscribe to your view of the importance of confidence and certainty in this economy, and I think it is all the more reason for us to pursue a steady policy, a steady path to restore this economy to a stable, noninflationary growth pattern.

I think there is no difference with respect to where we all want to come out, but there clearly are differences with rspect to our tactics. In our view there are various different sets of policy mix which create the risks of irreversible damage to our economy, which I think we should not take, and I think that when we construct policy positions, we should evaluate both the pros and the cons and the risks involved.

And to be sure, we may not always proceed on the correct path, and certainly in hindsight, we almost never do, but it is very important that above all we do not focus policy entirely within the short-term context and resist the temptation to adopt policies which have quick, short-term payoffs, but very severe consequences down the road.

I think it is about time we elongated the time frame of evaluation of economic policy in this country to the point where we evaluate not only the immediate consequences of particular policies, but also their long-term consequences for the American people. We should recognize—as I think many of us do— that much of the impact of our policy changes is experienced not next week or next month, but often 12, 18, and 24 months way, and many of them have residual effects far beyond that.

And I think it is terribly important when we formulate our policies that we keep fully in context both the short-term and the long-term costs and benefits of these particular policies.

Chairman HUMPHREY. Senator Proxmire.

Senator PROXMIRE. Mr. Greenspan, I want to follow up what you were talking about with Senator Humphrey. As I read your statement, it comes through to me as if the only really strong, clear statistic indicating recovery is the inventory figure. That is good, but it seems to me it is awfully lonely, awfully isolated. I just think you have "inventoryitis". When you look at some of these other things, business fixed investment, you admit further moderate downdrift over the balance of the year. In consuption, only a small portion of the tax cut has yet been reflected in consumer purchases, you say. And then you think the tax rebate will just continue to be saved.

Housing—that hardly represents a boom if it goes to 1½ million housing starts. That is far below the goals. It is below the average of what it should be, and I want to come to why I think it will not go even that high in just a minute.

What is left? Exports—I have indicated the OECD estimates are there will be less recovery elsewhere, and of course that means bad news for us in terms of the effect on our balance of trade.

Local and State governments, we are being told over and over again, they are having to curtail their spending. They are having to cut back, discharge people, lay them off, and you expect that to continue. Even police are being laid off in substantial numbers so where is the strength, other than the fact that inventories have been reduced?

Is not the outlook really rather grim overall?

Mr. GREENSPAN. Senator, the context of my remarks largely focus on 1975, and if you merely look at the potential swings in inventories themselves, they even in the absence of other changes, would create a significant growth in the economy. In the second quarter, the level of final demand was 2.4 percent above production. What that means is that, if you ran out to zero inventory accumulation by the end of the year, you are talking right there of a 5 percent annual growth rate in production.

Now, we do think that consumption will do a good deal better than is implied in a number of these sluggish forecasts. During the last 2 weeks, retail sales have been up, as I recall, quite significantly. It does suggest that whereas, in the very beginning most, if not a very, very substantial part of the tax rebates was saved; it is now clearly coming out into the retail expenditure stream. And when you begin to look at inventory investment changing, housing moving, albeit slowly, and these tax cuts beginning to work their way through, I must say, I will be quite surprised if consumer expenditures are not doing quite well in the fall and throughout the Christmas season.

Senator PROXMIRE. We hope so. But the tax rebate—the main effect of the tax action by the Congress is likely to have been in the second quarter, to have been historic, past. It may work its way out. It may, but this is not the kind of a tax cut, because it is not a very deep one for the individual, that is likely to be reflected as time goes on.

Be that as it may, let me come to the one section to which I think I have had a awful lot of exposure, and that is housing. As chairman of the Senate Banking Committee, as chairman of the Senate subcommittee of the Appropriations Committee that handles the money for housing, and as a member of this committee, I have listened to the Secretary of HUD repeatedly, over and over again, and I can tell you, there is no housing program. This administration does not have a program. They have no program for housing construction. The easiest way to put people to work today, in my view, is in housing. There is an enormous demand there. It can be promarily in the private sector, with very little Government stimulus.

We had a housing bill the President vetoed. The bill that he signed is going to have, in my view, a rather weak effect. At any rate, the one area where the Federal Government can really have an impact in housing is in Government assisted housing. Now, what do they tell us? They tell us, in the coming year, we will have less than 200,000 Government assisted housing starts. That is one-third of the Government assisted housing goals, which are 600,000. That is far below what we have had in periods of prosperity, let alone in recession, when we need it.

So it would seem to me that in this area, which could lead us out of the recession, where the Government has an opportunity to take great initiative, and where much of the stimulus would be in the private sector, I just do not see there is any program at all. And if there is, I would like to know what it is. I did not get it from the Secretary of HUD.

Mr. GREENSPAN. Well, she is the official spokesman for the administration, so she knows more about housing programs, by far, than I do. So I cannot imagine what I can add to what she has said.

Senator PROXMIRE. You have been very concerned about inflation, and properly so, and we all join that view. I noticed in this morning's paper that once again the aluminum industry says that they are going to increase their price. They say their costs are up, and they are going to increase their price. Last year they increased their prices 40 percent, far beyond any conceivable increase in cost. This year, they are going to do it again, not by that much, but they are going to increase their prices substantially. Now, what can we do about this kind of a situation?

Mr. GREENSPAN. Mr. Chairman, I think it is about time we woke up Mr. McAvoy.

Senator PROXMIRE. I was going to come to Mr. McAvoy with my next question, but, fine. Mr. McAvoy, we would be delighted to hear from you.

Mr. GREENSPAN. He is our microeconomist.

Mr. MCAVOY. Senator Proxmire, the aluminum situation is being reviewed.

Senator PROXMIRE. My point is they are operating far below their capacity. In a classical economic situation, when you would think they would be reducing their prices so they could increase their sales, and use more of their capacity, that would be the expected, predictable performance by an industry which is operating at well below capacity. But, go ahead.

Mr. MCAVOY. The aluminum experience is being reviewed today before the Council on Wage and Price Stability. Unfortunately, I cannot be in both places at the same time, to go through the presentations before the Council by the companies regarding their costs, demand changes, and their investment programs. However, reflecting on the general behavior of the larger corporations producing materials and metals in particular, it seems to me that one has to come to the conclusion that long-term investment programs play some role in determining prices in this industry. Here, as in the electrical generating sector of the economy and the transportation sector, long-term marginal costs, as well as present levels of marginal cost, with full capacity utilization, do affect prices.

In the absence of such effects, you would get severe bottlenecks in that part of the economy. The long-term marginal costs of building a new capacity in the metals industry are way above the short-term marginal costs. The costs of capital have increased over the last few years. Construction costs of new plant and equipment have increased threefold or fourfold.

I would expect that if corporations take a long-term view, looking for the continuity that Senator Humphrey looks for in economic policy, that they have to have prices somehow or other in relation to the cost of additional plant.

Senator PROXMIRE. But is it not true that between 1973 and 1974—between the middle of 1973 and 1974—there was this enormous increase in aluminum prices, one of the biggest increases in history, some 40 or 45 percent increase in that industry? That was only about a year ago. And that was at a time when they did have a tremendous demand, and it was understandable; they could get away with it. It did not seem right public policy, but nevertheless, I could live with it because you expect it when you have a situation where demand exceeds supply.

But now, you have the reverse situation. You have a situation where they are operating far below their capacity, and yet they are increasing their prices even now. Now, I am against wage and price controls. But it seems to me, we ought to have some way of being able to discipline an industry of that kind, if we really believe in fighting inflation on all fronts, and not just by having a situation where the unemployment is where it is.

Mr. MCAVOY. Senator, we are in the terribly difficult position in their discussion of trying to determine or complete a detailed economic analysis of each price change in a particular industry. It sems to me that the Council of Economic Advisers is not in a position to do this in detail for a large number of industries.

However, if one looks at behavior of that sector of the economy, over longer periods of time, it appears to me that the major exlaanation fo where we are involve the lagging reactions to price controls, under the freezes of phase 1 through phase 3, reactions to changes in longterm marginal costs, as a result of capacity change, and the prices of raw materials. As you know, the basic raw material in metals is, in many of these industries, imported, subject to the price changes that are levied by foreign governments, subject to energy price changes.

Senator PROXMIRE. You see what I am getting at is that this whole process, if you look at it from the standpoint of the economy as a whole, is really self-defeating, because the profitability that desponds to a price increase of the kind they are dealing for is far less than what they could enjoy from increased economic activity, in selling more. I am just concerned that this oligopolistic performance, this administered price inflation is likely to abort the recovery, keep us from moving ahead, and that it is going to hurt the aluminum companies and hurt others far more.

Let me just get to one other question, because my time is just about up, but I have one final question for you, Mr. McAvoy. The intention expressed by the Chairman of the Council of Economic Advisers this morning to repay consumers through rebates assumes substantial revenues to the Treasury from the windfall profits tax. Now, what does this assume about provisions we might have in the tax for plowback? As I understand it, the arguments have been made that, to the extent that the oil companies will put that money back that they make in additional profits in invesments, they might not have to pay the tax, in which case the revenues to the Treasury would not be very much, and there would not be much of a rebate. Could you spell that out a little bit for us?

Mr. McAvoy. The various tax proposals that are made in keeping with the scenarios for decontrol are complicated. They differ from proposal to proposal. They are matters of policy, which I understand will be before the Congress soon.

Senator Proxmire. Well, I know. Let me just put it this way, to make it simpler. What rough percentage of the windfall tax do you envision that the Federal Government would repay to the consumer, rebates to the consumer? Do you have any notion? Would it be 10 percent? Would it be 50 percent?

Mr. McAvoy. Are you asking me for a policy?

Senator Proxmire. I am asking you what would be the general limits of this kind of thing, because I think, personally, that that rebate has been greatly exaggerated because everything I have heard is that there is going to be a plowback provision, and the plowback provision would mean that if the oil company can justify the profit, in terms of increased investment, and boy, they can do that, then there will be very little windfall tax and very little rebate.

Mr. McAvoy. Well, the problem I have is that those are matters that Congress is discussing. There are many different tax and plowback proposals.

Senator Proxmire. FEA has 50 percent in their evaluation. Is that about right?

Mr. McAvoy. About right in what sense?

Senator Proxmire. Is 50 percent about right in what you would expect? Does that seem reasonable? You are an expert in the energy area. Does that seem like what the oil companies probably would plow back, 50 percent of their excess profits, additional profits permitted by higher prices?

Mr. McAvoy. That is in keeping with historical behavior; yes.

Mr. Greenspan. Senator, could I just make a point about what the policy is. I think that the amount that would be rebated to consumers is not what will, in effect, come out, necessarily in the wind fall profits tax. You start in that direction. It is the President's policy to rebate to consumers, to the extent of purchasing power lost, from the fuel bill. I think the question is, what type of tax structure is therefore required to assure that, and as a consequence I think you have to decide, as the Congress will decide, the various different forms of windfall profits tax, and what are the particular provisions?

But the amount that is going to be rebated, or should be rebated is, at least in my view, not related to that question. That is a second question. It is a source of funds by which the rebates are made, but not the other way around that one is going to make a determination of what the windfall profits tax is——

Senator Proxmire. What you are saying is, they may rebate much more than the windfall profits tax yields to the Treasury; is that right?

Mr. Greenspan. In the event that the windfall profits tax, whatever it is, is inadequate to fund that, I would suggest the answer to that is yes.

Chairman HUMPHREY. Senator Kennedy.

Senator KENNEDY. Thank you.

On the point that Senator Proxmire was making about the aluminum industry, Mr. McAvoy. Would you comment on whether the Council on Wage and Price Stability ought to be strengthened in any way? Should we be giving them more resources? Should we be urging them to do a sector-by sector review, rather than just one industry, like aluminum or steel? Would that not really provide us with additional and more accurate and better kinds of information? Would that not be valuable in meeting their responsibilities?

Mr. McAVOY. The Council on Wage and Price Stability has been moving from industry to industry, or dealing with industrial price changes, as they arise in sufficient detail to determine whether the price changes are out of keeping with the long-term demand and costs of those industries. The impression that I have is that additional information is potentially very valuable, that additions to staff would enable them to move more rapidly, to complete their analyses, and that those proposals are before Congress now. As an economist working in this area, the notion of completing studies of costs and demand more rapidly in a larger number of products is potentially productive.

Senator KENNEDY. Would we not be wise to urge them to consider a more comprehesive sector-by-sector review of the economy, rather than just individual industries? Do they need more resources and manpower? Does that not really make more sense than just reviewing a particular industry after a major price increase occurs? Shouldn't they be looking forward as well as backward?

Mr. McAVOY. I have difficulty forecasting which section to do. For example, in crude materials we have many metals in raw materials. In intermediate products we have production of the metals company. Prices in these areas have increased at a less rapid rate than in other areas of the economy. The wholesale price index here changed last month on an annual average of less than 2 percent.

However, there are problems that Senator Proxmire has raised with respect to the aluminum industry. If they had started in that sector, then, fine. If they had chosen the sector for general price level stability, then they would have missed aluminum entirely. I do not think we are any better off in forecasting sectional price changes than we are in general price level changes, so it is going to be quite difficult to set up a team, get them working, say on food processing only to find out that is not the area of the economy that has been experiencing rapid price changes.

Senator KENNEDY. We have to go vote But let me ask one brief question. The consumer price index went up 0.8 percent in June, and one of the important areas of increase was for food.

We have also read about a new Soviet wheat deal. Many of us still remember what the impact was on food prices for the American consumer as a result of the last Soviet wheat deal in 1972. Is it going to happen again?

What can you tell us about the impact on food prices from this proposed wheat deal in 1975?

Mr. GREENSPAN. Senator, I do not want to overwork my colleague, but since he has been following this subject quite closely and it is his area of expertise, I thought I might get him to answer and I will add additional comments to his if you like.

Mr. McAvoy. Living in one of the more rural parts of Massachusetts, I was chosen to be the agricultural economist and have learned a great deal about grain tasseling and soil conditions that I will never be able to use at home.

Senator Kennedy. If you make a mistake the chairman will correct you.

Mr. McAvoy. He has already, before we started. Although I did get an agreement from him that we would not discuss protein content. So I am fairly safe, so far.

I have been attempting, with CEA staff, to establish contacts and capability in forecasting grain production in the United States. It appears from a wide variety of sources of forecast, that we are going to have a record corn crop. We have experienced substantial increases already in the winter wheat crop. The spring wheat crop is forecast with small probable forecast error, to be also substantial with 6 billion bushels of corn and 2.2 billion bushels of wheat production forecast. With domestic consumption within the range respectively of 4.3 billion and 0.8 billion for corn and wheat, it appears that in the absence of exports, we would have increases in our inventories of five to seven times what we have coming into the year. With the sales that are forecast for other areas of the world, plus approximately 10 million tons of wheat and corn sold to the Soviet Union, we expect that our outgoing stocks will be more than twice our ingoing stocks. These sales will not have forecast measurable effects on the prices of wheat and corn. They will leave us with ending inventories that help us withstand future crop loss from dry conditions in Minnesota. We have every hope——

Chairman Humphrey. That is not our problem. We have a flood.

Mr. McAoy. But there is always a chance that Illinois would be dry and we would come out with a crop a little less. We have a margin for error in those forecasts that is well within our previous margins. And we will come out in good shape.

Senator Kennedy. But you can give us some assurance, then, that we are not going to repeat the 1972 grain deal and impact of inflation for the consumer?

What can you tell us if the situation is as favorable as you have reported? Will there be any reduction in costs of food for the American consumer?

Mr. Greenspan. Senator, one of the ways in which one can forecast prices of food, and I think in a certain sense, perhaps utilizing the best information available is to work off the futures market prices, because our market system is such that the full body of knowledge of what is going on in the world grain and livestock markets is reflected in the prices of these futures in such a manner that prospective shortages or surpluses in the future affect the current spot prices. So that one way in which one can evaluate almost any time what the price of food is going to be is to try to take a look at what the futures markets themselves were telling us.

And what they are telling us now is that there is very little change in the food price outlook in the period ahead. We hope, of course, that those meat price figures which we have seen in the most recent period are just a one-shot thing, which we do.

Senator KENNEDY. We have to go to the vote on the Senate floor. But Mr. Malkiel, I am sorry, I wanted to hear your views on the South Africa report that you made at Princeton. Many of us are aware of your work, and I think it was a very constructive report. I regret that we have to leave now. But I would like to submit a written question to you on it.

[The following written question and response thereto was subsequently supplied for the record:]

RESPONSE OF BURTON MALKIEL TO AN ADDITIONAL WRITTEN QUESTION POSED BY SENATOR KENNEDY

*Question.* You received a good deal of attention and praise a few years ago for the Malkiel Report, which dealt with Princeton's investment relationship with South Africa. Among other things, the report recommended that Princeton not invest funds in any companies whose primary business is in South Africa. How do you feel about that today? Should private universities hold such stock? Banks? Public or private institutions that receive tax deductible contributions? Would you submit to the committee a brief summary of your recommendations, their current status, and your current views?

*Answer.* During April 1968 I was asked by President Robert H. Goheen and the Board of Trustees of Princeton University to chair an Ad Hoc Committee to consider a student proposal that Princeton sell and refuse to accept further gifts of securities of companies which had subsidiaries or affiliates operating in the South African Rhodesian, Angolan and Mozambique economies (hereafter called "the designated shares"). The committee was also asked to recommend other ways in which Princeton could most effectively contribute to the abolition of *apartheid* and racism.

Our committee saw one important advantage to be gained from selling the designated shares. We were convinced by such an action Princeton could make credible to black people its determination to continue working toward the abolition of racial discrimination even when it resulted in considerable sacrifice to the University. It is difficult to exaggerate the horrors of apartheid and the inhuman and tyrannical practices that accompany it. Because of our deep concern we put considerable weight on the importance of such a symbolic gesture.

Nevertheless we did not consider the symbolic argument sufficient to justify a policy of Princeton's selling the designated shares. In arriving at that judgment we were influenced by the following considerations.

(1) We were not convinced that Princeton's investments did actually support racist regimes in southern Africa nor did they substantially profit from the exploitation of black workers. The designated companies held by Princeton generally had extremely small operations in southern Africa. Moreover, many of the designated companies had a history of pursuing notably progressive policies in such areas as job training of disadvantaged workers, support of local black community action groups, and furthering the cause of equal opportunity. Moreover, other companies, not designated by the student group because they had no subsidiary or affiliates in southern Africa, might actually be contributing more to those economies through purchases and through lending activities. Thus, we were convinced that selling stocks such as IBM, Xerox and Polaroid would have us settle for an appearance of moral concern while sacrificing its reality.

(2) Our committee concluded that sales of the designated shares would be completely ineffective in contributing to the abolition of apartheid and racism, in southern Africa. Princeton's holdings of the shares of the designated companies represented an insignificant fraction of the total number of shares outstanding. Thus, sales of our holdings would be unlikely to have any permanent influence on the market price. Moreover, even if the corporations themselves decided to disengage from southern Africa, evidence received by our committee indicated that willing buyers existed for any properties U.S. interests would want to sell. Indeed, the South African government itself would not have viewed as an unfavorable development the opportunity to buy such assets.

(3) Sales of designated shares, which comprised about one third of Princeton's endowment, would have involved substantial costs to the University.

The transactions (or switching) costs of selling well over $100 million of assets and redeploying them in other securities was estimated to be large in relationship to Princeton University's budget. Moreover, if the University were unable to accept gifts of stocks in such companies, it would run the risk of losing a substantial fraction of endowment gifts. Our committee examined a sample of large bequests in the three preceding years and found that 34 percent of the dollar value of stocks given to the University were on the designated list.

(4) Our committee was concerned that sales of the designated shares would commit the investment managers to a continuing series of decisions on the possible moral, political and social effects of all investments. Once the precedent had been established, a case could be made for avoiding investment in virtually any company. Indeed, some members of the University community freely admitted that once an action was taken on South African investments, the next step might well be to turn the attack on munitions makers, companies with "unfair" labor practices, companies dealing with discriminatory unions, companies with investments in Portugal, etc. Reference was also made to the likelihood of pressures that we avoid investment in companies that do business with communist countries. The dangers involved seemed very clear. It is hard to imagine a company completely free of connections that might be considered objectionable on moral, political, or social grounds by some part of the University community.

We concluded that selling the designated shares would neither cleanse the portfolio of all morally questionable investments nor could it be justified on the grounds of institutional effectiveness. We did not, however, minimize the importance of symbolic moves on the part of an institution such as Princeton University. We therefore sought other means that might do the cause of racial justice more good in the long run and Princeton less harm. We concluded that if we were seriously interested in improving conditions for blacks in southern Africa, we could be at least as effective by using the corporate connections we had than by disengagement. Indeed, pressing our views through all available channels, consistently and repeatedly was in our judgment a more realistic and ultimately perhaps even a more effective solution in the long run.

Specifically, we recommended that Princeton's trustees expressed our views to those corporations whose stocks we hold. Those views included a statement that if a U.S. corporation undertook manufacturing operations in southern Africa, we believed that at the very least it had a humanitarian responsibility to improve the lot of its black workers. We considered a labor policy of paying only minimally acceptable wages and benefits as inconsistent with honorable business practices. Moreover, we believed that U.S. corporations operating in South Africa could do much to encourage black African distributors and suppliers, to provide banking and credit facilities to non-Europeans, and to petition the South African government to liberalize the "pass laws" and other restrictions bearing on employment.

While such actions could lead to changes in corporate policies and some improvement in labor conditions for black workers, we had no high hopes that they would produce a dramatic effect. They are probably no more likely to end apartheid than selling the shares. The financial area is probably not one where a university can make its influence felt more effectively. A university's real effectiveness lies in education and research and it was in these areas that we felt our most constructive suggestions lay. Specifically, we recommended a number of programs that called on Princeton's talents in the educational field. These included a) programs for expanding the study of race relations in Princeton's course offerings; b) sponsorship of conferences and research in apartheid and racism; c) exchange programs involving African leaders, scholars and students; d) establishing an institutional relationship with the University of Botswana, Lesotho and Swaziland; e) collaboration with other African institutions; and f) programs for education of refugees from southern Africa.

The faculty of Princeton University at its meeting on January 20, 1969 adopted the recommendations of the Ad Hoc Committee on Princeton's Investments in Companies Operating in Southern Africa (the "Malkiel Report") with the following emendation:

"It is resolved that Princeton not hold any securities in companies that do a primary amount of their economic activity in South Africa."

The emendation was largely a symbolic one. Princeton owned no companies which did a primary amount of business in southern Africa.

My current views have not changed since issuance of the earlier report. I think no institutional investors (public or private) can be blind to the social consequences of their investments but I continue to think that policies of encouraging corporations to be instruments of progressive change is the best course of action. I have no illusion that these recommendations or any others will quickly end the horrors of apartheid. I do think, however, that continued participation of progressive corporations in these economies is likely to do more for black southern Africans than is disengagement.

Chairman HUMPHREY. Could I toss a quick one at you, Mr. Greenspan? Are you making any recommendations on the countercyclical assistance for cities? There is a meeting being held today in the White House, in the Domestic Council on this issue.

Mr. GREENSPAN. Actually, I think that meeting, unless I am mistaken, I think that meeting has been postponed. No, I am sorry. I was thinking of another meeting. Now, are you asking whether or not the Council of Economic Advisers——

Chairman HUMPHREY. Yes, whether or not the Council has taken any position or made any recommendation.

Mr. GREENSPAN. The Council is in the process of evaluating that. We have not made as yet, it is my understanding, any official recommendation.

Chairman HUMPHREY. How do you feel, warm or cool.

Mr. GREENSPAN. I have not taken my temperature on that question just yet.

Chairman HUMPHREY. You do not look very flushed. That is what is worrying me.

I think we have to go. The Senate is voting on cloture.

I wanted to ask you some additional questions. If you do not mind, I will have the staff send an inquiry to you, and I would like to get your response for the record.

[The following written questions and responses thereto were subsequently supplied for the record:]

### RESPONSE OF HON. ALAN GREENSPAN TO CHAIRMAN HUMPHREY'S WRITTEN QUESTION ON TAX REDUCTIONS, PERSONAL SAVINGS, AND CONSUMER CONFIDENCE

It is our view that approximately 75 percent of the tax rebates and the one time social security bonuses went into savings through the end of June. Our view that approximately 50 percent would be saved actually was for a longer time frame. We expect that about one half of the rebates will have entered the expenditure stream by the end of a four or five month period. We expect that ultimately more than 85 percent of the rebates and the social security bonus will be spent but this is unlikely to occur before the end of 1975.

I believe that the evidence of an improvement in consumer confidence is now becoming fairly widespread. The marked decline in the layoff rates in recent months and the more recent decline in seasonally adjusted initial claims for unemployment compensation have played an important role in restoring confidence as has the reduction in the overall rate of inflation. The improvement in confidence has contributed to a much more stable base for a continued expansion in consumer expenditures in the months ahead.

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### RESPONSE OF HON. ALAN GREENSPAN TO CHAIRMAN HUMPHREY'S WRITTEN QUESTION REGARDING MONETARY POLICY

I share your concern about the recent rise in short-term interest rates. The primary reason for the high levels of interest rates, however, is the high rate of inflation. Interest rates, and particularly long-term interest rates, will not decline unless inflation is reduced below its present rate. The difficult question then becomes to choose a growth rate for money over the coming quarters that will be high enough to permit a strong recovery in spending and production, but not so high so as to rekindle inflation and eventually cause another recession.

Growth rates in the various measures of the money supply over a few weeks, or even over a quarter, have a very uncertain impact on spending and on interest rates. For this reason I prefer to view money growth over periods of at least six months in attempting to gauge the probable effects of monetary growth on total spending. Money has grown at an annual rate of 7.5 percent during the past six months, a rate much higher than in the previous six months and a rate that is quite high by historical standards for the U.S. economy. I don't think there is any way to know precisely at this time whether this amount of monetary stimulus is too much or too little, but I believe that it is about right to attain both the best achievable short-term unemployment effects and the best achievable long-term inflation suppressing effects.

Concerning your last question, I would certainly agree with you that the growth rate in the real economy rather than in the money supply is the important variable. But phrasing the question that way ignores the unavoidable issue of having to choose a money growth path that is neither too high nor too low to allow us to achieve the best growth in the real economy, both this year and in the years to come.

Chairman HUMPHREY. I thank you all very much. And forgive us for the rapid departure here.

Mr. GREENSPAN. Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you very much. It has been a pleasure working with you.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, July 24 1975.]

[The following letter was subsequently supplied for the record by Chairman Humphrey in the context of Mr. Greenspan's testimony:]

CONGRESS OF THE UNITED STATES,
CONGRESSIONAL BUDGET OFFICE,
*Washington, D.C., August 4, 1975.*

ALAN GREENSPAN,
*Chairman, Council of Economic Advisers, Executive Office of the President, Washington, D.C.*

DEAR ALAN: Let me take this opportunity to respond to your statement to the Joint Economic Committee on July 23 in which you outlined a number of differences between our analysis of energy prices and your own.

In your testimony we find six criticisms of the analysis of energy prices contained in our report of June 30, *Inflation and Unemployment:*

(1) That we assumed a too-rapid pace of decontrol ("logarithmic" rather than linear);

(2) That we included the June 1 dollar-per-barrel tariff in our energy shock;

(3) That we overstated the likely rise in OPEC prices;

(4) That we overstated the price increases for natural gas and coal which are likely to follow an increase in oil prices;

(5) That we assumed a constant price of energy in our simulation of the state of the economy in the absence of decontrol, OPEC and the June 1 dollar-per-barrel tariff; and

(6) That we include induced increases in wages (and hence further increases in prices) which will not take place.

Let me address each of these points in turn.

On the question of the pattern of decontrol assumed by the CBO, I should begin with an apology. I have learned that a member of your staff was inadvertently misled by speaking with the wrong person at our office. In point of fact, we did assume linear decontrol, just as you did. In our stimulations, 62.5 percent of old oil (compare your 64 percent) had been decontrolled by the end of 1976. Thus this could not account for a $.63 per barrel discrepancy, as your testimony suggests.

On the matter of the second dollar-per-barrel import duty, it is important to understand the purpose of our analysis. We sought to provide the Congress with an assessment of the macroeconomic effects of events in the world oil market *subsequent to the First Concurrent Resolution.* This included the June 1 tariff, as well as our best guesses about decontrol and OPEC. Furthermore, not even the February 1 tariff has been fully reflected in oil prices to date. The June 1 tariff will raise prices mostly during the remainder of 1975, and thus is legitimately categorized both as a future price increase and as one which was not implicitly assumed in the First Concurrent Resolution.

We certainly would not defend our assumption that the OPEC increase would be $2.25 per barrel. At the time it looked near the middle of the popular range of guesses. You may be right in supposing that it will be under $2. Indeed, in our next report we may assume a still smaller increase, but this is nothing but guesswork. Naturally, a smaller OPEC increase means smaller macroeconomic effects.

We now believe that you are correct in suggesting that we overstated the "sympathetic" rises in the prices of coal and natural gas, especially the former. While no one knows the correct answer, our staff has had some time to study this issue since June 30, and now believes that very little reaction in coal prices can be expected. Intrastate natural gas is another matter. Many industrial and institutional users can switch between heating oil and natural gas, and more may do so if oil prices go higher. In any event, these assumptions had little effect on our analysis in *Inflation and Unemployment,* because (a) the assumed price rises were small compared to those for oil, and (b) the "sympathetic" movements were assumed to lag oil price hikes, and thus have not had significant impacts by the end of 1976.

Your statement seems to suggest that our representation of the economy in the absence of oil development—which we use to measure the impact of the June 1 tariff, decontrol and OPEC—assumes no increases in energy prices. This is not true. Our assumption was that, in the absence of these events, prices of fuels would rise smoothly at 1 percent per quarter. We have since learned that FEA's assumption for the same scenario is that prices would rise at 1.1 percent per quarter.

Finally, you raise the possibility that oil-induced inflation would not lead to wage increases (and hence to further inflation) if rebates were given to consumers to compensate them for the loss in purchasing power. While this is a conceivable outcome, it is by no means obvious that such a "social compact" could be forged. Furthermore, none of the proposed rebate packages seeks to compensate American consumers for OPEC actions. In any case, the "oil shock" studied in our report did not include any tax rebates.

In sum, we agree with one of your criticisms (No. 4), disagree with two others (Nos. 2 and 6), and believe that your staff simply misunderstood our methods in two other cases (Nos. 1 and 5).

I hope this serves to clear up some of the confusions. It is through a dialogue like this that the level of the entire debate is raised. We welcome your comments in the future.

Sincerely,

ALICE M. RIVLIN, *Director.*

# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

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**THURSDAY, JULY 24, 1975**

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

The committee met, pursuant to recess, at 10:08 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Proxmire, and Taft; and Representative Long.

Also present: John R. Stark, executive director; Courtenay M. Slater, William A. Cox, Lucy A. Falcone, Robert D. Hamrin, and Jerry J. Jasinowski, professional staff members; and M. Catherine Miller, minority economist.

## OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE [presiding]. The committee will come to order.

This morning the Joint Economic Committee continues its review of the economic situation. The chairman of this committee, Senator Humphrey, unfortunately, has been delayed, and will be here a little later. He has asked me to start off the hearings, and we are honored to have the distinguished Secretary of Labor, John Dunlop, and the distinguished Director of the Council on Wage and Price Stability, Albert Rees.

The questions that concern the committee very much are employment and unemployment. We are concerned with not only the effect that unemployment, unfortunately, has on the economy overall, and how many people are unemployed, but the devastating effect it can have in the future as people are unemployed for a lengthy time and lose their skills, and suffer the difficulty of being out of work not only for weeks, but for months. And we notice that the long-term unemployed is very greatly increased. It numbers more than 1 million.

And we are concerned with the effect that this can have on long-term productivity. On the wage side, it seems that there is a kind of division. Many people in the society have been concerned that wages will exhibit an upward pressure on prices. We will suffer from a cost-push inflation. Wage increases can be an inflationary element. This is always something to be concerned about. But it seems, on the basis of our experience, over the last several years, that on the contrary, wages have lagged far behind the cost of living, and that this may be one of the depressing elements in the economy.

We cannot have it both ways. I think it is hard to see that wages, at least to date, have had an inflationary effect; on the contrary, low wages may have an effect in prolonging and deepening the recession.

Finally, on prices, we are in a recession, and have been in a recession for some time. We are operating far below the preferred rate of capacity at something like 65 percent of the preferred rate of capacity for manufacturing. We are operating with ample resources available of all kinds, particularly manpower, and yet we see that some industries, particularly aluminum and chemicals are increasing their prices. They are operating far below capacity. In the case of both chemicals and aluminum, they enormously increased their prices last year. So if they needed to increase their cash flow or improve their investment position, or be in a better position to handle their costs, they took care of that in spades, and then some, last year, and yet they continue to increase their prices.

These are some of the areas that concern us. Of course, we are fundamentally concerned with what we can do to develop a vigorous and continuous recovery.

First, we will hear from Mr. John Dunlop, Secretary of Labor. Mr. Dunlop is an old friend of this Senator. I was one of his students years ago at Harvard, and he was highly esteemed then. And he has won greater distinction since then, not only as a great professor and economist, but also as one who has done a superlative job as Director of the Cost of Living Council and, now, Secretary of Labor.

Mr. Albert Rees, of Princeton University, has been the head of the Council on Wage and Price Stability since last September, and he has won our admiration and respect, particularly since he has done, I think, a remarkable job with very, very limited resources. I think you have something like 25 professionals working for you or did have; and half of these are concerned with the various government agencies, and their inflationary impact, which is a proper concern. But that leaves you a tiny group of 12 professionals to handle this enormously complicated private economy. You could justify, I think, that many for one industry, let alone the great, diverse enconomy we have. So I think, under the circumstances, you have certainly done a fine job. We are very cognizant of the fact that this may be your last appearance before this committee as Director of the Council. We are going to miss you.

Secretary Dunlop, I appreciate very much your giving not just one, but two very interesting and substantial statements, and I have had a chance to go over both of those. They have been made available to other members of the committee, too. If you would like to proceed, we would appreciate it if you could summarize those rather lengthy statements in about 10 minutes or so.

## STATEMENT OF HON. JOHN T. DUNLOP, SECRETARY OF LABOR

Secretary Dunlop. Thank you, Senator Proxmire, and thank you particularly for those kind words.

I will follow the format of submitting the statements for the record, with your permission, and emphasizing a few points.

Senator Proxmire. Yes. Both statements will be printed in full in the record at the end of your oral remarks.

Secretary DUNLOP. Thank you.

Let me make two or three conceptual and introductory points. First of all, I think it is very important to recognize that the concept of compensation is rather complicated, and it is composed of a large number of elements. You have wages and salaries, various kinds of benefits, and it is also true that the employment contract or the offering of a job and the acceptance of a position, carrying with it also a whole host of other conditions and rules of work, which often are very decisive in costs to management or to the income of individuals, workers, or groups of workers. And to reduce all of these complicated structures of compensation to a single number is often not only violative of its richness and diversity but also sometimes quite misleading. And I would like to just make that observation.

The second preliminary observation I make is that the wage and compensation arrangements in the country have a great deal on internal order to them, and as time has gone on, even in nonunion areas or areas not subject to collective bargaining agreements, there is a great deal of formal structure in the compensation arrangements of the country, particularly in large enterprises, although not so much in very small enterprises.

But in the process of determining compensations, one wage rate comes to be dependent upon other wage rates, either in the same enterprise, the same locality, the same industry. Without trying to sell a particular set of concepts which I first introduced over 25 years ago, I like to think of wages and compensation as being arranged in various kinds of contours, within which those contours, wages are more closely related with each other than they are with those outside. For example, wages in the basic steel industry, which are more closely alined within that than they are to wages outside, or wages for dump truck operators in the city of Washington are allied within themselves much more than to others. You can pick any example, almost, you wish. And it is, I think, an important concept to note that wage setting is not a series of isolated, entirely independent propositions. One wage does very much influence another, and therefore, the structure of wages and the way structures of wages change over time are crucial. And those of us who have been interested in stabilization or interested in collective bargaining, have to really become specialists in the way in which one wage is institutionally interrelated with another. And that, I think, is fundamental to all thinking about wages.

Next, I intend to call to your attention, briefly, a few tables in my prepared statement which set forth what has been happening. On table 1, you see the change in the effective wage rate adjustments, which went down from a peak of 1971, in the stabilization period of 1972, 1973; with the elimination of wage controls in 1974 they rose. Again, I think it is very useful, as the Bureau of Labor Statistics has been doing, to seek to break those adjustments down into their components. Some parts of the adjustments are the result of current settlements, some parts are the result of settlements last year or the year before, and some portion of those settlements or amounts are the result of the current operation of the escalator clause. And people who estimate wage changes and think about the problem, will be enhanced in their analysis if they bear this sort of breakdown in mind.

If you say, "what does a settlement cost?" it is always wise to consider, in a given year, whether one is thinking of what is written into a new contract, what was effective as a result of provisions of Next, I think I might point out that, in table 2B, I show some-escalation clause.

Next, I think I might point out that in table 2B, I show something about the extent to which escalator clauses have grown in agreements, which is a statistic worth noting, even in this hasty summary.

I think next I might point out to you, in tables 5A and 5B, how collective bargaining settlements and agreements have been going in recent years. As you know, there are two measures most commonly used. One is what the change is in the first year; the second measure is the average change over the life of the contract over 2 or 3 years, or whatever it may be. And we see in both of those measures the same pattern going on, that in the period from 1971 down to 1972 and 1973, the rates of increase dropped markedly, and then, in 1974, when we ended controls, they rose very markedly, and are rising at the rate shown in the tables.

Then to keep within my time limit, I might next, Mr. Chairman, take the concluding part of this and say a word about the general industrial relations and collective bargaining scene. It seems to me that we have had, in 1972, 1973, 1974, and 1975, a period really of relatively marked labor management quiescence. That is not entirely all reflected in the numbers but I would like to say the atmosphere has been good. The numbers, I think, do support it in general. I have set forth, in table 7, the major contracts that are open for negotiations during the rest of 1975, and through the calendar year 1976.

Now, no discussion of wages, I suppose, would be entirely complete in our time without saying a word about the construction picture. Mr. Rees has been working in this area too. The figures which might be interesting to you, which are not in my paper, show that construction agreement settlements in 1970 averaged over 15 percent. In 1971, they came down to 11 percent. In 1972, to 5.8 percent. In 1973, to 5.6 percent and in 1974, in the months before the elimination of controls the figure was 7.9. With the elimination of controls on May 1, 1974, they jumped nationwide, to over 10 percent, and the figures thus far in 1975 are running about the same nationwide, at an everage of about 10 percent, with a good bit of disparity around that, some areas being much higher, and some, lower.

I should conclude by saying that there are potential problems in the wage structure that could make our inflationary rates worse than they might otherwise be in the future. Those grow particularly out of certain distortions that have been created in some industries and in some localities. But on the whole if we were to rank the problems that the country faces, I do not think that this would, today, rank at the top of those lists. Nevertheless, I do feel that there is a good spirit and that we are drawing good cooperation to resolve disputes constructively. Along the same lines, I think Mr. Usery is an extraordinarily unusual man, and that he has been very helpful to us all in his phonomenal performance with the parties in the past week, in both the railroads and the postal service.

Finally, to end on a conceptual and theoretical point, Senator Proxmire, if we ever had a period in which one needed to reappraise certain views about the relationship of unemployment to wage changes, the current period suggests that academic views about that are not very helpful, that wages and unemployment are not simply, uniquely and directly related, as many of my colleagues have assumed, and wage setting has at its heart the fundamental question of relativity. And that leads me to the second paper that I presented and will not discuss.

While I was out of the government, I sought to put in one piece of paper, all I knew from my experiences of three times engaged in wage and price controls, and to indicate what that taught us about the nature of wage determination. That second paper was written in December. And I thought I might share it with you, because it does represent my considered judgment and considered conclusions about wage determination.

Thank you.

Senator PROXMIRE. It is a considerably valuable piece of work, and we certainly value it.

[The prepared statement of Secretary Dunlop and the statement entitled "Wage and Price Controls as Seen by a Controller" follow:]

### PREPARED STATEMENT OF HON. JOHN T. DUNLOP

#### INTRODUCTION

Mr. Chairman and members of the Committee, this is my first opportunity to testify before this Committee as Secretary of Labor. By arrangement with the Committee staff and with Dr. Rees, this testimony concentrates on wages, compensation, conditions of work and industrial relations. The discussion is divided into the following sections:

(1) The concept of compensation,
(2) Determination of money wages,
(3) Recent trends in wages, benefits and collective bargaining, and
(4) The role of government.

But, before I begin to discuss these topics, I would like, Mr. Chairman, to refer you to a document that I have attached to my statement. While out of government, following my tenure at the Cost of Living Council, I sought to describe my views about wage stabilization and policies of wage restraint. This discussion necessarily involved a good deal about wage determination, so, with your permission, Mr. Chairman, I would like to submit, for the record, this summary paper that I prepared late last year.

#### THE CONCEPT OF COMPENSATION

It is essential to be clear about certain concepts so that we can communicate in the same language. Wage or salary trends must be viewed in the light of all aspects of the employer-employee relationship; fringe benefits and work rules, personnel policies and industrial relations. Further, the determination of wages and various benefits, cost-of-living provisions, duration of agreements, conditions of work, and work rules, must be examined in the context of the current and prospective economic and social climate. It is because of these interrelated, nonwage factors that a single number so poorly describes developments related to compensation and other conditions of employment. A broader perspective tells us a lot more about the direction of wage and compensation patterns and their impact on an enterprise, industry or the economy than we can learn simply by looking at an average hourly earnings index or some other series.

Although wages and salaries are usually perceived as the most important part of a compensation package, they represent only one portion. The other parts include fringe benefits and conditions of work. Often, the effect of these provisions on labor costs and on economic activity in general may be greater than that of wage and salary changes alone.

To illustrate the relative importance of deferred compensation and other components of compensation change, I have included Table 1. First, referring to section "3" of the table, deferred increases from prior settlements have, along with wage changes due to escalator provisions, accounted for no less than 40% and up to 60% of annual wage rate adjustments since 1968. It is interesting to note that, in light bargaining years, such as 1969 and 1972, deferred wage changes increased in importance relative to changes occurring as a result of current settlements. Also, the importance of escalator provisions in wage rate changes increased from 5% of the total change in 1968 and 1969 to about 20% of the total in 1972 and 1973. This latter development reflects both the increase in usage of cost of living adjustment (COLA's) and the sharply higher rates of inflation that had become important influences on wage change in the intervening period.

Nonwage provisions are also important because they are traded off against one another, and against wages, in a manner reflecting employer-employee and collective bargaining priorities. Rarely are wages considered separately from these issues. Thus, in the discussion this morning I will generally be referring to the total package of working conditions and compensation in considering wage and salary trends. Perhaps the term "compensation package" would be a more descriptive term in this regard.

## DETERMINATION OF MONEY WAGES

Wage changes traditionally have been considered a function of supply and demand in some aggregate labor market or cluster of related, noncompeting groups. General economic models of the economy and wage setting have, in the past several decades, rather simplistically regarded money wage and salary levels as directly and significantly related, even in the short run, to the unemployment rate for the economy. According to this view, a rise in the unemployment rate dampens the rate of wage and salary increase, and a reduction in unemployment increases wage and salary rates.

TABLE 1. TOTAL EFFECTIVE WAGE-RATE ADJUSTMENT IN MAJOR COLLECTIVE BARGAINING SETTLEMENTS BY COMPONENT, 1968–74

| | Annual percentage change | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 |
| 1. Effective wage rate adjustment, total | 6.0 | 6.5 | 8.8 | 9.2 | 6.6 | 7.0 | 9.4 |
| 2. Adjustment resulting from: | | | | | | | |
| a. Current settlement | 3.2 | 2.4 | 5.1 | 4.3 | 1.7 | 3.0 | 4.8 |
| b. Prior settlement | 2.4 | 3.8 | 3.1 | 4.2 | 4.2 | 2.7 | 2.6 |
| c. Escalator provision | .3 | .3 | .6 | .7 | .7 | 1.3 | 1.9 |
| 3. Percent of adjustment resulting from: | | | | | | | |
| a. Current settlement | 53.0 | 37.0 | 58.0 | 47.0 | 26.0 | 43.0 | 51.0 |
| b. Prior settlement | 40.0 | 58.0 | 35.0 | 46.0 | 64.0 | 39.0 | 28.0 |
| c. Escalator provision | 5.0 | 5.0 | 7.0 | 8.0 | 11.0 | 19.0 | 20.0 |

Note.—Because of rounding and compounding, sums of individual items may not equal totals.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

The structure of labor markets and the dynamics of wage determination are far more complex. Contrary to current conventional economic wisdom, the rate of change in wages can continue to rise at a rapid rate during a period of high unemployment, and increasing unemployment rates may dampen wage and salary changes very little. There are several factors that help explain this. First, collective bargaining agreements run for a number of years and current increases are not so directly related to current unemployment (See Table 1). Also, expectations of changes in the cost-of-living, productivity and profits can significantly affect wage setting: Factors other than unemployment always play a role. Finally, and most importantly, individual wage setting is influenced by relative wages and benefits. Comparative wages and equities or relativities among occupations, industries and localities are always central to wage setting whether under collective bargaining or not, at least where groups of significant size are involved. This central rolv of relative relationships in wage and salary setting is now beginning to be accepted in the general economic literature.[1]

[1] See Sir John Hicks, The Crisis in Keynesian Economics, New York, Basic Books, Inc., publishers, pp. 59–85.

WAGE CONTOURS

I have found it helpful over the years to view movements in wages in the context of what I have called "wage contours." This concept describes a group of industries or firms that, for particular occupations in specific lcoalities, are related in such a way that they have a common impact on the movement in their wages, benefits and other conditions of employment. One might say that a wage contour is the sum of all those institutional arrangements within which the factors that impinge upon wage determination operate. The compensation setting arrangements in basic steel, the West Coast longshoremen, or dump truck operators in Washington, D.C., are illustrative.

Some of the relationships that define a contour might be common product or labor markets (including a common union such as the auto workers or steel workers), a common geographic area or other common organizational or institutional arrangements relevant to specific occupations. In some fashion, the wages and other conditions of employment in the contour are linked through these shared factors or characteristics.

Compensation and conditions of work are influenced by economic factors which impact on and work through the institutional framework of the contour. These factors include:

(1) The relationship of wages within the contour to each other, as well as to certain wages outside of the contour;

(2) The state of the product market; e.g., profitability and productivity of the firm or industry;

(3) Organizational and institutional considerations of management and unions involved;

(4) The employment prospects and flows in and out of the labor markets that are related to institutions within the contour.

Within a wage contour, there are generally certain units which are pattern setting, and whose settlements tend to be influential on compensation packages in other parts of the contour. Over a period of time following the initial pattern setting, settlement of wage and working conditions take place throughout the contour. This period is often referred to as the "wage round."

RECENT TRENDS IN WAGES, BENEFITS AND COLLECTIVE BARGAINING

During initial periods of high inflation, the duration of collective bargaining contracts may prevent wages from rising as fast as living costs. The severity of the problem depends, of course, on the specific provisions of existing contracts, but with an 8.8 percent rate of inflation in 1973 and a 12.2 percent rate in 1974, only those employees under contracts with the most liberal of cost-of-living adjustments escaped a serious erosion in their real wage. (See Table 2A.)

The number of workers covered by escalator clauses has approximately doubled between 1970 and the first quarter of 1975. By the end of the first quarter of this year, over ½ of all workers under major collective bargaining agreements were covered by escalator clauses. Nearly 1,000,000 workers are to be covered by such clauses in agreements concluded in 1974—and the trend appears to have accelerated in the first quarter of 1975, where about ½ million workers have already come under escalator provisions. Table 2B shows the trend since 1970 in number and proportion of workers covered by such provisions.

TABLE 2A.—COMPARISON OF COST OF LIVING ESCALATORS AND CHANGES IN THE CONSUMER PRICE INDEX

| | Consumer Price Index [1] | Average escalator increase [2] |
|---|---|---|
| 1970 | 5.5 | 3.7 |
| 1971 | 3.4 | 3.1 |
| 1972 | 3.4 | 2.0 |
| 1973 | 8.8 | 4.1 |
| 1974 | 12.2 | 5.8 |

[1] Percent changes, December to December.
[2] Percentage change in average cost of living increases under major collective bargaining contracts.

Source: "Monthly Labor Review," U.S. Department of Labor, Bureau of Labor Statistics, April 1975, p. 5.

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TABLE 2B.—PREVALENCE OF COST-OF-LIVING ESCALATORS: WORKERS UNDER MAJOR COLLECTIVE BARGAINING CONTRACTS,[1] 1970–75

| | All workers under major contracts (millions) | Number covered by escalator clauses on Jan. 1[2] (millions) | Proportion covered by escalator clauses (percent) |
|---|---|---|---|
| 1970 | 10.8 | 2.8 | 26 |
| 1971 | 10.6 | 3.0 | 28 |
| 1972 | 10.4 | 4.3 | 41 |
| 1973 | 10.5 | 4.1 | 39 |
| 1974 | 10.5 | 4.0 | 38 |
| 1975 | 10.3 | 5.0 | 49 |
| 1st quarter 1975[3] | 10.3 | 5.6 | 54 |

[1] Contracts covering 1,000 workers or more. Government employees (including U.S. Postal Service) are excluded for all years. The 600,000 postal workers have been covered by an escalator clause since 1972.

[2] Figures represent total number of workers covered by escalator clauses, not adjusted for changes in industry employment and turnover. Therefore, they should not be regarded as a definitive indicator of changes in coverage arising from newly negotiated escalator clauses, although they are reflective of this trend.

[3] As of Mar. 31, 1975.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

More widespread use of COLA's will tend to reduce the need to catch up with price increases as contracts expire. Nevertheless, many contracts will be coming up for renegotiation that do not presently contain automatic escalators and whose settlements, therefore, are likely to include some adjustment for past inflation. In addition to keeping pace with price increases, "catch-up" or "wage lag" indicates the relationship of one wage or group of wages to others within the overall wage structure. In this latter context, catch-up refers to efforts to restore traditional relativity among wages. Often, this form of catch-up is strongly related to price changes insofar as wage changes in some parts of the structure have been influenced by changes in prices.

While only about one-quarter of the work force is unionized, it is recognized that collective bargaining settlements between unions and employers tend to affect wages of many other employees in a variety of ways. Often, this is a result of the fact that the money provisions of such agreements tend to some degree to be formally or informally extended to nonunion workers in the same plant or industry. For example, a variety of area and occupational wage and fringe benefit surveys are used to influenced the setting of wages in larger enterprises not engaged in collective bargaining. There are, of course, areas of the economy, such as those characterized by small firms and individual professional and related occupations, where formalized wage setting is largely absent and compensation is independently determined.

When inflation is unexpected and longer term collective bargaining agreements have by and large been devoid of automatic catch-up provisions, the unionized sector may find that the relation of its wages to comparable nonunion wages has become relatively less favorable, as in the late 1960's. (See Table 3.) This occurs as workers, whose wages are not bounded by contracts, receive wage adjustments periodically throughout an inflationary period while those under collective agreements do not. There is a marked tendency for this disparity to be made up as contracts expire and new settlements are made. Also, as escalator clauses become more commonplace, the union disadvantage tends to dissipate as escalators prevent long-term contracts from "locking in" wages or workers under such contracts.

The indices of compensation per man-hour and average hourly earnings are commonly used to demonstrate compensation trends. Compensation per man-hour represents a somewhat broader measure because it includes some fringe benefits. One can see in Table 4 that the rate of increase in both of these measures has been increasing, in current dollar terms, since 1973.

By examining the compensation changes included in recent wage and benefit packages in Table 5, one can get an impression of the probable size of compensation packages that are yet to be negotiated, especially to the extent that one can identify pattern setting agreements. Table 5 shows a trend that is

TABLE 3.—COMPARISON OF WAGE CHANGES IN UNION AND NONUNION MANUFACTURING SECTORS,[1] 1960–74

| Year | Consumer Price Index [2] | Union (percent change) | Nonunion (percent change) | Total (percent change) |
|---|---|---|---|---|
| 1960 [3] | 1.5 | 3.4 | 2.5 | 3.2 |
| 1961 | .7 | 2.7 | 1.0 | 2.5 |
| 1962 | 1.2 | 2.6 | 1.6 | 2.5 |
| 1963 | 1.6 | 2.6 | 2.8 | 2.7 |
| 1964 | 1.2 | 2.2 | 2.0 | 2.1 |
| 1965 | 1.9 | 2.9 | 3.2 | 3.0 |
| 1966 | 3.4 | 3.2 | 3.9 | 3.3 |
| 1967 | 3.0 | 4.0 | 4.6 | 4.0 |
| 1968 | 4.7 | 5.0 | 5.0 | 5.0 |
| 1969 | 6.1 | 5.0 | 5.1 | 5.0 |
| 1970 | 5.5 | 5.7 | 5.1 | 5.6 |
| 1971 | 3.4 | 6.1 | 4.7 | 6.0 |
| 1972 | 3.4 | 5.2 | 5.0 | 5.2 |
| 1973 | 8.8 | 6.2 | 5.6 | 6.0 |
| 1974 | 12.2 | 8.0 | 8.0 | 8.0 |

[1] The table compares the median changes in wages per hour actually put into effect during the year; resulting from current, prior, or cost-of-living adjustments or any combination of the 3. The changes include adjustments for workers whose wages were unchanged or decreased as well as for wages increased. Figures obtained from a survey of manufacturing firms and weighted by employment to represent total manufacturing.
[2] Percentage change in Consumer Price Index, all items (December to December). Base year 1967=100.
[3] Union and nonunion breakdown estimated by the Bureau of Labor Statistics for 1960.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

not dissimilar to that of the earnings and compensation measures in Table 4: On average, wage and benefit packages have risen since the spring of 1974 to exceed the levels recorded in 1972 and 1973 but have remained generally below the levels recorded in 1970 and 1971.

We see in Tables 5A and 5B, line "1a", wage and benefit changes "over life of contract." This measures the average rate of increase to be expected annually over the life of the contract, but excludes possible effects of automatic cost-of-living adjustments because of their unpredictability. The second type of measure (line "1b"), the "first year adjustment", reflects both sorts of catch-up activity that were discussed, since the first year of a multiyear contract often includes much of the catch-up increases. (There is, of course, continuing debate and discussion in all negotiations over the appropriate reference point from which any catch-up is to be measured.) Notice in the chart that during 1974, and thus far in 1975, first year adjustments have risen appreciaby over the amounts received during 1972 and 1973, reflecting efforts to arrest the decline in real wages that took place when price increases far outstripped compensation gains.

While, in most cases, this "front end load" of collective bargaining agreements represents an understandable catch-up, it may be viewed by some establishments as pattern setting. Conceivably, then, even the most fair minded and equitable settlement could have a destabilizing effect if it is extended to other situations without regard to relative compensation level already achieved.

TABLE 4A.—COMPENSATION PER MAN-HOUR

[Percent changes at annual rates [1]]

| | Annual | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 |
| In current dollars | 3.8 | 6.9 | 5.3 | 7.8 | 7.1 | 7.4 | 6.6 | 6.1 | 7.7 | 8.8 |
| In constant (1967) dollars | 2.1 | 3.9 | 2.4 | 3.4 | 1.7 | 1.3 | 2.2 | 2.7 | 1.4 | −1.9 |

| | Quarterly | | | | |
|---|---|---|---|---|---|
| | 1974:1 | 1974:2 | 1974:3 | 1974:4 | 1975:1 |
| In current dollars | 7.6 | 12.7 | 10.7 | 8.6 | 10.4 |
| In constant (1967) dollars | −4.1 | 1.2 | −2.3 | −2.8 | 1.4 |

[1] Based on index of compensation per man-hour—total private economy, all persons.

TABLE 4B.—GROSS AVERAGE HOURLY EARNINGS [1]

[Percent changes at annual rates]

| | Annual | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 |
| In current dollars | 3.8 | 4.5 | 4.7 | 6.3 | 6.7 | 5.9 | 6.8 | 6.7 | 6.8 | 7.7 |
| In constant (1967) dollars | 2.0 | 1.5 | 1.9 | 2.2 | 1.1 | 0 | 2.5 | 3.2 | .7 | −3.1 |

| | Quarterly | | | | | |
|---|---|---|---|---|---|---|
| | 1974:1 | 1974:2 | 1974:3 | 1974:4 | 1975:1 | 1975:2p |
| In current dollars | 5.4 | 8.8 | 11.0 | 9.0 | 4.7 | 4.9 |
| In constant (1967) dollars | −6.2 | −2.3 | −1.4 | −2.8 | −3.3 | −1.0 |

[1] Production and nonsupervisory workers in the private nonfarm economy.
p=Preliminary.

Note.—Deflator for deriving constant dollar figures=Consumer Price Index.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 5A.—PERCENTAGE CHANGES IN WAGES AND BENEFIT MAJOR COLLECTIVE BARGAINING AGREEMENTS AVERAGE ADJUSTMENTS: 1970, 1971, 1972, 1973 (CONTRACTS COVERING 1,000 WORKERS OR MORE) [1]

| | Average adjustments [2] | | | | | |
|---|---|---|---|---|---|---|
| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 1st quarter |
| **1. Wages and Benefits Combined (5,000 Workers or More)** | | | | | | |
| (a) Annual rate of change over life of contract in: | | | | | | |
| All industries | 9.1 | 8.8 | 7.4 | 6.1 | 7.8 | 7.9 |
| Construction (1,000 workers or more) | 15.6 | 12.0 | 6.6 | 5.6 | 9.2 | NA |
| (b) 1st-year changes in: | | | | | | |
| All industries | 13.1 | 13.1 | 8.5 | 7.1 | 10.7 | 11.4 |
| Construction (1,000 workers or more) | 19.6 | 14.1 | 7.5 | 5.8 | 10.8 | NA |
| **2. Wage Rates Alone (1,000 Workers or More)** | | | | | | |
| (a) Annual rate of change over life of contract in: | | | | | | |
| All industries | 8.9 | 8.1 | 6.4 | 5.1 | 7.3 | 7.6 |
| Manufacturing | 6.0 | 7.3 | 6.5 | 4.9 | 6.1 | 6.5 |
| Nonmanufacturing | 11.5 | 8.9 | 6.9 | 5.3 | 8.0 | 8.1 |
| Construction | 14.9 | 10.8 | 6.0 | 5.1 | 9.6 | 9.7 |
| (b) 1st-year changes in: | | | | | | |
| All industries | 11.9 | 11.6 | 7.3 | 5.8 | 9.8 | 10.5 |
| Manufacturing | 8.1 | 10.9 | 6.6 | 5.9 | 8.7 | 9.3 |
| Nonmanufacturing | 15.2 | 12.2 | 7.8 | 5.7 | 10.5 | 11.1 |
| Construction | 17.6 | 12.6 | 6.9 | 5.0 | 11.0 | 11.2 |

[1] Possible changes in wages resulting from cost-of-living escalator adjustments (except those guaranteed in the contracts) are omitted from all the tables.
[2] Average adjustment during 4 quarters ending in December. 1st quarter, 1975 represents average adjustment in 4 quarters ending March 1975.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

There are a number of industries where historical wage relationships are out of line because of past inflation and resultant catch-up. There are also other areas where wages may already have been adjusted, but where attempts will be made to secure further increases. This may not distort relationships with other groups—who will then seek to restore their relative position in the contour.

Attempts to readjust wages in this fashion cannot only have a destabilizing effect on other wages but, through unit labor costs, on prices as well. As the economy recovers over the next 18 months, productivity should rise, exerting downward pressure on unit labor costs and, other things being equal, diminishing pressure on prices. However, this prospective diminishing of wage-cost

TABLE 5B.—PERCENTAGE CHANGES IN WAGES AND BENEFIT MAJOR COLLECTIVE BARGAINING AGREEMENTS (CONTRACTS COVERING 1,000 WORKERS OR MORE)[1]

| | Average adjustments[2] | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | I Mar. | II June | III Sept. | IV. Dec. | I Mar. | II June | III Sept. | IV Dec. | I Mar. |
| **1. Wages and Benefits Combined (5,000 workers or more)** | | | | | | | | | |
| (a) Annual rate of change over life of contract in all industries | 6.4 | 6.4 | 6.3 | 6.1 | 6.2 | 6.6 | 7.1 | 7.8 | 7.9 |
| (b) First year changes in all industries | 7.6 | 7.6 | 7.5 | 7.1 | 7.1 | 7.6 | 9.2 | 10.7 | 11.4 |
| **2. Wage Rates Alone (1,000 workers or more)** | | | | | | | | | |
| (a) Annual rate of change over life of contract in: | | | | | | | | | |
| All industries | 5.6 | 5.5 | 5.4 | 5.1 | 5.4 | 6.1 | 6.7 | 7.3 | 7.6 |
| Manufacturing | 5.7 | 5.6 | 5.5 | 4.9 | 4.8 | 5.1 | 5.4 | 6.1 | 6.5 |
| Nonmanufacturing | 5.5 | 5.5 | 5.4 | 5.3 | 5.9 | 7.1 | 7.7 | 8.0 | 8.1 |
| Construction | 5.2 | 5.1 | 4.9 | 5.1 | 5.3 | 7.1 | 9.0 | 9.6 | 9.7 |
| (b) 1st-year changes in: | | | | | | | | | |
| All industries | 6.5 | 6.3 | 6.0 | 5.8 | 6.1 | 7.2 | 8.8 | 9.8 | 10.5 |
| Manufacturing | 6.5 | 6.4 | 6.3 | 5.9 | 5.9 | 6.7 | 7.4 | 8.7 | 9.3 |
| Nonmanufacturing | 6.4 | 6.2 | 5.8 | 5.7 | 6.2 | 7.9 | 9.9 | 10.5 | 11.1 |
| Construction | 5.6 | 5.3 | 4.9 | 5.0 | 5.2 | 7.2 | 10.1 | 11.0 | 11.2 |

[1] Possible changes in wages resulting from cost-of-living escalator adjustments (except those guaranteed in the contracts) are omitted from all the tables.
[2] Average adjustment during 4 quarters ending in months shown.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

pressures could be hampered by some "leap-frogging" wage adjustments in the period ahead.

Presaging, perhaps, less necessity for price-related catch-up, there has been an increase in the number of contracts, with automatic cost-of-living adjustments. Illustrating the types of trade-offs that take place in the process of collective bargaining, we note that during 1974, settlements with COLA's averaged 6.1 percent over the life of the contract and those without, 9.1 percent. Also, the COLA provisions that have been appearing in collective bargaining contracts are more liberal than they historically have been. For example, caps or ceilings on potential COLA increases seem to be less common as negotiations take into account the unexpectedly high rates of recent past inflation.

Contract duration is important as an indicator of potential stability in wage contours during a given wage round. To the extent that normal patterns of the contour's compensation setting relationships are disrupted, the possibility for the occurrence of destabilizing adjustments will increase. Most of the larger, key settlements such as steel and autos have maintained their traditional patterns of 3-year contracts, but some others have, in the period of high inflation, concluded shorter agreements. In the aggregate, however, contract duration has been rising since the end of controls and contracts settled in the first quarter of this year have an average duration of 31.1 months compared to 26 months in 1972 and 28 months in 1973.

TABLE 6.—AVERAGE DURATION OF CONTRACTS

| | 1972 | 1973 | 1974 | 1975 (1st quarter) |
|---|---|---|---|---|
| Number of months | 26 | 28 | 30.1 | 31.3 |

Source: Department of Labor, Bureau of Labor Statistics.

To a large degree, longer contract duration may be associated with widespread use of COLA's. For, during periods of inflation, inclusion of COLA's in long-term contracts avoids the "lock in" effects of long-term contracts that do not contain automatic adjustment clauses.

As the parties sit down in the next year and a half (see Table 7) to discuss potential agreement on contractual issues, they will no doubt be looking at activity in those areas in the contour that have been traditionally related to them. In addition to wages, they will be interested in the kind and amount of benefits that some other workers have been receiving and perhaps in other parts of agreements that have recently gone into effect. It is likely that worker interest in job security has been heightened during this recession, which has produced such large increases in unemployment. This may become a particularly important issue in the public sector in local and State government as the fiscal crises in these governments continue. At the same time, interest in catching up with and adjusting to the effects of inflation may be expected to be a significant problem in many negotiations.

In the aggregate, strike activity thus far this year is below the levels experienced last year immediately following the termination of the controls program. As Table 8 shows, however, the number of strikes, the duration and the number of workers involved all have been growing as usual during the spring and summer negotiating season. This is particularly true in construction, which has accounted for some 90 percent of all major strike activity in May of this year compared to some 60 percent in May 1974. This increase is even more significant considering the fact that construction is one of the few industries for which it appears that 1975 will be an important negotiating period.

TABLE 7.—EXPIRATION OF MAJOR COLLECTIVE BARGAINING SETTLEMENTS, JULY 24, 1975 TO DEC. 31, 1976

| Industry and union | Number of workers in industry | Last settlement date | Expiration date |
|---|---|---|---|
| Airlines—Transport Workers Union, mechanics and stewardesses | 40,500 | May 26, 1974 | Aug. 31, 1975 |
| Airlines—International Association of Machinists, mechanics and ground service personnel | 51,000 | May 3, 1974 | Oct. 31, 1975 |
| National Trucking—International Brotherhood of Teamsters | 450,000 | June 28, 1973 | Mar. 31, 1976 |
| Rubber Industry—United Rubber Workers | 47,500 | Apr. 25, 1973 | Apr. 20, 1976 |
| Electrical Products—International Union of Electrical Radio and Machine Workers, United Electrical Radio and Machine Workers of America | 450,000 | June 1973 | June 27, 1976 |
| Meatpacking—Meatcutters | 43,000 | Aug. 25, 1973 | Aug 31, 1976 |
| Automobile—United Auto Workers | 682,000 | Nov. 19, 1973 | Sept. 14, 1976 |
| Farm Implements—United Auto Workers | 81,000 | Sept. 11, 1973 | Sept. 30, 1976 |

Source: U.S. Department of Labor.

TABLE 8.—STRIKE DATA FOR SELECTED PERIODS

| Period | Number of stoppages | | Workers involved in stoppages | | Days idle—in effect during period | |
|---|---|---|---|---|---|---|
| | Beginning in period | In effect during period | Beginning in period | In effect during period | Number (millions) | Percent of estimated working time |
| 1973: | | | | | | |
| January | 380 | 540 | 150 | 220 | 1.7 | 0.10 |
| February | 350 | 560 | 150 | 230 | 1.3 | .09 |
| March | 360 | 700 | 140 | 190 | 1.3 | .08 |
| April | 470 | 730 | 160 | 210 | 1.8 | .11 |
| May | 540 | 840 | 180 | 260 | 2.7 | .16 |
| Total | 2,100 | 3,370 | 780 | 1,110 | 8.8 | [1] .11 |
| 1974: | | | | | | |
| January | 379 | 573 | 112 | 174 | 1.4 | .07 |
| February | 377 | 589 | 128 | 181 | 1.4 | .09 |
| March | 484 | 763 | 155 | 232 | 2.1 | .12 |
| April | 607 | 918 | 191 | 282 | 3.0 | .16 |
| May | 795 | 1,191 | 410 | 536 | 6.1 | .34 |
| Total | 2,642 | 4,034 | 996 | 1,405 | 14.0 | [1] .16 |
| 1975: [2] | | | | | | |
| January | 350 | 520 | 104 | 517 | 1.6 | .09 |
| February | 300 | 530 | 101 | 183 | 1.7 | .12 |
| March | 370 | 570 | 90 | 171 | 1.8 | .11 |
| April | 517 | 741 | 130 | 221 | 2.5 | .15 |
| May | 619 | 919 | 242 | 412 | 4.9 | .30 |
| Total | 2,156 | 3,280 | 667 | 1,144 | 12.5 | [1] .16 |

[1] Average.
[2] Preliminary.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

### THE ROLE OF GOVERNMENT

I have previously testified on my views on the proper role of the government in promoting wage and price stability, so I will not detail those views here. However, I would like to draw some implications for government's role in wage setting.

The Federal Government should seek, in its continuing role in economic policy, to foster a healthy economic environment through the fiscal and monetary tools at its disposal. Further, as I testified before some of you on May 13, an active use of our manpower programs is appropriate, even in times of high unemployment, to prepare people for jobs in existing and in new technologies. The Comprehensive Employment and Training Act, I believe, is a means to improve our capacities in this respect in local labor markets.

With specific reference to improving the outcome of collective bargaining, I believe there are a number of ways in which the government can be helpful. Permit me to take this occasion to emphasize a general theme that the President has been stressing as of late: It is not necessary, nor is it helpful, in all instances for the government's role in promoting certain ends to be restricted to imposition of uniform compliance standards and regulations. By their very nature, uniform standards fail to account for differences in individual situations and are often unfair and inequitable, and promote conflict. The government can, nevertheless, properly take an interest in an institutional, but flexible fashion to help identify problems, to provide information, and to serve as a catalyst to private parties in a way that will allow them to reach accommodations that are in their own interest and in the national interest.

My experience with the Construction Industry Stabilization Committee and the results achieved there—without a single regulation—confirms that such accommodation and results are possible. The efforts of the Federal Mediation and Conciliation Service and the Council on Wage and Price Stability can provide examples of other successes as well.

Efforts can and should be made by the Department of Labor and other interested agencies, to provide timely information, both in the form of data and analysis that might expose potential conflicts or destabilizing trends in compensation. Also, efforts should be made to bring potentially conflicting parties together, informally or through formal committees, to discuss issues and seek common ground before it is necessary to come to the bargaining table in a spirit of conflict. These efforts will be most productive if not aimed simply at specific conflicts, but rather at improving the structure of collective bargaining in industries where this structure threatens stability in wages and other labor costs.

This process is difficult and time consuming but the way to industrial peace, productivity growth and responsible settlements, in my view, lies in working to improve and smooth the processes that determine compensation and working conditions. As Secretary of Labor, I will be working to help the various parties improve the structure of collective bargaining and wage determination and encourage such measures on the part of all interested and affected parties.

I will try to respond to any questions you may have.

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## WAGE AND PRICE CONTROLS AS SEEN BY A CONTROLLER *

(By John T. Dunlop)

The February 1919 issue of *The Quarterly Journal of Economics* carried "Price Fixing as Seen by a Price Fixer" by F. W. Taussig who as Chairman of the Tariff Commission had served as one of eight members of the Price-Fixing Committee of the War Industries Board.[1] The Committee was created on March 14, 1918 and had authority to report directly to the President. The article also discussed price-fixing activities by the two other price-fixing agencies of the war period: the Food Administration and the Fuel Administration. Regulation came to an end almost immediately after the conclusion of the armistice in November 1918.[2]

* This paper will appear in the published proceedings of the Industrial Relations Research Asociation in September 1975.

[1] F. W. Taussig, "Price-Fixing as Seen by a Price Fixer," *Quarterly Journal of Economics*, February 1919, pp. 205–41.

[2] For a discussion of World War I controls, see, Charles O. Hardy, *Wartime Control of Prices*, Washington, D.C., The Brookings Institution, 1940, particularly pp. 111–212.

Some of Taussig's comments on the experience may be of current interest: "The Price-Fixing Committee . . . started with the design of protecting the government, and extended its function, but gradually and slowly, toward the protection of the public also.", (pp. 207–8). "The prices fixed (by the Price-Fixing Committee) were in all cases reached by agreement with the representatives of the several industries. . . . The representatives of some industries, tho they accepted them, did so virtually under duress.", p. 209. ". . . government price-fixing during the war was not uniform in its objects, and was little guided by principle or deliberate policies.", (p. 238).

Taussig's concluding appraisal stated: "So far as the experiment went, and so long as it lasted, the outcome seems to me to have been good. . . . Supply and demand, monetary principles and monetary laws, are customarily formulated in exact terms, with an appearance of mathematical sharpness. The qualifications which must attach to these "laws" in any concrete application or predication, familiar to the well-trained economist, leave abundant room for some exercise of restraining and deliberate action. No doubt there are limits to which such action must be confined; but they are not narrow limits, and within them much was done which proved of advantage to the country.", (pp. 240–41).

These remarks summarize part of a larger review of wage and price controls which I have been interested in for some time. The objective has been to consider the fundamentals of wage and price controls programs in this country incorporating first hand experience of three eras: World War II, the Korean War era, and the period from the imposition of construction industry controls on March 29, 1971 to the expiration of controls authority, except for petroleum, on April 30, 1974.[3] The preoccupation has been with the principles of any future controls program. The purpose is to state succinctly—and perhaps dogmatically—what an economist should know about controls in a role as administrator or appraiser where one is required to deal with the totality of behavior rather than with the considerable abstractions of economic analysis. Another purpose is to indicate in a few instances some of the implications of controls experience for economic analysis and further research.

In view of the interests of the Industrial Relations Research Association these observations will be confined to wage and compensation policy, leaving the price side to another occasion.

The fundamental principles of a viable wage and salary stabilization proprogram are as follows in this country.[4] (Some principles are not necessarily transferrable among national industrial relations systems.)

1. It is essential that the recognized national labor and management leaders participate in the formulation and the administration of the wage and salary program. The quality of participation may range along the considerable spectrum from felicitous agreement to reluctant assent. But non-cooperation and hostility from labor or management leaders can quickly put the stabilization authorities under siege with massive law suits, concerted legislative attack and endless amendments to the statutory authority and limitations on appropriations, and most serious of all, labor disputes and work stoppages that are directed against the government and its stabilization program. There can be

[3] See, John T. Dunlop, "Decontrol of Wage and Prices," in *Labor in Postwar America*, Colston E. Warne, Ed., New York, Remsen Press, 1949, pp. 3–24; "An Appraisal of Wage Stabilization Policies," in *Problems and Policies of Dispute Settlement and Wage Stabilization During World War II*, Bulletin 1009, Bureau of Labor Statistics, Department of Labor, Washington, D.C., 1950, pp. 155–86.

[4] For some of the primary literature see, National War Labor Board, *The Termination Report*, 3 volumes, United States Department of Labor, 1947; *The National Wage Stabilization Board, January 1, 1946–February 24, 1947*, U.S. Department of Labor, 1948; John T. Dunlop and Arthur D. Hill, *The Wage Adjustment Board, Wartime Stabilization in the Building and Construction Industry*, *Cambridge, Harvard University Press*, 1950; *Wage Stabilization Program, 1950–1953*, 3 volumes, Wage Stabilization Board, Economic Stabilization Agency, June 30, 1953, Washington, D.C.: George W. Taylor, *Government Regulation of Industrial Relations*, New York, Prentice-Hall, Inc., 1948, pp. 90–244; Arnold R. Weber, *In Pursuit of Price Stability, The Wage-Price Freeze of 1971*, Washington, D.C., The Brookings Institution, 1973; Executive Office of the President, Cost of Living Council, *Economic Stabilization Program, Quarterly Reports* for the period August 15, 1971–June 30, 1974; John T. Dunlop, "Fundamentals of Wage Stabilization," *Daily Labor Reports*, Bureau of National Affairs, Inc., Washington, D.C., February 4, 1974, Section F; John T. Dunlop, *Inflation and Income Policies: The Political Economy of Recent U.S. Experience*, The Monash Lecture, Monash University, Australia, September 9, 1974; Daniel J. B. Mitchell, "Phase II Wage Controls," *Industrial and Labor Relations Review*, April 1974, pp. 351–75.

no survival of a wage stabilization program in that atmosphere in American society, only a massive wage and salary eruption.

A number of propositions are related to this basic inter-dependence of wage and salary stabilization and industrial relations.

(a) The stabilization authorities need to be closely allied with the on-going procedures for contract dispute settlement through mediation and arbitration. There can be nothing but confusion and conflict if stabilization authorities are continually pitted against mediators and arbitrators. The stabilization authorities need not themselves be fully involved in dispute settlement—as in World War II and Korea—but realistic attention to the necessities of dispute settlement in critical cases is essential to survival of stabilization. This is not a soft policy, rather does it seek to gain the assistance and respect of the mediation and arbitration fraternity. No amount of railing by stabilization economists against mediators or chest thumping over the primacy of stabilization responsibilities will settle a strike, nominally against an employer but actually against the government's stabilization program.[5]

(b) A major concern of a stabilization program is that it may divert bargaining artificially away from compensation to more onerous work rules and increased non-productive time on the job. The adverse consequences to productivity and real cost may be long run. Only the active participation of labor and management representatives and sympathetic relations to mediators and arbitrators familiar with the negotiations can begin to discover the practical effects on costs and earnings of contract language, manning requirements and rules changes. The flight pay rules in air transportation, the provisions relative to compensation on a paper machine, travel pay in construction, or manning in longshoring and maritime are illustrative. The artful diversion of collective bargaining under stabilization to enhance such rules cannot be prevented without the active assistance of the industrial relations community.

(c) The involvement of national labor and management leaders is essential to explain and defend to local parties, at least through internal lines of communication, the integrity and procedures of the stabilization agency. They should be free to criticize individual decisions or policies, but a program cannot long continue if labor and management representatives do not in fact support the program. They need to assure constituents of the accuracy of data and facts, and these can never be fully understood by staff alone. They are essential to advise and "try on for size" different possible decisions, to be sensitive for internal purposes to timing of actions, to assist in dispute resolution and to facilitate settlements more in keeping with stabilization objectives. The representatives of labor and management are indispensable—to even the most experienced neutral—to place a given case or problem in the sequence of upcoming situations likely to arise.

(d) The separation of policy making and administration in wage stabilization is a major mistake. In this field there is a significant interaction that takes place between case handling and the formation of general precepts. As will be developed in more detail below, the fundamental task of wage stabilization is the achievement of a wage and salary structure, a complex of differentials or relativities, which is generally acceptable and respected, and which does not contain within itself the distortions for continued self-generation of inflation. For such decisions in individual cases the full participation of labor and management representatives is indispensable. The resort to general rules or formulas simply will not work because it does not seek the essential ingredient of acceptability and relative equity to those directly involved and those likely to be subsequently affected. A viable stabilization program consists of a series of individual decisions and consolidations of general statements.

(e) The principle of participation is no less essential in dealing with nonuuoin wages and salaries or with executive compensation. Private decisions in these areas also have their own inner logic and relationships which must be understood. Elaborate data systems have emerged in most localities or industries and annual procedures for review and changes have become highly formalized in large entreprises. Stabilization authorities must be able to communicate with the relevant decisions makers in terms of these data and rules of thumb to avoid instabilities in relationships which generate further wage-to-wage inflation during the stabilization period or at its demise.

[5] Gardner Ackley, "An Incomes Policy for the 1970's," *Review of Economics and Statistics*, August 1972, p. 222.

(f) The careful involvement of labor and management representatives is nowhere more essential to a viable stabilization program than in relation to public employment. The relations of the federal government to state and local governments are sufficiently sensitive, and compensation rules are complex in part because they are incorporated often into statutes or ordinances that include the compensation of elected officials and government employees. Unionization campaigns further complicate any stabilization program in the sector. The industrial relations arrangements are in transition. The compensation of government employees is too significant to be ignored and too delicate not to require accommodation between national and local governmental responsibilities.

2. The substantive objective of a compensation stabilization program is to eliminate gradually distortions in wages and salaries, and fringe benefits as well, which have arisen from recent past inflation and which otherwise will generate by themselves a continuing process of increases seeking to restore traditional relationships or those appropriate to the longer term future among sectors, localities, occupations and private or public employers. Wage and salary stabilization in its content is, and has always been, an exercise in differentials, relativities and structure.[6]

In World War II the "Little Steel formula" was overtly designed to break the link between living costs and the wage level and to restore relative wage relationships among units that had prevailed in the pre-inflationary period of January 1941 by providing a standard of approval of a 15 percent increase over that base. Some wages had moved early while others had been held back by collective agreements or business conditions. Along with "inter-plant inequities," "wage brackets," "intra-plant inequities" and fringe policies, the "Little Steel formula" was directed toward an appropriate compensation structure. In the Korean period, General Wage Regulation 6 providing for a 10 percent increase by units over the pre-inflationary base of January 1950, and regulations on inter-plant and intra-plant inequities (G. W. R. 17 and 18) were the major standards similarly directed to the wage structure. Although the Pay Board in 1971–72 chose to emphasize a single self-administered "general wage and salary standard," its approvals in particular cases of far greater amounts constituted recognition of the decisive significance of relativities. The attention to relativities was at the center of the 1971–74 wage stabilization program in construction and for the economy generally from January 1973 until May 1, 1974.

The question may arise as to the relations of the general wage level and the structure of compensation. In this country, there are no institutional arrangements for a single decision maker or small group, consciously to set the money wage level. A number of key settlements spread and interact. The wage and fringe level at any moment is the result. A stabilization policy must focus on specific wages, salaries and benefits. The wage level is a non-operational concept. Moreover, to the extent not recognized by economists, general indices of average hourly earnings are a poor measure of compensation changes, particularly in times of inflation, because they do not incorporate changes in fringe benefits, neglect changes in work rules and are influenced by changes in the distribution of employment.

A number of observations are related to this substantive definition of the purpose of compensation stabilization in terms of relativities and structure.

(a) The very nature of inflation is that wage, salary and fringe benefit relationships among industrial relations contours (particular combinations of firms, labor organizations, localities and occupations) are distorted out of line with recent historical patterns or their emerging tendencies. Inflation can almost be defined in wage terms as the creation of widespread distortions in these relationships. The dispersion in wage relationships among the key wage settlements or leaders in the structure increase during inflation, and the struggle is on among bargainers and decision makers to restore more tolerable longer run relationships. The process may go on for a period after the general inflationary forces have subsided since labor agreements take time to expire and negotiate and annual reviews for non-union compensation come at different and discrete intervals.

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[6] See, John T. Dunlop, *Inflation and Incomes Policies: The Political Economy of Recent U.S. Experience*, op. cit.; John Hicks, *The Crisis in Keynesian Economics*, New York, Basic Books, Inc., Publishers, 1974, pp. 59–85.

(b) A single wage or salary standard, of the Kennedy-Johnson or Pay Board variety, is accordingly an inappropriate stabilization policy for a controls program, since it permits an equal increase (percentage wise) among units regardless whether they already have placed into effect out-of-line increases. The consequence of the single standard is to perpetuate distortions whereas the essence of a correct stabilization policy is to permit larger increases to those units that have lagged while holding down those that have sharply moved ahead, subject only to the concern over longer term adjustments to take account of emerging labor market and industrial relations considerations.

(c) Relative wage and salary relationships are particularly complex to re-establish when it is recognized that some wage adjustments are on an escalated relationship to the cost of living index, and there are wide differences in such formula and ceilings; and when many collective agreements use specified step increases rather than an escalation arrangement. Moreover, the durations of agreements, including reopening provisions, vary markedly among wage and salary schedules. In these circumstances the projection of future wage and salary relationships is complicated.

(d) One implication of the concern over differentials, relativities and structure for a stabilization program is to require a very considerable mass of wage rate, salary and fringe benefits data. Stabilization periods in the past have always enhanced materially the extent of compensation data.

(e) The attempt to reduce compensation adjustments of all types, including fringes and work rules, to a single number is not practical and may be very misleading. For instances, the costs of a uniform pension benefit will vary significantly with the age distribution and composition of the work force of a unit. Pension improvements in a relatively young unit may constitute very large cost increases when the same benefits are applied to an older work force. Accordingly, separate data on various fringes and benefits are required for an effective stabilization program, and separate standards may be required on various fringe benefits.

(f) The appraisal of changes made in conditions of work, work rules and manning requirements is a necessary part of a stabilization program whether changes are made more favorable to the workers (less favorable to the management) or more favorable to management (less favorable to the workers). The longer the stabilization program runs the greater the attention required to these elements of the employment-compensation bargain. The experience with "productivity bargaining" in the incomes policies of Great Britain illustrates the range of problems. A policy strict enough to foreclose fictitious changes in productivity may discourage many needed changes. Genuine productivity changes, on the other hand, are often most difficult to evaluate. The most serious stabilization problems created by work rule and productivity changes is that compensating higher wage or benefit increases may in fact spread to other related employees who do not make the same or corresponding productivity and cost-saving adjustments.

3. Stabilization programs in the United States contain provisions, as in other countries, providing for special treatment for low paid workers in the form of larger allowable increases or exemptions from controls. In other countries such provisions of incomes policies are designed to be redistributive. The views of Hugh Clegg on the British scene are illustrative: "Existing pay distribution is unfair. The chief cause of the pay explosion, and a major cause of many other industrial relations problems, is the growing realization of the injustice of our existing income distribution. An income policy which sustains existing relativities for long will be seen as unjust. The policy must therefore differentiate." Such redistributive views do not reflect the judgments of participants in the industrial relations system of this country.

The advocacy of greater increases or lesser restriction for those at the bottom of the wage structure is accompanied by the view that those above such a cut-off level ($3.50 an hour in the 1973 statute) should be free to maintain old differentials. Any compression of relativities is inappropriate. In these circumstances the stabilization authorities are not typically confronted with a major problem of realignment. Moreover adjustments allowed above the low-wage cut-off under stabilization rules are likely to be decisive for the lower end of the scale and set an upper limit to the amount or percentage of the increase. There has been little interest in this country among industrial relations participants for using wage stabilization programs for redistributive purposes.

In summary, the procedural fundamental of wage and salary stabilization in this country is the necessity for the sympathetic involvement of labor and management leaders, and the substantive fundamental is the objective of the gradual restoration of historical and emerging wage, salary and benefit relativities, correcting the distortions which are the essence of compensation inflation.

Senator PROXMIRE. Please proceed, Mr. Rees.

## STATEMENT OF HON. ALBERT REES, DIRECTOR, COUNCIL ON WAGE AND PRICE STABILITY

Mr. REES. Thank you, Mr. Chairman. Thank you especially for those extremely generous introductory remarks you made a moment ago.

Since I last appeared before this committee, in late February, the rate of inflation first declined in a very satisfactory fashion. But most recently, it is not that good. The seasonally adjusted annual rate of increase in the consumer price index for the 3 months ending in June was 7.1 percent. Through the corresponding 3 months ending in May, it was only 5 percent. So we have had something of a resurgence of inflation in June, which is very largely the result of two sets of prices; one, the price of meat, which has a very heavy weight in the consumer price index, and the other is the price of petroleum products. I am going to discuss those further in just a moment.

In February, I said that I expected the rate of inflation for the year as a whole to be between 7 and 8 percent, and the rate for the fourth quarter to be at an annual rate of 6 percent. Despite recent developments, I think that judgmental forecast is still reasonable, although the probability that we would do better than that, I think is smaller than I would have guessed in February. Some of the increase is energy prices, which in February I expected to take place earlier in the year, has been deferred by delays in agreement on an energy program, and therefore my original statement about the fourth quarter may prove to be quite a bit too low.

Let me discuss in a little detail three aspects of the price picture—food, energy, and industrial prices. Some of the uncertainties about food that have existed early in the year have now disappeared. We have had very large plantings, and we have had good growing weather early in the crop season. Except for winter wheat, however, the crop is not yet harvested. There is still some risk of drought late in the summer, or of early frost, so that we are not completely sure that we will have a good crop. But at least the early indications are favorable.

So far, we have had substantial declines in the price of grain and in soybeans, and world sugar prices declined very sharply from the peaks of last fall until a few weeks ago, when they began to rise again, but not anything like to their former level. I think the biggest uncertainty on the food-price crunch has to do with the situation of the grain crop in the Soviet Union. There is increasing evidence, increasing every day, that the Soviet Union is not having a good crop year; that they are moving into world markets to buy grain, not just from us, but from other grain-producing countries. We do not yet know how large those purchases will be.

The Soviet purchases could limit the further decline in our grain prices; if we have a very good crop. If our crop is not very good, and the Soviet purchases are very large, the grain prices could even rise somewhat. In many areas, the lower price of farm products have been passed on to consumers at the retail level. We are very pleased to see lower prices for bread, for some breakfast cereals, for soft drinks, for candy, and for a variety of other processed food products, including canned vegetables. I think all of that is very good news.

During the spring, livestock prices rose very sharply from the distress levels of last winter. This has been reflected in very large rises in the retail price of meat. In the months ahead, meat prices should level off, and are more likely to fall again somewhat. So, I would say that the general near-term prospect for food prices at retail is that they will be generally level or possibly falling slightly, despite the very substantial increased costs of processing and distribution.

Now, let me turn briefly to energy. In my February testimony, I mentioned the study done for the Council on Wage and Price Stability by Data Resources, Inc., estimating the effect of the President's energy program on the consumer price index at 1.6 to 1.9 percent during 1975. Now, some of those price increases that were included in that estimate already have taken place. They have taken place largely as a result of a $2 a barrel import duty placed on imported petroleum, and that in turn has been one of the causes of the recent increases in the price of gasoline at retail.

The President's proposal for the gradual decontrol of the price of old oil, which was recently defeated in the House, would have caused some further increase in prices to consumers. That increase is estimated by FEA at 1.4 points in the CPI. Sudden decontrol would produce that increase over a much shorter period of time. Gradual decontrol would spread it over several years.

The Council on Wage and Price Stability has not made any independent estimate of the price effects of the decontrol of old oil. There has recently been much concern about the intention of the OPEC countries to raise petroleum prices again next fall. At this point, we do not know how much OPEC intends to adjust the prices, and it is very difficult to speculate, therefore, about the effect of this on energy prices at the retail and consumer level.

My most important area of concern has to do with prices of industrial products. In late June and early July, the leading producers of aluminum announced a price increase of 2 cents a pound for primary aluminum, and two producers announced similar increases for most finished aluminum products. These increases amount to 5 percent on the price of virgin ingot. They amount to 2.3 to 2.7 percent on the prices of finished products. They have been delayed until early August at the request of the Council on Wage and Price Stability, and I am very gratified that the aluminum producers agreed to that request. We did not have any legal power to make them delay that price increase. They did so anyway.

We have just concluded hearings about those price increases, and we will be digesting the testimony of those hearings, and making some sort of report within the near future.

At about the same time as the price of aluminum was raised, tire producers announced general price increases. There are strong indications that automobile producers intend to raise their list prices by something close to 6 percent when they introduce the 1976 models. We have requested cost data from the tire producers and from the automobile producers. Some of the automobile producers already have been in to see us. Others will be coming in the next few days.

Now, it used to be that prices fell during recessions, especially during recessions as severe as this one. The prices of many industrial raw materials have declined, but the list prices of most finished industrial goods have not declined, and they are beginning to rise very early in the recovery.

What concerns me deeply is, if these price increases become widespread, this recovery will be less vigorous than it should be. The Congress has passed, and the President has signed into law, a substantial tax cut designed to stimulate the economy. This will help to produce a rise in GNP, measured in current dollars, but if that stimulus is dissipating price increases, the rise in real output and in employment could be disappointingly small.

Producers of industrial products are experiencing cost increases that are unusual for a recession; increases in energy costs; increases in labor costs; and increases in the cost of some imported raw materials, such as bauxite and imported iron ore. However, they entered the recession after a round of price increases that restored price/cost relationships to a very favorable position.

However, rising output will produce rising productivity, and will check the very severe rise in unit labor costs that was taking place last year and early this year. For these reasons, we hope that efforts to recoup cost increases will not be made prematurely, but can be delayed before a vigorous recovery is underway, and demand is closer to capacity levels.

The situation is a complex one, and requires much further study by the Council on Wage and Price Stability, by the Joint Economic Committee, and by private researchers. Just as the severity of inflation and recession should be taken into account by private decisionmakers, they should also be taken into account by those decisionmakers in government to make rules and regulations. And we are continuing to monitor the issuance of new rules and regulations very carefully, to make sure that they do not cost the buying public more than they need to achieve their desirable objectives.

Senator Proxmire, that concludes my opening remarks. I will be most happy to answer questions.

Senator PROXMIRE. Thank you, Mr. Rees.

[The prepared statement of Mr. Rees follows:]

PREPARED STATEMENT OF HON. ALBERT REES

Mr. Chairman and members of the committee, I am pleased to be with you again to discuss recent developments affecting prices and the rate of inflation and the prospects for the months ahead. Since I appeared before you in late February, the rate of inflation has first declined and then risen again. For the three months ended in June, the seasonally adjusted annual rate of increase in the Consumer Price Index was 7.1 percent. The corresponding figure for the three months ending in May was 5.0 percent. Much of the price rise in June was a result of higher prices of meat and petroleum products. I will discuss these price increases further in a moment.

In February, I said that I expected the rate of inflation for 1975 as a whole to be about 7 to 8 percent, and during the fourth quarter to be at an annual rate of 6 percent or less.

Despite recent developments, that judgmental forecast for the year still appears to be reasonable. However, some increases in energy prices that I had expected to take place earlier may be displaced into the fourth quarter. For this reason my original fourth quarter expectation may prove to be too low.

I should like to discuss in somewhat more detail three aspects of the price picture: food, energy, and industrial prices. Some of the uncertainties that surround the food picture earlier in the year are now diminished. We have had large plantings and generally good weather in the spring and early summer. Although there are still some risks of late summer drought or early frost, the general prospects are for excellent crops. This has already brought substantial reductions in the prices of grain and soybeans, and world sugar prices have also declined sharply from the peaks of last fall. However, in recent weeks the price of sugar has again risen somewhat, and the poor Soviet grain crop has caused the USSR to purchase grain from other countries, including the United States. This could limit further declines in grain prices here or even lead to some new price increases, depending both on the size of the Soviet purchases and the size of our crop.

In many areas, lower prices of farm products have been passed on to consumers. We now have lower retail prices for bread, cereals, soft drinks, candy and a variety of other processed foods. During the spring, livestock prices rose substantially from the distress levels of last winter, and this has been reflected in high retail prices of meat. In the months ahead meat prices should at least level off and are more likely to fall somewhat. Thus, the general near-term prospect is for generally level or slightly declining food prices, despite the continued rise in the costs of processing and distribution.

In my February testimony, I mentioned a study done for us by Data Resources, Inc., estimating the effects of the President's energy program on the Consumer Price Index at 1.6 to 1.9 percent during 1975. Some of these price increases have already taken place. The rise in the price of gasoline this month reflects in part the $2 a barrel import duty on petroleum. The President's proposal for the gradual decontrol of the price of old oil, recently defeated in the House, would have caused some further increase in prices to consumers. This increase is estimated by the Federal Energy Administration as 1.4 point increase in the CPI. Sudden decontrol would produce approximately this impact over a shorter period of time; gradual decontrol would spread it over several years. The Council on Wage and Price Stability has not made any independent estimates of these effects.

There has recently been much concern about the intention of the OPEC countries to raise petroleum prices again this fall. At this point, we do not know how much OPEC intends to adjust prices and, it is therefore very difficult to speculate on the probable effects of the OPEC price increases on the U.S. price level.

The most important area of concern over price behavior lies in the prices of industrial products. In late June and early July, the leading producers of aluminum announced price increases of 2 cents a pound for primary aluminum, and two producers announced similar increases for most finished aluminum products. These increases amount to 5 percent of the price of ingot and 2.3 to 2.7 percent for finished products. The increases have been delayed until early August at the request of the Council on Wage and Price Stability. At about the same time as the aluminum price increases, increases in the prices of tires were announced by several producers. There have also been strong indications by automobile producers that the prices of 1976 cars might rise by as much as 6 percent. The Council on Wage and Price Stability has requested cost data from all the producers who have announced price increases.

It used to be true that prices declined during recessions, especially during recessions as severe as this one. Prices of many industrial raw materials have declined. But list prices of most finished industrial goods have not declined, and they are beginning to rise very early in the recovery. What concerns me deeply is that if these price increases become widespread, the recovery will be less vigorous than it should be.

The Congress has passed and the President has signed a substantial tax cut designed to stimulate the economy. This will help to produce a rise in GNP measured in current dollars. But, if the stimulus is dissipated in price increases, the rise in real output and employment could be disappointingly small.

The producers of industrial products are experiencing cost increases that are unusual for a recession: increases in energy costs, in labor costs, and in the cost of certain imported raw materials such as iron ore and bauxite. However, they entered the recession after a round of price increases that generally restored price-cost relationships to a very favorable position. Moreover, rising output will produce rising productivity and will check the severe rise in unit labor costs that has been taking place in the past year.

For these reasons we hope that efforts to recoup cost increases will not be made prematurely, but can be delayed until a more vigorous recovery is under way and demand is closer to capacity levels. The situation is a complex one, which requires much further study by the Council on Wage and Price Stability, by the Joint Economic Committee, and by economists in universities and private research institutions.

Just as the severity of inflation and recession should be taken into account by private decision makers, they should also be considered by Government decision makers whose actions affect the prices of particular goods and services. The Council on Wage and Price Stability has been monitoring the proposed new rules of many Federal Government agencies to see whether they have an inflationary impact. In a number of cases we have suggested further study or possible modification of proposed rules. In doing so, we do not want to sacrifice any of the important and desirable objectives that these rules are designed to achieve. We do want to reach these objectives in ways that do not add unnecessarily to the cost of the goods we buy. Our actions in monitoring the inflationary impact of rules and regulations is far less dramatic than monitoring wages and prices, but in the long run it may be even more important.

Mr. Chairman, this completes my prepared statement. I would be happy to answer questions.

Senator PROXMIRE. I would like to start off with Secretary Dunlop. Secretary Dunlop, this is a kind of unusual statement of yours. It is a very thoughtful and scholarly paper, and we welcome it on that score. But we still suffer from very, very serious unemployment. It is at the worst level it has been at since the Great Depression. I do not see anything in your statement about this, and I would like to have your comment on this. In the first place, let me ask you how high you expect the unemployment rate to go, and whether you think that it is about to turn around, or might it get worse?

Secretary DUNLOP. First, Senator Proxmire, let me explain what I had originally perceived to be—maybe erroneously—the design of this discussion and testimony today; that Mr. Rees would talk about wages, and that is what I tried to talk about. Now, I am happy to talk about unemployment or anything else that you would like to.

As you know, on unemployment, as on all economic matters, I am not much of an admirer of economic predictions; and I suppose that in 1973 and 1974 particularly, predictions were particularly bad, because we were dealing with a world economic environment that was really very different than anything we had had in a hundred years, in so-called peacetime operations.

Now, on the other hand, I do believe that it is very much the concensus of economic forecasters that if nothing major and disastrous happens, that we have reached near, if not, the peak of unemployment; and that we will expect it gradually to come down.

I hold in my hand the weekly chart the Department puts out on unemployment rates, as reported by unemployment insurance systems; and any look at these numbers and the charts would suggest that we are near or have passed the peak. I think one final observation that I would say on the question you ask is that we know that economic activity as represented by output or profit or other measures will pick up more rapidly. When it does, then unemployment will drop.

We should, however, expect unemployment to continue to lag for two particular reasons. One is, we face a continued growth in the labor force, and for the unemployment to pick up, it would have to rise more than the labor force grows in order to reduce unemployment. The labor force grows, not only because of youth, but also because of women and others entering the labor force.

The second reason it will lag is because, at the initial stages of recovery, we all know that productivity, historically, tends to rise more than it does at the peak. And therefore, that rise in productivity will preclude a spontaneous and immediate response in employment. So we do expect a lag, as always, in the unemployment rate as activity picks up.

Senator PROXMIRE. And combined with that, the expectations we get from most private economists and the OECD, the Organization for Economic Cooperation and Development, they expect us to have about 5½ percent growth, a 5 percent growth in the rest of this year and 5½ percent in the first half of next year, private American economists generally seem to agree.

This is a very, very slow recovery, based on the experience we have had, which has averaged 11 percent in the first quarter of recovery, I understand, over the last five recoveries. This would suggest that the level of unemployment, because of the productivity increase and so forth, is likely to stay very high, perhaps above 8 percent, perhaps about 8 percent for a year and a half.

Now, this is something that I think, for many of us, is just unacceptable.

What do you think we can do about it? What strategy do you have to overcome that?

Secretary DUNLOP. Well, this is really an area of general economic policy, and I am happy to discuss that. Let me start by saying to you that I am not so confident as the people you referred to as to the pattern of recovery in this recession. The forecasts that are conventional assume a slower rate of recovery this time than, say, the median of the past five recoveries.

There is some basis, perhaps, for those forecasts in terms of the low state of the housing industry and the significant impact on economic activity of the sharp relative rise of energy costs and matters of that sort.

On the other hand, I myself am rather unpersuaded that that is necessarily true. And people in the Bureau of Labor Statistics and other places have done for me studies that suggest that if the recovery ahead should be the median of the last five recovery patterns, our unemployment rate would, in the end, be very much lower than the conventional forecasts, by the order of a whole point in 1976. So my first point is that I am not persuaded that the conventional wisdom on this matter is all that solid. To explain why I think it is not would take us a long time, but, nevertheless, I want to express that judgment.

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Now, the second aspect, regarding what to do about the situation is, I think, the right question. I myself feel that there is no doubt that our common purpose in Congress and the administration and the country should be how to create jobs and how to create good jobs. For I discern, Senator Proxmire, a view around the country that people are very much interested in good jobs, rather than simply more $2.10 an hour jobs and so forth; jobs which pay well, which have good benefits, which have safe working conditions, which have some promotion pattern within them, too.

If you ask yourself, Senator Proxmire, where in our economy does one find the conditions necessary for good jobs, and how do you create good jobs, I happen to think that there is evidence to show that they are associated with areas in which there are significant amounts of public and private capital. So, instead of treating the problem of capital formation and job creation as somehow in opposition to each other, one being inconsistent with the other, my own view is very much that they are very highly intercorrelated, in fact, and that our obligation is to try to develop these good jobs.

It seems to me the order of magnitude suggests they have to be mainly in the private sector. So we need a process of encouraging the creation of private jobs in our economy.

Now, just a note about the magnitude of this. We need jobs for about 3.2 million people to bring us back this June to the level of employment of June of 1974. We, in addition to that, need jobs for about 1.6 million people a year to bring us to something like moderately high levels of employment by 1980. So we have got to get jobs for 3.2 million people to get back, and another 1.6 million jobs a year to have our labor force reasonably employed as I see it. That is the magnitude of our task.

And what are the policies to do that? Those are the questions to which I think our discussion ought to be addressed. In the meantime, those who are unemployed, I think, deserve the best unemployment insurance system we have.

As you know Congress, with our recommendation, has extended those benefits. We are now in the process of making proposals to the Congress—I have already done so, before the House committee—to provide for permanent improvements in our unemployment insurance system.

Senator PROXMIRE. Well, of course, I cannot disagree with anything you said. We all want good jobs, and meanwhile we want adequate unemployment compensation.

But as I look at the economy and look at the various elements of the economy that can give us jobs, it seems to me that the outlook is not good. You spoke about housing, where we have a tremendous potential for jobs, but high interest rates, which are very high now, and seem unlikely, in my view to drop very much—they may go down a half percent, but the mortgage rate would still be above 8 percent—make it unlikely that we would get the kind of recovery there that we could use, with enormously high unemployment in construction, housing starts still hovering around a million.

As I say, there is a potential there, but it is hard to see it being translated into action without a monetary policy on the part of the Government, or a housing policy on the part of the Government, which I just do not see developing. I have listened to the Secretary of HUD. She has been before this committee and other committees. There does not seem to be a construction program there.

The automobile industry is certainly an industry that is vulnerable because of the energy situation and because of various other elements that have increased the cost of automobiles. It is hard to see that consumption generally, or retail sales, have a momentum that would sustain much of a recovery.

So, for all of these reasons, it seems to me it is hard to recognize where we are going to get the vigor that is going to do much about this unemployment situation. Meanwhile, to rely on unemployment compensation, I think, is right, but does it not raise the problem—and I mentioned it in my opening statement—of people being out of work.

We now have 1.3 million people who have been out of work more than 6 months, I understand, and who have a very serious problem, perhaps losing their skills and have a very difficult problem of adjusting in their family life and so forth, when they have that long-range unemployment.

What I am reaching for is whether or not you, as a distinguished labor economist, as Secretary of Labor, as the man in the administration who, perhaps, has a greater responsibility in the job area than almost anybody else, what you would suggest on this? You see, I know it is a very tough question, and perhaps it is unfair.

Secretary DUNLOP. No, it is not. I guess what I would say to you is this, Senator, first of all, the tax cut that our Labor Management Committee advocated, which I vastly prefer to that which the Congress enacted, was designed as a stimulus to the economy and one which would have not just a lump sum immediate impact, but a continuing effect. It does seem to me that such a fiscal tool should have been the major tool we used and we may have to use it again. I, myself, felt then, as now, that a combined business and personal tax cut was what was required. Our Labor Management Committee also thought so, and it seems to me that that tool may have to be used again.

Senator PROXMIRE. You say may have to be used again?

Secretary DUNLOP. Yes.

Senator PROXMIRE. We were discussing that yesterday with Mr. Greenspan. Do you feel at this time that it is rather clear that we should at least, at a minimum, renew the tax cut that we made for this year so that we do not have, in effect, a tax increase next year, which we would have if we simply let the tax cut lapse?

Secretary DUNLOP. As you know, that matter is very much under active consideration. Since I was not an admirer of the particular form of tax reductions that were enacted by the Congress in March, as I recall it, I am not here to say I propose that it be done again.

But the notion that some combination of household and business reductions should probably take place in the future is a point of view to which I am sympathetic. I think, since Congress is about to be away in August and so forth, we can all reassess that situation and be in a much firmer position to talk about Labor Day. So I do think that is one tool.

I do think that—just to get the arsenal out—that the 310,000 public service jobs are an important tool. Our Department administers those that are now in place. I have said before that I do not regard it as a general-purpose tool. We do have our program, which the Congress supported, for funds on the order of $500 million for youth in the summer, which provides various forms of assistance to about 1.9 million young people this summer. That is an element of the jobs picture, as I see it.

I myself feel, as you indicated, perhaps, that this should not necessarily be the end of the arsenal. That is why I was so pleased with the recommendations of my colleagues on the labor management group to do something in the utility area, where we need that program, in my judgment, partly for reasons of energy, partly for reasons of creating capacity. Because those plants take a long time to build, a program like this would mean that a year from now, 2 years from now, 3 years from now, when the economy will be high, we will not be frustrated and inflation stimulated by the absence of adequate capacity.

And finally, that program would very much be a job creation program in the private sector, of the sort we need. So that is another piece of the arsenal.

I am myself—aside from general tax reductions, aside from these public jobs and summer jobs—inclined to believe that one ought to give his attention to some of these particular sectors, like utilities, like housing, in terms of the process of further stimulation.

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

Senator Taft.

Senator TAFT. Thank you very much.

Mr. Secretary, you have just noted the utility construction problem. Have you noticed any tendency on the part of utilities to go to in-hand employment and construction, rather than to the building trades, and what is the effect of that?

Secretary DUNLOP. Senator Taft, I have not made a detailed study of that matter. That is not a new range of issues. It is very old, particularly with respect to relatively minor operations, such as certain switchyards, certain distribution lines, and the like.

With respect to a major powerplant—I mean, when we are talking about hundreds of millions of dollars of construction—I think, if I am not mistaken, of only one major development in that direction, and it may be that which you have in mind, in the southeastern part of the United States. But as a general proposition, there have always been, as there are in industrial plants, the questions of whether a change in the model year, whether a conveyor system, and whether minor construction types of things shall be done in-house or by contracting out.

I would expect, as an economist, that the relatively sharp rise of construction rates in the period 1969, 1970, and 1971 relative to industrial wages would have been a factor tending to stimulate the self-performance of some of that work. But large powerplant operations, I think not.

Senator TAFT. Do you think it would be feasible if it were tried?

Secretary DUNLOP. No, because—let me give you the reason—I think there are very few systems large enough to maintain in their permanent employment numbers on the order of magnitude of 5,000 or 10,000 people who are required to do a major construction site, and when that is done, that they would have to be laid off, and that would not be likely to succeed and be as economical as the contracting out of that operation.

Senator TAFT. Thank you.

Mr. Secretary, the share-of-the-work movement resulted in the 48-hour week becoming the 40-hour week in a time of economic weakness. As a result, millions of jobs and a wider distribution of income apparently were created. Other aspects would be earlier retirement age, apprentice programs for teenagers before they become a part of the labor force, longer vacation periods, and so forth.

What do you think about the possibility of a similar movement today, for instance with regard to a 4-day week or even a 3-day, long-hour week, as has been experimented with by some employers?

Secretary DUNLOP. Senator Taft, first to comment about the history you are reciting: I happen to think the Fair Labor Standards Act effective in 1938 had something to do with the reduction to 40 hours. Now, there has been generally in our society over the last decade a fair amount of experimentation with different hours of work, and one of my concerns as Secretary is to be sure that our Fair Labor Standards Act's provisions do not unduly inhibit——

Senator PROXMIRE. If the Secretary would yield for just a minute, that is a rollcall. I am going to go vote and leave Senator Taft here. Then I will come back and perhaps then we can proceed with very little interruption. So I will be back.

Secretary DUNLOP. At your pleasure, Senator Proxmire.

Senator PROXMIRE. Please go right ahead.

Secretary DUNLOP. And I was saying, I have been a little concerned that this innovative experimentation that is going on in various industries and plants not be unduly hampered by the strictures of that statute.

Now, we have to take into account two——

Senator TAFT. Well, of course, Ross-Healy and Davis-Bacon would have something to do with it, too, would they not?

Secretary DUNLOP. Well, I was thinking really of the overtime provisions. I guess that is possible too, yes. The answer to your question is in the affirmative.

There are really two groups of considerations in thinking about it. One is the desires of the people as to when they want to be available for work and their choice of the division between leisure and off worktime and worktime, and then there is the factor of the economics of operation.

Now, I would be glad to present to you the kind of results of some of these experiments. I know of places where shifting to these 4 10-hour days or something like that has worked out very well. I know of other cases in which people have tried it, and it has not worked out very well, and they have abandoned it, and I must say, my sense, Senator Taft, is that we also ought to distinguish between the general movement to reduce hours and the movement for flexibility at hours of work of the establishment and thirdly, the movement with respect to the flexibility in the hours of the work of the individual. These are not all the same thing.

Now, with respect to the first, my perception is that while there was a large preference in many workers and in collective bargaining to reduce the aggregate hours for some years, that has tended to level off. I do not mean to say there are not individual bargaining arrangements that do not go down to 35 hours or hours of that sort or less, but they are not as much pushed, in my perception, as they were at one time. There is some discernment on my part that this is partly because workers involved may be as interested in income as they are in added leisure.

With respect to the last two matters, I do think we have on the other hand seen a good deal of experimentation about the flexibility of hours of operation and flexibility in the hours of the work of individuals, and it is those experiments to which I have referred.

Senator TAFT. Mr. Secretary, moving on to another subject, I believe that during the Depression years—and I specify 1933 to 1943—anyone who was classified as on work-relief was still counted as unemployed. This would have included, as I understand it, persons working for WPA, CCC, and so forth. Have you seen the recent Library of Congress report which indicates that revised unemployment levels to take account of this fact imply that we are close to Depression levels of unemployment?

Secretary DUNLOP. Senator, I would have to be trusting a very old, old memory on that point, and I would like to check it. My impression is that the statement that you started with a moment ago on this question is correct, but I would like myself to check it.

Now, I suppose the issue today is, to what extent are public service jobs and other kinds of jobs we have analogous to those jobs in a recession period? In some ways, it also goes to the way in which we treat people who are on CETA funding of one kind or another, the Job Corps, and people of that sort, and I would beg your indulgence to give you a memorandum on this matter, so I do not clutter the record with a lot of inaccuracies, since I do not carry information on these matters in the forefront of my consciousness. I will get a statement for you, with your permission.

Senator TAFT. We would appreciate that and we will make available to you a copy of the Library of Congress report of January 28th, if you would like to have that to comment upon.

Secretary DUNLOP. Yes, sir, I would.

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

RECONCILIATION OF 1930'S UNEMPLOYMENT WITH CURRENT CONCEPTS

With levels of unemployment in the range of 8–9 percent in recent months, it is not surprising that attention has been focused on comparisons of our current unemployment experience with that of the 1930's depression. Indeed, it has been suggested that data for the 1930's, when adjusted to include persons working for the WPA, CCC, etc., as employed, indicate unemployment rates in the same 8–9 percent range as at present.

Direct comparison, however, between the two periods is not simple. First, with the data available, it is difficult to either assess or compare the hardship experienced during the two periods: The unemployment rate provides only an approximation of hardship, and other quantitative data reflecting the impact and severity of unemployment during the depression period are not readily available. Second, the official methods of calculating and defining unemployment were quite different in the 1930's than those in use since 1941. The official unemployment figures for the individual years of the 1930's were calculated after the end of the decade by subtracting total employment, based on the Bureau of Labor Statistics survey of nonagricultural employment and the Department of Agriculture's estimates of agricultural employment, from an estimate of the total labor force which were made by interpolating between the 1930 and 1940 Census counts. This simple estimation method makes any comparison between the 1930's figure and today's more timely and substantive figures analytically inaccurate.

A number of efforts, both within government and in the academic community, have been made to reconcile the 1930's data with current definitions, including a recent study by the Congressional Research Service of the Library of Congress. The Bureau of Labor Statistics is in the process of analyzing the data and studies of that period to determine whether the published estimates of unemployment for these years should be revised to accord with current definitions and thus allow more direct comparisons. In the meantime, it would not seem to be very precise or analytical to compare the highest monthly observation in 1975 (9.2 percent) to an estimated annual statistic of 8.9 percent for 1937 based on interpolated data.

To illustrate the higher quality of more recent statistics, we should note why better statistical comparisons can be made among reported unemployment statistics in the years since 1940. Since then estimates of unemployment have been obtained from a monthly household survey. Both unemployment and employment are directly enumerated and aggregated to civilian labor force totals, with the unemployment rate calculated by dividing unemployment by the civilian labor force. Unlike the data collected during the 1930's, current data are compiled and made available monthly, with voluminous detail on demographic and economic characteristics, allowing more careful study of the socio-economic impact of a given total unemployment rate. The margin of error in the current data is much lower than that which may be presumed for the 1930's, and hence more confidence may be placed in the accuracy of the present monthly estimates.

It would, perhaps, be helpful to make some additional observations on the hardship imposed by high levels of unemployment in the two periods. In August 1975, 6.2 million persons, or about 75 percent of the unemployed, were drawing unemployment compensation. In contrast, unemployment insurance benefits were not generally available until 1938–39, and even in July 1940, when the number of insured unemployed peaked at 1.7 million, the insured unemployed comprised just 18 percent of the total number of persons unemployed.

The degree to which employment is composed of involuntary part-time work can be an important indicator of the quality of employment. For example, a comprehensive study conducted in the early days of the depression found that nearly two-thirds of manufacturing workers who still had jobs were working part-time. In August 1975, part-time workers comprised only 18 percent of those at work in non-agricultural industries, with involuntary part-time workers accounting for less than 5 percent of the at-work total. Of course, to accurately measure hardship, other factors must be considered such as real wage trends, discouragement and the comparative effect on families with second wage earners.

Without minimizing concern and dissatisfaction with the high levels of unemployment that we currently face, it is clear that our ability to reach specific conclusions as to the relative severity of unemployment during the depression and the current period is limited by the data. However, based on the evidence available, it would be my view that unemployment and its effects are currently far less pervasive than during the 1931–40 period, and that the hardship associated with a spell of unemployment in 1975 is much less than that endured by those unemployed during the 1930's depression.

Senator TAFT. Secretary Dunlop, in April of this year the report on the equal employment opportunity program for Federal nonconstruction contractors was issued with its recommendations for the Department of Labor. These include accelerated implementation of a system to measure progress for nonconstruction contractors and to assess shortcomings of programs advancing minorities and women in the work force, establishment of training courses for compliance officers, and a requirement that compliance agencies take time in enforcement action with respect to contractors not complying with the Executive order.

There are several other areas that I have not mentioned. What progress has been made in implementing these recommendations?

Secretary DUNLOP. You started, did you Senator, by referring to the GAO report? Is that what you were talking about. I did not get the first line.

Senator TAFT. Yes; I think that is correct. It was a GAO report.

Secretary DUNLOP. Well, Senator, I testified about a month ago before Congressman Hawkins' subcommittee of the House of Representatives in which I dealt at some length with the subject you are talking about. So as not to clutter the record I will send you personally a copy of my testimony to Congressman Hawkins.

I have these observations: That the GAO report, which I have read, is correct, that there are major managerial problems in the Government in the executive branch in dealing with these programs —maybe "managerial" is not broad enough a term. Perhaps I can explain it this way: The first of these deal with the coordination and the interrelationship between the Commission, the Labor Department, Justice Department, and other agencies, which coordination was mandated by the Congress in a 1972 act. That has not worked well, and that is the first thing which we need to put in order in this area, and Mr. Perry, who is the new Chairman of the Commission, and I have talked about that at some length, and I am hopeful we can do better on that matter.

The second element deals with the Labor Department's program where, as you know, under the Office of Federal Contract and Compliance we have 17 different agencies which the Department is supposed to coordinate. We have 130 employees in our Department and 1,800 employees in these 17 different agencies. Needless to say, there is many a slip in that operation, and it is that area particularly which the GAO report was directed to, and I have that very much under review, as I testified to Mr. Hawkins.

I personally, as the Secretary of Labor, met with those key staff fellows and ladies from the procurement agencies.

The third area, I think, where something needs to be done is in our regulations. They need to be more appropriately fashioned to the characteristics of particular enterprises, and you should know, Senator, that I announced a week ago or so that starting August 20 our Department would hold hearings on the sensitive subject of the application of these regulations to universities, which has been the subject of a good bit of difficulty.

A final area which we are working on, I think, by common consent, applies to the notion that there is vastly too much paper required in this area, and we seek to simplify that problem.

Senator TAFT. Thank you very much, Mr. Secretary. We are going to recess this meeting very briefly until Senator Proxmire returns, while I make this rollcall vote.

Secretary DUNLOP. Thank you, sir.

Senator TAFT. Here is Senator Proxmire now.

Senator PROXMIRE. Mr. Secretary, one of the problems that has concerned me very much was brought out extremely well in table 4A of your prepared statement, where you have the compensation per man-hour. Now, first I want to ask you, does that compensation per man-hour, does that include wages, fringe benefits, et cetera? What does it include?

Secretary DUNLOP. It seeks to include fringe benefits; yes, sir.

Senator PROXMIRE. All right. Now, the extraordinary thing to me about this table is it shows in the first line under the annual increases, it shows that 1965 through 1974, during that 10-year period, there were only 2 years, 1966 and 1968, in which compensation in constant dollars exceeded 3 percent. I understood that the long-term productivity increase in the economy had been assumed to be about 3 percent, and, as I recall, the formula in the Kennedy-Johnson years, on the wage-price guidelines was something like a 3-percent allowance. Maybe, I am wrong about that, but something like a 3-percent allowance for productivity increase. Is that about right?

Secretary DUNLOP. 3.2 percent.

Senator PROXMIRE. 3.2 percent. All right. Then that means it was below that in 8 of the 10 years, and then we come into the period of 1974 through the first quarter of 1975, and there you find in three of those five quarters, there was a negative compensation in constant dollars.

Secretary DUNLOP. Yes, sir.

Senator PROXMIRE. Minus 4.1, minus 2.3, minus 2.8, in three of the five quarters that were down. When you look at gross average hourly earnings which, of course, also makes allowance for overtime and so forth, and there you find that recently the picture is even more bleak. Here you have a ceiling in constant dollars in every quarter of the last five, and then in the preliminary figures on the second quarter of this year ending June 30, that it continued to be in constant dollars down, negative. Now, this indicates a couple of things to me.

In the first place, it seems to be out of synchronization with what is going on in other countries. The data I have is that in Canada consumer prices went up 10.1 percent, very similar to the United States last year, and wages went up 18.6 percent, and in Germany prices went up only 6.4 percent, while wages went up 11 percent. It seems to me this is the only major country in which workers do not seem to be powerful enough to sustain their real incomes.

I realize that works counter to what you have been trying to do, Mr. Rees, and it is welcome as far as the inflation picture is concerned, but in terms of sustaining or building for recovery, it is not such good news.

Secretary DUNLOP. Senator, I do not, I must say, think that is a very accurate description. Let me try to say what I have problems with. First of all, going back to the statement about the Kennedy-Johnson years that I lived through in an active role as well, the 3.2 guideline was in money terms, it was not in real terms. It, in its intellectual presuppositions, I suppose, hoped that prices would, in fact——

Senator PROXMIRE. You are right. I stand corrected. I am happy you corrected that. I did not recall that.

Secretary DUNLOP. And, therefore, you had a similar table for the years of 1961, 1962, et cetera, 1963, 1964 and 1965. You would find that the rate of increase in real compensation in constant dollar terms would not have averaged—I do not recall what it averaged—but 3.2 is not in real terms. That is the central point.

Senator PROXMIRE. But, there was an assumption of price stability.

Secretary DUNLOP. There was an assumption of it, but reality was otherwise, although I do agree that it was a period of moderate price increases. There has been a lot of discussion of that in the economic literature. How much of that was due to the low level of activity after the recession of 1958 lasted so long and things were held stable——

Senator PROXMIRE. Then as you look at it over a period of 10 years, it seems that there is very little evidence of a cost push inflation, or at least a wage push inflation. There were only 2 years the real income exceeding 3 percent, and it is being uniformly very moderate.

Secretary DUNLOP. My second problem with what you have said is that the numbers which you gave me rightly for productivity increases of around 3 percent, 2.9 percent, what you wish, is a figure which arises over several years, and it is a fact in this country that in the period since 1965 we have not averaged the long-term trend. Part of that is because of the recession years of 1970 and other periods of 1968 as well, and part of it may be—it is a whole separate world—a structural matter suggesting that we have not been able to get the kind of investment in our output and technology, as well as in a skilled work force, that at botton is the source of all of our growth and productivity.

You see, what I am saying is that you point out certain things about these numbers, and I am saying to you, the numbers are accurate. They speak for themselves, but the inference you draw is disturbing to me, first, I am saying, because the target was not in real terms, in money terms, and, second, the productivity rates of increase since 1965 have not been on the order that they have historically been.

Now, there is another range of comments I believe that has to do with the question of the elements of compensation. I am not quite so certain, not having studied the tables from that point of view, that whether hourly earnings unweighted or weighted for industry shifts and so forth, would show quite the same pattern that you are talking about. I do not know. For example, if you look at the collective bargaining side of things, you clearly see, I believe, that the rates of increase—for example, in table 5A, first year changes in wages—are appreciably above those for total compensation. I grant you they are concentrated in collective bargaining areas. I would like to, perhaps, give a little more study to what you are saying, but I am saying a third problem I have is you did rightly pick a very comprehensive measure, compensation per man-hour. To what extent that is true because of the composition of the compensation side of that, I do not know and need to look at it.

Senator PROXMIRE. It seems to me that this weekly earning figure suggests something as far as what our policy ought to be with respect to recovery, but it could be constructive. We want recovery which will not be inflationary.

Secretary DUNLOP. Correct.

Senator PROXMIRE. How do we do it? One way we do it is, it seems to me, is to do our best to stimulate the economy because at least in the early stages and, perhaps, for a year or so under present circumstances, you would have a situation in which you can have an increase in weekly earnings because people would be working longer hours because more people would be working.

Secretary DUNLOP. Yes.

Senator PROXMIRE. Which would tend to reduce the pressure on wage rates, especially when you have unemployment continuing, which we know it is going to, at 7 or 8 percent during this period. So, would not a more rapid recovery in this sense be antiinflationary and is that not a good argument for a more stimulative monetary policy and fiscal policy?

Secretary DUNLOP. Well, let me comment on that. I reacted to what you were saying, first of all, by saying that I am not of the view that weekly earnings increases because of expansion of hours of work, hours actually worked, has very much really to do with wage rate determinations. Just as I do not think unemployment has much to do with it, I sure do not think that moving hours of work around has very much to do with wage rate determination. That would be my view, anyway.

I do agree that you put your finger on another reason why employment, however, will lag in the initial stages of recovery. As you just said, hours of work will expand and, therefore, added output will not be reflecting employment of new people as much as it might. It is reflected in the expansion of the hours of work of existing people. That I agree with you is a problem in this area.

Senator PROXMIRE. Not only a problem in the area but also a strong argument for further stimulation of the economy, and the argument that that stimulation, at least for a year or so, is unlikely to be inflationary within limits.

Secretary DUNLOP. Yes, there is merit to that. I think the issue which I would be intellectually happy to see more carefully explored in the country is what forms those stimulus would take. What you said, I do not disagree with, but I do think different kinds of stimulus might have different kinds of reactions. Could I ask Mr. Rees to help me?

Senator PROXMIRE. Mr. Rees, would you like to comment on that. I have neglected you. I have some other questions for you.

Mr. REES. I agree with Secretary Dunlop's answers to your questions. Let me make the following comments. First of all, weekly hours have held up fairly well in this recession. The cut has been in employment, rather than in hours. The latest figure that is in the economic indicators is, that weekly hours of manufacturing were 39 in May, and at peak in 1973, they were 40.7, so there is only about a little under 2 hours on average of the decline in man-hours, that is in hours per week, and the rest of it is in employment.

Senator PROXMIRE. Let me just interrupt. This is a figure that I have been fascinated by over the last 6 months, and I notice that in 1974 we had the first year in the history of the United States of America in which Americans worked less than the average of 37 hours a week overall. I am not talking about manufacturing; I mean overall. Our workers worked the shortest hours in history, shorter hours than in the Depression. They had never worked such short hours. Now, there are several reasons for this, I am sure, that both of you gentlemen could point out. There is the long-term tendency to work shorter hours. There is a shift in the nature of our economy now with less in manufacturing and more in the other areas. Even still, the 35.9 hours in May is an extraordinarily low level of work, and the 39 hours of manufacturing, on any kind of an historical basis, is low. There is still plenty of room here for longer hours, is that not correct?

Mr. REES. Well, there will be—I do not deny there will be some increase in hours as we get at the recovery; I just do not think that that is a major factor, because the decline in hours has not been that deep. When you talk about all nonagricultural private industry you are getting in the retail trade, where you have got an average weekly hours of 32.5, and that is the long-term trend to which you refer. Retail trade is increasingly going to the use of part-time employees.

Senator PROXMIRE. Let me just ask a question that I think—well, I do not mean to poach on Senator Taft's territory. Did you ask a question, Senator Taft, on automobile pricing?

Senator TAFT. No, I did not.

Senator PROXMIRE. Let me ask you, Mr. Rees, what would a 6 percent increase on new cars mean in dollar terms for the average car, just about?

Mr. REERS. It is on the rough order of $300, $200 to $300.

Senator PROXMIRE. Will that not further inhibit recovery in the automobile industry? Will that not mean that, again, you are pricing the consumer out of the market to a considerable extent?

Mr. REES. I am sure the automobile companies are giving that very serious consideration. The one company with which I talked very recently felt that a larger increase is cost-justified, and the reason they want to hold it below 6 percent is they do not want to spoil their market. We have not yet had an opportunity to study the figures, and I would not want to express any conclusion on either the cost-justification of that increase, or on its effect on sales.

Senator PROXMIRE. Will you study that?

Mr. REES. Oh, yes, we have it under very active consideration at the moment. We have the senior staff analyst devoting full time to it, and she is free to call on other members of the staff as she needs to.

Senator PROXMIRE. Will you be able to come up with a conclusion in time to have an influence on this if you decide that it is adverse?

Mr. REES. That is our intention, Senator, to have a firm view on this before the 1976 model prices are announced.

Senator PROXMIRE. What is your deadline?

Mr. REES. Mid-September.

Senator PROXMIRE. You expect to have that before that time?

Mr. REES. Yes.

Senator PROXMIRE. Have you done work in this area before?

Mr. REES. In the area of automobile prices?

Senator PROXMIRE. Yes, sir.

Mr. REES. Nothing systematic. We looked into some price increases that were announced last fall by one company, but that was a very short-term effort. As you know, the administration was involved in rolling back automobile prices in September 1974. That was done by Ambassador Rush, before I arrived on the scene.

Senator PROXMIRE. I was very impressed by your statement, Mr. Rees, when you said, list prices of most finished industrial goods have not declined. They are beginning to rise very early in the recovery. What concerns me deeply is that if these price increases become widespread, the recovery will be less vigorous than it should be. I could not agree with you more, and you look at a situation like aluminum, which we have been studying, where they are operating far below capacity, where they had a colossal increase in prices last year, and once again, they are pushing up their prices. And it is very hard for this Senator to understand how there can be much of a justification for that.

It seems to contradict the kind of economic behavior we have been led to expect in a free enterprise system, where they are operating so far below capacity, and in view of the big increase they had last year, again, it is hard to understand.

But then you have chemicals, which are doing the same kind of thing. You are studying aluminum, I understand, having hearings on it. You may have an opinion on it, and to provoke some influence. What about chemicals? Are you going to be able to move into that area?

Mr. REES. Yes; we also are conducting a study on prices of industrial chemicals. We have one senior staff analyst working on that full time. Chemicals is a much more difficult industry to study than aluminum. The variety of products is enormous. The one, I think, that concerns us most deeply at the moment, is caustic soda. There have been tremendous increases in prices of caustic soda. It is not a petroleum-based product. It is produced jointly with chlorine, for which there is a very depressed market.

Senator PROXMIRE. Diamond Shamrock is a fine example. Here they are losing their market. They are facing a sharp drop in demand this year, because of slowdowns in pulp and paper, and so forth. But they have curtailed their production, to such an extent that they have actually been able to raise prices and put their customers on allocation. Now what kind of a system is that?

Mr. REES. Now, what they tell us—and we are just in the preliminary stages of that investigation—is that the chlorine cannot be stored, and they have to reduce production because they have no way to dispose of the chlorine. We will be looking into that, and we will develop some views as to whether that position is justified.

Senator PROXMIRE. My time is up. I yield to Senator Taft.

Senator TAFT. Thank you.

Mr. Rees, there are several models in current use to forecast energy price increases. You mention that the Council on Wage and Price Stability had made no independent estimate. If Government and private economists are using the same outside models without outside verification, do you think we are beginning to see a virtual inbreeding of the same numbers, upon which we are putting too much reliance?

Mr. REES. Senator there have been some rather sharp differences between estimates of the effect of energy policy on prices. There were differences between the figures that we produced and those that were produced by the Library of Congress. I do not think there is any collusion among the econometricians here. We have not tried to reconcile all of these divergent numbers. The main reason why we do not devote more attention to that is, of course, that the Federal

Energy Administration has a very large staff of economists who work on nothing but this, and we have the whole rest of the economy to deal with.

Senator TAFT. Mr. Rees, other economists, including some from the administration, have downplayed the role of the Soviet grain purchase, but you state in your prepared statement that it might even lead to some new price increases, depending on the size of the Soviet purchase. As of yesterday, the Wall Street Journal reported that Russia had purchased 381.6 million bushels of grain from the United States. They have also made purchases from Australia and Canada. Do you regard this as large enough to make the impact on prices that you are considering a possibility?

Mr. REES. I am not really terribly expert in this area. My opinion would be that the purchases that have been made so far would not, in themselves, have an appreciable effect on prices. I think my concern is more about the magnitude of future purchases, and we do not yet know what those are going to be.

Senator TAFT. Do you think the rumors about future purchases, as well as current purchases that have occurred and are occurring, affected the market psychologically, so that this has brought about an increase in grain prices or prices of grain-derivative products?

Mr. REES. There is no question that this is a market that is very sensitive to day-to-day changes in the news. And any news of that sort has an immediate effect on market prices. Now, it is possible that the market has overreacted. It is possible that they are assuming that the Russian purchases will be larger than they in fact will turn out to be, and in that case, prices would retreat again.

Senator TAFT. Do you feel that our information, or the information available to you, as to the production situation in the Soviet Union is adequate to base opinions upon?

Mr. REES. I really do not have a judgment on that. I would be happy to look into it, if you want me to.

Senator TAFT. I see. I suppose you are relying primarily upon information from the Department of Agriculture.

Mr. REES. Yes, we are. Naturally, we do not make independent forecasts of the Soviet grain crop.

Senator TAFT. Mr. Rees, yesterday we heard that the tax cut so far has produced relatively little impact on retail sales, but is expected to provide a stimulus in consumer purchasing in later 1975 and 1976. In your prepared statement, you seem more pessimistic about the possibility of price increases offsetting any greater consumer spending. How great is the likelihood of your expectation?

Mr. REES. Well, the point I was trying to make there, Senator, is simply this, that consumers have had a reduction in their withholding taxes that gives them more purchasing power in current dollars. To the extent that prices go up, that added purchasing power gets used in paying for the same number of physical units, and is not available to buy more physical units, and it is for that reason that a round of price increases very early in the recovery could have an adverse effect on the strength of the recovery.

Senator TAFT. Thank you very much.

Chairman HUMPHREY [presiding]. I apologize for having missed the better part of this hearing. I have a couple of questions that I would like to put to our witnesses, not so much on the basis of just your testimony, but on the basis of our continuing interest. There are those of us here in the Joint Economic Committee that believe that the administration, in pursuing its policies, is, as I put it yesterday, afflicted with timidity, uncertainty, and hesitancy.

I recognize the very serious question of inflation. And just as the members of the administration remind us that the fires of inflation could flare up again if certain things happen, if the money market is too tight and so forth, they seem to forget that the economy could be thrown into a tailspin again with certain actions on the part of government, such as those being considered today with the substantial rise in the price of fuel energy.

But what bothers me most is that there is an apparent willingness to let the recovery come along at a very slow rate, knowing full well that the unemployment figures will remain high—in other words, a kind of callous indifference to the rate of unemployment. Concentrating only on the steady movement toward recovery in terms of GNP, in terms of profits, in terms of the wholesale price index. I just cannot bring myself to believe that this is the kind of a pattern that this country ought to pursue.

Now, Secretary Dunlop, my staff reminded me that in your prepared statement you had said that increasing unemployment rates may dampen wage increases very little. And I suppose that is a fair evaluation.

Could you explain to me why people continue to believe that we must have such a cautious, gradual recovery in order to keep down inflation? Slow recovery will not slow down wage gains to an appreciable degree. It will not provide productivity gains. It surely will not slow down energy prices, and it will not slow down food prices.

I would like to say regarding food prices, that if we do not get some rains in the Midwest, some of these projections on the availability of food may be very much altered. All of the projections thus far are theoretical.

What I am getting at is that there are certain factors that are almost beyond our control in terms of what we do about a recovery program. The Shah of Iran is not really going to be looking at our wholesale price index. He is going to be looking at what he can get for oil, and the OPEC countries are going to take a good hard look at how much they can extract from the world market as a price for their oil.

Therefore, after giving some thought to these uncontrollable items such as the weather, such as OPEC, do we not need a faster recovery than is either anticipated or desired by the administration? Because a strong recovery is the only way that we are going to put people back to work; and if we do not put people back to work, we are going to increase the deficit due to lack of revenues and due to increased costs of unemployment compensation.

To put it on the line, what justification does the administration have for this half-step approach to the recovery program that is needed for this country?

How long can we tolerate 6-, 7-, and 8-percent unemployment and still have an economy working at 75 percent of capacity? I think that is a good one for both of you to chew on for a while.

Secretary DUNLOP. All right. I will try to make a few comments about that, Senator.

First of all, I think that it should be stated, at least as I perceive it, that there is no policy that is designed to create or keep unemployment high in order to prevent inflation. The sentence which you quoted from my prepared statement is designed, Senator, to deal with a rather large set of ideas in economics, theoretical economics, which will have one believe that wage changes are primarily and uniquely related to the level of unemployment or to the changes in the level of unemployment. I am saying there that I do not believe, intellectually, that wages and unemployment are simply related, as has so often been assumed.

Chairman HUMPHREY. I agree with your analysis on that.

Secretary DUNLOP. And also, therefore, that from a policy point of view anybody who aspires—and I know of no one who does, at this point—to keep unemployment high for the purpose of holding down wage increases is, I think, not only socially erroneous in this respect, but also I am suggesting the data would indicate that that would not be achieved, becauses wages are determined by other factors.

Chairman HUMPHREY. All right; we can agree on that.

Secretary DUNLOP. Right; we will put that aside.

Now, the second observation I make to you is that I think we are all interested in achieving as rapid a recovery as possible that is sustainable. The history of Western societies is full of cases—the British postwar experience, Senator, being the classic illustration of essentially stop-go policies, where you build into the recovery process the inevitability of its culmination in a recession.

What we need to do is to push ahead as fast as we can, seeking the long-term growth levels which will be sustainable. And that, I would hope, is really the objective of all of us.

Chairman HUMPHREY. I do not disagree basically with what you are saying, that we need a movement toward recovery that can be sustained. What bothers me is that there is a willingness to accept not only unemployment in terms of numbers of unemployed but an unwillingness to accept job making for the unemployed, as well.

Now, for example, I would prefer as many of the jobs as possible to be in the private sector. I think that is where people are the happiest. I think that is where productivity is the best. I think that is where we get the most out of both human and physical resources. But if you cannot have that, then it seems to me there ought to be some way to put people to work. And even though they may be classified statistically as unemployed, they have public service jobs, or they are in some form of job making, such as public works, that gives them something to do in our economy.

That, to me, is one of the ways of getting the country moving, where people are beginning to have income over and beyond what is just available in unemployment compensation, where they are contributing something to the society, except to line up in the office to get their unemployment compensation check.

On one hand, the administration says it does not want people unemployed. It says it wants to put people back to work. But when we propose programs to put people to work they are turned down by the administration. In this instance, public service jobs, accelerated public works, these kinds of things are just tools to fight the current recession. But it bothers me that the administration says, no, we cannot do that.

Now, I have yet to find anybody who thinks—except Mr. Burns—that a 5 to 7½ percent increase in the money supply is adequate for a recovery. And yet we pursue that.

Now, for a period of time last spring the money supply was increasing at a 15 percent rate. You talk about stop and go. The Fed has increased $M_1$ 15 percent and then it comes sliding on back again. Why does the Fed operate with such a sporadic policy?

Secretary DUNLOP. Well, Mr. Chairman, you have given me a long, wide area of items to comment on. I want to be helpful, particularly so from my high regard for you, too.

Now, before you came in this morning, I did say to Senator Proxmire who was chairman, that I felt that our problem in the country in jobs could be put this way: We need jobs for 3.2 million people to get us back to last June; we then need jobs for 1.6 million people a year between now and 1980 if we are to put our growing labor force to work.

Chairman HUMPHREY. And what rate of unemployment will that be?

Secretary DUNLOP. In the area of 4 to 5 percent.

Now, that, as I see it, Mr. Chairman, should be our objective. I do believe it represents the objective which I, certainly, have been putting to my colleagues on the Economic Policy Board. I do believe that they are interested in it, too.

Now the debate and the discussions, perhaps, in which people are engaged in the building next door, where these matters are debated, really go to the question of what is the best way to achieve that objective, and what are the mechanisms that are most likely to yield those objectives which I have specified in fairly specific number terms.

Now, I guess I would answer that by saying that we need some combination of both general, particularly fiscal, measures and measures designed for specific areas. On the general measures, I still think that the most effective instrument is the tax reduction area.

Moreover, I am very much opposed, Mr. Chairman, to the debate that has been created, the kind of an opinion which has been created, with some people allegedly seeking tax policy for people as households and some seeking it for capital formation. That is a false dichotomy. In a proper balance our Labor Management Committee in January, Mr. Chairman, urged very strongly that we have a tax cut for both households and for business. That, it seems to me, is absolutely essential. It seems to me that, in terms of stimulus in the economy, that is the key general measure.

Now, beyond that, I do think it is appropriate to zero in on particular areas of the economy where we have social objectives, or where we have particular problems that are acute, as I happen to think we do, Mr. Chairman, in the utilities area, as I happen to think we do in housing and in a few other such areas.

So my philosophy about it, very briefly to you, sir, is we need jobs for 3.2 million people to get us back to levels of last June, and we need jobs for 1.6 million people a year through 1980 to get to the 4 to 5 percent area. We need a mix of the kinds of general policies, which I mentioned. Those fiscal measures are necessary in part because our past incurred inflation is making the real bite of the tax greater. Those tax reductions ought not to be in the form of rebates; they should be in the form of effects on the tax rate, so it gets into the households of people, into their spending patterns on a current basis.

Now, Mr. Rees said he would like to comment on that, if I could stop at that point.

Chairman HUMPHREY. Would you hold for a minute so we can set some things aside as we go along. I have always found these visits with you very helpful.

First of all, on tax policy, again, I thoroughly agree with you that that is the most effective way to deal with inflation, and it ought not to be in the form of rebates. It ought to be related to what is actually happening in the economy; namely, a kind of an indexing for inflation.

Secretary DUNLOP. I do not want to do it automatically.

Chairman HUMPHREY. No; that is not necessary. But I think because we have inflation and unemployment simultaneously, an indexed tax for households and investment would help to relieve the burden.

Frankly, the complaint I have about the administration's policy is its lack of continuity. For example, I do not believe in a 1-year investment tax credit. If you are going to have an investment tax credit policy, you have got to know it takes more than 1 year to get at something, and it ought to be longer than that.

I think that the Congress itself is derelict in this. We ought to put on an investment tax credit for, I think, 3 to 5 years at a minimum. That is where it ought to start. I am for 10 percent and would go even higher in certain industries.

I agree with you on utilities. They are a serious problem in the country today, and they are going to need special types of consideration for the financing that will be necessary for their proper construction.

I do not know what you have in mind for housing. I hope it is not what is currently being done in housing, because it is plainly not working. I do not care how much rhetorical optimism anybody has got on housing, Secretary Dunlop; if you talk to the builders and the building trades you will find out what is going on in housing. What is going on is too little.

Secretary DUNLOP. You know, Mr. Chairman, I know that industry extremely well.

Chairman HUMPHREY. The most important thing you said is that you are apparently talking about a goal. I hope that this is the case in the Economic Council, a goal and a time frame to get our unemployment rate down to between 4 and 5 percent. I want to make it quite clear I am a 4 percenter.

But if we have got that goal—and the next question, Secretary Dunlop and you are a man who can do something about it—is the time frame for reaching our unemployment goal. I think operating within a specific time frame helps inject confidence into the economy.

Secretary Dunlop. Mr. Chairman, may I interject? I think I had an agreement with Senator Proxmire that I could go at 11:30 a.m. to another appointment. I was anxious to stay to renew our association and with your permission, could I be excused?

Chairman Humphrey. You can, indeed. I had a couple of dandies here.

Secretary Dunlop. We will save them for next time.

Chairman Humphrey. I think we touched them a bit. The most important thing in your visit here, Secretary Dunlop, is that I think we learned something, and I mean that very sincerely. So we will have you back.

Thank you.

Secretary Dunlop. Thank you, Mr. Chairman.

Chairman Humphrey. Now, Mr. Rees, I have a few questions I would like to ask you about prices.

Go right ahead, you had some comment on Secretary Dunlop's statement?

Mr. Rees. Thank you, Mr. Chairman.

I just wanted to say two things. First, I thought I caught in one of your questions to Secretary Dunlop an implication that this recovery was going to be very sluggish. It seems to me the events of the last couple of months really do not support that. The turnaround came, I think, sooner than most economists had predicted. I can remember back last winter when everybody was talking about the possibility of a long flat bottom of an L-shaped kind of a recession. Nobody is talking about that anymore. The early signs are that the recovery will be quite vigorous.

I attended a meeting a week or 10 days ago where all three chairmen of the Council of Economic Advisers under the Kennedy-Johnson administration were present, including the very distinquished Professor Walter Heller from the University of Minnesota. It was the general consensus of that meeting shared in by the Democratic economists present as well as the Republican ones, if I can identify them by which administrations they have served under, that in the next year we are likely to get the rate of recovery that is about equal to the rate of recovery in other postwar recessions. And it seems to me there was not much dispersion in that group of 11 academic economists on that kind of a forecast.

The other point I would like to make——

Chairman Humphrey. But have we gotten that now? The point is our rate of recovery has been much slower than after other recessions, is that not true?

Mr. Rees. We are only 1 or 2 months into the recovery. We only have statistics for 1 month of that recovery. It is just not possible to say yet. But I think the early signs suggest it will be at least as vigorous as the average previous postwar recoveries.

Chairman Humphrey. But might I just say, Mr. Rees, what is disturbing is that while there is indeed some rate of recovery—and I hope it will continue—some of the real pillars of a sustained recovery are really wobbling.

You know, as Senator Proxmire said yesterday to Mr. Greenspan, everybody looks at the inventory liquidations and says, aha, that means that recovery is on the way. But in reality, that is only a short-term phenomena, not an indication of a strong recovery.

Now, when you see that housing is not really picking up as it ought to pick up, and the auto industry has not improved significantly, and investment in capital goods is not anywhere near what it ought to be, don't these factors indicate a weakness in the structure of the recovery?

Now, what are your views on that?

Mr. REES. Mr. Chairman, I would be happy to give them. I wonder if I could be permitted to finish the point I started to make a moment ago?

Chairman HUMPHREY. Yes.

Mr. REES. Earlier in the morning when Senator Proxmire was presiding over the hearings he made the point, I think quite correctly, that we have been through a couple of years of declining real wages. That is unusual; it has not happened in the American economy in my memory. I think that has some implications for the strength of the increase in employment in this recovery. I think it suggests that employment will pick up perhaps more relative to output than it has in the past recoveries. This is the good side of something which, viewed from the standpoint of price stabilization, is perhaps not so good. And that is that during 1974 American industry put its price wage relationships in very good shape indeed.

Prices are quite high relative to wages, even despite some of the cost increases of the past year. That means that relative to the beginning of past recoveries, labor is a bargain, labor is cheap relative to alternative resources. And that gives me some reason to believe that not only will the recovery be good when measured in terms of output but also that it will be good when measured in terms of employment.

Chairman HUMPHREY. That is encouraging and I hope it is correct. The July 21 Business Week says that the recession is over, by general agreement if not yet by official decree, and economists are shifting their attention toward the shape of the economic recovery. The consensus among them is for a growth in real gross national product, that is GNP adjusted for inflation of something less than a 6 percent by mid-1976.

This would be moderate indeed for the first year of recovery after recession and far less than the snappy rebound that usually follows a serious economic decline. In the five cyclical upswings of the past quarter of a century, the first quarter of recovery witnessed an average increase in real GNP at an annual rate of about 11 percent. That is my point. I thought that the snap rebound; there has not been much snap. It was sort of like one of those tennis balls that have been left out over the fall season and you pick it up in the spring; it still bounced a little bit but it did not quite have the zip on the court that it ought to have.

The recovery seems to lack the strength it should have and I would like to add that important areas of our economy are not experiencing the revitalization that they should be.

I personally believe that if the business community in this country and the labor community really had some idea that the administration was pursuing a steady course along with the Fed and gave some assurance that we were going to have next year a continuation of withholding tax reductions next year, a continuation of the investment tax credit, and a continuation on the part of the Federal Reserve Board of a sensible rate of money growth, that the level of confidence would be considerably increased.

Business managers are cautious and rightly so particularly if they think the Government is playing games with them. Mr. Rees, Government has been playing games with every side of this economy. We have had surtaxes and surcharges and wage freezes. We have had a pledge of a tax increase, and then it is switched to a tax decrease. Good God, you would have to have the faith of a child to believe that the Government has a policy. And all I am trying to get at in all of these hearings is, what are our goals, what kind of policies are you going to have to pursue them, and finally, that there will be continuity and a long-term commitment on the part of the administration in pursuing these goals.

No man in his right mind is going to make an economic decison with no understanding of what tax or monetary policy is going to be.

Signs do not indicate that a strong recovery is underway. The stock market is down again. Unemployment in the Twin Cities was 5.5 in May, it is 6.5 now. If unemployment has gone up 1 percent in our part of the country—and I know that the mayors around here are telling us what is happening in their cities—I think that the signs of real recovery are not very strong.

Mr. Rees, you are the Chairman of the Wage and Price Control Council. Can you explain why prices are going up in so many industries? The aluminum industry has increased prices tremendously. Farm machinery has gone up 22 percent since May 1974. Health costs have gone up. Metal cans have gone up tremendously in price. Gardner Means presented an analysis that in 1974 concentrated industries raised the wholesale price index 27 percent while nonconcentrated industry raised it only 5 percent; that is at least surface evidence that there is something going on in administered prices.

I have got a whole list of price increases here and yet attention is only being focused on price increases for food and energy. What are the justifications for these other increases? What is the justification for the automobile industry increasing the price of automobles, for example?

Mr. Rees. Senator, I mentioned before you arrived, we are studying the price increases of the automobile industry. We requested detailed cost data from all four of the major domestic producers. They are supplying it. One of them has already supplied it and has been in to talk to us about their data to see whether we needed any further information. Another one is coming tomorrow. I expect within within the next week or so we will have had face-to-face discussions with the executives of all four of the major domestic automobile producers.

What they are telling us—and we have not yet had time to verify this—is that they are facing very sharply higher prices of materials and of labor.

Chairman Humphrey. The automobile industry says, we are charging more because aluminum has gone up, and steel has gone up, and all of the component parts have gone up. And I think the job for your agency is to see why those prices have gone up.

You know the thing that bothers me is as a Midwesterner, when we have overproduction in a raw material, we have lower prices. I know that is simple economics, but nevertheless raw materials do relate to the laws of supply and demand unless they are maneuvered, unless there is an oligopoly of some kind.

So the automobile industry, I am sure, can show you that everything they are trying to buy has gone up, and of course a lot of things they are trying to buy they buy from their subsidiaries, and they have gone up.

We have got all of these subsidiaries all the way down the line, like the oil companies—they show that prices have gone up. They own the fleets; they own the tankers; they own the pipelines; they own the refineries; they own the whole business, and by the time it gets out here to the pump, of course the price has gone up.

Mr. Rees, what do you feel has been accomplished as a result of the various price investigations? Do you think that the Council has made any significant contribution to holding down the inflation rate?

Mr. Rees. I thnk we have made a small one, but a significant one. I think that many of these industries of which you are speaking are going to think twice about both the timing and the size of their price increases, and they are going to postpone them until they feel that they are absolutely necessary.

The fact that we requested the aluminum industry to delay its price increases for 30 days and that they did delay them for 30 days while we held public hearings, I think, will not be lost on other similarly situated industries.

Chairman Humphrey. Your feeling is that because you do focus the spotlight, that you do ask for price information, that you do launch investigations, that these efforts do tend to retard or hold back price increases that are not justified?

Mr. Rees. Yes, sir, I do feel that.

Chairman Humphrey. Mr. Rees, I wish we had more time. Let me take a moment to thank you for your service to the country and your cooperation with this committee.

We have honest differences of opinion about these matters around here, and that is what public policy is all about. If we did not have these differences of views, it would not take any time at all to get us into real trouble.

Thank you.

Mr. Rees. Thank you, Mr. Chairman.

Chairman Humphrey. Good luck.

Now, I have to go for a vote on the floor.

[Whereupon, at 12:12 p.m., the committee was recessed, to reconvene at 10 a.m., Friday, July 25, 1975.]

# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

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**FRIDAY, JULY 25, 1975**

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

The committee met, pursuant to recess, at 10:07 a.m., in room 318, Russell Senate Office Building, Hon. Edward M. Kennedy (member of the committee) presiding.

Present: Senator Kennedy and Representative Long.

Also present: John R. Stark executive director; John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

## OPENING STATEMENT OF SENATOR KENNEDY

Senator KENNEDY. We will come to order.

The chairman, Senator Humphrey, has asked me to open the hearings this morning.

This morning we continue our midyear review of the economic situation and outlook with two of the Nation's most respected economists. Today we expect to focus primarily on the outlook of prices and unemployment. Our No. 1 priority today is still recovery from the recession. With 8 million Americans out of work and a record number of them moving into the ranks of the long-term unemployed, there is a conspicuous absence of any strategy to deal with the problems of the jobless in the administration's economic policies. We all agree on the necessity for substantial and extended unemployment compensation, but that cannot be the only component of our unemployment strategy. It ignores the problems of lost skills, the declining family status, the future productivity and the willingness of citizens to work. We cannot condemn a substantial portion of the labor force to high unemployment for the rest of this decade.

I am especially concerned that many of our young people graduating from high school or college will experience weak labor markets for many years. Some of them may not hold a full-time job before their mid- or late-20's. We are now approaching the 30th anniversary of the Employment Act of 1946. That act established a national goal of promoting maximum employment, production and purchasing power, but we have never been farther from achieving that goal.

We are especially pleased to have with us this morning two economists who have consistently supported policies designed to help reach that goal. Mr. Aaron Gordon, currently president of the American Economic Association, is one of the best known macro-labor market economists in the country. Mr. Gordon headed the prestigious Gordon Commission appointed by President Kennedy to review unemployment statistics in the early 1960's.

We are also pleased to have Mr. Paul Samuelson, Nobel laureate in economics, who has probably introduced more students to the world of economics through his many books than any other economist.

On behalf of the entire committee it is a pleasure to welcome you both here today. We look forward to hearing your testimony. It is especially a pleasure for me to have the opportunity to present to the committee a citizen of the State of Massachusetts and someone who has been a longtime friend.

Mr. Samuelson, would you please proceed.

## STATEMENT OF PAUL A. SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Samuelson. Thank you.

Let me begin by commenting on where we now are. I think the economic history books will record that the recession of 1973–75 had its trough probably just before midyear, perhaps in May. Its official beginning will be declared by the National Bureau of Economic Research, on some unknown future occasion, probably to have been November 1973. But if you date the beginning of the growth recession from the time when the economy ceased to grow at the rate which it needs to grow in order to offset population increase and the normal improvements in productivity, then this growth recession goes back to the spring of 1973. That makes it a full 2-year growth recession and certainly the worst of the whole post-World War II epoch in terms of duration.

By our quaint semantic use of words some people feel happy when the recession comes to an end, but what that really means is that the economy has hit bottom. It is at its very worst. It is the dark before the dawn.

So if past patterns continue to be a guide, we know that the job opportunity situation and the unemployment rate will continue to rise as it continued to rise after the trough had been reached in earlier recessions for some time. And so the betting odds are that into the summer employment will continue to increase and probably peak off somewhere above 9 percent only beginning to decline very slowly in the fall.

I think the prime question that this committee should ask itself now, and ask the witnesses, is what is a desirable goal for the first year of recovery? It is the first year of recovery when policy is very important. In a sense, policy is easiest; but it is an opportunity that can be muffed and missed. So it is critical, I think, to set the stage for prudent thinking.

Senator Kennedy. Is this not part of the problem? We really have not had the establishment of a goal by the administration. They have given us some rough estimates about what they expect, but they have not really set a goal. I agree with you that I would not think it would be essential that such a goal be established, so that we can consider the best means of trying to achieve it.

Mr. SAMUELSON. I have not been able to find an official goal, an official target of the administration, although I have been able to piece together various remarks which are not always internally self-consistent.

For example, Secretary Simon was widely quoted as having said that a 5 percent rate of real growth would be desirable. When he was reproached for that he said, oh, no, that is the long run. But that is much too high for the long run and it is much too low for the short run.

His most recent utterance that I have been able to monitor was 6 percent, and I think that the rhetoric of 6 percent is better than the rhetoric of 5 percent, but I do not think it is good enough.

I have tried, however, the exercise of working out from the actual policies espoused by the administration what must be the implicit goal that a jury of informed economists would say must be in the minds of these people, on the assumption that there is a connected line of reasoning involved in the exercise. And I do not think, as I shall develop in my testimony, that it is consistent with what I would consider to be a minimum real goal that we should be aiming at in this crucial first year of recovery; namely, at least a 7 percent real growth rate.

I consulted with my esteemed colleague, Professor Modigliani, in preparing this testimony, and he berated me for my moderation, pointing out, I may say, not in terms of rhetoric but in terms of the pattern of experience with how inflations accelerate, that at least an 8 percent goal should be this committee's goal and it should be the Government's goal. But let me state this case for 7 percent because I do not think that present policy posture, either by the administration or by the Federal Reserve, is by any means guaranteed to achieve what I would regard as this modest and desirable real goal.

Senator KENNEDY. As I understand the recovery rates in prior recessions going back to 1949, they have often been higher than today. In 1949, the rate, which was somewhat distorted by the Korean war, was 14 percent. In 1954–55 it was 8 percent; 1958–59, 9 percent; 1961–62, 7 percent; 1970–71, 5 percent.

So the average, as I understand it, is 9 percent. And if you leave out the Korean war, it comes to 7½ percent.

Mr. SAMUELSON. I believe that some sage has compiled those numbers and I must agree with their correctness. So that if economic forecasting was so simple a procedure that you just have to consider what happened in all of the previous first years of recovery, then we could look forward with confidence to something like a 7½-percent rate of real growth.

It is precisely that kind of thinking, however, which contributed to the famous error of 1971 forecasting, the famous 1065 forecast by the Nixon administration, which led to a great deal of criticism, proper criticism, I may say, by your committee of the witnesses of the administration who were not able to buttress the case because they did not take that second look at the special features present in this unique epoch in history.

And so I think if you take the second look, it will be very hard on a reasoned basis to see the extraordinary vitality in the automobile industry which, for example, characterized the automobile industry in the 1954–55 recovery.

Senator KENNEDY. Just before moving on, if you say that we now have the worst recession since the period of the thirties, and 7½ percent as an average recovery rate, are you still suggesting that 7½ percent should be our goal now?

Mr. SAMUELSON. I think that is a fair question. Since the patient is extraordinarily down, the good physician might be prudently expected to anticipate a better than average recovery.

I could well be berated for my modration because it means that the unemployment rate will not be down to a halfway desirable level for years. You are a pessimist if you think that the economy of the United States in its 200th year cannot stand 6 percent unemployment or something under that. But, if you follow the modest goal that I have stated, which I think is above that which policy is most likely to realize, you will not be down to 6 percent unemployment rates until towards the end of this decade.

Now my reason for the moderation, and you may wish to reject it, is that we have come out of an unprecedented peacetime rate of inflation, double-digit price inflation. That has improved but it is like a wolf outside the door. It has just gotten out of gunshot, but it is waiting there.

Since the Nation has a legitimate preoccupation with price stability and also with unemployment, I have tried to state this testimony on the side of modertion. But it may well be that your committee will wish to give greater weight than I have done in this testimony to the human costs of unemployment, of poor job opportunity, and particularly to the uneven incidence of those costs to unskilled workers, to minority workers, to young workers, and to female workers.

Senator KENNEDY. You said that with your plan of growth, we might be able to get down to 6 percent unemployment by the end of the decade. How do your figures work out for the next year if you take 7 percent expansion? I guess under Okun's law, that is a 1 percent cut in unemployment for every 3 percent above the normal 4 percent level, you would have a 1 percent cut in terms of unemployment at the end of 1976.

So your growth pattern would reduce the unemployment from 8½ percent down to, I suppose, 7½ percent in the period of a year.

Mr. SAMUELSON. In the first year of the recovery.

Senator KENNEDY. How do you see it moving down to the 6 percent level by the end of the decade? Just a gradual decrease from 6 percent in the next 4 years?

Mr. SAMUELSON. I think if we achieve the 7 percent rate, we can hope for another year to achieve at least that equal rate, even though it would be quite an incident in American history to have 2 back-to-back years of 7 percent.

I think that we have here an inherited situation similar to that of the problem facing the John F. Kennedy administration at the beginning of 1961 as a result of no less than three recessions thrust into the two Eisenhower terms.

The problem, as advisers to President Kennedy saw the situation, was for a very long recovery.

Now in fact, with a little luck, we did have a very long period of recovery, an unprecedentedly long period of recovery from 1961 until 1969. The last part of it was marred, of course, by the financing of the Vietnam war, or rather the lack of financing of the Vietnam war. But I think the same thing is required at this stage of the game. It would be tragic to begin this recovery with 9 percent unemployment, to have a disappointing first year at all comparable, say, to the 1970–71; and then in the second year of recovery to make the same mistake that was made in the election year of 1972 of stepping on the gas as you are beginning to eat into reserves of industrial capacity; and then by 1977 to be back to the races again in another recession.

I think if we are going to make a mistake on the side of overexpansion, the time to make that mistake is in the first year of the recovery. Then you have the most working for you against a reactivation of inflation from your own actions because of the reserves of manpower and because of the reserves of industrial capacity.

If you made a mistake in that same direction in the second or third year, particularly the third year of recovery, then you would be inviting an aborted expansion period to be followed by still another recession. And I believe that is a lesson which all of us, both in the administration and the Congress and outside of Washington, should have learned from the 1970–71 to 1972–73 period.

I may say that in the testimony I give and the advice which I provide, I try to be evenhanded and I come into court with clean hands, clean even hands, because it was in 1972 that Professor Modigliani and I were warning against the overstimulus, both fiscally and by the Federal Reserve which was taking place at that time.

Well, we can afford 7 percent as a goal. I think that if it turned out to be 8 percent, it would not be cause for regret in this first year of recovery, and that is the first important thing to say.

Senator KENNEDY. Just on this point—if you aim for 7 percent growth, you might hit 6, or you might go up to 8. Are the chances fairly good that you will not hit the target exactly, and that you may miss it by a percent on either side of the desired growth rate? And if you get 6 percent growth, won't you have economic stagnation and higher unemployment?

Would you not be better off to aim at 8 percent, and take the chance you might go down to 7, or up to 9 percent growth? Wouldn't that be a better target?

Mr SAMUELSON. Well, certainly the precision with which any policymaker can predict the results of his own policies is limited in an inexact science like economics. I would say if you leave things to the present drift of policy, the likely spread, and nobody can really narrow that spread cogently, in my view, is something like a 3½ percent of real growth, which would be very disappointing indeed, to possibly 8 or 9 percent.

And when I say you should aim for 7, that is only the present indication, and if 3 months from now it is more apparent that we are going to be in the lower part of the range of 3½ to 9 percent, then you should increase policy.

There is a lot, if I may say so, superficial near-nonsense that is heard in this town. You had a very good friend of mine appear as he was to be confirmed for the Council of Economic Advisers, and he was asked what is the role of policy in ending this recession? He said the recession would have ended anyway. I do not suppose he had much time to prepare that answer, but if he were a student of mine I would send him back to rethink it because what has actually happened is that the recovery is pretty much on the button with what the consensus forecasters, people like Professor Otto Eckstein of Data Research, Mr. Michael Evans of Chase Econometrics, Mr. Lawrence Klein of the Wharton School, thought it would be. But they have built into their model the lowering of interest rates which the Federal Reserve or someone had forced upon it ever since the summit meetings of last fall. It was not a natural recovery.

Now, we would be pessimists to believe that the economy would go down forever in the absence of wisdom by this committee. Thank God we do not have to depend on that for the recession ever ending. But for the recession to have ended the way it has ended, the fiscal stimulus of Congress was just there in the figures. The increase in consumer sentiment is related to the fact that fiscal stimulus was known to be on the way and has arrived, and you do not get things simply by natural forces beyond those which the natural forces will dictate.

And so it is with respect to the coming year, a one-shot operation of rebating 1974 taxes is going to be something for the history books very soon from now, but it does not mean that the economy can make its normal desired amount of forward progress in job opportunity in 1976 on the basis of that one single incident.

Senator KENNEDY. Of course, that is against the background of the Administration's record last year, in urging a tax increase while the economy was poised on the brink of a recession. Congress ignored the request and later the President changed his mind and supported the tax cut Congress was enacting to stop the recession.

Mr. SAMUELSON. Oh, yes, at the summit meetings in September, 23 out of 28 economists, which in my field constitutes a majority—in fact, unanimity—told the President that he did not have the single problem of fighting inflation. But of course the President was not listening for another 2 or 3 months.

It was not until the American public spoke in the November elections that this seemed to be brought home in a policy sense to Washington.

Now, I would also remind you——

Senator KENNEDY. What would have happened if we had had a tax increase?

Mr. SAMUELSON. If we had had a tax increase?

Senator KENNEDY. Yes.

Mr. SAMUELSON. Given the sorry state of consumers' confidence, if interest rates had stayed high, if inflation had remained the sole concern of policy, if we had followed the advice not only of the last President of the United States who told us all to save $1\frac{1}{2}$ percent extra of our income but his successor in his first months in office—if you put that scenario through the computer, then I fear there would still be a point to the questions that every economist was recently besieged with. Are we in for the greatest depression since the 1930's? Is my money safe in the banks?

I think that you might then have had a replay of 1930–31. Now, I do not say you would have a replay of 1932–33 because, thank God, we no longer let 10,000 banks go under, just wringing our hands with sad statements about how the cookie crumbles. We have insurance: The Government will perforce do something about it.

But the point is that it is never foreordained that a recession which starts with an oil boycott, and ensuing weakness in housing and in autos, will not snowball. Economists like Mr. Arthur Okun were telling committees like this back in the years 1973–74: It is true the paper industry is very strong; it is true the steel industry is very strong; it is true that nonferrous metals involve round-the-clock operations; it is true plant equipment investment is still strong. But these will not remain strong if the total flow of disposable income keeps declining, if housing and autos are weak, and if you let the multipliers act and cascade through the system. And so, their dire apprehensions came to pass.

I can tell you it was a sorry crowd at the Iron and Steel Institute a couple of months ago whom I addressed, and when I had to tell them that their good days were over, I really thought I might be lynched, but afterwards in the corridors I was told that I did not realize how bad the situation was.

There have been a lot of new theories developed, and it is always interesting to float them: There was a theory developed by a good friend of mine that inventory cycles are a thing of the past because now businesses have computers and now they know how to control their inventories. Well, the last quarter's inventory numbers were minus $33 billion annual rate of accumulation—nothing remotely like that in history books.

There was a theory by another expert whom I have quoted favorably that unemployment does not grow anymore the way it used to because businesses hold on in Japanese fashion to their workers, even when they do not need them. Unfortunately, just as the ink was drying on the computer printouts, Okun's law came back into force and unemployment leaped from August 1974 of 5.5 percent to our present near 9 percent.

Well, I would say that the natural forces of the recovery are not compatible with the monetary program, outlined before this committee a few months ago by Mr. Burns on behalf of the Federal Reserve, of a 5 to $7\frac{1}{2}$ percent increase in the money supply from March to March, and then modified, as I understand it, in his yesterday's congressional testimony to 5 to $7\frac{1}{2}$ percent increase in $M_1$ from the second quarter of 1975 to 1976. It may be that this amount of money increase is compatible with the 7 to 8 percent real growth in GNP, which in part of Mr. Burns' quoted testimony he referred to.

But if it is, he has a different model from that of Chase Econometrics, which I studied while I was perusing his testimony in this morning's New York Times on the airplane coming down from Massachusetts. He has a different model from Mr. Eckstein's DRI model. He has a different model from the Wharton School model. Now it may be that if his model was laid before you in all of its detail, it will turn out that the jury will agree that it is a likely scenario.

But let me simply, as a visiting anthropologist, testify to you that most of the consensus models would show a lower rate of improvement in the first year of recovery than what I have told you is a desirable goal, 7 percent in real terms. They average between 6 and 7 percent at best, and I am taking only the better forecasters of recent years.

They have, in their scenario, increases in the money supply between now and the second quarter of 1975, which are usually outside the upper Burns interval: 7.49999 percent $M_1$ increase in all likelihood yield 7 to 8 percent real growth.

Now economics is an inexact science. It could be that the weakness of the automobile industry will, starting with the next 10 days in August, turn out to be a thing of the past. It can be that housing will suddenly, showing nothing in the permits data, nothing in the commitment data, will suddenly take off. Things like that do happen. Something like that happened in 1954–55 with respect to automobile sales, but I do not think that prudent policy of a great Nation can be based upon Micawber-like hope that something will turn up and that something that will turn up might be favorable and might be the economy.

And it is perhaps ironic that this committee has been flexing its muscles against the very vulnerable position of the Federal Reserve, which I think did outstay its market and miscalculated the whole delicate problem of political independence up in the Federal Reserve System. After all, we do not have four branches of government—a legislature, an executive branch, a judiciary, and also a Federal Reserve System.

If the central bank, the Federal Reserve, is not in the last analysis —I am not speaking of its day-to-day activities—responsive to the Executive, which is the way the railroad is run in most parts of the world—which, in most cases, have been behaving better in the postwar period with respect to the report card of economic performance than our own performance—then it must be responsive to the Congress.

The value-judgment problems, very delicate as they are between inflation and unemployment, between the timing of employment opportunity now and employment opportunity at other times, are not to be decided according to the digestion of people with 14-year appointments. Plato's philosopher kings have not been put into a marble palace to legislate into effective action their best guess as to where the prudence balance lies. We are not destined to be at the mercy of the circulatory systems of fallible men.

These are matters which the electorate, with Congress as representatives, must decide. Well, partly as a result as I say of the leverage of the Federal Reserve having gotten too far out on a limb, it has for the first time come before you with long-range intervals for the money supply. Now, most economists are just throwing their hats in the air with cheers about this happy state of affairs.

Qualitatively, yes, my hat goes in the air, but not by many inches. Quantitatively, a first year of recovery, ought to be at least 7 percent in real terms. But consider the exogenous factors working on the price levels. Thus, we just heard today from Mr. Albert Rees as he leaves the Government service that the increase of prices in the fourth quarter of the year now looks to be bigger than he thought last February.

Given that situation, I do not think that a 5 percent increase in $M_1$ is going to be conducive toward a sustained, healthy recovery starting out at the pace it ought to go, nor do most of the people who have been most worth listening to in terms of their predictions.

I do not want to overstate the case for successful economic prediction in recent years, but if you actually reviewed the testimony, you will find that 7½ percent will not do it, and so I think this committee at an earlier date found itself, mistakenly, as I testified at the time, naming very narrow guidelines, which I remind you were much lower than the ones we are talking about for the Federal Reserve.

So I think the Federal Reserve will find it very easy to come before you with a range which looked all right in terms of their own earlier writing.

Well, I would like to suggest in this testimony that the likelihood is that prudent policy, taking into account inflation risk, should be at the 7 to 10 percent increase in the money supply, not at the 5 to 7½ percent.

Senator KENNEDY. What should we be watching, the interest rates or the money supply?

Mr. SAMUELSON. I think God gave us two eyes, and with respect, I think he must have had a purpose in doing so. It is not necessary, as the monetarists say, to watch only one thing; namely, the money supply, nor is it necessary, as the denizens of the New York money market used to think, that all you need do is watch interest rates.

I think you have to do both. At this point in the game, what I would think to be extremely sad would be the following: Suppose interest rates, short-term interest rates, were to be permitted to rise substantially; suppose the Federal Reserve in its statements did not make clear its disagreement with the view that an increase in the money supply of 10 percent in the first year of recovery, when there are exogenous price increases in the system, of 10 percent, is an immoderate number. How sad if purely out of speculative liquidity preference, people in the money market fear that rising interest rates means a further rise in interest rates, so that the attempt of the Federal Reserve to modulate the degree of increase in $M_1$ was incorrectly interpreted by the denizens of the money market to reflect a cavalierness with respect to inflation and a sure sign that we are going to have more inflation. Under this sad scenario, you could find yourself with an aborted first-year recovery, one I think is all quite unnecessary.

I don't argue that all is lost if short-term interest rates rise from the 5 percent level slowly as the recovery materializes; I do not come before you with a recommendation that a new iron target on short-term interest rates be set. I do, however, think that proper policy should keep the interest rates from growing in a way that they do grow when the first preoccupation, even in the first year of recovery, is with the rate of inflation.

Senator KENNEDY. Should we have a third eye to look at the Federal fund rates? How important is that?

Mr. SAMUELSON. I think the Federal fund rates and the Treasury bill rates are the most important short-term interest rates. You certainly want to keep both your eyes on them. The one thing that needs to be stressed——

Senator KENNEDY. What is your reaction to the significant increase in that rate which we have seen recently? Is that something that we ought to be troubled by?

Mr. SAMUELSON. I think we should be a bit troubled by it, because what has happened lends itself to the interpretation that, as long as the Federal Reserve was frightened by its political vulnerability as the economy was still in recession still sliding downward, then it was willing to be expansionary and to put into proper perspective the problem of controlling inflation. But the moment we made the turn, and consumer sentiment improved, and it looked as though the heat was off, then the Federal Reserve was back in the habit it got into in the 1950's. For example, within a month or two after the April–May bottom of 1958, the Federal Reserve under Chairman Martin was tightening. That led to a very short and very aborted recovery, combined, by the way, with horrible fiscal policy, in that particular period.

Senator Kennedy, may I—before I conclude my testimony—I want to be a responsible witness. I think the important question in thinking properly about the tradeoff of inflation and job opportunity is how much extra inflation does the Government generate? If it creates policies which give you 7 percent real growth, 8 percent real growth, instead of 4 or 5 percent, that is the appropriate question that should be asked.

Senator KENNEDY. Now, let us hear you answer it.

Mr. SAMUELSON. Right. To give my answer I have given my best judgment, but I also consulted Townsend-Greenspan estimates of what is going to happen to the economy and also the Citibank's estimates with respect to inflation. My answer is the following: People differ in what they think is going to be the rate of inflation. Mr. Eckstein is more optimistic than Mr. Evans of Chase. But all of these authorities, when they put in different rates of growth, due to differential changes in policy—such as the monetary targets, such as the tax, fiscal targets—find very small changes in the resulting rate of price inflation from our doing the job—as I think you ought to think it should be done—namely, from insuring a 7 or 8 percent real growth, as against a 3 or 4 percent real growth.

A majority of Congress, who insist, with the blessing of the White House, or against the attempts to veto it, that the first year of the recovery be a healthy and vigorous one, will not have to answer to history and to their consciences that they jeopardized the problem of inflation control, and that they were skating with a reactivation of double-digit price inflation.

We may find ourselves, by the end of the year, in a worse situation with regard to inflation than we are now. It will not be because macroeconomic policy was made to be too activist. It may be, as we saw with respect to the Consumer Price Index just a couple of days ago, that the oil price increases, with respect to our longrun oil program, will cause the cost of living to rise.

I understand we have some unpleasant news awaiting us on the Wholesale Price Index. If the rains are not kind in the Mississippi Valley, if the Russian drought worsens, you may well have disagreeable price inflation. But that is not the appropriate question for the Joint Economic Committee to be asking itself when it is considering the merits of policies which will aim for a 5 percent real growth, or a 3 percent real growth, or a 7 percent real growth, or a 9 percent rate of real growth.

And I think that every witness before you should be interrogated on that point, because if I am wrong on this, if there is some cogent evidence not available to the various authorities whom I have consulted and not readily inferable from the statistical abstract of the United States and the record of history from the National Bureau of Economic Research, if there is some evidence which is contrary to that, then it is extremely important that your committee learn about it, and that we all learn about it, and that we then rethink the problem.

But my tentative findings, in having done my homework at some length, is that the preponderance of the evidence is against that particular view.

Senator KENNEDY. On this point, we could be somewhat more precise? The Senate Budget Committee talks about the option of extending the tax cut to keep withholding rates constant, which comes to a cut of $12 or $13 billion for the next year. The committee also talks about an additional $15 billion cut that could be added to that. And they also talk about a significant cut in spending.

When we had Mr. Greenspan here before the committee just the other day, we asked whether we could afford not to have a tax cut for the next year. We know that by not extending the tax cut, we are going to have a tax increase in January; that is, the immediate prospect, a tax increase. By refusing to take a position for a tax cut, we are really saying to the American people, in January, you are going to get a tax increase.

Mr. SAMUELSON. More than that, the recommended oil programs —unless you have before you detailed offsets for the deflationary impact on the real economy of those price increases—will result in an insufficiency of effective demand, so that, although I have spoken to you about a probable 3½ to 9 percent real growth range, that could be falsified in terms of the downside. And so, I would think that at this time it would clarify the planning of business enterprise, the corporate enterprise, all over the Nation, and also family income planning, to indicate that it is the intention of Congress and the administration to pursue policies which are consonant with the goal of a healthy recovery. I do not think we should be afraid, at this point, of a return toward prosperity, because, heaven knows, we are not going to be back to anything like full employment, by anybody's definition, even on the basis of what we have been talking about here, until long after our Bicentennial celebration is a memory to the American people.

Senator KENNEDY. Would you favor the extension of the tax cut now?

Mr. SAMUELSON. Yes.

Senator KENNEDY. Do you think we ought to act now to help the American people plan for the future? Would you go beyond the continuation of a tax cut? Do you think we should be thinking in those terms? And if we should be, in what dimension?

Mr. SAMUELSON. Well, I would go beyond it, in that, in any energy legislation that is seriously contemplated, there should be a double entry, detailed statement, showing exactly how the recycling of any income absorptions is going to be handled, because, if I may say so, in the energy field, we have again and again been told that this objection to a program or that objection is going to be taken care of. For example, when we were in the middle of the oil boycott, and there was quite a lot of political steam for some kind of fair shares rationing, we were told that, "Oh, no, it will be done by the pricing system, but there will be offsets to the lower income groups, by way of actual tax abatements," and so forth.

Those promises were very nice to hold the fort against the populist hordes in favor of rationing, at the moment. But nothing ever came of it in the way of material plans put before Congress or the American people afterward. They were, apparently just what they seemed to be at the time, debating points designed to carry the day. And similarly, I have, in participating in energy discussions, official and unofficial, heard statements that, "Oh, yes, we are going to make sure that every dollar taken away is going to be recycled back." I do not think that is good enough.

What needs to be put into the legislation is the specific way in which it is to be done, with the economic accountants auditing the books to see whether, in fact, it leaves you with a hole with respect to the strength of market demand for a consumer's durables, nondurable services, and so forth, whether it is consonant, in other words, with the hope for behavior of the macroeconomy over the next 12 to 18 months.

Senator KENNEDY. If the administration does not move with regard to extending the tax cut, and if we expect to get maybe a \$1 to \$1.50 increase in OPEC prices, if we have a deregulation of domestic prices of oil, what will be impact of these factors be in terms of recovery and the questions of unemployment? Will the brakes go on further?

Mr. SAMUELSON. Well, I would say that if the longrun problem of lessening the trend of American dependence upon imported oil, seen now to be possibly a precarious source of supply, were simply left to the long run, and not made part of the mandatory agenda for near-term discussion, those economists who specialize in the business cycle and in the state of unemployment, and in the state of monetary policy would have an easier task. In other words, doing things now, and beginning to do them now in a serious way and in a militant way, about the longrun energy problem of this country is calculated to make more difficult the transition from what has been the worst recession of the post-World War II period to a desired recovery. And it makes it more difficult to control what has been the worst peacetime price inflation in this country.

Now, I would not want it to be inferred that the long run will always be treated as manana, and that we never begin to come to grips with it. But many economists have counseled that until the recovery is established beyond the gleam of the computer's eye, and is proceeding in a healthy way, and until the problem of inflation worsening has seemed to have lost its immediacy, there is a case for going easy on the long run needed energy proposals.

The present system, perhaps by chance, is not a bad and inefficient system. The method of entitlements is a very ingenious one, and it is very hard to document with facts, atrocious cases of oil being misused in Texas because it is old oil, and of things not being done. We have tried to run down the anecdotes and get some notions of quantitative importance and frequency. You find that the present situation is not an intolerable one.

As I understand it, the pressure for getting on with the longrun energy program has not arisen, even within the administration, primarily from the energy experts or the economists. It has been from the high councils of foreign policy and diplomacy having to do with the prestige of the U.S. negotiators, as they look in the eye, or look down into the eye, of other people. There is no reason why anybody should not get into the game of economics, but it would be nice to have the documented memorandum of analysis to appraise just how worthwhile those policies are.

The case has not been made in economic terms. It is not part of the public record. It is not part of the great debate yet.

Senator KENNEDY. I agree with you. We have seen over a period of time that foreign policy implications are the dictating factors in terms of the domestic energy program. We have really put the American economy through the wringer, for what in many instances are questionable political objectives.

Let me just ask a final question on this. Mr. Rees was here yesterday, and talked about the fact that real wages have actually dropped during the recession, so that labor now is really a bargain for business compared to other costs. Therefore, he sees the possibility of a faster-than-predicted decline in unemployment.

Could you comment upon those factors?

Mr. SAMUELSON. Well, it is true that real wages have, for the first time in many, many times, been stagnating, and it is blamed upon the inflation. But it has actually been primarily because a terms-of-trade effect and because of the increase in the price of energy and the increase in the price of food all over the world.

I would say that in the first year of recovery the bulk of historical experience has been that productivity is at its very best, and you would not expect employment opportunity to increase in the normal fashion with the expansion of real output. I do not know whether this has been factored into the picture—but I presume that, as an expert labor economist, Mr. Rees has done it. I would have to see his argument as to why, after this has been factored into the picture, the cheapness of labor is important.

What I think is fairly clear is that the weakness of the American dollar has until recently floated downward, making American labor cheap relative to labor in Germany and in some of our competing trade partners. This is in refreshing contrast to what was happening from 1959 on, when the American dollar was grossly overvalued, and when we were trying to defend the indefensible. In that sense there may be a little good news.

On the other hand, you probably would note that the American dollar has been a little stronger recently. To the degree that is the case, we will lose that temporary advantage from a temporarily undervalued dollar.

Senator KENNEDY. Let us hear from Mr. Gordon now, and then we will come back to some general questions for the both of you.

[The prepared statement of Mr. Samuelson follows:]

PREPARED STATEMENT OF PAUL A. SAMUELSON

*Recession bottoming.* The recession's trough probably occurred in May. Its official NBER beginning was probably November 1973. But real growth below the 4% per annum needed to keep unemployment level probably dates back to Spring 1973. A full-two-year growth recession makes this the worst of the post-World War II epoch. Unemployment should continue to grow for some months yet, perhaps peaking somewhere above 9% of the labor force, again the worst performance of the last 30 years and a situation that will not be substantially improved for several years, until toward the end of the decade itself.

*First-year-of-recovery goals.* Balancing the dangers of reaccelerating inflation against the wastes and human costs of continuing high unemployment, particularly in its unequal incidence on minorities, youths, the unskilled, and females, *I would consider a 7% real growth rate the optimal target for the first year of recovery, from mid-1975 to mid-1976.* Earlier, Secretary Simon was quoted as aiming for 5% growth as a target: more recently he has espoused 6%. None the less, if I judge Administration and Federal Reserve officials, not on their rhetoric, but on the probable implications of their effective actions, I would guess that an actuality of 5-to-6% is what is implied rather than my target of 7%.

The first year of recovery, by definition of being a first year, is the time of greatest slack in terms of both manpower and industrial capacity. Therefore, one can better afford a 7% growth rate then than in the second or third year of recovery. And yet, as in 1971, the political system is better geared to produce modest rates of recovery in the early stages, followed by disastrous speedups in the pace just when the excess in efficient plans and equipment capacity is beginning to ebb away. Redoing past history, it would have been better if the Nixon Administration and the Fed had engineered more rapid growth in 1971 and less rapid growth in 1972, than the actual pattern that then prevailed. Furthermore, Japan, Germany, and the other OCED nations are at this time running behind the U.S. in their stages of the business cycle. In the 12 months ahead we can count least on getting stimulus from them, and by the same token it is in this time period that we can do them the most good.

To sum up: It is in this first year of recovery that we can prudently afford to insist on a strong growth target. The very length of the recession behind us, and the very magnitude of the slack now in the economy, makes it desirable to aim for a vigorous rather than a modest rate of expansion at this time. I have scanned the alternative forecasts of the more accurate economic predictors to see what are the tradeoff dangers for price inflation involved in our growing at 7% rather than 6% or 5% or 4%. The consensus forecasters by no means agree on the likely level of inflation over the next 12 months. But they are in surprising agreement that the likely rate is not sensitive to variations in the growth rate of these magnitudes. Prices will improve if the harvest is good, if OPEC oil prices are steady, if productivity performance is at its cyclical and trend levels. Price inflation will worsen if exogenous factors are unfavorable. But for the next 18 to 24 months the differences in rate of price advance to be expected from a 7% growth rate rather than a 4% growth rate is—according to the Wharton, Chase, DRI, and standard bank or university model—likely to be less than 1% per year, a magnitude small compared to the intrinsic unpredictability of the price level.

*Probable natural strength of the recovery.* The average of all postwar recessions would give a first year recovery of *more* than 7 per cent. However, relying on such a mechanical averaging turned out to lead to an over-optimistic forecast by the Nixon Administration for 1971. Considering the lack of vigor in the auto and housing rebounds, the widespread recession all over the world, and the dire fears by policy makers concerning return of double-digit inflation, present policies taken in conjunction with the natural forces of the recovery, I would expect, will lead to growth over the next 12 months of anywhere from 3½% to 9%, with greater likelihood of being in the lower half than in the upper half of this range.

*Fiscal and monetary recommendations.* The fiscal stimulus voted by Congress since last fall has been very much needed. I do not think that a one-shot rebating of 1974 income taxes is enough to keep the recovery growing at its desired rate. New and continuing reductions in tax rates and/or expansions of public spending at the three levels of government is called for. Throughout much of 1974 the Federal Reserve was dangerously tight in its monetary and credit policies. It seriously underestimated the virulence of the August to April decline in the economy. It pushed so feebly on the downward-moving stick of monetary policy that it mistakenly inferred it was "pushing on a string." Congress has properly been reproaching the Fed for its overly-restrictive actions. But the March 74-March 75 program of a 5-to-7½% growth rate of the money supply will, I think, unduly slow down the pace of the recovery. Most of the consensus forecasters have been premising their predictions of 6% real growth on increases in $M_1$ that (a) lie above the Burns range, and (b) lie considerably above the 6% rise in $M_1$ between now and next March that would be required to keep actuality in that range.

I conclude that it will be better to exceed the 5-7½% M-growth target by 2 or 3% than to fall below it or even than to achieve its midpoint. Since prices will exogenously rise by 4-to-8 per cent, nominal GNP can be targeted to desirably rise by 11-to-15%. Unless $M_1$ increases 7-to-10%, the pressure from *inadequate real money supply* will threaten to weaken the first year recovery and abort the *sustained* expansion needed to bring the unemployment rate down to 6 per cent and below.

Senator KENNEDY. We are glad to have you here, Mr. Gordon, and we look forward to your comments and testimony.

## STATEMENT OF R. AARON GORDON, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. GORDON. Thank you, Senator Kennedy.

I have a rather long prepared statement which I will present for the record and try to give a somewhat abbreviated version of it here.

In response to a letter from Senator Humphrey, I am going to concentrate on these two widely cited goals of macroeconomic policy: What do we mean by full employment and price stability? Both goals seem to have moved farther and farther away from realization.

Indeed, I suggest the administration has largely abandoned the goal of full employment, despite the mandate of the Employment Act of 1946 that the Federal Government, "use all practical means to promote maximum employment, production, and purchasing power."

Certainly, the administration's actions and statements indicated that it is not seriously trying to minimize unemployment, which is the counterpart of maximizing employment. I assume the President and his advisers would reply that they are using all practical means to increase employment. taking into account above all the need to curb inflation and also the need to hold back the rise in Government spending.

My view of what is practicable differs significantly from that of the administration.

As for the goal of price stability, it is obvious that no one takes this goal literally in the sense of no change at all in the price level. The goal of price stability today seems to mean as little inflation as is, to use that word again, "practicable," given the need to avoid prolonged periods of massive unemployment and the consequent possible tearing apart of the very social fabric of the Nation.

In taking yet another look at these two goals of macroeconomic policy, I think that it is important to distinguish between what can be done in the short run—say, in the next year or two—and what is feasible over a longer period, into the 1980's.

I shall first comment briefly on the goal of reducing the inflation rate. There has been a gratifying decline in the rate of inflation, as measured by the major price indexes, during the first half of this year. Much further deceleration during the rest of this year will be difficult to achieve, and indeed there are a number of signs on the horizon that the rate of inflation may accelerate again in the next year. Among the reasons for some pessimism are the increased duty on imported oil, a prospective further increase in the price of petroleum by the OPEC countries, and the continued efforts of labor to catch up with past increases in the cost of living.

To these should be added the apparent intention of the administration to lift price ceilings on domestically produced "old" oil.

Recent events have forced us to recognize that bringing down the rate of inflation further during the next year or two cannot be achieved simply by restricting aggregate demand. Our recent and current inflationary problems have stemmed chiefly from the supply side in particular sectors, notably oil and food, and from cost-push forces on the labor side. Not much can be done in the short run with respect to oil and food, except to recognize that higher import duties on oil imports and rapid removal of price ceilings on domestic oil and gas will simply make inflation worse in the short run.

As for rising wage rates and labor costs, the administration is in a poor position to ask for restraint from organized labor in view of its slowness to move to reduce unemployment and its reluctance to take further steps in this direction. A rate of increase in the CPI of about 6 percent, give or take a percentage point, is probably the best that we can hope to achieve in the next 12 to 18 months.

What about the longer run? Here there are obviously some imponderables about which one can only make assumptions based on greater or less ignorance. Based on more rather than less ignorance, I shall assume: First, that the OPEC countries remain relatively well behaved from 1976 on and that by the end of 1977 the effect of recent and imminent increases in the price of imported and domestic oil and natural gas will have filtered through the system.

Second: That we will have normal agricultural harvests around the world during the rest of the 1970's.

Third: That some slow, but still unsatisfactory, progress will be made in improving the agricultural potential of Third World countries.

And fourth: That we do not get another worldwide boom among the industrial nations as vigorous and as sychronized as the last one, with the same upward pressure on raw material prices.

Given these assumptions, then the problem of holding the rate of inflation to, say, 5 percent or less from 1977 into the 1980's will depend on the trend in unit labor costs. The behavior of unit labor costs depends on the behavior of hourly compensation and manhour productivity. I should like to speak briefly about prospective trends in these two variables.

Table 1 in my prepared statement summarizes changes in output per man-hour, hourly compensation, unit labor costs, and the implicit price deflator for selected subperiods since 1950 for the private nonfarm economy, with a further breakdown into manufacturing and nonmanufacturing. The story that the table tells of an acceleration in the rate of increase in wages, unit labor costs, and prices between 1960 and 1973 is familiar. So also is the startling acceleration in costs and prices in 1974. But let us take a longer view and look at the subperiods in the table back to 1950.

I call your attention particularly to the figures for the nonmanufacturing sector, a sector which has been steadily rising in importance. In 1973 it employed well over twice as many workers as did manufacturing. Since 1960, man-hour productivity in this sector has been rising much more slowly than in manufacturing. In each of the subperiods between 1960 and 1973, wages rose faster in this sector than in manufacturing, and as a result, the rise in unit labor costs and in prices was much faster.

In the 1950's, the opposite sort of contrast prevailed. This change in relative trends since the 1950's has been due to both a marked retardation in the increase in productivity in nonmanufacturing relative to manufacturing as well as to the fact that since 1960 nonmanufacturing wages have been rising somewhat faster than in manufacturing.

With the still further increase in the relative importance of the nonmanufacturing sector that is in prospect, these recent trends do not augur well for the rate of increase in the price level during the next decade.

I suspect—perhaps guess would be a better word—that the best we can hope for in the late 1970's and the first half of the 1980's is a set of figures similar to those in table 1 for 1969–73. This would mean a rate of increase in the implicit price deflator for the private nonfarm economy of something like 5 percent per annum.

What does all this imply as to an antiinflationary policy for the Federal Government? In terms of the trends I have thus far discussed, the need obviously is to improve labor productivity, particularly in the nonmanufacturing sector, and even more important, to hold down the rate of increase in money wages.

As for increasing productivity, a variety of measures could be used. The administration believes that a significant contribution could come from tax measures that would improve after-tax corporate profits and stimulate corporate fixed investment.

Whatever potential there is here, I suggest that it will have more effect in the manufacturing than in the nonmanufacturing sector. If tax incentives are to be used, I should like to see more attention given to the possibility of stimulating private employers to reduce labor costs through further improvements in personnel management and through greater resistance to large wage increases.

Yet, to be perfectly blunt about it, I am not sure that I want to see much acceleration in the rate of productivity increase. To bring down the unemployment rate faster than is now generally expected, we must find ways of accelerating the opening up of jobs for those groups with particularly high unemployment rates, and these groups, almost by definition, tend to produce a lower output per man-hour than do those groups which typically have relatively low unemployment rates.

Here again we run into the trade off between unemployment and inflation. Some of the types of measures to reduce unemployment that I shall suggest would tend to retard the rate of increase in productivity that might otherwise be expected. Slowing down the rate of increase in productivity would tend to worsen the inflation problem, unless some way can be found to retard the rate of increase in wages.

So far I have said nothing about possible government efforts to influence pricing policies, particularly of large scale business.

In my opinion, we should not only continue the Council on Wage and Price Stability, but also, despite the views to the contrary expressed by its outgoing director, we should give the Council additional powers. I think that more government intervention in the field of wages would also be desirable, although the possibilities here are obviously severely limited in view of the poor relations between this administration and organized labor. More of a serious commitment by the administration to the goal of full employment, in both the short and longer run, might provide the basis for securing greater wage restraint from organized labor.

Clearly, however, for this to happen, there would also have to be more government intervention in the field of prices than is now the case, or in prospect.

I turn now to the goal of full employment. In the 1960's, this goal was fairly generally taken to correspond to a national unemployment rate of about 4 percent. It is by now forgotten that in the first economic report of the Nixon administration, the Council of Economic Advisers even implied that a goal of 3.8 percent might be practicable.

Things changed dramatically after that. As inflation worsened and total unemployment remained stubbornly above 5 percent from mid-1970 through all of 1972, it was increasingly suggested that structural changes that had been occurring required that we should have to settle for a full-employment goal corresponding to an unemployment rate of more than 4 percent. Both the Council and nongovernment economists began to make estimates of how much the national unemployment rate had been increased by the fact that teenagers and women, with their relatively high unemployment rates, had become a significantly larger fraction of the labor force than had been the cas in the mid-1950's. As a result, the administration began talking of unemployment rates of 5 and even 5½ percent as corresponding to full employment.

As the inflation problem worsened, the administration and many nongovernment economists lowered their sights still further. At the beginning of this year, in his budget message, the President presented a set of economic projections through 1980 that both startled and alarmed many Members of the Congress and a good fraction of the informed public.

Among the projections was a set of unemployment rates that would still be as high as 7.5 percent in 1977 and would have fallen only to 5.5 percent by 1980. The average projected unemployment rate for the 6 years 1970–80 would be 7 percent; for the 3 years 1978–80, the average would still be 6.2 percent.

To provide some perspective, I should point out that between 1947 and 1974, we had only 2 years, 1958 and 1961, when the national unemployment rate averaged above 6 percent.

Let me repeat. In my opinion the administration is not seriously trying to implement the maximum employment provision of the Employment Act. And it steadfastly refuses to consider seriously the arguments made by many critics that much more could be done than is now planned to reduce the unemployment rate.

What should be our full-employment goal for the next decade or so? As I stated before this committee nearly a year-and-a-half ago, I think that we should stop talking about a full-employment goal in terms of a single figure for the national unemployment rate. Instead, I strongly urge that the Federal Government should develop an array of target unemployment rates for different segments of the labor force, particularly when the labor force is classified by age, sex, and color.

I hardly need to remind you of the wide dispersion of unemployment rates in the United States by age, sex, color, occupation, and industry, and also education. Table 2 in my prepared statement presents some of the relevant figures for particular groups when the labor force is classified by age, sex, and color. In addition to the officially reported rates presented in table 2, I also show some adjusted unemployment rates for the nonwhite groups.

Labor force participation rates for these groups, all males and young females, are significantly lower than for whites of the same age and sex. These lower participation rates presumably reflect primarily the "discouraged worker" effect. Were decent jobs available for these nonwhites, nonwhite participation rates for these groups would presumably be about as high as for whites.

Thus the adjusted unemployment rates are calculated by adding to those reported as in the labor force and as unemployed the additional number needed to bring the labor force participation rates for these nonwhite groups up to those of the corresponding white groups.

Even without this adjustment, the figures for white teenagers and for nonwhites are bad enough, with white teenage unemployment rates of 12 to 15 percent and rates for black teenagers of 30 to 40 percent—about 40 percent in the last few months. But I call your attention also to the rate for nonwhite males in the 20–24 age group in the relatively good year 1973, a rate nearly twice as high as for white males in the same age group.

And before I am criticized by the fairer sex, I should remind you that unemployment rates for women are significantly higher than for men, overall and in most age groups.

Now I come to the adjusted unemployment rates. For all nonwhite males, the official unemployment rate is nearly doubled if we include the presumably discouraged workers. It is trebled for nonwhite males in the 45–54 age group. This is merely one of the many pieces of evidence pointing up the severity of the problem of structural unemployment in the United States and the need for pinpointing our employment targets on the most disadvantaged groups.

It is of interest that our adjusted unemployment rate for all nonwhite females is much lower than the actual rate. This is because the labor force participation rates for all nonwhite females age 25 and over, particularly age 25–44, are higher than for whites. This is a reflection both of the need for an additional worker in intact nonwhite families and of the greater prevalence of female-headed families among nonwhites.

Let me mention just a few other points comparing the figures for 1956 and 1973. Relative to the unemployment rates for all whites of each sex, the unemployment rates for white teenagers, male and female, have risen a bit, but not much. And white male teenagers were relatively worse off, compared to white males, than were white female teenagers relative to all white females. The dramatic deterioration in the relative position of teenagers has been among nonwhites, and especially males. The male nonwhite teenage rate was about twice the overall nonwhite male rate in 1956; it was 3.5 times the nonwhite male rate in 1973.

For nonwhite female teenagers, the corresponding ratio also rose, but not as much—from 2.6 to 3.3.

I will cite the results of one last set of calculations, because they are very relevant to the administration's unemployment projections for the rest of the decade. As I have already noted, much has been made of the impact of the changing age-sex composition of the labor force on the overall unemployment rate. Comparisons are usually made with the situation in 1956, when the national rate was 4.1 percent. There are two ways of making this sort of comparison. Skipping details, which are in my prepared statement, these two adjustments come to either 0.5 percent or 0.9 percent, depending on which calculation is used.

Let us use the larger adjustment and arbitrarily round it out to 1 percent of the labor force. This would suggest that, so far as the effect of changes in the age-sex composition of the labor force is concerned, a national rate of 5 percent today is about as difficult to achieve as a 4 percent rate in the mid-1950's.

The administration is probably right that the attempt to push the national unemployment rate down to 5 percent exclusively through the of fiscal and moneary policy would exacerbate the inflation problem. At least, it would do so if policy were so expansive as to bring the national rate down from 9 percent to 5 percent in, say, 2 years or so.

But I think the job can be done through a combination of a program of wage and price restraint, a monetary and fiscal policy more expansive than is now being tried, and a much expanded and improved set of programs directed toward manpower training and placement and toward public service employment.

At this point I need to come back to my distinction between what can be done in the short run and over the longer term. In the short run, we need a more expansive monetary and fiscal policy than we now have or are likely to get in the next year. The temporary tax reductions of 1975 should not only be continued through 1976, but should be increased in amount. Monetary policy should be eased, and we badly need a very substantial expansion of public service employment.

And, given the plight of the cities, I would favor some additional revenue sharing for this purpose. I am confident that the economy can absorb the increased Federal deficit that these recommendations imply. Certainly also, given existing levels of excess capacity and unemployment, these expansion measures would not lead to a significantly faster rate of inflation than is already in prospect, and they would still leave the national unemployment rate in the neighborhood of 7 percent at the end of 1976.

For the longer term, we need to supplement macroeconomic policy with a set of programs geared to reducing the unemployment rates that are particularly high. I suggest that we concentrate on programs that promise to bring down the unemployment rates for youth, young adults, and ethnic minority groups.

Let me cite a few more figures to suggest what might be possible. In 1973, when the national unemployment rate was 4.9 percent, the unemployment rate for male teenagers was 14 percent, and for female teenagers it was 15 percent. For the 20–24 age group the rates for males and females were, respectively, 7.3 and 8.4 percent. Now assume that with a more imaginative set of programs than we now have, we could have brought these unemployment rates down to 10 percent for teenagers and 6 percent for young adults. This would have reduced the national unemployment rate by almost 0.7 percent.

Assume further than, by a more vigorous and expanded set of affirmative action and manpower programs, we could reduce the ratio of the nonwhite to the white unemployment rate from about 2 to 1 to, say, 1 1/3 to 1. Under 1973 conditions, this would have reduced the national rate further by about 0.35 percent.

Both reductions together, after eliminating duplications, would have brought the 1973 unemployment rate down from 4.9 percent to about 4.1 percent, close to that magical 4-percent figure that now seems so far beyond our reach.

How do we achieve these more ambitious disaggregated goals? While I cannot offer you the detailed answers today, it does seem to me that these are the directions in which we should bend our efforts. With respect to youth and young adults, we have to begin with the schools, with improved vocational programs, a closer partnership between the schools and local business concerns, transferring some of the educational process, at least for students who so elect, to local employers, and so on.

And probably, although this is of course highly controversial, we need a differential minimum wage for teenagers. Essentially these same recommendations were made in the 1973 report of the Panel on Youth of the President's Science Advisory Committee.

The problems of ethnic minority groups are, of course, not confined to that of relatively high unemployment. A variety of manpower programs have been tried, but so far with only modest success. To me, this means that we should not relax our efforts, but rather intensify them. And manpower policies need to be combined with a variety of other programs, particularly to provide better education, housing, and neighborhood conditions.

And finally, we need a permanent—and I emphasize permanent—we need a permanent and large-scale public service program specifically directed toward the disadvantaged of all races. Such a permanent program should be the base on top of which we can continue a triggered program that would go on and off with changing economic conditions.

Thank you very much.

Representative LONG [presiding]. Thank you very much, Mr. Gordon.

Without objection, your prepared statement will be made a part of the record.

[The prepared statement of Mr. Gordon follows:]

PREPARED STATEMENT OF R. AARON GORDON

*Another Look at the Goals of Full Employment and Price Stability*

I

Senator Humphrey has indicated that the Committee would like particularly to discuss today the setting of appropriate policy targets for prices, output, and employment. I shall therefore devote myself this morning to taking yet another look at those two widely cited goals of macroeconomic policy—full employment and price stability. These are goals we continue to talk about—but which in the 1970's seem to have moved farther and farther away from realization.

Indeed, I suggest, this Administration has largely abandoned the goal of full employment, despite the mandate in the Employment Act of 1946 that "it is the continuing policy and responsibility of the Federal Government to use all practical means . . . to promote maximum employment, production, and purchasing power." Certainly the Administration's actions and statements indicate that it is not seriously trying to minimize unemployment, which is the counterpart of maximizing employment. As Tom Wicker of the *New York Times* put it in commenting on a recent press conference of the President: President Ford "left no doubt whatever that his only policy is to hold down inflation and those without jobs or hope of jobs are out of luck, as far as he's concerned."

I assume that the answer of the President and his economic advisers to this charge would be that they are using all *practicable* means to increase employment, taking into account above all the need to curb inflation and also the need to hold back the rise in government spending and to finance the federal deficit that is in prospect. I confess that my view of what is practicable differs significantly from that of the Administration.

As for the goal of price stability, it is obvious that no one, in or out of the Administration, in this or any other country of the Western World, takes this goal literally, in the sense of no change at all in the price level. The goal of price stability today seems to mean as little inflation as is (to use that word again) "practicable", given the need to avoid prolonged periods of massive unemployment and the consequent possible tearing apart of the very social fabric of the nation.

In taking yet another look at these two basic goals of macroeconomic policy, I think that it is important to distinguish between what can be done in the short run—say, in the next year or two—and what is feasible over a longer period, through the remainder of the 1970's and into the 1980's.

II

I shall first comment briefly on the goal of reducing the inflation rate.

There has been a gratifying decline in the rate of inflation, as measured by the major price indices, during the first half of this year. Much further deceleration during the rest of this year will be difficult to achieve, and indeed there are a number of signs on the horizon that the rate of inflation may accelerate again in the next year, in part at the initiation of the President and his advisers. Among the reasons for some pessimism are the increased duty on imported oil, a prospective further increase in the price of petroleum by the OPEC countries, and the continued efforts of labor to catch up with past increases in the cost of living in spite of the high level of unemployment. To these should be added the aparent intention of the Administration to lift price ceilings. wholly or in substantial part, on domestically produced "old" oil.

Events of the last two to three years have forced us to recognize that bringing down the rate of inflation further during the next year or two cannot be achieved simply by restricting aggregate demand. Our recent and current inflationary problems have stemmed chiefly from the supply side in particular sectors—notably oil and food—and from cost push forces on the labor side. Not much can be done in the short run with respect to oil and food, except to recognize that higher import duties on oil imports and rapid removal of price ceilings on domestic oil and gas will simply make inflation worse in the short run. As for rising wage rates and labor costs, the Administration is in a poor position to ask for restraint from organized labor in view of its slowness to move to reduce unemployment and its reluctance to take further steps in this direction. A rate of increase in the CPI of about six percent, give or take a percentage point, is probably the best that we can hope to achieve in the next 12 to 18 months.

What about the longer run? Here there are obviously some imponderables about which one can only make assumptions based on greater or less ignorance. Based on more rather than less ignorance, I shall assume the following: First, that the OPEC countries remain relatively well behaved from 1976 on and that by the end of 1977 the effect of recent and imminent increases in the price of imported and domestic oil and natural gas will have filtered through the system. Second, that we will have "normal" agricultural harvests around the world during the rest of the 1970's. Third, that some slow, but still unsatisfactory, progress will be made in improving the agricultural potential of third world countries. And fourth, that we do not get another world-wide boom among the industrial nations as vigorous and as synchronized as the last one, with the same upward pressure on raw material prices. Given these assumptions, then the problem of holding the rate of inflation to, say, 5 percent or less from 1977 into the 1980's will depend on the trend in unit labor costs and, to a less extent, in profit margins. The behavior of unit labor costs depends on the behavior of hourly compensation and manhour productivity. I should like to speak briefly about prospective trends in these two variables and what policy might be able to do to affect these trends.

Table 1 summarizes changes in output per manhour, hourly compensation, unit labor costs, and the implicit price deflator for selected subperiods since 1950 for the private nonfarm economy, with a further breakdown into manufacturing and nonmanufacturing. The story that the table tells of an acceleration in the rate of increase in wages, unit labor costs, and prices between 1960 and 1973 is familiar to all of us. So also is the startling acceleration in costs and prices in 1974. But let us take a longer view and look at the subperiods in the table back to 1950, with particular attention on the years since 1960.

TABLE 1.—CHANGES IN MAN-HOUR PRODUCTIVITY, HOURLY COMPENSATION, UNIT LABOR COSTS, AND PRICES PRIVATE NONFARM SECTOR, 1960–74

[Percentage changes annual rates]

| Period | Output per man-hour | | | Hourly compensation | | | Unit labor cost | | | Implicit price deflator | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Manufacturing | Nonmanufacturing | Total | Manufacturing | Nonmanufacturing | Total | Manufacturing | Nonmanufacturing | Total | Manufacturing | Nonmanufacturing |
| 1950–60 | 2.1 | 2.2 | 2.1 | 5.0 | 5.6 | 4.8 | 2.8 | 3.3 | 2.6 | 2.6 | 2.6 | 2.6 |
| 1960–65 | 3.5 | 4.2 | 3.0 | 3.8 | 3.6 | 4.0 | .4 | −.7 | .9 | 1.1 | .3 | 1.6 |
| 1965–69 | 1.9 | 2.2 | 1.7 | 6.5 | 5.7 | 6.9 | 4.5 | 3.5 | 5.1 | 3.4 | 1.8 | 4.2 |
| 1969–73 | 2.5 | 4.6 | 1.6 | 6.8 | 6.6 | 7.0 | 4.1 | 1.9 | 5.3 | 3.9 | 1.7 | 5.0 |
| 1973–74 | −2.8 | .7 | −4.5 | 8.8 | 9.5 | 8.6 | 11.9 | 8.8 | 13.6 | 11.4 | NA | NA |

Source: "Manpower Report of the President," April 1975, pp. 336–339

I call your attention particularly to the figures for the nonmanufacturing sector, a sector which has been steadily increasing in importance. (In 1973, it employed well over twice as many workers as did manufacturing.) Since 1960, manhour productivity in this sector has been rising much more slowly than in manufacturing (leaving aside the startling absolute decline last year); in each of the subperiods between 1960 and 1973, wages rose faster in this sector than in manufacturing; and, as a result, the rise in unit labor costs and in prices was much faster. In the 1950's, the opposite sort of contrast prevailed, with wages and unit labor costs rising considerably more slowly in nonmanufacturing than in the manufacturing sector. (Prices in the 2 sectors rose at about the same rate.) This change in relative trends since the 1950's has been due to both a marked retardation in the increase in productivity in nonmanufacturing relative to manufacturing as well as to the fact that since 1960 nonmanufacturing wages have been, on the average, rising somewhat faster than in manufacturing. With the still further increase in the relative importance of the nonmanufacturing sector that is in prospect, these recent trends do not augur well for the rate of increase in the price level during the next decade.

I suspect—perhaps "guess" would be a better word—that the best we can hope for in the late 1970's and the first half of the 1980's is a set of figures similar to those in Table 1 for 1969–1973.[1] This would mean a rate of increase in the implicit price deflator for the private nonfarm economy of something like five percent per annum—*if* the relatively favorable assumptions I made earlier about oil, world agriculture, and the rest are all realized.

What does all this imply as to an anti-inflationary policy for the federal government? In terms of the trends I have thus far discussed, the need obviously is to improve labor productivity, particularly in the nonmanufacturing sector, and, even more important, to hold down the rate of increase in money wages. As for increasing productivity, a variety of measures could probably be used. The Administration apparently believes that a significant contribution could come from tax measures that would improve after-tax corporate profits and stimulate corporate fixed investment. Whatever potential there is here, I suspect that it will have more effect in the manufacturing than in the nonmanufacturing sector. If tax incentives are to be used, I should like to see more attention given to the possibility of stimulating private employers to reduce labor costs through further improvements in personnel management and through greater resistance to large wage increases.

Yet, to be perfectly blunt about it, I am not sure that I want to see much acceleration in the rate of productivity increase, particularly in the nonmanufacturing sector. To bring down the unemployment rate faster than is now generally expected, we must find ways of accelerating the opening up of jobs for these groups with particularly high unemployment rates, and these groups, almost by definition, tend to produce a lower output per manhour than do those groups which typically have relatively low unemployment rates. Here again we run into that notorious trade-off between unemployment and inflation. Some of the types of measures to reduce unemployment that I shall suggest would tend to retard the rate of increase in productivity that might otherwise be expected and which underlies the widely cited "Okun's law." Slowing down the rate of increase in productivity would tend to worsen the inflation problem—unless some way can be found to retard the rate of increase in wages.

So far I have said nothing about possible government efforts to influence pricing policies, particularly of large scale business. Apparently, industrial prices have been becoming more inflexible in a downward direction. If administered prices do not fall during recessions, then the long-run upward trend in prices is clearly more pronounced than if these prices show some flexibility downward as well as upward. The recent rise in aluminum prices, in the face of a fall-off in demand and large-scale excess capacity, clearly reflects a trend that calls for some sort of government action, as did the steel industry's similar action earlier in the year. And now we are being told of substantial price increases in 1976 automobiles, despite the excess capacity in that industry.

In my opinion, we should not only continue the Council on Wage and Price Stability but also, despite the views to the contrary expressed by its outgoing director, we should give the Council additional powers. I think that more government intervention in the field of wages would also be desirable, although the possibilities here are obviously severely limited in view of the poor relations between this Administration and organized labor. But even here I think that something could be done. More of a serious commitment by the Administration to the goal of full employment, in both the short and longer run, might provide the basis for securing greater wage restraint from organized labor.

[1] I realize that we had wage and price controls during 1971–1973, but for the entire subperiod 1969–1973 I do not think that the figures in Table 1 would have been significantly different in the absence of controls.

Clearly, however, for this to happen, there would also have to be more government intervention in the field of prices than is now the case.

III

I turn now to the goal of full employment. In the 1960's, this goal was fairly generally taken to correspond to a national unemployment rate of about four percent. In the first *Economic Report* of the Nixon Administration, the Council of Economic Advisers even implied that a goal of 3.8 percent might be practicable.

Things changed rapidly and dramatically after that. As inflation worsened and total unemployment remained stubbornly above 5 percent from mid-1970 through 1971 and all of 1972, it was increasingly suggested that structural changes that had been occurring required that we should have to settle for a full-employment goal corresponding to an unemployment rate of more than 4 percent. The then Secretary of the Treasury John Connally once referred to the 4 percent goal as a "myth," and the annual reports of the Council of Economic Advisers began to pay increasing attention to the changing age-sex composition of the labor force. Both the Council and non-government economists began to make estimates of how much the national unemployment rate had been increased by the fact that teenagers and women, with their relatively high unemployment rates, had become a significantly large fraction of the labor force than they had been in, say, the mid-1950's. As a result the Administration began talking of unemployment rates of 5 and even 5½ percent as corresponding to full employment.

As the inflation problem worsened, with inflationary price expectations helping to generate accelerating wage increases, the Administration and many nongovernment economists lowered their sights still further. At the beginning of this year, in his budget message, the President presented a set of economic projections through 1980 that both startled and alarmed many members of the Congress and a good fraction of the informed public. Among the projections was a set of unemployment rates that would still be as high as 7.5 percent in 1977 and would have fallen only to 5.5 percent by 1980. The average projected unemployment rate for the six years 1975–1980 would be 7 percent; for the three years 1978–1980, the average would still be 6.2 percent. To provide some perspective, I should point out that between 1947 and 1974, we had only two years, 1958 and 1961, when the national unemployment rate averaged above 6 percent. Yet the President and his advisers were apparently prepared to steer an economic course that would still leave the national unemployment rate at 6 percent or above by the end of the 1970's.

I gather that the Administration has backed away a bit from these pessimistic projections, but I am not aware that any alternative and less pessimistic projections have yet been officially announced.

Let me repeat. In my opinion the Administration is not seriously trying to implement the "maximum employment" provision of the Employment Act. And it steadfastly refuses to consider seriously the arguments made by many critics that much more could be done than is now planned to reduce the unemployment rate.

What should be our full-employment goal for the next decade or so? As I stated before this Committee nearly a year and a half ago, I think that we should stop talking about a full-employment goal in terms of a single figure for the national unemployment rate. Instead, I strongly urge on the Congress that the federal government should develop an array of target unemployment rates for different segments of the labor force—particularly when the labor force is classified by age, sex, and color. I first made this proposal nearly a decade ago, and I still think today that this is the direction in which we have to move. I shall now try to elaborate.

I hardly need to remind you of the wide dispersion of unemployment rates in the United States by age, sex, color, occupation, and industry. Table 2 presents some of the relevant figures for particular groups when the labor force is classified by age, sex, and color. In addition to the officially reported rates presented in Table 2, I also show there "adjusted" unemployment rates for the nonwhite groups. Labor-force participation rates for these groups—all males and young females—are significantly lower than for white of the same age and sex. These lower participation rates presumably reflect primarily the "discouraged worker" effect. Where decent jobs available for these nonwhites, nonwhite participation rates for these groups would presumably be about as high as for whites.[2] Thus the "adjusted" unemployment rates shown in Table 2 are calculated by adding to those reported as in the labor force and as unemployed the additional number needed to bring the labor-force participation rates for these nonwhite groups up to those of the corresponding white groups.

TABLE 2.—UNEMPLOYMENT RATES FOR PARTICULAR AGE, SEX, AND COLOR GROUPS, ACTUAL AND ADJUSTED, 1956, 1973, AND 1974

[Percent]

| | Actual rates | | | Adjusted rates [1] | |
|---|---|---|---|---|---|
| | 1956 | 1973 | 1974 | 1973 | 1974 |
| **White** | | | | | |
| Male: | | | | | |
| 16 to 19 | 10.5 | 12.3 | 13.6 | | |
| 20 to 24 | 6.1 | 6.5 | 7.8 | | |
| 45 to 54 | 2.8 | 2.0 | 2.2 | | |
| Total | 3.4 | 3.7 | 4.3 | | |
| Female: | | | | | |
| 16 to 19 | 9.8 | 12.9 | 14.5 | | |
| 20 to 24 | 5.1 | 7.0 | 8.2 | | |
| 45 to 54 | 3.3 | 3.1 | 3.6 | | |
| Total | 4.2 | 5.3 | 6.1 | | |
| **Nonwhite** | | | | | |
| Male: | | | | | |
| 16 to 19 | 15.3 | 26.9 | 31.6 | 45.4 | 48.7 |
| 20 to 24 | 12.0 | 12.6 | 15.4 | 16.7 | 19.7 |
| 45 to 54 | 5.4 | 3.2 | 4.0 | 8.9 | 12.6 |
| Total | 7.9 | 7.6 | 9.1 | 14.2 | 16.1 |
| Female: | | | | | |
| 16 to 19 | 22.8 | 34.5 | 34.5 | 55.1 | 56.8 |
| 20 to 24 | 14.8 | 17.6 | 18.0 | 23.1 | 25.2 |
| Total | 8.9 | 10.5 | 10.7 | .4 | 3.0 |

[1] Adjusted unemployment rates were calculated as follows: The difference between white and nonwhite participation rates was determined for each age-sex group, and this difference was multiplied by the nonwhite population to determine the change in the nonwhite labor force necessary to make nonwhite participation rates equal to those of whites in all a ge-sex groups. This increment in the labor force was then added to both unemployment and the actual labor force to derive an adjusted unemployment rate.

Source: "Manpower Report of the President", May 1975

Even without this adjustment, the figures for white teenagers and for nonwhites are bad enough. Much publicity has been given to white teenage unemployment rates of 12 to 15 percent and to rates for black teenagers of 30 to 40 percent—about 40 percent in the last few months. But I call your attention also to the rate for nonwhite males in the 20–24 age group in the relatively good year 1973, a rate nearly twice as high as for white males in the same age group. And before I am criticized by the fairer sex, I should remind you that unemployment rates for women are significantly higher than for men—overall and in most age groups.

Now I come to the "adjusted" unemployment rates for nonwhite teenagers and nonwhite adult males. For all nonwhite males, the official unemployment rate is nearly doubled if we include the presumably discouraged workers. It is trebled for nonwhite males in the 45–54 age group. This is merely one of many pieces of evidence pointing up the severity of the problem of structural unemployment in the United States—and the need for pinpointing our employment targets on the most disadvantaged groups.[3]

It is of interest that our "adjusted" unemployment rate for all nonwhite females is much lower than the actual rate. This is because the labor-force participation rates for all nonwhite females age 25 and over, particularly age

[2] I realize that lack of jobs is not the only reason nonwhites withdraw from the labor force. The health of nonwhites tends to be less good than that of whites, and the availability of only low-paying and otherwise demeaning jobs also discourages work incentives. But these are merely aspects of the general discrimination against nonwhites that is built into the social and economic environment.

[3] I shall not try to deal with the other elements that enter into the calculation of what is called a "subemployment index," particularly low wages and involuntary part-time unemployment.

25–44, are higher than for whites. This is a reflection both of the need for an additional worker in intact nonwhite families and of the greater prevalence of female headed families among nonwhites.

There are a number of other points that can be made about the figures in Table 2. Let me mention just a few, comparing the figures for 1956 and 1973. Relative to the unemployment rates for all whites of each sex, the unemployment rates for white teenagers, male and female, have risen a bit but not much. Anl white male teenagers were relatively worse off, compared to all white males, than were white female teenagers relative to all white females. The dramatic deterioration in the relative position of teenagers has been among nonwhites, and especially males. The male nonwhite teenage rate was about twice the overall nonwhite male rate in 1956; it was 3.5 times the nonwhite male rate in 1973. For nonwhite female teenagers, the corresponding ratio also rose, but not as much—from 2.6 to 3.3.

If we turn to trends in unemployment differentials by color and sex, we find some modest improvement in the differentials by color for each of the sexes, but deterioration in the relative position of women, a bit more for nonwhites than for whites.

At the risk of overwhelming you with figures, I will cite the results of one last set of calculations, because they are very relevant to the Administration's unemployment projections for the rest of the decade. As I have already noted, much has been made of the impact of the changing age-sex composition of the labor force on the overall unemployment rate. Comparisons are usually made with the situation in 1956, when the national rate was 4.1 percent. There are two ways of making this sort of comparison. One is to recompute the national rate for 1956, using the actual 1956 unemployment rates for the different age-sex groups but weighting them by the relative importance of these groups in a more recent year, say, 1974. If this is done, the recomputed national rate for 1956 is raised from 4.1 to 4.6 percent. The other method is to reverse the procedure, and to weight the actual 1974 unemployment rates for the different age-sex groups by their relative importance in 1956. If this is done, the 1974 unemployment is lowered from 5.6 to 4.7, or by 0.9 percent. The second adjustment is nearly twice the first.

Let us use the larger adjustment and arbitrarily round it out to one percent of the labor force. This would suggest that, so far as the effect of changes in the age-sex composition of the labor force is concerned, a national rate of 5 percent today is about as difficult to achieve as a 4 percent rate in the mid-1950's. But obviously the present Administration thinks that a 5 percent rate in the late 1970's would be much more difficult to achieve than a 4 percent rate 20 years ago.

The Administration is probably right that the attempt to push the national unemployment rate down to 5 percent exclusively through the use of fiscal and monetary policy would exacerbate the inflation problem. At least, it would do so if policy were so expansive as to bring the national rate down from 9 percent to 5 percent in, say, 2 years or so. But I think the job can be done through a combination of a program of wage and price restraint, a monetary and fiscal policy more expansive than is now being tried, and a much expanded and improved set of programs directed toward manpower training and placement and toward public service employment.

## IV

At this point I need to come back to my distinction between what can be done in the short run and what our policy should be over the longer term. In the short-run, we need a more expansive monetary and fiscal policy than we now have or are likely to get in the next year if the Administration and the Federal Reserve Board have their way. The temporary tax reductions of 1975 should not only be continued through 1976 but should be increased in amount; monetary policy should be eased; and we badly need a very substantial expansion of public service employment. And, given the plight of the cities, I would favor some aditional revenue sharing for this purpose. I am confident that the economy can absorb the increased federal deficit that these recommendations imply. Certainly, also, given existing levels of excess capacity and unemployment, these expansionary measures would not lead to a significantly faster rate of inflation than is already in prosepect. And they would still leave the national unemployment rate in the neighborhood of 7 percent at the end of 1976.

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For the longer-term, we need to supplement macroeconomic policy with a set of programs geared to reducing the unemployment rates that are particularly high. As I suggested before, we need to disaggregate the full-employment goal and concentrate on reducing those unemployment rates that are much too high. I suggest that we concentrate on programs that promise to bring down the unemployment rates for youth, young adults, and ethnic minority groups.

Let me cite a few more figures to suggest what might be possible. In 1973, when the national unemployment rate was 4.9 percent, the unemployment rate for male teenagers was 14 percent, and for female teenagers it was 15 percent. For the p0–24 age group the rates for males and females were, respectively, 7.3 and 8.4 percent. Now assume that, with a more imaginative set of programs than we now have, we could have brought these unemployment rates down to 10 percent for teenagers and 6 percent for young adults. This would have reduced the national unemployment rate by almost 0.7 percent.

Assume further that, by a more vigorous and expanded set of affirmative-action and manpower programs, we could reduce the ratio of the nonwhite to the white unemployment rate from about 2 to, say, 1-1/3 to 1. Under 1973 conditions, this would have reduced the national rate further by about 0.35 percent.

Both reductions together would have brought the 1973 unemployment rate down from 4.9 to about 3.9 percent, below that magical 4 percent figure that now seems so far beyond our reach.[4]

How do we achieve these more ambitious disaggregated goals? Certainly, I am not competent to offer you detailed answers today, but it does seem to me that these are the directions in which we should bend our efforts. With respect to yout hand young adults, we have to begin with the schools—with improved vocational programs, a closer partnership between the schools and local business concerns, transferring some of the educational process, for students who so elect, to local employers, and so on. And probably, although this is of course highly controversial, we need a differential minimum wage for teenagers. Essentially these same recommendations were made in the 1973 report of the Panel on Youth of the President's Science Advisory Committee.

Since 1960, there has been a modest decline in the ratio of the nonwhite to the white unemployment rate. The improvement has been more noticeable for men than for women and came chiefly in the 1960's. There has been little further improvement since 1969, despite the efforts spent on affirmative action programs.

The problems of ethnic minority groups are, of course, not confined to that of relatively high unemployment. A variety of manpower programs have been tried but so far with only modest success. To me this means that we should not relax our efforts but rather intensify them. And manpower policies need to be combined with a variety of other programs, particularly to provide better education, housing, and neighborhood conditions. And, finally, we need a permanent and large-scale public-service program specifically directed toward the disadvantaged of all races. Such a permanent program should be the base on top of which we can continue a triggered program that would go on and off with changing economic conditions.

Representative LONG. The gist of the recommendations and of your comments very closely aline themselves with the conclusions that I have reached, in the 6 months that we have been sitting here before this committee listening to leading economists and businessmen of the United States. About the only exceptions with the recommendations varying everywhere from the treatment of the energy question to jobs, to monetary policy, to what has been nearly a unanimous point of view have been those witnesses that are directly connected with the administration.

Practically the only exceptions——

Mr. GORDON. May I explain that to you?

[4] Actually there is some duplication in adding these two calculated reductions in the unemployment rate since the assumed lower rates for the .2 younger age groups already incorporate an assumed decline in the nonwhite-white differential as well as a decline in the white rate in these age groups. Eliminating this duplication brings the total reduction in the national unemployment rate down to 0.8 percent instead of a bit over one percent.

Representative LONG. Certainly.

Mr. GORDON. The economic advisers to the President and the President himself practice economics not as some imperfect mixture of an art and science. They practice economics as a religion.

Representative LONG. As a religion.

Mr. GORDON. Yes.

Representative LONG. Would you like to go further and describe what type of religion this is that they have?

Mr. GORDON. Keep the Government out of things as much as possible. Inflation is far worse—5 or 6 percent inflation is far worse—than 9 or 10 percent unemployment, and that is the religion.

Representative LONG. The President has succeeded in doing something that I think is wrong and I would appreciate yours and Mr. Samuelson's views on this. And that is basically, he has succeeded in making in the minds of the American public through the use of the media that is unique to a President, the question of energy and the adequate supply of energy as the No. 1 issue facing the United States today.

I have felt for a long time that it was perhaps the second most important problem facing America today. And, of course, directly related to what I consider to be the most important problem facing America today, but not the most important, and the most important one being economic recovery. This again has been, with the exception of those witnesses of the administration, fairly unanimously the view of both business people and economists of all political ilks from the extreme left to the extreme right, both in the economic field, the business field, and the political philosophy field, or in all three as they have appeared before this committee and as I have listened to them.

I would appreciate, Mr. Samuelson, your views on this, if we may?

Mr. SAMUELSON. As I said earlier in commenting on the interaction between the long-run energy problem and the rest of the decade problem of recovery, I think that the recovery is our No. 1 problem. I think it has two facets; namely, unemployment and two-digit price inflation, which we as a nation must not get back into.

So, it is a stagflation problem. It is a problem of growth and unemployment combined with the problem of less price stability or more price stability. And I think that is our No. 1 problem. This does not mean that from a long-run viewpoint there is no energy problem. There is an arguable energy problem. I say arguable because there are quite a number of authorities who are of the opinion that technological change around the corner in the field of fusion means that even the energy problem is a transition problem from where we are now with our dependence upon fossil fuels and our desire in terms of our usual way of life, to have a very convenient fossil fuel; namely, oil and natural gas.

But if I were asked which of these is the more important problem; the problem of bring 9 percent unemployment down to 6 percent and below within a couple of years—2 or 3 years—and the related problem of how we can level off with a rate of price increase we can live with, whether it be stable prices which few are optimistic enough to think is available to us or whether it be 3 percent price increases or

4 or 5 percent price increases—I would answer that I think that the energy problem is secondary.

For one thing, we are not a country like Japan, which is almost totally dependent for offshore supplies of energy. We use energy so lavishly in this country in ordinary times that by relatively modest changes in our behavior patterns during a real emergency (industry is very important; it is often easy for industry to save 30 or 40 percent when it is worth its while to do so), we can last through boycotts and emergencies for a long, long time. So that even the long run, the energy problem has many different sides to it. It has to be stressed again and again that the big change that has taken place in the last 3, 4, or 5 years has not been a change in the balance sheet of geology, nature's finite storehouse of energy, but, of what is happening to the industrialized nations and the developing nations in their use of energy for transportation, for fertilizer and so forth.

The changes in that respect have been of two kinds. Some have been favorable, some have been unfavorable. The big change has been the firming up of an OPEC oligopoly so that a fourfold to fivefold increase in the price of oil could take place overnight with no commensurate change overnight or over the decade in the fundamental supply and demand balance for oil in terms of resources and use. Now, given that fact, even the long-run energy problem is different from much of the scare talk that you hear about. And the optimal solutions to it can be of quite diverse sources.

I find that I must say, speaking as an economist, I find it ironic that even the opposition party in Congress sort of reproaches itself that it has not come up with a bold scheme for energy that the White House is able to make political advantage that it is ahead of the Congress and it is constantly challenging the Congress. It is as if somebody were to say, why cannot the two Houses of Congress solve the problem of squaring the circle. Then vast majorities in both Houses say, why is it that we are not able and that the President is putting us on the spot to be able to square the circle. Congress has taken the dunce's hat and has put it firmly on its head.

Whereas, if Hans Christian Andersen could be here to write up the fairy tale, he would, I think, have to point out in very low-keyed terms exactly what it is we are discussing here—that there is a very problematic issue over the next 15, 20 years as to what the OPEC oil monopoly will be able to charge. You know you can get any number of economists in my profession who will come up here in the hundredfold and all swear that no monopoly has ever held up in the history of mankind from which they draw, I think, the wrong conclusion; namely, that the OPEC monopoly is going to fall on its face tomorrow or 6 months from now or at some other statable period. I do not think that is the correct conclusion. The correct conclusion is that the OPEC countries are not able to sell all they wish as members of the cartel at the rigged world price and it simply depends upon who is going to hold the umbrella, who is going to swallow the unsellable oil. Will there be a Libya which will break the traces? Will there be an Algeria? Will there be an Ecuador? That is the way the cartels come to grief.

And it depends on alternative source of supply and not clever negotiation by a Secretary of State and certainly not, one would hope, on guarantees made by representatives of the consumers to the oligopoly of a price floor in return for some kind of moderation of a price ceiling which the whole experience in dealing with these particular kinds of oligopolies has always suggested. The promised price ceiling is only worth the paper it is written on, which is the price of paper.

Representative LONG. I could not agree with you more with respect to every statement that you have made even including that of the criticism with respect to the Congress having put the dunce hat on its head and sitting there with respect to a determination of what the major problems are and the relative importance of the problems that are facing this country.

I think we have had a great deal of help on misinformed, unwilling to do its detailed work, press in this regard. And I think they have played upon the international aspects of the oil situation; the machinations of our Secretary of State in this regard who has suddenly become an economist as Mr. Gordon was saying in another context a few minutes.

But we in the Congress, for example, speaking of the question that Mr. Gordon mentioned, and while we did not target it to the degree that he would like to see it done nor to the degree that I would like to see it done, we passed a job program that fairly met, in general terms, many of the objectives that were set forth by Mr. Gordon in his statement of those areas of unemployment that needed to be treated. And as a possible workable solution to this massive unemployment that we find ourselves in; what happens again in following their religion, they end up with the President vetoing that piece of legislation.

I do not think anybody in the Congress looked upon that as the ultimate solution to the problem. We looked upon it as an interim-type of solution or interim-type of help I guess rather than even classifying it as a solution at all; and then with a view of moving into those types of programs that might long range, and as Mr. Gordon characterized as a permanent type of program that would relate to employment for those types of groups of people.

Again I agree. We had—I think it was the Secretary of Treasury here 1 day—and 2 or 3 days after the President had vetoed the jobs program and our chairman, Senator Humphrey, in his own inimitable style made what I thought was a classic remark to the Secretary. He was telling him, he said what we are interested in is J-O-B-S, jobs, not B-S, but J-O-B-S, which I thought was a pretty good point because that seems as though what we are getting to a great extent.

Mr. Gordon, Senator Kennedy had explored a number of these points with Mr. Samuelson. I would like to go back to another one which is related to that, which he did explore with Mr. Samuelson yesterday. I think it was before the House Banking Committee that Mr. Burns appeared. In his position as Chairman of the Federal Reserve he reiterated what he had been telling us here for a long period of time that the money supply targets, 5 to 7.5 percent of the money supply, and he reiterated those again yesterday as what his targets were. We again nearly unanimously as he came before the Joint Economic Committee, said he was not being realistic. In Louisiana political terms we would say he is talking out of both sides of his mouth at the same time and whistling Dixie all three at the same time.

But during the past 3 months the money supply has grown considerably more rapidly than what he had said as what his target was going to be. And even getting him to admit that it has grown faster than what he said it started to be even though you look at the figures, there is concrete evidence there, it becomes difficult even to get him to admit that it has. But in the past few weeks which has really caused, I think, a lot of us a great deal of concern, his signals seem to be an even tighter control on the monetary policies than have been followed by the administration even though they were talking 5.5 and 7 and they were really dealing in some figures all of that time rather than talking it and some figures that were higher than that.

And some things that have happened in the last few weeks have indicated a tightening up policy. He said in his statement yesterday, the Federal Reserve has already set in motion forces that should in the near future return the growth of the monetary aggregates to the moderate path desired. Now, that to me is a little bit of a frightening statement. What is your view on monetary policy? Has it been during these last few months unduly expansive in view of the economic circumstances that exist? Is there a need now to considerably restrict monetary growth in order to make the average over time come out right; as he would see it quoting again and closed quoting at the same time with respect to a 5.5 to a 7 percent? And is this an appropriate time to begin to tighten monetary policy with the economic recovery, even by the most optimistic, just beginning to get underway?

And I am not one that thinks frankly it has done any more than perhaps bottom out. What is your view with respect to those three?

Mr. GORDON. I think my answer would be in three parts. First, with respect to the announced objectives of the Federal Reserve Board with respect to growth in money supply, which Mr. Burns now puts in terms of a rise from the second quarter of 1975 to the second quarter of 1976. In my opinion—and here I agree completely with Prof. Samuelson—this calls for too slow a rate of growth in the money supply.

Now, as to what should be done in the immediate future, the next few months, what the Board is clearly trying to do is to average out the faster than desired rate of growth in the money supply of the last few months with a rate of growth considerably less than the 7½ percent, so that by the second quarter of 1976, we will have that 7½ percent or less. I think that is nonsense. As a matter of fact, I think it is a tragedy.

Representative LONG. That sounds sort of like a self-fulfilling prophecy, does it not?

Mr. GORDON. Pretty much. I wish Mr. Burns would pay more attention to the unemployment rate than the rate of change in the money supply.

Representative LONG. As you know, in following—and I assume you do—what this committee has done, we have pressured, pushed, cajoled, begged, done everything we can to try to get him to do that over the past few months.

In this—well, not completely in this context—but in your prepared statement, you recommended a more expensive policy designed to bring the unemployment rate down to about 7 percent. It would be required by the end of next year. This, by the way, also——

Mr. GORDON. What I said was, I did not expect you could get the unemployment rate lower than 7 percent by the end of next year. That is certainly not projected in the longer run.

Representative LONG. In order to accomplish this, this would require about a 9 percent growth of real output. Is that about right?

Mr. GORDON. Yes.

Representative LONG. Now, what Mr. Samuelson had said, in glancing over his testimony; he had recommended perhaps an increase of about 7 percent growth rate during that period. Do you think that perhaps Mr. Samuelson is being a bit too conservative in that regard?

Mr. GORDON. Mr. Samuelson stated very carefully that he was trying to be moderate, take account of both extreme positions, and this was a moderate and, in his view, reasonable projection. I would risk being more expansive, and my view of the underlying situation is that what acceleration of price increases that you are going to get in the next year are not going to come from a faster rate of expansion than Professor Samuelson was contemplating.

Representative LONG. They are not?

Mr. GORDON. They are not. They are going to come from exogenous forces, coming from food and from oil and so on; and with an unemployment rate of about 9 percent, excess capacity across the board, adding another 1 or 2 percent to the rate of expansion for the next year is not going to exacerbate the inflation problem from the demand side.

Representative LONG. Going back to your, I thought, very very unusual and, I think, very descriptive description of the economic policies followed by the administration as being a religion that they are following——

Mr. GORDON. I am surprised that surprises you. I thought that was obvious.

Representative LONG. It might be. I just had never quite thought of it in those terms. One of the reasons I have not been able to think of it in those terms is that one of the basic facets of most religions that I am familiar with has somewhere at the end of them a glowing light, you know; a hereafter that is going to bring peace and harmony, and all of us are going to be happy in the hereafter. And that facet of their religion seems to me to be missing. So I had never really thought of it as a religion, and maybe that is the reason I had not thought of it as a religion.

Mr. GORDON. Well, many religions also contain pictures of hell and damnation.

Representative LONG. Well, I can recognize those aspects of it, you know. But I have been, and I think many of us who have studied this problem have been disturbed and discouraged by their unwillingness to establish economic goals. And this gets back to the religious aspects of it. You know, religion to me—and maybe it is because of the fact that I grew up as a Southern Baptist—is that they have these particular things that you are supposed to do, and everything is concrete and put into a specific place on the headstone when you die, on back the other way.

Mr. GORDON. So it is in the administration.

Representative LONG. We have not been able to get them in all of their appearances of practically every economist they have at the top level, and every policymaker that they have at the top level in their appearances before this committee. We have not been able to get them to establish specific goals for the economic policy that they are following.

My belief is the reason we have not been able to get them to do that is, they are not willing to admit publicly that that has to involve an unemployment rate of such a high percentage that they are both politically and realistically, as to the impact it will have on the American people, unwilling to admit as to what it is.

Mr. GORDON. Let us put it this way. We talk about the tradeoff between inflation and unemployment a great deal. Let us talk about a tradeoff with respect to religion of the administration, but make the tradeoff percentage of the GNP spent by the Government and the rate of unemployment. And the administration's religion leads it to believe in a tradeoff that it is worth an extra few percentage points on an unemployment rate to reduce the percentage of the GNP spent by the Federal Government by a percentage point or two. That is the religion.

Representative LONG. Mr. Samuelson, do you think we should continue, or that it is wise on our part to continue, to get them to try to set specific, quantitative goals for output unemployment and/or prices? Do you think this is worth pursuing? Is this of importance enough, as something to see, and if you do, do you have any suggestions of what we might do further in that regard?

Mr. SAMUELSON. Yes. If I may lapse into the parlance popular here, I think it is the Lord's work that you are doing because I think that the actual recommendations and performance of the administration have been better because of the pressure that they have been put under. I think that if it had not been for the congressional pressure, you would not have the administration agreeing with the proposals that they have agreed to. Often, they regard this as a compromise to prevent something worse from happening, and so you do get a half loaf. Indeed, just to disgress for a moment, it is quite possible that the Democratic Congress, in its militance and vigilance against the occurrance of a really serious depression as against a recession, may turn out according to historians to have reelected President Ford.

The Democrats were not able to reelect Herbert Hoover, but if they had been more effective, they might have lowered Franklin Roosevelt's 1932 majority. Because you do find, there is not question about it that the index of consumer sentiments is better, as we sit here now, than it was 5 months ago, 7 months ago. And this has not been an accident. It has been the result of the more stimulative behavior forced upon the United States Government by the people through its representatives, and forced upon the Federal Reserve.

Representative LONG. Mr. Samuelson, I could not agree with you more. But of course, looking at it as a person that is involved in politics, is that I think the majority of the members of Congress that are active in this field were absolutely convinced that the policies that were being followed—and let us just take energy as an example, and go back to a particular date in time.

We had a period in time there where, within a period of 36 days, under what the President was advocating as an energy program, four things would have happened in what he was advocating. The first was the first dollar of duty. The second was at the end of 30 days, the second dollar of duty. The third was at the end of 60 days, the third dollar of duty; and then, immediately following that, was the removal of all controls on old oil in the United States.

We must have had 20 witnesses before that committee. I think the unanimous view, again with the sole exception of those that were the hired guns of the administration; they were of the view that—and I am not being overly dramatic when I say this—that should that energy policy have been imposed upon the economy of the United States at that particular time, the result would have been absolutely catastrophic. And I think the reason that was not imposed upon the American people in the sequence that I set forth is because of the pressure that was brought by this committee and the other committees and the other Members of the United States Congress, and the Democratic Members of the Congress.

I did not sleep many nights, worrying about this coming about; ~~and I think the reason it did not come about is because of the pres-~~ sure that we borught at the time. And continually, as I said before, it distresses me that we are able to find that this continues to be presented by the press, because of the unique access that the President of the United States has to the media as this energy problem does, as the No. 1 problem facing America. And I recognize, as you stated so eloquently, that it is a serious problem. It is a transition which needs some attention. But it is not something, in my opinion, that is the most urgent problem facing America today.

We went through this period with President Nixon on impoundment, Mr. Gordon, as you well know, where the Congress was passing programs and President Nixon was impounding the moneys; where, if we had had those set forth and started in motion at the time that this was being done, we would have been in a much better position to have gone into the more permanent aspects of what you are suggesting with respect to the jobs program. But they were impounded.

We have really, in effect, had an impoundment by the Republican administration of the Full Employment Act of 1946. Is that not about right?

Mr. GORDON. I agree.

Representative LONG. By just an ignoring of the provisions of the law.

Mr. GORDON. As a matter of fact, may I take the liberty to suggest to you in some future hearing of this committee, in which representatives of this administration are present, that you cite the particular section from the Employment Act that I have in the second paragraph of my prepared statement; that "it is the continuing policy and responsibility of the Federal Government to use all practical means * * * to promote maximum employment, production, and purchasing power." And ask the members of the administration what is their interpretation of that clause?

Representative LONG. I will accept your suggestion, and I will go a step further. Do they feel they are fulfilling their oath of office to uphold the laws of the United States with respect to that particular point of law? Because that is the law of the United States.

Mr. GORDON. I had that in mind, but I preferred that you made the suggestion.

Representative LONG. I would be happy to do it. Thank you.

Do either of you gentlemen have anything further to add to this? You have been most helpful, and we are appreciative of both of you coming down and giving us the benefit of your very expert knowledge in this field; and your excellent reputations in this field are again justified by your appearance here today. And as Senator Humphrey would say, I am sure that you are bound to be extremely brilliant, because you agree with me.

Thank you very kindly. The committee stands recessed.

[Whereupon, at 11:55 a.m., the committee recessed, to reconvene at 10 a.m., Tuesday, July 29, 1975.]

# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

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TUESDAY, JULY 29, 1975

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

The committee met, pursuant to recess, at 10:05 a.m., in room 318, Russell Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Sparkman, Proxmire, Kennedy, and Javits.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

## OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. We will convene the meeting of the Joint Economic Committee. This morning we continue the process of our midyear review on the economic situation and, of course, we are very pleased to once again welcome as our witness Mr. Arthur Burns, Chairman of the Board of Governors of the Federal Reserve. Mr. Burns, as I said to you a moment ago privately, and I now say publicly, it is a special pleasure to welcome you this morning. And I might add that it is also always a challenge for those of us on the committee when you appear before us as a distinguished economist, as Chairman of the Federal Reserve Board and the Open Market Committee.

And as the supervisor of a large and highly qualified professional staff, you represent and indeed you are personally a storehouse of information and analysis about the economic situation. The challenge to Congress, frankly, has often been to obtain that information from you. The passing of the congressional resolutions is in a large part responsible for your presentation to Congress of the monetary targets of the Federal Reserve. I believe that this is an historic step forward and I believe that your appearances before the Senate Banking Committee last May and before the House Banking Committee this past week have been enormously helpful and constructive.

However, this is only the beginning. Congress continues to need more information and I suggest that it is not always getting all the information it needs, in part due to its own inadequacies and possibly in part due to our lack of proper structure. Congress is still not succeeding in exercising the fundamental control over monetary, and I might add, fiscal policy which it ought to exercise. The responsibility of Congress, however, is not to see that the money supply grows at any precise rate nor that interest rates be held in any precise level. The responsibility of Congress is to set objectives for protection, employment and income, price structure, and then to insist that the respective agencies of government and, in this instance, the Federal Reserve and its policy is consistent with those objectives. I must confess publicly, as I have privately, that I think the Congress has been derelict in this. This committee has set objectives and we have published them as the advisory body to the Congress.

But it is my judgment that we in the Congress by formal resolution need to establish those objectives. The House Banking Committee urged you this past Thursday to give them your estimate or your staff's estimate of the projected employment and price levels which could be expected next year if your announced monetary targets are observed. I gather that you refused to do that precisely but you may want to comment on that.

You told a member of the committee, and I quote you, "when you talk about goals, I think you personally, members of this committee and members of the Federal Reserve System would agree on goals pretty closely. We all want a high rate of employment. We all want a low rate of unemployment. We all want an improvement in our standards of living." And, of course, I trust that we all agree on those goals. But for me, those goals are too general to serve as an adequate operating guide to economic policy. This committee has been in disagreement with the administration as to the immediate policies which would best move us toward even those general goals.

In our annual report last March, this committee set forth specific objectives in terms of billions of constant dollars of GNP and in terms of the unemployment rate for the end of next year. I think we did fulfill our responsibilities under the law as a committee to set those objectives. But we have never succeeded in getting the administration to comment directly on the desirability of these goals. However, it is apparent from the policy recommendations of the administration, that they feel that the goals specified in our March report are too ambitious and that a more moderate approach to economic recovery is desirable.

Now, we have had Mr. Greenspan and members of the Council of Economic Advisers before us as well as the Director of the Office of Management and Budget and I think it is fair to say that our disagreement is not over the long-term targets but rather, over the pace of achieving those targets.

Mr. Burns, we are not quite sure just where the Federal Reserve Board comes out. For example, on the rate of recovery, are you for a rapid recovery or a more cautious and moderate recovery? And I might add, I for one am more concerned about a sustained recovery. You indicated to the House Banking Committee last week that you had hoped to see the unemployment rate fall to around 7.5 percent over the next year. However, none of the three respected private forecasts which I have had the staff of the Joint Economic Committee examine, saw the unemployment rate dropping that much over the next four quarters. And every one of those forecasts predict a growth of the money supply above the upper end of the Federal Reserve's target range. What we would like to know then and we have a number of questions, of course, when the question period comes, is whether any quantitative work done by the Federal Reserve Board or its professional staff shows the unemployment rate dropping to the range of 7.5 percent by the third quarter of next year if the money supply has been growing within the target range that you announced, I believe last May. If not you may have very good reasons for rejecting the staff forecast and predicting a sharper drop in unemployment. We would like to know what those reasons are. I will, of course, along with other members of this committee, return to these questions and others as we open the question period.

It is essential that Congress know the specific income production and employment goals at which the Federal Reserve Board is aiming within the objectives that had been set in the Employment Act of 1946. If those goals differ from those at which the Congress seems to be aiming, then those differences have to be resolved. Let me say again that I believe that one of our problems is the impreciseness of the targets that we are aiming at. And in all candor and fairness, I believe that the Congress itself has been derelict in this responsibility. We are the policy body of the Government and we ought to conduct ourselves accordingly.

As I say, it is ultimately the responsibility of the Congress, the elected representatives of the people, to establish these goals and to see that the other agencies of government conform.

Mr. Burns, you have been patient, we look forward to your testimony and we always learn a great deal when you are here and so, I say to you with great respect, Professor, you may proceed.

I understand Senator Javits has a comment.

Senator JAVITS. Thank you very much, Mr. Chairman.

First I will consider it always a great privilege to hear Arthur Burns, especially when he is summing up, as he will be today, the valuable and intelligent planning for our country. I also would like any of your thoughts you would have, Mr. Burns, on the subject of the national planning bill, which Senator Humphrey and I have introduced.

But I would also like to throw into the hopper a few other questions to which we hope you will address yourself. One is the matter of international monetary reform. Seemingly, that matter has been shelved. Question—do we have any right, in the interests of world peace and world economic stability, to shelve reform as we have seen, that we can be dragged down by the world economic situation just as it can be dragged down by us? Question—can we afford to just let it move along without reforming the international monetary system? Question—should we be considering issues of industrial efficiency, depreciation allowances, the investment tax credit, and other efforts to stimulate industrial production and productivity.

Question—is the United States relegated to be in the cellar, as they say in baseball, in terms of productivity? Are we sentenced to an endemic unemployment rate of 9 to 10 percent? Or can we pull our socks up and really become No. 1 in the world as we have been for many decades? And finally, what is the impact of the practical bankruptcy and anarchy of the cities on the economy of our country? These are critical problems upon which I, and I believe my colleagues, would like to hear from the man we respect so much in this field.

Thank you.

Chairman HUMPHREY. We will come back to those questions again because we need your counsel. We have here Senator Sparkman who you know so well and I am sure he has a comment.

Senator SPARKMAN. Mr. Burns, I am always glad to see you appear before this committee and also the Senate Banking Committee. Unfortunately, I have a conflict this morning. The Senate Banking Committee is in session now, that is the reason why Senator Proxmire is not here, we are having a markup on a rather important bill and I am going to have to go for that markup. However, I did want to come by. I have your statement. I am taking it with me. I will read it carefully and I just regret that I am not going to be able to be here for the questioning. I know you will give this committee a lot of good advice that you always do.

I have great confidence in your leadership and I am very glad that you are before us again this morning.

Chairman HUMPHREY. Senator Sparkman, I want you to hurry up to the markup and get back. You are an experienced member of this committee and former chairman of the Senate Banking Committee. May I say to you, Mr. Burns, that Members of the House will be with us later but they are in a legislative session at the moment.

We look forward to these hearings as a part of a national education process, Mr. Burns, and I notice that we have a good deal of media here which is very helpful in bringing the public into closer understanding of what is developing in our economy. I happen to be one that believes that a congressional hearing ought to be more than just bombast, it ought to be an educational process. We will proceed now, and we look forward to what you have to say.

## STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you very much, Mr. Chairman, and my thanks to you, Senator Javits.

Before I turn to my testimony and my statement this morning, I would like to say a word about the Joint Economic Committee. The Joint Economic Committee has established a great tradition, a tradition of inquiry, a tradition of cooperation. I find it more pleasant, more instructive to appear before your committee, Senator Humphrey, than any other of the Congress and I very much hope that you, with your fine energy, will move your committee onto the even higher plane that you seek.

When the Employment Act was written, it was the intent of the Congress that the Joint Economic Committee formulate general economic policies to serve as a guide to the legislative committees of

Congress. Things have not worked out in quite that fashion. I find the comments that you made this morning, your objectives, very heartening. I hope you succeed.

Now, my prepared statement, in view of the scholarly interest of your committee, is a long one. In the interest of time, I think it might be best if I start with the monetary policy part of that statement. The earlier parts are devoted to an analysis of the causes of the recession and some of the corrective processes.

Chairman HUMPHREY. We will, of course, include the entire text of your prepared statement in the record at the end of your oral statement.

Mr. BURNS. Thank you very much.

Last summer, as signs of weakening of economic activity multiplied, the Federal Reserve began taking steps to increase the availability of money and credit. Open-market operations were oriented toward a more liberal provision of reserves to the banking system; later, these actions were reinforced by several reductions in the discount rate and in reserve requirements.

During the fall and winter months, the demand for credit by businesses and consumers weakened on account of the recession, and commercial banks used the more abundant supply of reserves to repay their indebtedness to the Federal Reserve. Growth in $M_1$—that is, currency plus demand deposits—was therefore slow to reflect the easing of monetary policy. We at the Federal Reserve were concerned about this development, but we refused to run the risk of releasing fresh inflationary forces and rekindling inflationary expectations. In any event, broader monetary aggregates displayed a more vigorous response to our easing actions. For example, flows of individual savings into commercial banks and thrift institutions began to pick up in the fourth quarter of 1974; and by the first quarter of this year, these deposits were expanding at a seasonally adjusted annual rate of over 13 percent.

Federal Reserve actions to increase the availability of reserves take some time to work their way through the economic system. As a consequence, some of the effects of easier Federal Reserve policies during a recession may not register in $M_1$, the narrowly defined money stock, until the demand for transactions balances begins to strengthen. That may well have been a factor in the huge bulge of the money supply during May and June of this year. However, a large part of this bulge was also the direct result of the tax bill passed earlier this year by Congress. The tax rebate checks and supplemental social security payments disbursed by the Treasury were temporarily added to the public's holdings of currency, demand deposits and savings accounts. Thus, $M_1$ grew at an average annual rate of 14.5 percent during the months of May and June, and $M_2$—which includes consumer-type time deposits at commercial banks, besides currency and demand deposits—increased at a rate of about 16 percent. By late June and early July, as individuals disposed of their additional funds, the explosion of the monetary aggregates subsided.

Over the past three quarters as a whole—that is, during the period of steeply declining business activity—the additions to money and credit supplies have been on the generous side for an economy that is continuing to suffer from inflation. In fact, the growth rates of the monetary aggregates during this recession have been appreciably higher than during comparable periods of earlier postwar recessions. The narrowly defined money stock, $M_1$, increased at an annual rate of about 5 percent from the third quarter of 1974 to the second quarter of this year. Increases in broader measures of money balances were considerably larger over this period. For example, $M_3$—which includes all consumer-type time deposits at depositary institutions, in addition to currency in checking accounts—rose at an annual rate of 9 percent over the three quarters. As these facts indicate, Federal Reserve policy contributed materially to establishing the financial basis for an upturn in business activity.

In recent weeks, signs have multiplied that the economy is moving through a turning zone from recession to recovery. Improved markets for consumer goods have been leading the way, with retail sales gaining strength progressively since early this year. The appreciable pickup in new auto sales over the past several months is continuing, and so is the uptrend in sales of residential real estate. Sales of new houses in May were 50 percent above their trough last December, and the backlog of unsold units is down to 8 months, supply at recent sales rates.

With excess inventories at retail, wholesale, and manufacturing firms being worked off and the curve of consumer sales still rising, businessmen have become more optimistic about the future. New orders for durable goods—an important leading indicator of industrial activity—have risen in each of the past 3 months. Moreover, industrial production, after declining in 8 consecutive months, registered its first advance in June.

In the labor market, too, there are numerous signs of improvement. The range of nonfarm industries adding to their payrolls has been widening steadily, from a low of 17 percent in February to about 50 percent in May and June; total employment has increased by 600,000 over the past 3 months; the average factory work week has lengthened; and, of late, initial claims for unemployment insurance have dropped substantially.

We may be reasonably confident, therefore, that a recovery in business activity will develop soon, if it is not already underway. Inventory liquidation in some lines—particularly among producers of capital equipment—seems likely to continue for a time, and an upturn in business fixed investment may lag beyond the expansion in general economic activity. In many sectors, however, the need to rebuild stocks in response to improving sales will add a strong upward thrust to industrial production and to employment in the months ahead. As uncertainties about jobs and earned income abate, consumer spending will advance further. A significant rise in residential building activity may also be expected, since the underlying improvement in the condition of real estate markets has just begun to register in rising new home construction.

The outlook for our foreign trade balance, while less clear, also appears to be favorable. To be sure, recent trade surpluses reflect in part the impact of the decline in domestic activity on our imports—

especially of fuels and industrial supplies. A revival of economic activity here will tend to boost these imports; but once foreign economies begin to recover, which seems likely before the year comes to an end, our exports of industrial materials will also pick up. Exports of machinery have been maintained at a high level this year, despite the weakness of foreign economies; these exports may be expected to do well over the next year. And in view of unsatisfactory harvests abroad, our exports of grain will be large—perhaps even embarrassingly large.

Recovery from the recession of 1974–75 thus seems likely to be broadly based. How strong the recovery will be, no one can foresee with any assurance. The amounts of idle labor and capital resources are certainly sufficient to permit rapid growth over the next several quarters. Past cyclical experience suggests, moreover, that a steep decline in business activity such as we have experienced is usually followed by a brisk recovery.

We must recognize, however, that our economy is confronted with some troublesome problems to which policy must attend if full employment is to be regained. Energy prices are extraordinarily high, and they may well rise further. Shortages of energy supplies and other industrial materials could become a serious impediment to the expansion of production and jobs in a year or two. Our financial markets, meanwhile, will have to absorb a huge volume of Treasury securities this fiscal year—at a time when private credit demands will be expanding to finance larger economic activity. To make matters worse, inflation is still adding its own dimension to pressures in financial markets.

The vigor of economic expansion in the year ahead, and even more over the next few years, will depend heavily on the ability of our Government to find ways to cope with these difficulties. Let me, therefore, turn to the implications of these problems for public policy.

As far as the Federal Reserve is concerned, the only responsible policy is to pursue a moderate course of monetary and credit expansion, such as I described before the House Committee on Banking, Currency, and Housing a few days ago.

The relation over time between money balances and the fiscal volume of economic activity is rather loose, since so much depends on the attitudes of businessmen and consumers as well as on other governmental policies that are pursued simultaneously. But with $M_1$ growing in a range of 5 to 7½ percent, and more comprehensive measures of money expanding substantially faster than this, it should be entirely possible to finance a recovery of normal cyclical dimensions over the next year. History teaches that the turnover of money—that is, the willingness of people to use their existing money balances—tends to rise much faster in the recovery stage of the business cycle than does the monetary stock itself. This basic fact about the business cycle must never be overlooked in judging the reasonableness of monetary growth rates.

I might add that materially higher or lower monetary aggregates than the Federal Reserve has projected for the coming year would involve serious risks. If, for example, the expansion of $M_1$ were held down to 3 or 4 percent, short-term interest rates might rise rapidly

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and impede economic recovery. On the other hand, if a growth rate of 8 or 10 percent were sought, inflationary expectations would be intensified, and larger increases in prices and costs would be encouraged. In these circumstances, long-term interest rates would tend to rise, since investors would insist on getting, and borrowers would be willing to pay, a higher inflation premium. It is highly important to bear in mind the longer run effects of the policy alternatives now available to the Federal Reserve. More rapid monetary growth would indeed tend to hold down short-term interest rates and thus impart some immediate stimulus to economic activity. But long-term interest rates would soon rise and perhaps frustrate any reasonable prospect of recovery in housing or business capital investment.

As I noted earlier, the growth of monetary aggregates in recent months has been well above the longer run rates of expansion that we have been seeking. The Federal Reserve has no intention of permitting rates of increase as high as those in the second quarter to continue. The special Treasury disbursements have come to an end; and we have already set in motion forces that should, in the near future, return the growth of the monetary aggregates to the moderate path desired. These recent actions have left their mark, if only temporarily, on short-term market rates of interest. But if that had not occurred, the business and financial community, which nowadays is highly sensitive to monetary growth rates, might well have concluded that the Federal Reserve is releasing a new wave of inflation. Any such interpretation by market participants could have had damaging effects on economic prospects at this stage of the business cycle.

As I believe this committee recognizes, the growth ranges for the monetary aggregates that we have projected for the next 12 months may need to be adjusted one way or another. Clearly, the growth rates presently sought by the Federal Reserve, while appropriate in the present environment of high unemployment and unused industrial capacity, could not be maintained indefinitely without giving up the fight against inflation. As the economy returns to higher rates of resource utilization, it will be necessary to reduce the rate of monetary and credit expansion, so that the basis for a lasting prosperity is laid.

Timely steps may also be needed to reduce the degree of fiscal stimulation as economic recovery proceeds. The gigantic budget deficits for fiscal 1975 and 1976—coming on top of the persistent Federal deficits of the past decade—are a major source of the inflationary expectations that are holding up long-term interest rates. When anticipations of inflation are as pervasive as they are today, the only effective device available to the Federal Reserve for holding down long-term interest rates is to pursue a moderate montary policy. But fiscal policy can also be very helpful in this regard. The American people are awaiting further evidence that their Government will restore the fiscal discipline needed to cope with inflation. The Federal Reserve Board therefore urges this influential committee to use its good offices to press for moderation in fiscal affairs during this and the next fiscal year.

Our country is confronted today with a serious dilemma in its search for ways to move the economy toward full employment. Highly expansionary monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But, later on, the rate of inflation would accelerate sharply—a development that would create even more difficult economic problems than we have yet encountered. The Senate Committee on Banking, Housing and Urban Affairs has recognized this basic truth. Its recent report on monetary policy states unequivocally that if inflation is rekindled, any recovery will be short lived and will end in another recession, one almost certain to be more virulent than the present one.

In the current economic and financial environment, conventional thinking about stabilization policy is insufficient. We need to reopen our economic minds and actively seek ways of achieving reasonably full employment without resorting to ever larger monetary and fiscal stimuli.

A part of our recent problem of continuing inflation amidst widespread unemployment stems from a failure to attend sufficiently to modernization and improvement of our Nation's industrial plant. Our country has been devoting relatively less of its economic resources to business capital expenditures than any other major industrial nation in the world. The result has been a diminishing rate of increase in productivity, the emergence in 1973 and 1974 of severe shortages of critically needed industrial materials and supplies, and continuing upward pressure on costs and prices. Renewed scarcities of major materials—such as steel, industrial chemicals, and plastics—could impede the projected economic recovery unless action is soon taken to step up the rate at which modern facilities are expanded in these industries.

The inadequate rate of investment among American enterprises reflects to a large degree the fact that business profits over the last decade have fallen short of the amounts needed to finance a good rate of growth of effective industrial capacity. Last year, the after-tax domestic profits of nonfinancial corporations—excluding inventory gains—were actually smaller than they were 8 or 10 years ago, when the dollar volume of the output of these corporations was about half what it is today.

The slump of profits, besides its adverse effect on investment, has led to increasing dependence of business corporations on borrowed funds. The amount of debt owed by corporations relative to their equity position has risen sharply for more than a decade, and many businesses therefore no longer have the resiliency they once had to resist economic and financial adversity. There is a clear need in our country not only for larger business capital investment, but also for larger reliance on equity funds in financing capital expenditures.

These objectives may be promoted by an overhaul of the structure of Federal taxation. Value-added taxes are widely used in western Europe, and it may be instructive to reexamine the merits of such a tax for our country. There are, of course, numerous other possibilities. For example, dividends on preferred stock might be made tax deductible, as the President has recommended, or taxation of dividends that are reinvested in new shares—at the option of the shareholder—might be deferred. These and other ways of integrating business and personal taxes deserve thorough study by the Congress.

Another area that needs immediate action is our national energy policy. Uncertainties created by the delay in adopting legislation on the oil-pricing problem are becoming a serious obstacle to private economic planning and may increasingly impede the recovery as time goes on. In formulating a national energy program, it is of course necessary to give attention to sources of energy besides oil. Shortages of natural gas are likely to curtail production in some States this winter, and this problem will become more acute in later years if current policies for controlling the price of natural gas are not modified. And let us not overlook the importance of expanding the rate of construction in the electric utility industry. The President's Labor-Management Committee has developed a series of recommendations to accomplish this objective that I hope the Congress will weigh carefully.

Among these recommendations is a suggestion that environmental restrictions be stretched out to facilitate the expansion of electric-generating capacity. Of course, the impact of environmental regulations on the economic activities of our Nation goes well beyond the electric utility industry. A good deal of industrial construction across our land is being held up by environmental regulations and litigation. A significant part of business capital outlays, moreover, is now being channeled into equipment for the abatement of pollution, rather than for expanding industrial capacity. For example, in 1974, producers of iron and steel, nonferrous metals, and paper devoted more than 20 percent of their capital budgets to pollution control. Regulations with respect to the environment and safety have also been a major factor running up auto prices in recent years, and thus putting a damper on auto sales and production.

We at the Federal Reserve are concerned, as are all thoughtful citizens, with the need to protect the environment and improve in other ways the quality of life. We are also concerned, however, about the vigor of economic recovery and the dampening effect of environmental regulations on business activity. Here, too, a middle ground is needed.

Governmental practices and programs affecting labor markets also have to be reviewed in any serious search for noninflationary measures to reduce unemployment. For example, the Federal minimum wage law is still pricing many teenagers out of the job market. Programs for unemployment compensation at times provide benefits on such a generous scale that they may be blunting incentives to work. Even in today's environment, with perhaps 9 percent of the labor force unemployed, there are numerous job vacancies—perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. It is hard to believe that better results could not be achieved with more effective job banks, more realistic training programs, and other labor market policies.

Indeed, many structural reforms will prove necessary to enhance the prospects for expanded employment, while at the same time reducing the pressures on costs and prices. We need to gather the courage to reassess our laws directed against restraint of trade by business firms, to reassess the enforcement of these laws, also the monopoly of first-class mail by the Post Office, the various restrictions on entry into the professions, the effects of the Davis-Bacon Act on construction wages and employment, the intricacies of governmental regulation of transportation, the role of trade unions in the public sector, the effects on consumer prices of remaining fair trade laws, other legislation or practices that impede the competitive procsse. Nor would I rule out the possibility that some form of incomes policy, going beyond the legislation governing the Council on Wage and Price Stability but continuing to rely mainly on voluntary compliance, may yet be of some benefit in moving our Nation toward the goals of full employment and a stable price level.

What I have tried to suggest in these brief comments on structural policies is that we can make better progress in moving toward our national goals by reducing the burden being carried by monetary and fiscal policies. The well-meaning citizens who now keep urging stronger monetary and fiscal stimuli seem to overlook the fact that excessive reliance on such policies brought on an accelerating inflation during the past decade. They overlook the fact that the current recession was caused basically by an inflation that got out of control.

And they also overlook the fact that a large part of the effort that our Nation has directed during the past decade or longer to improving the lot of poor people—through increases in social security benefits, welfare programs, and other means—has been nullified by the cumulative force of inflation.

Our Nation has paid a heavy price during the past year for tolerating inflation and allowing it to get out of control. All of us in government must now work to promote a good recovery in jobs and production; but all of us must also take great care lest the hard-won gains of the past year be destroyed by a new round of inflation. The rise of the consumer price level in June at an annual rate of over 9 percent is a warning that the menace of inflation is still very much with us. The task facing our country, therefore, is not only to hasten the process of economic recovery, but also to unwind the inflation and thus lay the basis for a lasting prosperity.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Burns follows:]

PREPARED STATEMENT OF HON. ARTHUR F. BURNS

I am pleased to meet once again with this distinguished Committee to present the views of the Board of Governors on the condition of the national economy.

The performance of our economy during the past two years has been disappointing. We have suffered the most damaging peacetime inflation in our nation's history, a critical shortage of energy supplies, and the deepest decline in business activity since the end of World War II.

Signs of faltering in the pace of economic expansion already emerged in the spring of 1973. Homebuilding began to turn down, and so too did sales of mobile homes, new autos, and other big-ticket consumer items. A declining trend in the physical volume of other goods purchased by consumers soon followed.

In the winter of 1973–74, the Arab embargo on oil exports caused some interruption of economic activities. A related and perhaps more ominous development was a quickening of the rate of inflation. The steep rise in oil prices diverted purchasing power to foreign suppliers. Rising prices of consumer goods and services eroded the purchasing power of workers' incomes and savings, and resulted in a further weakening of retail sales. Inflation also led to a burgeoning of credit demands, both public and private, and interest rates soared.

These developments, however, were largely overlooked by a business community caught up in the euphoria created by inflation. New orders flowing to manufacturers continued to rise, order backlogs generally incrased, and stockpiles of materials and other commodities mounted. By the summer of 1974, the physical volume of business inventories was already higher in relation to sales than at any time since the Korean War, but inventories still kept climbing. The stage was thus set for a significant economic adjustment.

Business activity began to decline sharply in the autumn of last year. Between September 1974 and May 1975, industrial output fell by 12½ per cent. As a result. a substantial part of the nation's industrial plant became idle; total employment dropped by 2½ million from its peak in October 1974 to a low in March of this year; the length of the average workweek declined; the rate of unemployment rose from under 5 per cent in late 1973 to perhaps 9 per cent at the present time; and business profits slumped.

The recession has cut deeply into the nation's economic life, but it has at the same time been performing an unavoidable function. Because of neglect of inflation over the previous decade, our national economy was in serious trouble a year ago. Inflation was raging. Industrial commodity prices in wholesale markets were rising at an annual rate of over 25 per cent. Interest rates were at record highs. Not a few financial and industrial firms were encountering difficulties in rolling over their commercial paper or in raising funds through other channels. Cancellations or postponements of corporate bond and stock offerings were announced almost daily. Stock prices plummeted. Fears spread that real estate investment trusts, public utilities, other business enterprises, and even banks might be unable to weather the gathering financial storm. And many millions of American workers, investors, and businessmen became deeply concerned about their own and the nation's economic future.

We have by no means found a satisfactory solution to all the economic and financial problems that troubled us a year ago. Confidence, however, is reviving as a result of the corrective forces that have been at work in recent months.

Thus, business competition is now much keener than it was a year or two ago. Business managers are also devoting more attention to cost control and improvements in efficiency. Prices of industrial raw materials have fallen substantially. Price increase at later stages of processing have also become less extensive. The rise of the general price level has therefore slowed—from an annual rate of about 12 to 14 per cent late last year to about half that rate recently. Increases of wage rates, moreover, have moderated, although they are still much higher than the long-run rate of increase in productivity.

As industrial activity declined in our country, the need to import industrial materials and other goods diminished. Our merchandise exports, on the other hand, continued to reflect the improvement of our competitive position in world markets during the past two or three years. The foreign trade balance of the United States therefore moved from a sizable deficit in the first half of 1974 to a substantial surplus this year. This development helped to cushion the decline in domestic economic activity, and it also contributed to the strengthening of the dollar in foreign exchange markets since last March. The dollar, I am glad to say, is reestablishing itself as the strongest currency in the world.

In financial markets, the marked improvement in sentiment over the past year has been reflected in a recovery of stock and bond prices. Interest rates on short-term securities declined very sharply. The federal funds rate—that is, the interest rate banks pay when borrowing reserves from one another—fell from a high of 13½ per cent last summer to about 5¼ per cent in early June. The comercial paper rate declined from over 12 per cent last July to a low of about 5½ per cent. And the prime rate of interest on bank loans to businesses fell from 12 per cent to a low of 7 per cent.

Interest rates on long-term securities declined much less than short-term rates. Long-term rates typically fluctuate within a narrower range than short-term rates; but in the present instance, other powerful factors have also been at work. Fears of inflation are still widespread among both lenders and borrowers, and long-term interest rates therefore still contain a sizable inflation premium.

As the condition of our money and capital markets improved, so also did the financial position of business firms. Corporations have issued exceptionally large amounts of longer-term securities this year, and they have used much of the proceeds to repay short-term debt or to acquire liquid assets. The liquidity position of consumers has likewise been strengthened; instalment debts to banks and other lenders have been paid down, and many millions of individuals have added substantially to their savings deposits and other liquid assets.

Financial intermediaries, too, have improved their condition. Commercial banks have taken advantage of the reduced demand for business and consumer loans to repay their borrowings from Federal Reserve Banks, to reduce reliance on volatile sources of funds, and to rebuild liquid assets. In their turn, savings and loan associations and mutual savings banks have reduced their indebtedness and enlarged their holdings of Treasury securities and other liquid assets, thus laying the basis for the renewed expansion of mortgage lending during recent months.

The beneficial effects of easier conditions in financial markets, and of the moderation of inflation, began to appear in markets for goods and services while recessionary forces were still spreading. For example, new mortgage loan commitments of savings and loan associations began to turn up in November of last year. By January, sales of new single-family homes were also rising. The backlog of unsold units therefore declined, and residential building began to recover.

In consumer markets, price concessions on autos and other items became common early this year, and retail sales—especially of durable goods—expanded. In fact, consumer expenditures during the first quarter rose in real terms as well as in dollars. This upward trend continued in the second quarter, as spendable incomes of consumers were augmented—first, by tax rebate checks, later by extra social security checks.

With consumer purchases expanding and production declining, the efforts of business firms to work down their excess stocks have been remarkably successful. In the second quarter of this year, inventory liquidation reached an annual rate of around $35 billion—or about 2½ per cent of the dollar value of the gross national product. This is the largest decline of inventories, relative to the gross national product, in any quarter of the entire postwar period. The rate of production in the second quarter was thus unusually low relative to final sales. With the level of inventories in most consumer lines now in rather good balance with sales, the base has been laid for a recovery in aggregate economic activity.

Correction of the economic and financial imbalances of a year ago has resulted, in large part, from the internal workings of the business cycle. These self-corrective forces have been aided powerfully, however, by fiscal and monetary policies that sought to cushion the effects of economic adversity, moderate recessionary forces, and provide some stimulus to economic recovery. I need not dwell on the fiscal measures that have been adopted to combat recessionary forces; these measures have already been widely discussed. Let me note merely that I believe the Congress acted wisely in providing only a temporary fiscal stimulus through the Tax Reduction Act of 1975. The confidence of our citizens in the nation's economic future has been bolstered by evidence that responsible members of both the executive and legislative branches of our government are seeking ways to stimulate recovery without releasing a new wave of inflation.

This principle has also guided monetary policy. Last summer, as signs of weakening in economic activity multiplied, the Federal Reserve began taking steps to increase the availability of money and credit. Open market operations were oriented toward a more liberal provision of reserves to the banking system; later, these actions were reinforced by several reductions in the discount rate and in reserve requirements.

During the fall and winter months the demand for credit by businesses and consumers weakened on account of the recession, and commercial banks used the more abundant supply of reserves to repay their indebtedness to the Federal Reserve. Growth in $M_1$—that is, currency plus demand deposits—was therefore slow to reflect the easing of monetary policy. We at the Federal Reserve were concerned about this development, but we refused to run the risk of releasing fresh inflationary forces and rekindling inflationary expectations. In any event, broader monetary aggregates displayed a more vigorous response to our easing actions. For example, flows of individual savings into commercial banks and thrift institutions began to pick up in the fourth quarter of 1974; and by the first quarter of this year, these deposits were expanding at a seasonally adjusted annual rate of over 13 per cent.

Federal Reserve actions to increase the availability of reserves take some time to work their way through the economic system. As a consequence, some of the effects of easier Federal Reserve policies during a recession may not register in $M_1$, the narrowly-defined money stock, until the demand for transactions balances begins to strengthen. That may well have been a factor in the huge bulge of the money supply during May and June of this year. However, a large part of this bulge was also the direct result of the tax bill passed earlier this year by Congress. The tax rebate checks and supplemental social security payments disbursed by the Treasury were temporarily added to the public's holdings of currency, demand deposits, and savings accounts. Thus, $M_1$ grew at an average annual rate of 14½ per cent during the months of May and June, and $M_2$—which includes consumer-type time deposits at commercial banks, besiles currency and demand deposits—increased at a rate of about 16 per cent. By late June and early July, as individuals disposed of their additional funds, the explosion of the monetary aggregates subsided.

Over the past three quarters as a whole—that is, during the period of steeply declining busines activity—the additions to money and credit supplies have been on the generous side for an economy that is continuing to suffer from inflation. In fact, the growth rates of the monetary aggregates during this recession have been appreciably higher than during comparable periods of earlier postwar recessions. The narrowly-defined money stock, $M_1$, increased at an annual rate of about 5% from the third quarter of 1974 to the second quarter of this year. Increases in broader measures of money balances were considerably larger over this period. For example, $M_3$—which includes all consumer-type time deposits at depositary institutions, in addition to currency and checking accounts—rose at an annual rate of 9% over the three quarters. As these facts indicate, Federal Reserve policy contributed materially to establishing the financial basis for an upturn in business activity.

In recent weeks, signs have multiplied that the eccnomy is moving through a turning zone from recession to recovery. Improved markets for consumer goods have been leading the way, with retail sales gaining strength progressively since early this year. The appreciable pickup in new auto sales over the past several months is continuing, and so is the uptrend in sales of residential real estate. Sales of new houses in May were 50 per cent above their trough last December, and the backlog of unsold units is down to eight months' supply at recent sales rates.

With excess inventories at retail, wholesale, and manufacturing firms being worked off and the curve of consumer sales still rising, businessmen have become more optimistic about the future. New orders for durable goods—an important leading indicator of industrial activity—have risen in each of the past three months. Moreover, industrial production, after declining in eight consecutive months, registered its first advance in June.

In the labor market, too, there are numerous signs of improvement. The range of nonfarm industries adding to their payrolls has been widening steadily, from a low of 17 per cent in February to about 50 per cent in May and June; total employment has increased by 600,000 over the past three months; the average factory workweek has lengthened; and of late, initial claims for unemployment insurance have dropped substantially.

We may be reasonably confident, therefore, that a recovery in business activity will develop soon, if it is not already underway. Inventory liquidation in some lines—particularly among producers of capital equipment—seems likely to continue for a time, and an upturn in business fixed investment may lag behind the expansion in general economic activity. In many sectors, however, the need to rebuild stocks in response to improving sales will add a strong upward thrust to industrial production and to employment in the months ahead. As uncertainties about jobs and earned incomes abate, consumer spending will advance further. A significant rise in residential building activity may also be expected, since the underlying improvement in the condition of real estate markets has just begun to register in rising new home construction.

The outlook for our foreign trade balance, while less clear, also appears to be favorable. To be sure, recent trade surpluses reflect in part the impact of the decline in domestic activity on our imports—especially of fuels and industrial supplies. A revival of economic activity here will tend to boost these imports; but once foreign economies begin to recover, which seems likely before the year comes to an end, our exports of industrial materials will also pick up. Exports of machinery have been maintained at a high level this year, despite the weakness of foreign economies; these exports may be expected to do well over the next year. And in view of unsatisfactory harvests abroad, our exports of grain will be large—perhaps even embarrassingly large.

Recovery from the recession of 1974–75 thus seems likely to be broadly based. How strong the recovery will be, no one can foresee with any assurance. The amounts of idle labor and capital resources are certainly sufficient to permit rapid growth over the next several quarters. Past cyclical experience suggest, moreover, that a steep decline in business activity such as we have experienced is usually followed by a brisk recovery.

We must recognize, however, that our economy is confronted with some troublesome problems to which public policy must attend if full employment is to be regained. Energy prices are extraordinarily high, and they may well rise further. Shortages of energy supplies and other industrial materials could become a serious impediment to the expansion of production and jobs in a year or two. Our fnancial markets, meanwhile, will have to absorb a huge volume of Treasury securities this fiscal year—at a time when private credit demands will be expanding to finance larger economic activity. To make matters worse, inflation is still adding its own dimension to pressures in financial markets.

The vigor of economic expansion in the year ahead, and even more over the next few years, will depend heavily on the ability of our government to find ways to cope with these difficulties. Let me therefore turn to the implications of these problems for public policy.

As far as the Federal Reserve is concerned, the only responsible policy is to pursue a moderate course of monetary and credit expansion, such as I described before the House Committee on Banking, Currency and Housing a few days ago.

The relation over time between money balances and the physical volume of economic activity is rather loose, since so much depends on the attitudes of businessmen and consumers as well as on other governmental policies that are pursued simultaneously. But with $M_1$ growing in a range of 5 to 7½ per cent, and more comprehensive measures of money expanding substantially faster than this, it should be entirely possible to finance a recovery of normal cyclical dimensions over the next year. History teaches that the turnover of money—that is, the willingness of people to use their existing money balances—tends to rise much faster in the recovery stage of the business cycle than does the monetary stock itself. This basic fact about the business cycle must never be overlooked in judging the reasonableness of monetary growth rates.

I might add that materially higher or lower monetary aggregates than the Federal Reserve has projected for the coming year would involve serious risks. If, for example, the expansion of $M_1$ were held down to 3 or 4 per cent, short-term interest rates might rise rapidly and impede economic recovery. On the other hand, if a growth rate of 8 to 10 per cent were sought, inflationary expectations would be intensified, and larger increases in prices and costs would be encouraged. In these circumstances, long-term interest rates would tend to rise, since investors would insist on getting, and borrowers would be willing to pay, a higher inflation premium. It is highly important to bear in mind the longer-run effects of the policy alternatives now available to the Federal Reserve. More rapid monetary growth would indeed tend to hold down short-term interest rates and thus impart some immediate stimulus to economic activity. But long-term interest rates would soon rise and perhaps frustrate any reasonable prospect of recovery in housing or business capital investment.

As I noted earlier, the growth of monetary aggregates in recent months has been well above the longer-run rates of expansion that we have been seeking. The Federal Reserve has no intention of permitting rates of increase as high as those in the second quarter to continue. The special Treasury disbursements have cofe to an end; and we have already set in motion forces that should, in the near future, return the growth of the monetary aggregates to the moderate path desired. These recent actions have left their mark, if only temporarily, on short-term market rates of interest. But if that had not occurred, the business and financial community, which nowadays is highly sensitive to monetary growth rates, might well have concluded that the Federal Reserve is releasing a new wave of inflation. Any such interpretation by market participants could have had damaging effects on economic prospects at this stage of the business cycle.

As I believe this Committee recognizes, the growth ranges for the monetary aggregates that we have projected for the next twelve months may need to be adjusted one way or another. Clearly, the growth rates presently sought by the

Federal Reserve, while appropriate in the present environment of high unemployment and unused industrial capacity, could not be maintained indefinitely without giving up the fight against inflation. As the economy returns to higher rates of resource utilization, it will be necessary to reduce the rate of monetary and credit expansion, so that the basis for a lasting prosperity is laid.

Timely steps may also be needed to reduce the degree of fiscal stimulation as economic recovery proceeds. The gigantic budget deficits for fiscal 1975 and 1976—coming on top of the persistent Federal deficits of the past decade—are a major source of the inflationary expectations that are holding up long-term interest rates. When anticipations of inflation are as pervasive as they are today, the only effective device available to the Federal Reserve for holding down long-term interest rates is to pursue a moderate monetary policy. But fiscal policy can also be very helpful in this regard. The American people are awaiting further evidence that their government will restore the fiscal discipline needed to cope with inflation. The Federal Reserve Board therefore urges this influential Committee to use its good offices to press for moderation in fiscal affairs during this and the next fiscal year.

Our country is confronted today with a serious dilemma in its search for ways to move the economy toward full employment. Highly expansionary monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But, later on, the rate of inflation would accelerate sharply—a development that would create even more difficult economic problems than we have yet encountered. The Senate Committee on Banking, Housing and Urban Affairs has recognized this basic truth. Its recent report on monetary policy states unequivocally that "if inflation is rekindled, any recovery will be short-lived and will end in another recession, one almost certain to be more virulent than the present one."

In the current economic and financial environment, conventional thinking about stabilization policy is insufficient. We need to reopen our economic minds and actively seek ways of achieving reasonably full employment without resorting to ever larger monetary and fiscal stimuli.

A part of our recent problem of continuing inflation amidst widespread unemployment stems from a failure to attend sufficiently to modernization and improvement of our nation's industrial plant. Our country has been devoting relatively less of its economic resources to business capital expenditures than any other major industrial nation in the world. The result has been a diminishing rate of increase in productivity, the emergence in 1973 and 1974 of severe shortages of critically-needed industrial materials and supplies, and continuing upward pressure on costs and prices. Renewed scarcities of major materials—such as steel, industrial chemicals, and plastics—could impede the projected economic recovery unless action is soon taken to step up the rate at which modern facilities are expanded in these industries.

The inadequate rate of investment among American enterprises reflects to a large degree the fact that business profits over the last decade have fallen short of the amounts needed to finance a good rate of growth of effective industrial capacity. Last year, the after-tax domestic profits of non-financial corporations—excluding inventory gains—were actually smaller than they were eight or ten years ago, when the dollar volume of the output of these corporations was about half what it is today.

The slump of profits, besides its adverse effect on investment, has led to increasing dependence of business corporations on borrowed funds. The amount of debt owed by corporations relative to their equity position has risen sharply for more than a decade, and many businesses therefore no longer have the resiliency they once had to resist economic and financial adversity. There is a clear need in our conutry not only for larger business capital investment, but also for larger reliance on equity funds in financing capital expenditures.

These objectives may be promoted by an overhaul of the structure of Federal taxation. Value-added taxes are widely used in Western Europe, and it may be instructive to reexamine the merits of such a tax for our country. There are, of course, numerous other possibilities. For example, dividends on preferred stock might be made tax deductible, as the President has recommenled, or taxation of dividends that are reinvested in new shares—at the option of the shareholder—might be deferred. These and other ways of integrating business and personal taxes deserve thorough study by the Congress.

Another area that needs immediate action is our national energy policy. Uncertainties created by the delay in adopting legislaition on the oil pricing problem are becoming a serious obstacle to private economic planning and may increasingly impede the recovery as time goes on. In formulating a national energy program, it is of course necessary to give attention to sources of energy besides oil. Shortages of natural gas are likely to curtail production in some states this winter, and this problem will become more acute in later years if current policies for controlling the price of natural gas are not modified. And let us not overlook the importance of expanding the rate of construction in the electric utility industry. The President's Labor-Management Committee has developed a series of recommendations to accomplish this objective that I hope the Congress will weigh carefully.

Among these recommendations is a suggestion that environmental restrictions be stretched out to facilitate the expansion of electric-generating capacity. Of course, the impact of environmental regulations on the economic activities of our nation goes well beyond the electric utility industry. A good deal of industrial construction across our land is being held up by environmental regulations and litigation. A significant part of business capital outlays, moreover, is now being channeled into equipment for the abatement of pollution, rather than for expanding industrial capacity. For example, in 1974, producers of iron and steel, nonferrous metals, and paper devoted fore than 20 per cent of their capital budgets to pollution control. Regulations with respect to the environment and safety have also been a major factor running up auto prices in recent years, and thus putting a damper on auto sales and production.

We at the Federal Reserve are concerned, as are all thoughtful citizens, with the need to protect the environment and to improve in other ways the quality of life. We are also concerned, however, about the vigor of economic recovery and the dampening effect of environmental regulations on business activity. Here, too, a middle ground is needed.

Governmental practices and programs affecting labor markets also have to be reviewed in any serious search for noninflationary measures to reduce unemployment. For example, the Federal minimum wage law is still pricing many teenagers out of the job market. Programs for unemployment compensation at times provide benefits on such a generous scale that they may be blunting incentives to work. Even in today's environment, with perhaps 9 per cent of the labor force unemployed, there are numerous job vacancies—perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. It is hard to believe that better results could not be achieved with more effective job banks, more realistic training programs, and other labor market policies.

Indeed, many structural reforms will prove necessary to enhance the prospects for expanded employment, while at the same time reducing the pressures on costs and prices. We need to gather the courage to reassess our laws directed against restraint of trade by business firms, to reassess the enforcement of these laws, also the monopoly of first-class mail by the Post Office, the various restrictions on entry into the professions, the effects of the Davis-Bacon Act on construction wages and employment, the intricacies of governmental regulation of transportation, the role of trade unions in the public sector, the effects on consumer prices of remaining fair trade laws, and other legislation or practices that impede the competitive process. Nor would I rule out the possibility that some form of incomes policy, going beyond the legislation governing the Council on Wage and Price Stability but continuing to rely mainly on voluntary compliance, may yet be of some benefit in moving our nation towards the goals of full employment and a stable price level.

What I have tried to suggest in these brief comments on structural policies is that we can make better progress in moving toward our national goals by reducing the burden being carried by monetary and fiscal polices. The well-meaning citizens who now keep urging stronger monetary and fiscal stimuli seem to overlook the fact that excessive reliance on such policies brought on an accelerating inflation during the past decade. They overlook the fact that the current recession was caused basically by an inflation that got out of control. And they also overlook the fact that a large part of the effort that our nation has directed during the past decade or longer to improving the lot of poor people—through increases in social security benefits, welfare programs, and other means—has been nullified by the cumulative force of inflation.

Our nation has paid a heavy price during the past year for tolerating inflation and allowing it to get out of control. All of us in government must now work to promote a good recovery in jobs and production; but all of us must also take great care lest the hard-won gains of the past year be destroyed by a new round of inflation. The rise of the consumer price level in June at an annual rate of over 9 per cent is a warning that the menace of inflation is still very much with us. The task facing our country, therefore, is not only to hasten the process of economic recovery, but also to unwind the inflation and thus lay the basis for a lasting prosperity.

Chairman HUMPHREY. Thank you very much, Mr. Burns, for a very instructive message this morning, and one that is provocative in a constructive manner. You have presented some material which I think is vital for consideration by the Congress.

I make note of your emphasis upon the environmental measures that we have taken, for example, and the policy question as to how fast we should proceed with these measures because of their impact upon economic recovery. I could not help but think that the American public still has to realize that environmental protection costs money. Sometimes we are unwilling to accept the fact that in order to have a higher quality of life, we are going to have to build that higher cost into our overall economic equation.

Just as I happen to believe that the day of what we once called cheap food is most likely over, if the scarcities continue in the world market; the days of cheap energy, as we knew it, of the $2 and $3 a barrel oil and the plentiful supply of natural gas that lent itself to wasteful measures is also most likely over. I think we just have to face up to it, and as much as I would like to return to the days of 4 percent interest rates, I am afraid that I have to concede that that day is most likely over.

What I am getting at is that there are a number of new factors in the economic equation that have not as yet been fully assimilated. And the question is, how do we adjust ourselves to these new factors?

Mr. Burns, I want to commend you on some of your references to tax reform and reminding us of some of the responsibilities that we have. I am particularly interested in what you have had to say about investment and the ability of our economy to provide the investment capital that is needed for modernization, plant improvement, and productivity. Hopefully, in that improvement of productivity, we will improve our competitiveness in world markets.

The central problem, as a recent Gallup Poll indicated—is that outside of the issue of crime—which is the overriding concern of the American people, and understandably so—that the second issue is unemployment. And then, there are other matters. But about in fourth or fifth place is the cost of living. That surprised me. Quite frankly, I have admonished members of the staff of the JEC, my own staff, and others, because I thought that the hidden tax of inflation was still the most volatile and pervasive issue in the American political and economic scene.

Nevertheless, the public opinion surveys now show that the concern over unemployment is right at the top of the list, second only to the concern over crime.

We have addressed ourselves in this committee to the problem of unemployment with a considerable amount of effort. I believe that much of our differences with the representatives of the administration that have appeared here is over the question of how rapidly we can reduce that unemployment rate without igniting the fires of inflation. I sometimes think we tend to forget that, historically, in other periods of recession, we did not have inflation; we had unemployment. This recession is characterized by high rates of inflation, double-digit—and a rising rate of unemployment.

Now, our rate of inflation has subsided somewhat, but not enough to make us happy about it. And our rate of unemployment has become very sticky. Temporarily, through some seasonal adjustment mechanism, it looked a little better in June. But most people indicate that it will still be up around 9 percent come this fall.

In its annual report last March, the Joint Economic Committee recommended certain targets for real GNP, and using Okun's law relationship between unemployment and output, these targets imply unemployment rates of 7.8 to 8.1 percent in the first quarter of this year, and 6.5 to 6.8 in the first quarter of next year. We stated in our report, however, that the measured unemployment rate would lag somewhat behind changes in output, so that these unemployment rates might, in fact, take an additional quarter to achieve.

Unfortunately. few people now seem to think that these targets are achievable. So far, we have not followed the expansionary policies which this committee recommended. What I would like to hear from you, Mr. Burns, because of your great knowledge in these matters, is some comment on these targets. Were they, or have they become, from your point of view, too ambitious? Are they unrealistic? In other words, would it be undesirable to move the economy that fast?

We did lay down targets for real GNP in 1958 dollars for about $830 billion in the fourth quarter of 1975, and $890 to $900 billion for the fourth quarter of 1976. Now, of course, that means that in current dollars it is substantially higher than the present GNP. Our target unemployment goals were 7.8 to 8.1 percent for the fourth quarter of 1975 and 6.5 to 6.8 in the fourth quarter of next year.

Mr. Burns. I think your GNP targets are reasonable. They are perhaps a little on the high side, but I think all of us should strive for goals, that may be somewhat difficult to attain. And you are not outside a realistic range. I would say that the reduction in unemployment you have set as a goal may take a little longer than you indicate. In my own thinking, bringing the unemployment rate down to about 7½ percent by the middle of next year, and close to 7 percent by the end of next year, is a reasonable and entirely reachable goal. That is not very far from the objective that the Joint Economic Committee has set for itself and for our Nation.

Chairman Humphrey. We set our target at about 6.5 to 6.8 percent. You cannot use targets. They are imprecise. But around 6.8 at the fourth quarter of next year; you feel that in that quarter, a target of 7 percent is not unrealistic. Is that correct?

Mr. Burns. Yes, I would say so.

Chairman Humphrey. Do you feel that——

Senator Kennedy. Could I ask you just to carry that point forward? How do you get there if you accept the base level of 4 percent growth in GNP. Under Okun's law, you need 3 percent additional growth for every point reduction of unemployment. We have got 9 percent unemployment now, and you are talking about reaching 7 percent. So you are talking about a rate of growth of 10 percent. Or do you not accept Okun's law?

Mr. BURNS. Well, Okun's law is not a natural law. It is a generalization about experience on the part of a very capable economist. It is a kind of summary of past experience, and it is reasonably accurate, to the best of my knowledge. But Art Okun would be the first to agree that current events can deviate from past experience.

There are different ways, I think, of speculating about the economic future. One is in terms of Okun's law. Another—which I find more congenial to my own way of thinking—is to draw on past experience during economic recoveries. You will find, if you examine the record, that in the first year of economic recovery we normally have a reduction of about 1½ or 2 percentage points in the unemployment rate. With the unemployment rate at present at a level of perhaps 9 percent, it might well be at a level of 7½ percent a year from now, if we have a recovery of average intensity. And with the recovery continuing and expansion cumulating, a figure of perhaps 7 percent by the end of 1976 is not an unreasonable expectation.

Senator KENNEDY. This will be the last point, because I am on the chairman's time. As I understand it, in the five recovery periods since 1949, the average rate of recovery was 7½ percent. That would give you the 1 to 1½ percent in terms of reduction of unemployment. There has been no such suggestion, at least that I have seen, in statements by yourself or the key administration figures, that would suggest that we are moving even at this rate of recovery.

Specifically, what is the percentage rate of recovery that you——

Mr. BURNS. I approach economic policy in a somewhat different way from most members of the economics profession. As a practicing economist, and one who has done quantitative research for 50 years now, I have learned that my ability, and that of my colleagues in universities and research institutes, to make numerical projections that are at all valid is very limited. All that economists have learned to do tolerably well—I do think we do this tolerably well—is to forecast the direction of economic activity.

As far as economic policy is concerned, I wish we would recognize that, however difficult it may be for the Congress to do so, the only thing you can really do is arrive, as you best can, at a political decision—which means by a process of discussion, give and take, and usually compromise—regarding the measures that are needed to move our economy towards our objectives—our goals, if you like.

You decide on certain policies that you believe will move you towards the goal, recognizing that you may be doing too much or that you may be doing too little. After, say 3 months, you might reappraise the situation—have you done enough? Or have you perhaps gone too far? And then you can adjust your policy.

Fortunately, the Federal Reserve Board, which has highly flexible instruments of policy, can proceed in such a fashion. But to predict with numerical accuracy is something that economists have not learned how to do, and I cannot help but wonder why they continue. The only explanation I have is that many in the business world, in the Congres, and elsewhere see the future darkly, and we therefore turn to economists the way kings and princes turned to necromancers in olden times, and we ask them to prophesy for us. The demand being there—and the rewards being great in the private sphere, and not negligible in the way of public recognition in the governmental sphere—the supply is forthcoming.

Honestly, I sometimes think that if we asked some economists these days to estimate the number of fleas on Mars, they would proceed to do so.

Chairman HUMPHREY. Mr. Burns, I am intrigued with your discussion of the profession; and I must say that at times, I find myself in some substantial agreement with you. But there are some very tough practical problems that I think we have to discuss.

For example, the typical forecast shows that unemployment would be around 8 percent next year. Do you feel that we can get it down to around 7 percent next year?

Mr. BURNS. That is true.

Chairman HUMPHREY. I would be interested why you feel this way. Frankly, I am happy that you feel this way, but I want to know why you feel this way.

Mr. BURNS. I will be very glad to comment on that, Senator. I have learned over the years that economists, with very few exceptions, at the early stage of recovery underestimate its strength. There is a downward bias in economic forecasting, and there is a reason for it. Economists will sit back and look for sources of strength in the economy, but since we have an economy in which decisions about the future are made by many millions of economic units, their ability to foresee is very limited. And because they do not see sufficient sources of strength, they tend to jump to the conclusion that sufficient sources of strength do not exist. They overlook the fact that once a recovery ges underway, it develops a momentum of its own which seemed unlikely 6 months or 3 months earlier but which turns out to be a new fact of life.

This has been clearly shown by studies of economic projections not only by me, but by others. This is demonstrable.

Chairman HUMPHREY. I tend to be one of the more well-established optimists of the Nation's capital over a long period of time. It is very difficult for me to become——

Mr. BURNS. Well, I am going to tell you something, Senator. You look as good as you do, you are as energetic as you are, you radiate sunshine as you do, for that reason; and you are a blessing to many of us.

Chairman HUMPHREY. I appreciate that very much.

Here is what has disturbed me in some of the commentary that we have picked up, and the studies that we have show that inventory liquidation has proceeded rather rapidly. Mr. Greenspan and others who have testified feel that at least there is what we call an economic bounce underway. The question is, whether the bounce continues to be just a bounce, or whether it becomes a sustained recovery. I see some troublesome areas in our economy that create some doubt in my mind as to whether the bounce will develop into a sustained recovery.

For example, in housing. The housing starts, in June, were down again. I hope that that is only a temporary aberration. Also, auto sales are really not up that much.

Mr. BURNS. They were in the first 20 days of July. Sales of domestically produced cars have been running at a rate of 7½ million.

Chairman HUMPHREY. Well, that is good. But it has not been as good as they had hoped. And in another area, durable goods, there is not a sharp upturn, even though there has been some improvement in the last month.

My point is that in order to get this lower rate of unemployment, there is a feeling that many elements necessary for real progress or output are not present. This gets right back to the question of the money supply, the availability of credit, which is right in your ball park.

I do not underestimate other factors in terms of fiscal policy attitudes, these intangibles. But, Mr. Burns, if you saw, for example, that the rate of unemployment was going to be at 8 percent at the end of next year, would you take another hard look at your money targets and decide that you wanted to do something about it?

Mr. BURNS. Senator, let me say this to you. I and my colleagues at the Federal Reserve take that hard look every day. We have, I think, the best economic intelligence system not only in this country but in the world. We make our mistakes. We have done so in the past, and life being what it is, and our knowledge being so limited, our vision so imperfect, we will make mistakes in the future. But we continue to reexamine our position constantly.

The Federal Open Market Committee meets once a month, and the Federal Reserve Board meets three times a week. And I and others work at this 7 days a week. So you need have no concern about our having a frozen position. You might well feel that we have made mistakes in the past, and that we are making mistakes now; that is a difficult matter of judgment. But our minds are not closed. We are openminded.

Chairman HUMPHREY. You do feel a 7 percent target for next year is a reasonable target?

Mr. BURNS. Yes, as I have said.

Chairman HUMPHREY. You would be prepared, as the Chairman of the Federal Reserve, to make your contribution for the achievement of that target. Do I understand that?

Mr. BURNS. Of course.

Chairman HUMPHREY. It could require adjustments in what has been announced policy. Is that correct?

Mr. BURNS. It may. But, of course, we have to watch so many things.

Chairman HUMPHREY. Well, I understand that.

Mr. BURNS. We have to watch not only the concerns of today, but also the concerns of tomorrow.

Chairman HUMPHREY. Senator Javits.

Senator JAVITS. Mr. Burns, I would like to take up exactly at that point in your prediction—or at least your aspiration—or optimism toward the 7 percent unemployment rate. Does that assume if we just carry on, or do you expect affirmative steps first from the Government; to wit, the Congress and the President, second from the private economic system, in order to bring that 7 percent about? And, if so, what are the steps?

Mr. BURNS. I am inclined to think that the monetary and fiscal policy that we have set is likely to move us toward that objective. I am looking more seriously now, not at further monetary or fiscal stimulus, but at structural policies which I think have been neglected. This is a very important point, and if I may take a minute, I would like to develop the thought.

When I was a student at the university, I was unhappy with the economics of that day. We had all grown up on Alfred Marshall. I revered Alfred Marshall, but there was a shortcoming in his economics. Every economic problem was analyzed in terms of supply and demand. The average economist talked like a parrot about supply and demand. That was the entire intellectual apparatus that he had for dealing with the real world and its problems.

Now, a new orthodoxy has developed; now, economists will talk about global fiscal policy, global monetary policy. When they consider the problem of unemployment, what do they think of? They think of reducing taxes, increasing Federal spending, and easing monetary policy, either in the sense of expanding the growth of the money supply or of achieving lower interest rates. And they stop there; structural policies are neglected.

That is why I said in my prepared statement that it is important that the economic mind of America be reopened. We need a renaissance of economic thinking in our country. We have been putting too great a burden, I believe, on monetary and fiscal policies. We have neglected structural policies.

Senator JAVITS. Well, now, Mr. Burns, I happen to agree with you. But I would like to get the precise ambit of what you have in mind. Do you think it is a 7 percent unemployment rate, down roughly 2 percentage points of where we are now? In your prepared statement, you detail the following, beginning with modernization and improvement of the Nation's industrial plant—which I assume would mean better depreciation schedules, and perhaps even a more extensive investment tax credit.

You speak of beefing up the interests and capital, if necessary, by allowing dividends on preferred stocks to be deducted, or otherwise doing our utmost to deal with aftertax domestic profits of corporations. You speak of a reform of the tax system, and you speak of the uncertainties essential to correct our national energy policy.

Now, if we did all those things, and let us assume that we did, what effect would that have on your unemployment estimate? In other words, would it go down; and if it went down, by how much? In short, you have given America, in this testimony, one option—pretty much do what you are doing, and you ought to go ahead with the natural recovery which is now including 7 percent unemployment. Let's suppose you do these affirmative things, including beefing up the tax system with both tax reform and a value-added tax. What can you attain in 1 year, 2 years, in terms of the unemployment rate?

Mr. BURNS. I cannot answer your question. I think it would move us in the right direction. I have no way of giving you anything approaching numerical estimates.

Senator JAVITS. Can you say whether it would be a material improvement over the 7 percent?

Mr. BURNS. Well, I cannot say even that, being a realist, because Congress is not ready. If the Congress could, by some miracle, legislate these reforms today, it would take some time before the effects would be worked out. The effects over the next year or so might be very limited. Over the long run, the effects would cumulate.

Senator JAVITS. Mr. Burns, for myself, I believe that unless we correct the structural difficulties immediately after this recovery, which may last 2 to 4 years, we are in for even a steeper recession. Now, for those who believe that, would you not say, therefore, that these—the correction of these structural inadequacies becomes a vital consideration, even if it will not have an effect next year?

Mr. BURNS. Very definitely—yes. And I hope that your committee will deliberate on that, and make recommendations.

Chairman HUMPHREY. Will you yield for just a minute? May I just assure you, Mr. Burns, this is a matter that the committee is giving very serious study to, because most of us believe that structural changes, particularly in fiscal and tax policy are vitally necessary, and we will give it serious study.

Senator JAVITS. Mr. Burns, I have two other questions. One is engendered by this morning's news that New York City's unemployment rate is 11.7 percent, as contrasted with the national average of around 9 percent, a perfectly horrendous figure. It comes from our Commissioner of Labor Lewis Levine. Now the terrible financial difficulties of New York City has undoubtedly contributed to it. Our question—what do you believe is the impact on the national economy which these dread events are having for New York City. New York City is but the tip of the iceberg. Many, many major cities in the country, including many in my own State of New York, are suffering comparably, and if that is the case, what should the Federal Government, with its overall economic responsibility, do about it?

Mr. BURNS. Well, that is an extremely difficult question. You know New York City and its problems better than almost anyone else in the country. I think business has carried a heavy burden in New York City. Taxes in New York City are very high. The cost of running the city is enormous, very much higher than the cost of running any other city, making full allowance for the size of the population. New York City has not been governed properly for many, many years now.

We have similar difficulties in some other cities, of course. And you have raised a very difficult question here of income redistribution. I have talked to many of the Congressmen from New York State, and I have found that Congressmen from upstate New York or from Long Island have different attitudes toward help from the Federal Government than do Congressmen from New York City. And I have found some surprising differences even among New York City Congressmen. I recall one meeting with a number of New York City Congressmen in which one from New York City whispered to me, "I cannot say what I think here, but New York City will have to solve its problems by itself, rather than have the Federal Government solve the problems for it."

Indeed, the idea of calling upon citizens of our smaller cities, our large better managed cities, and our villages and farms to help New

York City, and perhaps some other cities that are in difficulty, is not being greeted very favorably over the country. The one proposal in this whole area that has a chance of winning congressional support, as I see it, and which may have some intrinsic merit, is a contracyclical revenue-sharing program. That proposal, I think, is now under consideration. I have not studied it sufficiently myself, but I think there may be some possibilities in that type of legislation for help to some of our cities that are in difficulty at the present time.

Senator JAVITS. Well, the comparison has often been made, Mr. Burns, about the fact that the Fed—I think it is well over $1.3 billion of money—bailed out the Franklin National Bank from its disaster. Now, if New York City is really in a disaster, or any other kind of city is in a disaster, facing bankruptcy, without saying what your recommendation would be, what is the power of the Federal Reserve in that regard?

Mr. BURNS. Well, let me first comment on the facts, and then I will turn to your question.

We did an extraordinary thing in coming to the assistance of the Franklin National Bank. There was no precedent for it; nothing like it, or nearly like it, had ever happened before. We extended a loan of $1.75 billion to that bank. Why did we do it? Well, certainly not because we liked that bank. We had grave doubts about that bank; we had had doubts for years about its management. But the failure of a $5 billion bank at that particular time, in our judgment, could have brought on a financial panic in our country, and perhaps internationally. So we saw grave consequences that we attempted to avert.

It took us some time to work out a decent merger for Franklin National. But that was finally arranged. Franklin National closed 1 day under its own name and opened the next day under another name. No depositor lost a penny. The bank's business connections with borrowers were maintained. Business went on as usual.

Now, to turn to your question. Under the law, as it stands—that is, under paragraph 3 of section 13 of the Federal Reserve Act—we could determine that "unusual and exigent circumstances" exist. If five of the seven members of the Federal Reserve Board voted affirmatively, a loan could then be extended to a municipality.

There are certain conditions in the law, and I cannot, at this moment, recite all of them. But one condition is that satisfactory collateral must be provided, and it is not at all clear that this is possible in the case of New York City. Second, under the law, there must be some assurance that funds will be available to repay the loan in a short time, and it is, again, very far from clear that there is a good, realistic basis for any such assurance in this case.

Although you may well know it, I must, in all candor, add this comment. If we extended a loan to New York City a question would arise promptly as to why we did not extend loans to other cities which consider their needs to be great and which in the eyes of their Congressmen and Senators are also worthy.

To a Congressman from New York City, New York City may be especially worthy of a loan, but to a Congressman from a small town in Minnesota, a town of 10,000, a loan to that town may be no less worthy. And I am a little afraid that the Federal Reserve, which has been a nonpolitical island in this city, could become politicized in the process. This is a consideration that I cannot ignore and that I hope others will understand.

Senator JAVITS. Well, Mr. Burns, there is no question about the fact that I evaluate everything you say with great respect, that there are lots of answers to what you have said. But the important thing I wanted to get was the question of power, if you did face an extreme situation, and I hazard to guess that it would be at least as serious for New York to go bankrupt as for the Franklin National Bank to close. And that is why I asked the question of the conditions, et cetera. One may or may not be able to meet but at least one ought to know whether there is adequate power to do this particular job.

In addition, there is a strong belief that some form of the contracyclical bill may go through. It came out of our Committee in Government Operations the other day.

I personally would favor some kind of a guarantee plan with conditions which would assure that the indebtedness would be repaid.

Mr. BURNS. I have great sympathy with what you say, but I do want to point out that the Federal guarantee of a municipal issue would convert that municipal issue into a debt instrument that is superior in quality to a Treasury issue—for the very simple reason that the municipal issue is tax eempt, and having a guarantee, it is as good as a Treasury issue. That is something to think about very seriously.

Senator JAVITS. Well, of course, the Treasury has competed with tax exempt first rate municipal issues for years and the Treasury has managed to raise its money and the municipalities, too. It is a very unusual situation when any major municipality is challenged as to their credit worthiness, so that does not intimidate me. But be that as it may, I just wanted to lay the case out.

If I had time for one other question, I would like to ask you this—my time is gone by but Senator Humphrey is very indulgent. You made a very provocative statement in your prepared statement by saying:

> Nor would I rule out the possibility that some form of incomes policy, going beyond the legislation governing the Council on Wage and Price Stability but continuing to rely mainly on voluntary compliance, may yet be of some benefit in moving our Nation toward the goals of full employment and stable price level.

Could we ask, Mr. Burns, what form of incomes policy are you speaking about? This may be a very useful suggestion.

Mr. BURNS. This is something that I have proposed in the past. The time does not seem to be right for it and perhaps it is just as well to simply extend the present Council, but to give it subpena power, which is important. I think that is contained in the legislation the House is now acting on. But I have been in favor of a somewhat more active Wage and Price Review Board and I still am.

Such a Board should have broad investigative and prenotification powers. It should be well staffed and energetic. It should hold public hearings on price and wage increases that are being projected, and that seem to have large and disturbing implications for the national economy. It should make recommendations, but should not have any enforcement power; I think the force of public opinion itself is very often sufficient. And it should, having made recommendations, publish compliance reports from time to time.

Let me put it differently. Sooner or later, in my judgment, we will move once again toward an incomes policy in this country, toward acting somewhat more energetic than we are acting now through the Council on Wage and Price Stability. This is an area that calls for experimentation and no country has found the answer. But our economic problems in this country and around the world being what they are, I think the world will continue to look in this direction for part of an answer to its problems. I feel that we should put economic theology to one side and continue to look for that answer.

Senator JAVITS. Thank you very much, Mr. Burns.

Thank you for your indulgence, Senator Humphrey.

Chairman HUMPHREY. Senator Kennedy.

Senator KENNEDY. Thank you very much, Mr. Chairman.

I wonder, Mr. Burns, if we could get back to the earlier exchange we had during the questioning by the chairman about the rate of recovery. This obviously is a matter of great importance and consequence nationally. It is also especially serious in the part of the country that I come from, in New England, which has the most severe economic recession of any part of the Nation. You mentioned in your response to the comments that I made and to those that were made by the chairman, the lack of preciseness in terms of economists' projections over any period of time. And I would agree with the chairman that all of us have seen in the past cases where economists have been misinterpreted on various trends in our economy.

But, nonetheless, I think it is one of the important responsibilities of this comittee in guiding the Congress to give, to the best of its ability, some benchmarks from which to make some judgements on fiscal policy and monetary policy.

Now, on the figures that you used in terms of unemployment, you suggest the figure of approximately 7.5 percent, which is really the most optimistic figure that I have heard from any witness before this committee, based upon the policy of the administration, unless there is going to be a significant increase in the money supply. As a matter of fact, the testimony that we have had here before this committee, including the Wharton model, are talking about a rate of growth which is significantly higher than the ones that you have used, in order to bring unemployment down.

So, I would like to get back to this particular issue; whether the comments that you are expressing here are really your own personal views or whether they express the views of the Federal Reserve Board or whether they represent the staff. If they do, could you, to the extent possible, be more specific on what indicators have been available to you? You have got the best intelligence, the best information, the best access to various economic trends of any group in the country. Could you let us know what you are getting that these other groups are not, so that we can assess where they are wrong or where we are wrong in assessing the trends?

Mr. BURNS. Let me say this. The judgments that I have expressed about the level to which the unemployment rate might decline by the middle of next year and by the end of next year are my own.

Senator KENNEDY. Your own.

Mr. BURNS. My own judgments. I have no way of knowing what the precise thinking is of the other members of the Federal Reserve family. There are no two views precisely alike among the staff. I believe that I am more optimistic than most members of our staff. However, I might add that the staff is much more optimistic now than it was in the month of March. So far, I have been more nearly right; the next time they may be more nearly right. That is the way life goes.

Senator KENNEDY. What are the figures, rather than just the general precedents? You mentioned you have got the best information. What is the——

Mr. BURNS. I was going to turn to that question. As far as governmental statistics are concerned, we have no information that is not also available to others within the Government and to private economists. We do get some confidential information from some key business concerns. We also have about 200 Reserve Bank directors scattered over our country, including some very able people from New England, who submit their views at least once a month. I started this after I came to the Federal Reserve. Statistics always lag behind developments, and I felt that by being in contact with businessmen, bankers, industrialists, merchants all over the country, we could learn a little faster not only about underlying sentiment and how it is changing, but also about the flows of orders, inventories, and other aspects of business activity that would subsequently be recorded in the statistics collected by the Federal Government and, to a degree, by private agencies. That is the additional information that we have.

I should add that we have an extremely capable research staff, which processes this information systematically. They do their work thoroughly and conscientiously.

Senator KENNEDY. Well, evidently, we cannot get this material. Evidently we do not have that material, or you are not prepared to discuss it. All of us have great respect for your opinions, but you have access to information and intelligence and statistics all over the country, and you have the best staff in the world, and you still have not given us any statistics or figures or projections or charts, or any other data to suport your estimates.

Mr. BURNS. This question keeps coming up. I was questioned on this very closely last Thursday when I testified before the House Banking Committee, and a request was made for the projections, prepared by our research staff. I declined to submit that information in what may have appeared to be a capricious response on my part. I do not believe it is, and let me explain why.

First of all, our staff has the unique virtue of revising its detailed projections systematically once a month, and this revision process——

Senator KENNEDY. That is too much for us to understand up here in the Congress?

Mr. BURNS. No; but, if I may, I would like to continue my answer to your question.

These revisions occur during the month as well, and they frequently are very extensive.

Now, to publish projections by our staff at a given time would add to confusion because they are soon going to be different, and they may be quite different, 2 weeks or a month later. But that is not the only reason; there is another very powerful reason. These are internal documents, worked on objectively. If members of our staff thought that these projections were going to be made public, they might have a certain tendency—perhaps unconscious—to tailor, to adjust the projections one way or another to suit the environment. And there might be a certain tendency on the part of the staff, having made a projection at a given time, not to revise the projection, or to revise it only a little. This would not be unnatural.

Therefore, the objectivity, the completely dispassionate objectivity, now characterizing our staff work could be lost. That would be a loss not only to the Federal Reserve—to the Federal Reserve Board and the Federal Open Market Committee—but to the extent we do our work at all well, it might well be a loss to the country.

Senator KENNEDY. Well, I respectfully disagree with that.

Mr. BURNS. I understand.

Senator KENNEDY. It seems to me that in this Nation of 220 million people, we could get an appropriate staff that would be willing to put it on the line, so to speak, and have sufficient confidence in their own intelligence and achievement and knowledge and understanding to be willing to lay out what they thought or projected, and make whatever adjustments they could, without feeling that they were going to lose their sense of professional standing or that they would have to bend to the winds in terms of what they were expected to do. I dare say I think we could get such individuals to serve with distinction and sense of position in the Federal Reserve.

Secondly, I think we have gone through a period in our history where many officials felt that the American people were unable to face the music, and that they might be confused about what was national security and national defense. I think we have seen that the American people not only can tolerate it, but can benefit from it. Our whole system can benefit by sharing the kind of information which is of enormous importance to our national society. We do not become a more weaker or more confused Nation, but a stronger one. Why do you feel a reluctance to share it with the peoples' representatives in the Congress of the United States.

It was not my purpose to get into this at length this morning. But I am concerned over the fact that we cannot share this kind of information with the peoples' representatives in Congress. Have I overstated it? Do you draw a distinction between what the public ought to have and what the peoples' representatives that have the responsibility to legislate ought to have?

Mr. BURNS. I think you should understand that what you are asking me now is to release to the public or to the Congress——

Senator KENNEDY. The appropriate committees of the Congress.

Mr. BURNS [continuing]. Projections made by staff. Members of the Federal Open Market Committee may disagree with the staff's projections, and they frequently do. We make our policy on the basis of our individual judgments rather than on the basis of the projections made by our staff. That is merely one kind of raw material that is used, and it is used in very different ways by different members of the Federal Open Market Committee.

Senator KENNEDY. You have expressed your view, my time is up.

Chairman HUMPHREY. Mr. Burns, I am going to give Senator Proxmire just a moment to have a chance to look over your testimony. I will ask a few questions and then turn to Senator Proxmire, whom you have discussed these matters with from time to time.

The other day we had witnesses here, I believe Senator Kennedy you were presiding when Mr. Samuelson and Mr. Aaron Gordon testified. We have noted that the Federal Reserve has taken several steps to make a date for a tighter monetary policy. Now, I do not want to be misunderstood, I realize that monetary policy is somewhat like an accordion, it flexes, it is not static. But on Monday of last week, the Fed entered the market to sell bills and when it sells bills it sops up credit and when it buys bills it opens up credit. By selling the bills, it had the effect of reducing bank reserves. The market apparently intercepted this as a significant action on the part of the Fed and there was a movement in interest rates, interest rates went up accordingly. And the shift here has drawn some criticism, as you know. Mr. Paul Samuelson testified at this committee on Friday, "Prudent policy taking into account inflation risk should be at the 7 to 10 percent increase in the money supply, not at the 5 or 7.5 percent."

Mr. Aaron Gordon testified, "The announced objectives of the Federal Reserve Board call for too slow a rate of growth in the money supply." Now that was related, of course, to the rate of recovery. Money supply is meaningless unless it is directed towards some objectives, rate of recovery, rate of reducing unemployment.

Now, Mr. Burns, I guess we all have to indicate that the recovery is at best barely underway. There are indications that are encouraging. Many think it is still rather fragile, I do. I think it is a very delicate matter now. What answer do you have to the criticism of your policy by Mr. Samuelson or Mr. Gordon and others? And might I add that Mr. Samuelson went back to 1958 and made note, and I quote him, "that within a month or two after the May bottom of 1958, the Federal Reserve under Chairman Martin was tightening, in other words, recession had bottomed out as it has now and Chairman Martin, then of the Federal Reserve, started to tighten things up and this led to a very short and a very aborted recovery." So, my question is, what answer do you have to the criticisms that are made and what assurance, if any, can you give that the history of the aborted recovery of 1958 will not repeat itself? Because, in your statement today you stated very firmly—that there has to be moderation and that you are going to watch this business of money supply and of growth very, very closely.

Would you like to comment on that?

Mr. BURNS. Yes, I would be very glad to comment on that. In the months of May and June the rate of growth of the narrowly defined money supply was not 8 percent or 10 percent, it was 14.5 percent.

Chairman HUMPHREY. Yes, I am aware of that.

Mr. BURNS. And the rate of growth of broader and more significant indicators of money supply was larger still. Now, this was being interpreted by many people to mean that the Federal Reserve had discarded the target that it had announced before the Senate Banking Committee. They feared that we were embarking on a far more expansionary policy. And this aroused in the business and financial world—or in the part of it that I have been able to glimpse—fears that a new wave of inflation was being set off by the Federal Reserve.

Now, in the month of July, people knew that prices had risen in June; and many people now know that wholesale prices this month—particularly in the agricultural area, but not confined to that area—are rising rather sharply. I think all of us will feel pretty unhappy when the wholesale price index for July is published. I do not know what the precise figure will be, but it will show an uncomfortably large increase in the price of food. This has been understood in general, although not in specific quantitative terms, by observers of the financial scene. Under these circumstances, and bearing in mind also the concurrent resolution of the Congress, I do not think we had any choice except to indicate to the financial world that we had not gone haywire, that we still were pursuing, intently pursuing, a moderate goal.

I honestly do not see what else could have been done responsibly. You should bear this in mind—the adjustment that we made was a very small adjustment, and I hope it will prove sufficient. I cannot say to you at this time whether it will or not; that will depend on circumstances that no one of us can foresee. But monetary and credit expansion is continuing and the rise that we had in short-term interest rates was confined pretty much to open market rates. Moreover, the action of the Federal Reserve was only one factor in the rate increase. You must keep in mind that the Treasury has been coming to market with much larger issues of Treasury bills, and that foreign governments of late have not been buying Treasury bills on the earlier scale because there has been a shift in the balance of payments.

I believe the action that we took has, by and large, been reassuring. Of course, as you all know, no matter what the Federal Reserve does, it will always be criticized by some people. That is not exceptional. But there is also no escape from responsibility.

Chairman Humphrey. That is one of the areas where we elected officials and the Federal Reserve have a common meeting place. I thought it was appropriate to ask the question, Mr. Burns, because one of the purposes of this committee is to get on the record the rationalization for these policy changes. Something that was also disturbing to me and maybe a word of comment from you would be enlightening to us; that there has been a growth in the money supply of late, which you have indicated and which we are well aware of. And obviously, over certain periods of time, this growth has been substantially larger than the annual target rate.

In a recent Wall Street Journal they said: "In contrast to the growth of the money supply, business loans on the books of the Nation's banks continue to dwindle."

What is disturbing here is that while we have these signs of recovery that relate to inventory liquidation, the real solid underpinnings of recovery are still somewhat in the shadows, so to speak. To what would you attribute the lack of business loans and the dwindling of those loans and the banking structure?

Mr. BURNS. We have had extraordinarily large issues of corporate securities; I believe that in the first half of this year these issues came to $32 billion. This has been due to the fact that our corporations had an excessive amount of short term obligations and they have been funding these obligations. Also, their profits have been low and they have borrowed more to be able to finance their operations. But what they have done is to borrow in the open market, in the public market, on the basis of bonds and, to some degree, equity issues, and they have paid off loans to the banks. This is the underlying factor.

As for bank loans, what you have said is entirely correct for the banking system as a whole. But the decline in loans has been pretty much a big bank, big city phenomenon; big corporations are paying back their bank debts. At smaller banks, loan expansion is underway over much of the country.

Chairman HUMPHREY. Senator Proxmire.

Senator PROXMIRE. Mr. Burns, I have had a chance to read your prepared statement; I read it last night carefully. It is another fine statement, and I agree with much of what you say, particularly in the area of a more responsible fiscal policy. I think you are right that we have to do that. There is no question that we have had some very good news on the inventory front, but I feel that there is a very, very powerful case now for a stimulating monetary policy, and I would like to state it briefly and get your comment on it. Except for the improvement in inventories, it seems to me that the outlook is not good. Business investment in plant and equipment, for instance the accelerator in the economy, all of the indications are, including the testimony by Mr. Greenspan the other day, that that would not be very stimulative in the next 12 months or so. Housing: Some people think we may go to 1.5 million housing starts, but those are the optimists and that's anemic. Others think it will not because of high long-term interest rates. The automobile industry suffering from the energy shortage is unlikely to pick up very greatly. Exports, which have been good, are not likely to improve very much in view of the estimates that—by OCED and others—that foreign economies are not likely to grow as much as we do. And if they do buy from us in increasing amounts, they will buy food primarily, which does not really stimulate jobs. So, that might cool off. State and local governments: Every indication is that they are going to have to in many cases sharply reduce their expenditures and their payrolls. Retail sales, mixed, but not really very encouraging. Much indication that it is not likely to grow very much.

Now, if we follow your advice, and I hope we do, on fiscal policy, that means that unless we get some substantial stimulation in the monetary area, we are likely to have a very anemic recovery, if any recovery at all. So, as I look at this picture, it seems to me that if we advise both fiscal restraint and, at best, monetary moderation, we are likely to stagger along with the high level of unemployment for some time to come.

What is your reaction to that?

Mr. BURNS. Well, my preponderant reaction is that you are a very gloomy man, Senator. I see the world differently.

Senator PROXMIRE. Where are my facts wrong? Would you say that we are going to have a bigger housing expansion? Autos? Exports going to increase? State and local governments to all of a sudden come up with the funds?

Mr. BURNS. Let us talk a little, first, about durable goods expenditures. Orders for automobiles have risen in 3 successive months. Contracts for commercial and industrial building expressed in physical units show an increase——

Senator PROXMIRE. Mr. Burns, let me just interrupt you to say as far as business investment in plant and equipment, if you can cite any cases, when we have been operating at 65 percent of capacity and when at the same time business has been investing vigorously in new plants and equipment, I would like to hear them.

Mr. BURNS. I am only indicating what the flow of orders is, and those are facts that we can accept. As to the statistics on capacity utilization, they come from the Federal Reserve Board. I wish we could discontinue those statistics because I do not think that they are reliable.

There are signs of recovery in the early stages of business capital investment that you overlooked.

Senator PROXMIRE. I would point out, Mr. Burns, that the Department of Commerce estimates that in dollar terms there will be virtually no growth in business investment in plant and equipment the rest of this year. In real terms, by the end of the year it will be down 10 percent.

Mr. BURNS. I understand that, but I am referring to more recent data, monthly data on orders and contracts which, over the years, have been a more reliable indicator of business capital investment than the surveys of the Commerce Department.

I wish I could say to you that a vigorous recovery in business capital investment is underway, but as I think my statement makes clear there is as yet no basis for that. However, you must never overlook the fact that once a recovery gets underway, a certain momentum develops in the business world.

Senator PROXMIRE. Let us assume that I am completely wrong and that these facts and figures are——

Mr. BURNS. I am not going to make any such assumption.

Senator PROXMIRE. Let me assume that; I am willing to assume that. I would like to know where the inflation is going to come from if we do have a growth of 7, 8, or 9, percent, in view of the fact that we have such available capacities, such available manpower, virtually no shortages anywhere that we can find. The great unlikelihood that we reduce unemployment below 7.5 percent for 1½ years. It seems to me a great unlikelihood we are going to be operating anywhere near capacity in any industry for many, many months to come. The increase in prices in June, confined to food and energy, primarily—there were some increases elsewhere, but those were the two big factors in the inflation, neither one of which is affected by expanding demand or by fiscal or monetary policy. So where are we going to get this additional inflation if we do engage in a stimulative policy that gives us 11 or 12 percent growth instead of the 7 or 8 percent?

Mr. BURNS. Well, Senator, inflation has not come to an end. It has been continuing at a high rate, and it is coming from many sources. One of the important sources it is coming from and will continue to come from is the increase in wages. Wages are rising at a rapid rate.

Senator PROXMIRE. Mr. Burns, we heard testimony from Secretary Dunlop the other day in which he pointed out that in every single quarter of the last five quarters real wages had declined, including the latest quarter; that this is the only country in the world, the only free country, where we have had a drop in real wages this year and last year.

Mr. BURNS. We are not talking about real wages. We are talking about prices, and therefore about money wages.

You have asked me about the sources from which price increases might come. I have given you one very significant source, a major source. It is not the only one. Profit margins in the business world have been low, and with recovery, many corporations can be expected to attempt to improve profit margins. You and I are going to hear about that and we may deplore it, but it is reasonable to expect such attempts to be made. And so prices will go up.

Senator PROXMIRE. Would you not agree, Mr. Burns, as we stimulate the economy and as we get more activity, more economic activity, that productivity will improve? It has improved consistently in the past under those circumstances. As it does, wage costs tend to moderate even though wages may go up, may go up somewhat, the wage cost does not go up as much because productivity increases, and the way to get that productivity increase is to stimulate the economy so we have more economic activity, is that not correct?

Mr. BURNS. I think what you say about productivity is true for the early stages of a recovery. But inflation is still very much with us, and there are many economists who believe that the moderation in the inflation rate has virtually run its course. They may be wrong. I have some misgivings on that score myself. I may be wrong. You have said nothing, and I have said nothing, about energy prices; they are not coming down.

Senator PROXMIRE. They are not coming down. But would you not agree that, in general, they are not affected as much by monetary policy or by fiscal policy as they are by other actions of government, direct policies with respect to energy by our government in particular and the governments of the oil producing countries?

Mr. BURNS. I would. But as far as monetary policy is concerned, once you create the money it is going to do its work. Perhaps not this year, perhaps not next year, but eventually. And while the relation between money and prices is very loose in the short run, over the long run the relation is a decisive one.

Senator PROXMIRE. Let me ask you this. In the hearings on May 1, when you testified before the Senate Banking Committee, you said if we conduct ourselves responsibly, the rate of inflation may come down to perhaps 5 percent. Now, if your expectations changed, do you think that this is still the case, or would you modify that?

Mr. BURNS. Well, my statement was so carefully guarded, with so much emphasis on prudence and responsibility, that I see no reason to change it at this time.

Senator PROXMIRE. What did you say, sir? I missed that last part.

Mr. BURNS. I used too many words. I see no reason to change that statement.

Senator PROXMIRE. Now, you talk about changes in tax policy that would help encourage investment; and you suggest the value-added tax, which some of us have opposed on the grounds that it is not a progressive tax. How about something like this? How about phasing out this corporation income tax? It is not as big a revenue producer as many people feel, and produces only a little more than 10 percent of our revenues. So phase it out over a period of years; and phase in a more progressive income tax so that you would not have the regressive effect that you might otherwise have.

What that would do, as I understand it, is to provide for a much greater cash flow; would eliminate a great deal of the incentive for the waste we have in corporations now, where Uncle Sam pays about half of any cost that you get, regardless of how justified it is, and end the notion of double taxation of dividends. And it would seem to me it would be more acceptable to many people than a sales tax substitution for a corporation income tax.

Mr. BURNS. I think that is a constructive line of thinking, Senator. I must, however, add one comment. Let me make an assumption this time; namely, that business investment in our country is inadequate. Let me make the assumption that investment should constitute a larger par of our total economic activity.

Now, whether you agree or not, make that assumption with me for a moment. Putting government to one side, if business capital investment is to play a larger role in our economy, if more of our resources, relatively, are to be devoted to investment, then the resources that are devoted to consumption will have to be smaller. That, at least for a closed economy, is an economic truism. I see no escape from that, and we must not fool ourselves when we talk about stimulating business capital investment.

Senator PROXMIRE. Can I interrupt to say that there is another option, and that is, if we have more jobs, if we have more production, if we do not lose the $250 billion a year we are losing now because we are producing so far below the level of production with 4 percent or 5 percent unemployment, that we could have more available for both investment and consumption.

Mr. BURNS. Well, Senator, I do not think I have spoken very clearly. I was going to cite some figures on the proportion of the gross national product that is accounted for by business investment in this country and in other countries around the world. I cannot locate the precise numbers at the moment.

Senator PROXMIRE. I realize that we are way down.

Mr. BURNS. All right. We are very low in comparison with other countries. What I tried to say is that if want to increase that proportion, and if we do not want to diminish the relative use of resources by government, it will have to come out of consumption. That is all that I said. You cannot quarrel with that; nobody can. It is plain arithmetic.

Senator PROXMIRE. My time is up.

Chairman HUMPHREY. We have some time constraints. I just want to put a couple of quick pragmatic questions to you, Mr. Burns. How do you feel about extending the tax cut; do you feel it should be extended?

Mr. BURNS. As of today I would do nothing, Senator. I would delay action on that. Let us see where we are toward the end of the year and arrive at a conclusion then.

Chairman HUMPHREY. To watch to see the rate of recovery?

Mr. BURNS. That is right; exactly.

Chairman HUMPHREY. In other words, you are openminded about it, depending upon what the rate of recovery is.

Mr. BURNS. Yes.

Chairman HUMPHREY. Do I understand that you favor a more permanent type of investment tax credit?

Mr. BURNS. The answer, sir, is yes, provided that we do not lose——

Chairman HUMPHREY. Provided what?

Mr. BURNS. Provided that we do not lose tax revenue. If we allow our tax base to be eroded——

Chairman HUMPHREY. I agree with that, sir.

I want to say, I have to leave to go to vote. But let me just use this moment to give you an indication of my concern. Like many Members of Congress, I am not an expert, I am a general practitioner; and that means that you know a little about a lot, and not much about anything. What has bothered me about our policy in recent years is its lack, as I said the other day, of any continuity, any certainty, any consistency.

I am not speaking now of just a monetary policy. I am speaking of tax policy, of price and wage policy. We have had surtaxes and surcharges, price controls and decontrols. There has been such a lack of direction that it seems to me that the finance community or the business community that must make investments has every reason to be concerned as to just what the ground rules will be.

I am one of those people that does believe, sir, that we need a higher rate of investment. I know of no better way to create jobs than to have the investment that makes possible the employment of people, along with the improvement, obviously, of our employment rate itself. As Senator Proxmire has said here very properly, we have lost a tremendous amount of income, which contributes to our Federal Government deficits, which contributes to local government deficits, which contributes to all kinds of problems because of the lack of the employment. And we have simply got to have a higher level of employment.

I hope that the favorable economic indicators you point out will be lasting. I just would be interested, very briefly, to what extent you think that this temporary bulge might have been due to tax rebates and tax reduction.

Mr. BURNS. Well, I have no opinion on that myself. But our staff estimates that about 5 percentage points of the May–June increase in the narrowly defined money supply is attributable to tax rebates and special social security payments. In other words, that in their absence the rate of increase would have been, say, 9 or 9½ percent. It is a very difficult thing to estimate, and on this matter, I have done no research at all myself. That estimate represents the best thinking of our staff, but they do not feel very confident about it.

Chairman Humphrey. I understand that Senator Kennedy is coming back, and wanted to ask an additional set of questions. But I must go now. Would you be kind enough to wait just 5 minutes, and if the Senator is not back, we of course will excuse you. I will try to get back as quickly as I can.

Mr. Burns. I shall wait 10 minutes. This is the old academic rule of waiting for the professor.

Chairman Humphrey. That is good. Thank you.

[A brief recess was taken.]

Senator Kennedy [presiding]. We might come to order.

Mr. Burns, I am wondering if you have expressed any opinion about the importance of continuing the reduction in taxes that we made this year.

Have you expressed any view on this?

Mr. Burns. Senator Humphrey just asked me that question, and it is my view that action on continuation of that reduction should be deferred for several months, until close to the end of the year. I think it would be well to take another close look to see where we are, how fast we are moving and how well we are doing. It may then appear to be necessary. Or, again, it may seem undesirable. Depending on circumstances, if you ask my opinion down the road, you might find that I am for it.

Senator Kennedy. If we do not extend the tax cut, as I understand it, the practical effect is that there will be a tax increase in January of $12 billion on individuals and of $1½ billion on small business. By not taking any action, we are, in effect, providing a $15 billion tax increase for next year.

Mr. Burns. Of course, that sort of thing is inherent in temporary tax cuts. As to whether extension will or will not be a desirable action, I can only say, once again, let us wait awhile to judge it.

Senator Kennedy. When do you think you will have the information on which to make a recommendation?

Mr. Burns. Well, I will never know enough. I hope that Congress will continue to study this question, as I think all of us should; I certainly will. I would like to see a delay until late in the fall.

Senator Kennedy. In your prepared statement, you refer to value-added taxes, as widely used in western Europe. "It may be instructive to reexamine the merits of such a tax for our country," you say.

Do you think that we ought to go to an added-value tax?

Mr. Burns. I am not ready to pronounce an opinion on that. I wanted merely to indicate that that is one possibility, among others, that ought to be examined by the Congress if the Congress is going to take measures that would stimulate capital investment, so that capital investment would play a larger role in our economy than it has.

Senator Kennedy. Isn't a value-added tax quite inflationary and regressive? Is it not, in effect, a sales tax?

Mr. Burns. I think that is correct. But I stated—you were not here—what is an economic truism. If we want business capital investment to be a larger share of our gross national product, and if we do not wish to diminish the resources relative to our gross national product that go into governmental activities, then, as a matter of arithmetic, the relative share going to consumption will have to come down.

Senator KENNEDY. Do you feel this is one of the best ways of doing it?

Mr. BURNS. The value-added tax? No, I have no fixed opinion on that. I would have to study the matter much more closely, probably more closely than I will have the opportunity to do.

Senator KENNEDY. In your testimony you say, "In view of the unsatisfactory harvests abroad, our exports of grain would be large, perhaps even embarrassingly large."

Can you tell us what that means? Would this be embarrassingly large for the American consumer, who may be paying additional costs for food?

Mr. BURNS. I was thinking about what may happen to the price of——

Senator KENNEDY. Are we in danger of another Soviet wheat deal, where we saw a significant and dramatic increase in the cost of food for the American consumer?

Mr. BURNS. I would not rule out that possibility.

Senator KENNEDY. Would the administration's program allow for sizable grain exports?

Do you think that there is a real possibility that it will reflect itself in a significant increase in the cost of food for the American consumer?

Mr. BURNS. There already has been a significant increase in grain prices. They have run up rather sharply.

Senator KENNEDY. What sense does it make for the administration to go ahead, then, from an economic point of view, or does it make any sense?

Mr. BURNS. To do what?

Senator KENNEDY. To go ahead and have large sales of grain and food products?

Mr. BURNS. Well, it is a——

Senator KENNEDY. If it is going to cost the American consumer, as the last Soviet deal did, hundreds of millions and billions of dollars?

Mr. BURNS. That is not an easy question. We have, for years, been trying to get other countries to buy more of our agricultural products. We have been critical of other countries for imposing barriers to the importation of American grain. For years we have been preaching, wisely or unwisely, the doctrine of substantially free trade. Now, there also are foreign policy considerations here, of a political sort as well as an economic sort. And there are longrun considerations as well as shortrun considerations.

Senator KENNEDY. Well, the shortrun considerations, as I understand from your answer, is additional money out of the pay check for every worker in this country.

Mr. BURNS. I do not see any escape from that conclusion.

Senator KENNEDY. How much are we prepared to pay for foreign policy objectives, for a wheat deal in the Soviet Union?

How does that really advance our foreign policy considerations?

Mr. BURNS. Well, you know, this is such a difficult question.

Senator KENNEDY. How high do you think it is going to go in terms of additional costs for the American housewife?

Mr. BURNS. I cannot answer that. You see, we do not have precise information.

Senator KENNEDY. Then should we be considering doing it, if we do not have precise information?

Mr. BURNS. I did not finish my thought. We do not have anything approaching precise information on the amount of the grain that Russia will be importing. We know literally nothing about inventories of grain in the Soviet Union. I have seen estimates that cover a wide range, and I must say to you, in all honesty, some of these estimates frighten me. Are they valid? I certainly do not know, and I doubt that anybody does. And I think this is a very troublesome question.

There are other considerations, Senator. I find myself so uncertain about all this. On the one hand, from a moral standpoint, I would not like to use foodstuffs as an instrument of foreign policy. And, yet, in the kind of tough world in which we live, we are the granary of the world as things stand, and if the Arabs have a monopoly on oil, for every practical purpose at the present time we have a monopoly on grain. So I find myself vacillating between human considerations and political, nationalistic considerations. I find this very difficult.

Senator KENNEDY. Well, the point here is not whether we are prepared to meet our responsibilities to starving people. I think the American people want to know what the cost is going to be for them.

Now, we had members of the Council of Economic Advisers who appeared at this witness table and stated that there would be no increase in prices for the American consumer from the kind of grain deals and food exports they are anticipating.

Mr. BURNS. Well, that is surprising.

Senator KENNEDY. Well, all you have to do is read the McElvoy testimony. I asked him specifically about this.

The question is, if we are going to have to pay a cost, the American consumer ought to know what that cost is going to be. If they are going to pay 1 or 2 cents more per loaf of bread, so that we are not going to see starving children in Bangladesh or in other parts, I think they will pay for it.

But I think that they want to know the cost, and I think it is important that they do, before they move ahead and sell; and we are talking now about sale of grain to the Soviet Union before the cost is clear. I think the important point is that you are stating here that, with this kind of anticipated grain deal, American consumers can expect a sizable increase in their food budget. And we ought to know that now.

Mr. BURNS. Senator, that is definitely my opinion. Others are better qualified than I to discuss that, and I would counsel hearings on this subject. Congress should bring in experts from the grain trade, among others, to testify on this question.

Senator KENNEDY. I think the committee will have to.

That is the 5-minute bell.

Let me just ask you, Mr. Burns, are you prepared to use the various resources at your command to lessen the impact of an OPEC energy increase this fall, if it begins to adversely affect the economy?

Mr. BURNS. Well, it is not easy for me to see what we could do about that.

Senator KENNEDY. The President says if decontrol takes place, he is going to provide a rebate, so that the impact to the American consumer will be minimized. This makes sense from an economic point of view. I am wondering, if we get an increase in OPEC prices, whether you are prepared to exercise what influence you can in monetary policy so that the impact to the American consumer will be reduced?

Mr. BURNS. The best influence that we can have on prices—and this is an influence that will not be felt immediately but only over the longer run—is by pursuing a moderate monetary policy. If we create money at a more rapid rate than we have been doing, sooner or later that money will go to work and express itself in higher prices.

Senator KENNEDY. Thank you.

Chairman HUMPHREY [presiding]. I wanted to ask a couple of more questions in reference to the city situation that Senator Javits brought up, on a little broader range, if I might. There is a development in the municipal bond market that is very disturbing. The New York situation seems to be affecting many other issues of municipal bonds, and the interest rates are going up very rapidly.

Last week, Philadelphia, which according to the information that I have received has been a good bond city, sold 30-year, tax-exempt securities this past week, at an average interest cost of 8.66 percent. That is over 8.5 percent, or an A-rated bond, tax-exempt.

Today, the State of Wisconsin, with a AAA rating—now, that is about as high as you can get—will market 10-year securities at an average interest cost of 6.5 percent. That is an exorbitant rate for the highest rating available. How large an interest premium do you think the cities and States are paying on their securities, as a result of this siuation that has developed relating to New York City finances? And might I ask, do you think this is going to continue?

Mr. BURNS. That is not easy to answer. There is a premium; there is no question about that. The highest rate reached on long-term, 20-year U.S. Government bonds was 8.7 percent in 1974. Now the rate is down to about 8.2 percent.

Chairman HUMPHREY. Those are U.S. Government bonds?

Mr. BURNS. U.S. Government long-term bonds.

Chairman HUMPHREY. Those are taxable.

Mr. BURNS. I know. I am working toward an answer to your question. Take the AAA utility bonds; they reached a peak of 10.6 percent in 1974; now they are down to 9.4 percent. On the other hand an index of yields on municipal bonds shows that the yield is now higher than it was even in 1974. So a rather large differential has developed.

Now, that is due in a significant degree to the difficulties of New York City, but not entirely. A number of other cities have been in difficulty, and you may recall the trouble that we had several months ago with the Urban Development Corporation securities in New York State. A wide differential is emerging between some municipal securities, where the yield has actually been dropping, and others, where the yield has risen sharply, and New York City is a significant part of that problem.

Chairman HUMPHREY. I think the question that is bothering many of us here in the Congress is just what to do about that very critical matter in New York. I listened very attentively to what you said to Senator Javits. I understand the limitations that you feel ought to be respected, insofar as the Federal Reserve Board is concerned.

We are trying to pass a bill on countercyclical assistance. Communities that have a high rate of unemployment, above 6 or 7 percent, would receive assistance, on a kind of very specialized revenue sharing. And then when it drops down to 6 percent, their assistance is removed. That will be of some help to some of these municipalities. Fortunately, most municipalities are not in the grave situation—I say most of them are not—that New York finds itself.

You are familiar with Big MAC financing. The municipal bond market has had an average volume of approximately $2 billion worth of issues in the first months of the year. Despite the fact that New York City has not participated actively in that market, it is participating but the buyers have not been there. What will be the impact on that municipal bond market, when the Big MAC, that is New York State's Municipal Assistance Corporation, goes on the market, with $1 billion a month over the next 2 months? How high will this push the interest rates for other issues, or what do you feel will happen, and will other issues, particularly lower rated issues be crowded out of the market?

Mr. BURNS. The question that has concerned me is whether Big MAC will go to the market at all. You know what happened to the first issue—the syndicate was broken up, and the market yield rose very sharply. And it is very uncertain whether the issue planned for, I believe, August 7 will actually go forward.

If it does go forward, and assuming that the banking judgment is sound—that is to say, that there is reasonable prospect of selling that issue—that would mean to me that the problems of New York City have been reevaluated and that some basic improvement is underway. Then I would not be fearful of the effects on interest rates that will have to be paid by other cities. The money is there.

Chairman HUMPHREY. The money is there. It is a question of where they want to put it.

Mr. BURNS. Exactly. And that is just the problem in New York City. Unfortunately, at the present time, the city inspires very little confidence on the part of investors, and that has rubbed off on Big MAC.

Chairman HUMPHREY. Well, now, Senator Javits questioned you in reference to the role of the Fed, if any. One suggestion that might be of some value is a bridge loan from the Fed to MAC; that is, for a short period of time, allowing so-called Big MAC to spread out its issues over a longer period of time, so you do not get $1 billion in 1 month. Does that have any value or any merit, Mr. Burns?

Mr. BURNS. Well, I can only say this. If the financial outlook for New York City and Big MAC improves to the point where all that is needed is a bridge loan, I do not think Big MAC would have any difficulty getting such a loan from the commercial banks.

Chairman HUMPHREY. From the commercial banks?

Mr. BURNS. That is right.

Chairman HUMPHREY. Would the Fed participate in that, in any way?

Mr. BURNS. Well, it would not have to if the commercial banks are doing it. We would then be very happy, and there would be no reason for us to act.

Chairman HUMPHREY. So what you are really saying is if they get their house in order, the commercial banks will handle it?

Mr. BURNS. That is my judgment.

Chairman HUMPHREY. But if the commercial banks hesitate, it is because of what has been a period of less than prudent management, for whatever the reason may be, because New York City has unusual difficulty and problems that are not characteristic of many other cities. Would the Fed in some way collaborate with the commercial banks, in order to help out?

Mr. BURNS. Well, that is a very difficult question for us, and I do not know what my colleagues on the Board would conclude. All I can say is that, as of today, I see no reason for encouraging——

Chairman HUMPHREY. Well, I would say that if I were a New Yorker, I would not be totally despondent as a result of that answer. I would say that as of today we have to give you some encouragement, but it does not sound too promising, does it?

Oh, Mr. Burns, you open up so many possibilities. I was interested in one statement you made: "In the current economic and financial environment, conventional thinking about stabilization policy is insufficient. We need to reopen our economic minds and actively seek ways of achieving reasonably full employment without resorting to an even larger monetary and fiscal stimuli."

One of these evenings when I get a chance, and you have got an open evening, I would like to get together with you and discuss these statements.

Mr. BURNS. I hope that evening will come very soon, Senator.

Chairman HUMPHREY. I do, too, because it seems to me that we need to get away from conventional thinking. I have been exploring ways that we can deal with this unique situation. We have got a unique political situation that this country has never experienced, without passing any political or moral judgment on it. We have a President and Vice President that came in under the 25th amendment. They did not have an elected constituency. That is they have not stood for national election. We have a Democratic majority in this Congress that sometimes does not know how to act like a majority. We have high rates of inflation, and growing rates of unemployment. And it is really the most unique, complex, and difficult situation that a republic like ours has ever faced, not only in terms of government, but in terms of the economy.

I noted what you had to say about some of the laws that we passed and their impact on employment. I am sure there are people today who can draw unemployment compensation. They can get food stamps, they can get a lot of things that are a disincentive to taking a job, unless it is the one they really want. The job I really wanted, I did not get, so I came back and took a second job. [General laughter.]

And I understand how people feel about not getting the job they really want. But they can get over it. I wanted to get that on the record.

We need to develop a set of policies in the public sector that promote work and employment dramatically. When I see the amount of money that we are spending on unemployment compensation and the amount of money that we are putting into the social services, due to unemployment, it sometimes bothers me that we are not coming up with proposals to get this country back to work.

And I know the private sector ultimately will get back to work. I have no doubt about that. But there is always more residual unemployment after each recession we experience.

Mr. Burns, I would really appreciate any suggestions that you and your professional staff and your Board members have as to how we can change the conventional approach to get at this problem of unemployment. I realize that as we attack it now with the conventional methods we run serious dangers of propelling the inflation again.

But we just cannot settle politically, morally, or economically for leaving a large segment of our population unemployed, drawing benefits that they really do not want. Most of these people do not want these benefits. They want to go back to work.

I think you have been here long enough, but you are a great philosopher, and I thought I would give you a little of my country philosophy before you left.

Mr. BURNS. Well, I am very grateful and also thankful to you for the gracious way in which you have conducted this hearing.

Chairman HUMPHREY. Thank you, sir. The committee stands recessed.

[Whereupon, at 12:55 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, July 30, 1975.]

# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

WEDNESDAY, JULY 30, 1975

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey and Kennedy.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

## OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. It is a special pleasure to welcome you. I am very appreciative of your presence here today.

I would like to make note of something that one of my aides said as we were coming in the door. He said, well, you can tell that the administration witnesses are not here. When the administration witnesses are here, we have the press tables filled, the television and the radio, and sometimes I feel that it is the blind leading those that are losing their sight.

Today we possibly have a chance to see what is really going to happen, or at least get some forecasts—and I say this with great respect for those that have testified prior to this morning; because we all have a high regard for gentlemen of the quality of Mr. Burns or persons of the quality and ability of Mr. Greenspan, and members of the Council of Economic Advisers. But I intend to keep saying what I am about to say now. I feel that if the American people are going to be properly informed about economic choices, then it is imperative that they hear different points of view. And, regrettably, that does not happen, because the only means of public education we have in this country on issues such as this is the media.

We have had some of the most brilliant and competent spokesmen on business, finance, economics, agriculture, labor, to appear before this committee. Regrettably, these witnesses rarely receive press coverage.

The Joint Economic Committee is continuing its review of the economic situation today with a panel of respected economic forecasters. In the past week, we have received testimony from a number of administration representatives. Yesterday, Mr. Arthur Burns, the Chairman of the Federal Reserve Board, responding to a question asked by the committee agreed that the Joint Economic Committee's recommendation for an unemployment rate at or slightly below 7 percent by the end of 1976 was a reasonable goal. He further stated that the Federal Reserve policy was aimed at an approximate achievement of that goal.

Mr. Burns assured us that monetary policy was under constant review in order to help stimulate a consistent and sustained recovery, and an early reduction of the extremely high unemployment that we are now suffering. In spite of Mr. Burns' assurances, I am not convinced that the current administration's policies, either fiscal or monetary, are sufficiently stimulative to produce the real growth needed to lower unemployment to 7 percent by the end of next year—and might I add, I think that 7 percent is an unacceptably high goal.

The major sectors of the economy have as yet failed to show the strength needed to sustain a healthy recovery. Housing, business investment, consumer durables—none of these sectors show the resurgence which was characteristic of previous economic recoveries. The precarious nature of what appears to be a fragile recovery is heightened by the uncertainty that surrounds energy policy at present. In the absence of substantial tax cuts to restore the purchasing power of households, increases in the per barrel price of OPEC oil, coupled with an immediate or short-phase decontrol of old domestic oil would almost certainly have the same impact on economic recovery that tight monetary policy did in 1958, and I might add in 1974.

In contrast to the aborted 1958 recovery, however, the sharp increase in the price of energy would not only dampen real output and thus employment, but also it would renew the inflation spiral, which appears to have abated somewhat. Let me add here, if our witnesses will be patient with me for a moment; yesterday, Mr. Burns made some comment about food prices. I was out of the room at the time; I had to go cast a vote.

I have a high regard for Mr. Burns, as I said, as an economist. But I must take issue with his comment on the impact of wheat prices. If the price of wheat goes up 50 cents a bushel, it will not affect the price of bread at all. The amount of wheat that goes into a loaf of bread is not going to skyrocket the price of bread. What is causing the price of bread to go up is the paper that it is wrapped in, the transportation that brings it to the marketplace, the processing and the labor that goes into it, the advertising that is related to it, and a host of other things.

Even if the price of wheat goes up to $4 a bushel, it is not going to affect the price of bread over half a cent a loaf—a penny at the most. There seems to be a total lack of understanding of the relationship of a basic raw material such as wheat to a loaf of bread or a box of Wheaties. It is not wheat that makes Wheaties cost money, it is the advertising and the package, and the vitamins that they say they put in it. I think it is time that the people that advise this Government on economic policy know what they are talking about.

Now, the important thing is the drought that is afflicting certain parts of the Midwest and I am going to write Mr. Burns about this. I want him to advise the President that a sensible agricultural policy requires having sufficient food reserves so that our country is not victimized by speculation in the marketplace or skyrocketing food prices. I think it is much better to inform the President, rather than frighten the public, as to what needs to be done to see that things do not get out of hand.

This morning, we will hear from three economists who are representing their own forecasts on the economic outlook for the next 18 months—and that is some assignment, I might add, since the signs of recovery at present are still fragmentary. I think it is especially important that both Congress and the administration follow the development of the economic situation closely, so that needed changes can be made in fiscal and monetary policy if recovery does not develop as we all hope it will.

You will be pleased to note, yesterday, the Senate of the United States adopted a recommendation of the Joint Economic Committee. It took several years to get it through, but it was adopted finally. It is called countercyclical assistance to our local governments. It will give special economic aid to local governments that are the victims of recession and unemployment, which have suffered lowered tax revenues, and have caused serious economic problems for our citizens.

This committee seeks to prepare, resign, and initiate proposals of this nature. So, we welcome today Mr. Lawrence Klein, professor of economics at the University of Pennsylvania. Mr. Klein is well known for developing the Wharton economic model, to which we refer repeatedly. The committee finds this model extremely helpful.

Mr. Karchere is director of economic research at IBM. The IBM forecast, while not widely distributed, is among the best-known models, and has an excellent track record.

Mr. Synnott is vice president and head of the economic analysis department of the United States Trust Company of New York. We look forward to hearing his views on the general outlook, as well as on the outlook for financial markets.

Gentlemen, it is my pleasure to welcome you, and we are really grateful for your willingness to come here and share your thoughts with us.

I think we will start out with Mr. Karchere, and, if it is agreeable, gentlemen, we will go right down the line. By that time, some of our colleagues will have joined us, and then we will go to the questioning.

## STATEMENT OF A. J. KARCHERE, DIRECTOR, ECONOMIC RESEARCH, IBM CORP.

Mr. KARCHERE. Senator Humphrey, thank you very much for asking me to come to give a forecast for the next 18 months.

A forecast of any kind really depends upon the present state of the economy and the momentum that has been built up and also on economic policy. It would be presumptuous of me to make predictions of economic policy in this place, which is so influential in the determination of economic policy. I think it may help, however, if I give you forecasts which are dependent upon three of the main alternatives in economic policy that are currently under debate.

The first forecast I am going to give you, is a middle, or base forecast; it assumes that expenditure will be at the level of the congressional budget limitation. It also assumes that the temporary tax cuts of 1975 will be continued and that monetary policy will accommodate the expansion. We expect a normal increase in interest rates for this kind of expansion.

Chairman HUMPHREY. Do you have any indication as to how you would measure the adequacy of that money supply?

Mr. KARCHERE. Yes, Senator. We have an econometric function which measures the demand for money. If you specify the increase in interest rates and the increase in the gross national product, the result is the demand for money.

Consistent with the forecost, that I will describe, the demand for money would be 8½ percent.

Chairman HUMPHREY. That is on an annual basis?

Mr. KARCHERE. That is right.

Now, we are also assuming that OPEC will raise the price of petroleum $1 a barrel in the late fall in the base case, in case I.

In case II, we are considering the consequences of an energy program on case I. So what we are measuring directly is the effect in 1976 of an energy program. I will come back to that later.

In case III, we are going to assume that the tax cuts are not extended, that Federal expenditure is at the administration's May 30 budget level. Otherwise, it is the same as case I.

And in the final case, we are going to assume that we are going to have an extra $20 billion of stimulus over and above what we have in case I, and we are going to examine the consequences of that.

Chairman HUMPHREY. How do you relate those to the charts that you have given us here?

Mr. KARCHERE. These charts will help you follow what I am saying.

Chairman HUMPHREY. OK.

Mr. KARCHERE. I am talking from my first chart, which says "Assumptions."

[The chart follows:]

## ASSUMPTIONS

### CASE I

- TAX CUTS EXTENDED
- FEDERAL EXPENDITURE AT CONGRESS LIMITATION
- MONETARY POLICY ACCOMMODATES EXPANSION
- OPEC PRICE RISE $1.00 PER BARREL

### CASE II

- CASE I PLUS ENERGY PROGRAM

### CASE III

- TAX CUTS NOT EXTENDED
- FEDERAL EXPENDITURE AT MAY 30 BUDGET LEVEL
- OTHERWISE SAME AS CASE I

### CASE IV

- CASE I PLUS
  - $15 BILLION TAX REDUCTION
  - $5 BILLION ADDITIONAL EXPENDITURES

Mr. KARCHERE. Now, let me talk a little bit about recent economic developments. In the second quarter, we had a very small decline in the gross national product. But for the first time in 2 years, final sales increased. Final sales is a much better expression of underlying demand than GNP itself. Final sales increased because the volume of consumption spending increased. This is very significant, because this recession fundamentally goes back to an inflation which caused—in this country—prices to rise more rapidly than wages and real wages to fall for a period of 2 years.

So the increase in consumption, along with an increase in the saving rate, I might add, is an indication that the tax cuts and rebates are beginning to work. The increase in saving that we got in the second quarter will help consumption in the third quarter.

In the second quarter, we also began to get some advance indications that plant equipment spending is going to increase, perhaps not in the third quarter, but in the quarters beyond. We also got an indication that residential construction spending is going to go up—again, probably not a great influence on the third quarter.

But the dominant thing in the second quarter was the monstrous drop in inventories, at an $18 billion rate in real prices. Now, a decrease of that size in inventories will not happen again. We will get a decrease in the third quarter, but that decrease will be substantially less, and the swing in inventories will contribute to an expansion in the third quarter and again in the fourth.

In conclusion, momentum has built up in the economy and it is leading toward an expansion.

Now, let me turn, on the next chart, to fiscal policy. Any single number measurement for fiscal policy is bound to be wrong in some respects, but this is the one we use, and we do think it is simple and indicative. The number we focus on is the change in Federal expenditures, and it is always an increase. And we add to that the effect on tax receipts of a change in tax rates.

[The chart follows:]

## Fiscal Policy

(Billions of Dollars)

| | Change in Federal Expenditures | Change in Federal Receipts Due to Tax Changes | (1)-(2) | (3) as % of GNP |
|---|---|---|---|---|
| 1969 | $7.7 | $11.4 | $-3.7 | -.4 |
| 1970 | 14.7 | -8.6 | 23.3 | 2.4 |
| 1971 | 16.4 | -7.3 | 23.7 | 2.2 |
| 1972 | 24.4 | -3.2 | 27.6 | 2.4 |
| 1973 | 19.4 | 8.0 | 11.4 | .8 |
| 1974 | 34.9 | 3.2 | 31.7 | 2.3 |
| 1975 Case I | 58.4 | -14.4 | 72.8 | 5.0 |
| 1976 Case I | 37.7 | 9.0 | 28.7 | 1.7 |
| 1975 Case III | 55.4 | -14.4 | 69.8 | 4.8 |
| 1976 Case III | 27.2 | 18.2 | 9.0 | 0.6 |
| 1975 Case IV | 58.4 | -14.4 | 72.8 | 5.0 |
| 1976 Case IV | 42.8 | -6.0 | 48.8 | 2.9 |

Mr. KARCHERE. We expect in 1975, in case I, that the increase in Federal expenditures will be $58 billion. And the net effect of the tax rate changes in 1975 wil be about $14 billion for a total increase of about $70 billion, which is 5 percent of the GNP. This is an extremely large figure.

But if you look at the similar figure for 1976, you find it is 1.7 percent of the GNP. And it begins to approach the very low figures of 1969 and 1973, of years just prior to years of recession.

Now, if we go down to case III, the increase in Federal expenditures in 1976 is smaller and there is no continuation of the tax cuts.

The fiscal stimulus is 0.6 percent of the GNP. This is the kind of number we got in 1969 and 1973. It is the kind of a number that led into the recession of 1970 and the recession of 1974.

Now, when we examine case IV, there is substantially more expenditure and tax cuts than case I, $20 billion, more in 1976. The stimulus as a percent of the GNP is 2.9 percent. This is only a little more than the economy got in 1970, 1971, and 1972.

I am turning now to the next chart, Senator. When we put together the momentum that has built up in the economy and the fiscal policy that we have specified for case I and run them through our model, we get the case I forecast. We show it for GNP and final sales in constant prices, and the Consumer Price Index. We expect very substantial increases in the GNP in the third quarter and fourth quarter of this year, in excess of 7 percent.

[The chart follows:]

## CASE I FORECAST

(% CHANGE AT ANNUAL RATES)

| | | GNP CONSTANT PRICES | FINAL SALES CONSTANT PRICES | CONSUMER PRICE INDEX |
|---|---|---|---|---|
| 1975 | 1 | -11.9% | -0.7% | 7.3% |
| | 2 | - 0.3 | 3.2 | 6.3 |
| | 3 | 7.8 | 2.1 | 6.5 |
| | 4 | 7.3 | 3.3 | 6.6 |
| | YEAR | -3.7 | -1.5 | 8.9 |
| 1976 | 1 | 7.0 | 5.7 | 5.3 |
| | 2 | 6.9 | 5.8 | 5.7 |
| | 3 | 5.0 | 4.9 | 6.0 |
| | 4 | 4.2 | 4.3 | 6.2 |
| | YEAR | 6.4 | 4.6 | 6.1 |

Mr. KARCHERE. But, if you examine the increases in final sales, which are increases on the order of 2 or 3 percent, you can see that the major thrust of the expansion in the third and the fourth quarter is in inventories. It is the swing of the inventory cycle that I have already referred to. Final sales will begin to pick up in the first and second quarters of 1976, but by the end of 1976, both GNP and final sales will begin to slow down. And this is the beginning of bad news for 1977.

Now, our forecast for the Consumer Price Index, at about 6 percent for 1976, is very high by historical standards. And it comes from the fact that the economy has not fully absorbed the 1973, 1974 inflation. In particular, profit margins are low and they probably will be rebuilt during this period of expansion.

In addition, the cost of machinery, and equipment, and plant, have gone up and they are not fully reflected in product prices. So we do expect a fairly substantial rate of inflation in 1976, by no means, I might add, the kind of inflation that we had in 1973 and 1974.

Now, I might say a little bit about the inflation. By the second quarter of this year, 1975, we had a substantial reduction in the rate of inflation. The Consumer Price Index was at a 6.5 percent rate. That is not very good, but it is substantially better than the 12 percent of 1974. The industrial wholesale price rate in the second quarter of 1975 was at 4.5 percent and this is very substantially better than the 27 percent of 1974.

Chairman HUMPHREY. Yesterday, Mr. Burns indicated that we would see a very marked increase in the Wholesale Price Index for the month of July.

Mr. KARCHERE. I think it is a mistake, Senator, to focus on month-to-month movements on price series. We got a big increase in the June Consumer Price Index due to meat prices, due to the import duties on petroleum, and a little bit coming out of mortgage rates. Now, these are all peculiar factors that do not really have anything fundamental to say about the balance of demand and supply in the economy.

I think we will get a bump in the Wholesale Price Index in July, but increases in wholesale prices are usual in a period of recovery and our forecast of a 6 percent increase in the CPI is big enough to accommodate substantial increases in the Wholesale Price Index.

Chairman HUMPHREY. Thank you.

Mr. KARCHERE. Now, let me focus on the next chart. We have put out a lot of numbers. And let me talk about this a little bit because I think people are mesmerized by the effect of the expansion that came after the 1969–70 recovery.

[The chart follows:]

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## COMPARISON OF U.S. RECESSIONS

| RECESSION | PEAK TO TROUGH DECLINE IN REAL GNP | GROWTH IN REAL GNP: TROUGH + 6 QTRS. 1/ | IN QUARTER OF REAL GNP TROUGH: UNEMPLOY. RATE | CAP. UTIL. ALL MFG. | CAP. UTIL. MATERIALS INDUSTRIES |
|---|---|---|---|---|---|
| 1953-54 | 3.4% | 7.3% | 6.0% | 83.7% | 77.5% |
| 1957-58 | 3.9 | 5.7 | 7.4 | 74.3 | 69.9 |
| 1960-61 | 1.5 | 7.0 | 7.0 | 74.2 | 72.7 |
| 1969-70 | 1.4 | 6.3 | 6.0 | 74.2 | 85.5 |
| 1974-75 | 7.8 | 6.7 2/ | 8.9 | 66.5 | 70.2 |

1/ ANNUAL RATE 2/ FORECAST



## CONSUMER PRICE INDEX

(% CHANGE AT ANNUAL RATES)

| RECESSION | DURING RECESSION | DURING FIRST SIX QUARTERS OF RECOVERY |
|---|---|---|
| 1953-54 | 0.8% | 0.0% |
| 1957-58 | 2.8 | 1.1 |
| 1960-61 | 1.5 | 1.2 |
| 1969-70 | 5.7 | 3.4 |
| 1974-75 | 10.6 | 6.2 1/ |

1/ FORECAST

Mr. KARCHERE. We are tending to fight that war, yet, again, not recognizing that there is a massive difference between the recession that has just finished and the recession of 1969 and 1970.

And let me be very specific about that. If you look at the GNP movement from the peak to the trough of the recent recession, what you find is that this current recession has gone down by 7.8 percent. That is a huge number, compared with anything else that we have had in prior recessions. It is particularly large when you compare it with the 1969–70 recession.

If you look at the recovery that we have projected for case I, you find that it is below the standard of the recovery following the 1953–54 recession. It would have been below the recovery after the 1957–58 recession except we had a steel strike in 1959. As a matter of fact, the only recession where we had a recovery that is more modest than the one we are forecasting is the 1969–70 recovery.

If you look at the unemployment rate, 8.9 percent at the low point on a quarterly average basis, we have not had anything like that in prior recessions, and particularly in the 1969–70 recession. If you look at the utilization of capacity, either for all of manufacturing or for the materials industries, you find that our present recession has generated a monstrous amount of excess capacity.

Now, in these circumstances it is hard to imagine massive inflation starting again. As a matter of fact, one could make a very substantial argument that a recovery will help contain the inflation, rather than increase it. And that is because, if we have recovery, we will begin to get increases in productivity. Generally, the better the recovery, the better the increases in productivity. The increases in productivity will hold down unit labor costs. And when we hold down labor unit costs, we hold down the inflation.

Now it is not unusual for the inflation to moderate during a period of recovery. Generally, during recessions, the inflation is more severe than it is in the first six quarters of recovery.

And indeed, this is what we forecast. In those terms, the forecast of a 6-percent increase in the CPI does not appear to be out of line.

Next, let me make a remark about deficits. We expect a Federal deficit, on a national income basis, of $78 billion in 1975, and $67 billion in 1976. These are large numbers, by historical standards, even as a percent of the GNP. But deficits in themselves do not produce inflation. Deficits, in a period where the economy is underutilized, where there is excess supply of plant and labor, tend to get the economy to grow and do not add to the inflation. Deficits, when the economy is fully employed, are another matter, and at that point, they do add to the inflation.

So, finally, let me make a comparison of the three cases, and let me just refresh your memory as to what they are. In the first case, we have assumed the Federal expenditure at the congressional limitation level along with a renewal of the 1975 tax cuts. Case III, we are assuming the administration's May 30 budget expenditure and no renewal of the tax cuts. And case IV, we have a $15 billion additional stimulus in terms of tax cuts and $5 billion in additional stimulus in terms of expenditures.

Chairman HUMPHREY. When you say additional, do you mean over and beyond the present tax?

Mr. KARCHERE. Over and beyond case I.

Chairman HUMPHREY. Case I is with the present tax cuts?

Mr. KARCHERE. Yes.

Now, as you can see from my next chart, if you look at the growth rates through the course of 1976, that is, from the fourth quarter of 1975 to the fourth quarter of 1976, we get a very substantial difference in the growth of the GNP in, the three cases, ranging from case III, which is the low one, at 4.3 percent to case IV, at 7 percent.

[The chart follows:]

## Comparison of Cases I, III, IV

| | 1976.4 | 1976.4 -1975.4 | 1975.4 -1975.2 |
|---|---|---|---|
| GNP $58 | ($ Billions) | (Annual Compound Growth Rate) | |
| Case I | 857.0 | 5.9% | 7.6% |
| III | 841.6 | 4.3 | 7.0 |
| IV | 865.9 | 7.0 | 7.6 |
| Consumer Price Index | (1967=100) | (Annual Compound Growth Rate) | |
| Case I | 174.5 | 5.9% | 6.6% |
| III | 174.7 | 6.0 | 6.6 |
| IV | 174.4 | 5.8 | 6.6 |
| Unemployment | (%) | (Average--During Period) | |
| Case I | 7.7 | 8.0 | 8.9 |
| III | 8.6 | 8.6 | 8.9 |
| IV | 7.4 | 7.8 | 8.9 |

Mr. KARCHERE. We also get a difference in the employment and a good way of looking at that is where we are in the fourth quarter of 1976. You see that even in the best case, we are 7.4 percent in the fourth quarter. Now, let me just say a word about that—I am probably talking too long.

Chairman HUMPHREY. That is all right.

Mr. KARCHERE. Once you get an unemployment rate up, it is very hard to get it down, and this is because of the fundamental dynamics. Now, when we begin to get a recovery, we get about 3½ percent increase in productivity. We get at least a one-half percent increase in the workweek. People stop working short time and begin to work overtime, and we get upward of 1-percent increase in the labor force. So we really have at least 5 percent or 5½-percent increase in the supply of labor. Therefore, to get any decrease in the unemployment rate, we need a growth rate of at least 6 percent. So, in the early stages of recovery, to get that unemployment rate down, you need a growth rate of 6 percent or better. And to have the economy drag down to a 4-percent growth in the last quarter of 1976 implies bad news for the unemployment rate.

And finally, on this chart you can see that we get very little difference in the three cases on the inflation. We get offsetting effects. We get increased demand in the higher GNP case, but we also get decreased labor costs, which offset.

Chairman HUMPHREY. So you are saying that the administration's growth rate is 4 percent?

Mr. KARCHERE. That would not touch the unemployment rate.

Chairman HUMPHREY. You would have to get up to about 6 percent before you begin to cut into it?

Mr. KARCHERE. That is exactly right.

Chairman HUMPHREY. The problem is, how do you get a growth rate of 6 or 7 percent without an increase on the inflationary pressures?

Mr. KARCHERE. In my opinion, with the excess capacity that we have in the economy, both in terms of labor and in terms of plant capacity, we do not have a problem in 1976 of resumption of higher inflation.

There is also another aspect of this which is relevant, the inflation that we had in 1973–74 was a worldwide inflation. It happened because we had a synchronous expansion all over the world, and the world developed excess demand for raw materials and primary products. There were also crop failures in that period of very high demand.

We do not have anything like that now. Western Europe is depressed, as is Japan, and in terms of recovery, they are behind us. So we are not going to get this synchronous development of high demand, certainly not in 1976.

Thank you.
Chairman HUMPHREY. Thank you.
[The prepared statement of Mr. Karchere follows:]

PREPARED STATEMENT OF A. J. KARCHERE*

THE OUTLOOK FOR THE U.S. ECONOMY THROUGH 1976

*Introduction*

Signs of economic recovery are legion, but the strength of the recovery and its impact on inflation are in doubt. Economic policy can help or hinder the recovery. I have used a moderate sized econometric madel of national income and expenditure that has been in continuous forecasting use for some years to make a base forecast and explore the effects of three alternate economic policy mixes. Detailed results for each case are given in the Appendix.

One of the great advantages of an econometric model is that it requires the forecaster to make the assumptions of his forecast explicit. The assumptions of the four cases are given below in considerable detail. Case I is the Base Case. It results from a credible set of assumptions covering a wide area, but excludes changes in energy policy. Case II uses the Base Case assumptions, but adds to them assumptions on energy policy that seemed plausible on July 24, 1975. Case III calculates a forecast based on the May 30, 1975 Administration Budget, and to make it comparable with Case I excludes changes in energy policy. Case IV is based on policy assumptions that are more expansionary than Case I and also treats energy policy as in Case I. The assumptions for each of the four cases are given below in more detail.

*Case I—Base Case Excluding Energy Policy Changes*

1. The following tax cuts, scheduled to expire at year-end, are extended through 1976: (a) $30 per person credit ($5.2 billion); (b) Higher standard deductions ($2.6 billion); and (c) Cut on first $50,000 of corporate income ($1.4 billion).

2. A tax "reform" bill will be enacted by year-end 1975, but, aside from the above extensions, will provide little change in aggregate personal or corporate tax liability.

3. There will *not* be a resumption of the oil embargo. Recycling of oil revenues will continue in an orderly fashion.

4. OPEC will raise crude oil prices $1 per barrel effective October 1, 1975.

5. Federal Expenditures (NIA basis), excluding energy policy changes, will be $9.3 billion higher in FY 1976 than called for in the May 30 Administration Budget. Assumed expenditures are very close to the Congressional ceiling.

(a) There will be no "cap" placed on Social Security and other transfer payments geared to CPI changes and essentially no cap on Federal salaries.

(b) Little of the remainder of expenditure reductions proposed by the President in January will be adopted.

(c) An incremental public jobs program, costing about $2 billion and building to some 300,000 jobs, will be instituted in January 1976.

(d) A $1½ billion program of recession-related assistance to cities will be instituted in early 1976.

6. The combined Social Security tax rate will remain at 11.7% through 1976, but the taxable income base will rise from $14,100 this year to $15,300 in 1976.

7. Monetary policy will essentially accommodate the Federal deficit and the projected economic upturn. The rise in short-term interest rates will be normal in relation to the size of the upturn.

*Case II—Base Case Including Assumed Energy Policy Changes*

Superimposed on Case 1:

1. The import fee on oil products is raised from $.60 to $2 per barrel, effective September 1, 1975.

2. A program instituted on January 1, 1976 providing:

(a) Phased decontrol of "old" domestic crude over 36 months.

(b) A $2 per barrel excise imposed on uncontrolled crude.

(c) A $13.50 ceiling on all uncontrolled oil, except for stripped output (8.5% of total consumption). Prices of "decontrolled" crude rise to $13.50 ceiling and of stripper oil to $15, including the excise tax.

(d) "Windfall profits" tax, completely offset by plough-back allowances.

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* The author is Director of Economic Research of the IBM Corporation; however, the analysis and opinions expressed here are his own and do not necessarily reflect the views of the IBM Corporation.

(e) Revenue increases from oil duties already in effect ($3.0 billion annual rate by late 1975), from the assumed rise in the oil product duty ($1.2 billion), and from the $2 excise on uncontrolled crude (averaging $3.9 billion next year) are largely offset. The offsets include cuts in personal taxes ($4.0 billion) and corporate taxes ($0.8 billion), non-defense purchases ($0.4 billion), and grants-in-aid to state and local governments ($0.8 billion).

3. Prices of natural gas and coal increase at about the same trate as oil.

*Case III—May 30 Administration Budget Case Excluding Energy Policy Changes*

1. Recently enacted temporary tax cuts scheduled to expire on December 31, 1975 are *not* extended.

2. Federal expenditures are in accordance with the May 30 Budget, excluding new energy expenditures, as amplified by the conversions of the data to a quarterly NIA basis in the June 1975 *Survey of Current Business* and supplementary detail provided by OMB. This expenditure pattern incorporates the caps and other cutbacks embodied in the President's proposed package of reductions for FY 76 and excludes some additional expenditures assumed in Case I.

3. Assumptions 3, 4, 6, and 7 of Case I are also assumed.

*Case IV—More Stimulative Fiscal Policy Case Excluding Energy Policy Changes*

Superimposed on Case I:

1. Personal taxes are lowered by $12 billion and corporate taxes by $3 billion for calendar year 1976.

2. Effective January 1, 1976 Federal transfers to persons are raised by $3 billion and non-defense purchases by $2 billion (phased in gradually).

*Recent Economic Developments*

A forecast not only depends on economic policies in force during the period of the forecast, but also on economic policies and conditions prior to the forecast period. For that reason a brief review of recent economic developments is in order.

Although there was a decline in the real GNP in the second quarter, economic developments suggest that there will be a strong rise this quarter. It is significant that real final sales rose appreciably in the second quarter. This is the first increase since the third quarter of 1973 and is indicative of strengthening underlying demand. The improvement in final sales stems primarily from rising consumer expenditures which took place despite a large increase in the safing rate. It is clear that the tax cuts and rebates affected both consumption and savings. The additional saving and continuing effects of the tax cuts will have a favorable influence on consumer spending in the months ahead.

Inflation rates have moderated significantly during the first half of this year, as the table below indicates:

INFLATION

[Percent change—annual rates]

| | 4 quarters 1973 to 4 quarters 1974 | 4 quarters 1974 to 1 quarter 1975 | 1 quarter 1975 to 2 quarters 1975 |
|---|---|---|---|
| Industrial Wholesale Price Index | 27.1 | 6.5 | 4.5 |
| Consumer Price Index | 12.1 | 7.3 | 6.4 |

There was a large increase in the Consumer Price Index in June, but much of it reflected transitory food supply conditions and the impact of the oil tariff.

The moderation of inflation is important because the fundamental underlying cause of the recession was the long and sharp decline in real spendable earnings caused by the inflation. Moreover, the improvement in consumer confidence since the first of the year is not unrelated to the moderation of the inflation.

Since this recession originated in the consumer sector and was particularly long and deep because of the weakness in consumer expenditures, the improvement in consumer spending and debt position in the second quarter, along with moderation of the inflation and strengthening of consumer attitudes, are particularly sigificant for recovery in this quarter.

However, the chief reason to expect a strong third quarter is inventory investment. The decline in inventory investment last quarter was immense. We will not have another one like it, although we do expect some inventory reduction this quarter. This swing from a large decline in inventories to a smaller one will exert a strong positive influence on production. Inventory investment will continue as a force for expansion into 1976.

The leading indicators of residential construction and plant and equipment spending turned around in the second quarter. While this will not have much impact on spending in this quarter, it is a favorable sign for the future.

The conclusion that follows from the observations that have been made so far is that momentum leading to expansion has built up.

FISCAL POLICY

[Billions of dollars]

| | (1) Change in Federal expenditures | (2) Change in Federal receipts due to tax changes | (3) (1)−(2) | (4) (3) as percent of gross national product |
|---|---|---|---|---|
| 1969 | 7.7 | 11.4 | −3.7 | −0.4 |
| 1970 | 14.7 | −8.6 | 23.3 | 2.4 |
| 1971 | 16.4 | −7.3 | 23.7 | 2.2 |
| 1972 | 24.4 | −3.2 | 27.6 | 2.4 |
| 1973 | 19.4 | 8.0 | 11.4 | .8 |
| 1974 | 34.9 | 3.2 | 31.7 | 2.3 |
| 1975 | 58.4 | −14.4 | 72.8 | 5.0 |
| 1976 | 37.7 | 9.0 | 28.7 | 1.7 |

*Case I—Base Case Excluding Energy Policy Changes*

The Case I fiscal policy assumptions are summarized in the table below in a form that gives an indication of their expansionary impact. The Case I assumptions result in an increase of Federal expenditures of $58.4 billion in 1975, and a decrease in Federal receipts due to net tax rate reductions of $14.4 billion; or a total stimulative effect of $72.8 billion, which is 5.0% of 1975 GNP. This is twice as stimulative as fiscal policy was in any year since 1969. However, there is a dramatic reverse in 1976. The increase in Federal expenditures is considerably less and the effects of the 1974 tax rebates are lost. As a result, fiscal stimulus falls to 1.7% of the 1976 GNP, lower than any year shown on the table except 1969 and 1973, years when fiscal policy contributed to the development of recession.

The Case I forecast that results from the present state of the U.S. economy and the assumptions made earlier follows. Four principal subjects will be discussed: 1) the trend of economic activity; 2) unemployment; 3) the inflation; and 4) the Federal deficit.

*The forecast of economic activity* is summarized in the table below:

CASE I FORECAST

[Percent change at annual rates]

| | GNP constant prices | Final sales constant prices |
|---|---|---|
| 1975: | | |
| 1 | −11.9 | −0.7 |
| 2 | −.3 | 3.2 |
| 3 | 7.8 | 2.1 |
| 4 | 7.3 | 3.3 |
| Year | −3.7 | −1.5 |
| 1976: | | |
| 1 | 7.0 | 5.7 |
| 2 | 6.9 | 5.8 |
| 3 | 5.0 | 4.9 |
| 4 | 4.2 | 4.3 |
| Year | 6.4 | 4.6 |

There is an initial surge in real GNP in the third and fourth quarter of 1975 that results mainly from the favorable turn in the inventory cycle. The growth rate of real final sales in those quarters remains quite low despite the improvement in consumer spending. The effect of the tax rebates and cuts and the decline in interest rates on the growth rate of final sales reaches a maximum in the first half of 1976 and thereafter diminishes. In the second half of 1976 inventory investment makes no contribution to the growth rate of GNP and the growth rate of final sales declines. The falloff in the rate of growth evident in the last half of the year is primarily a consequence of fiscal policy assumed for 1976. This slow down in the momentum of economic activity in the last half of 1976 will influence the prospects for 1977.

*The unemployment rate* is likely to rise during the next several months, partly for technical reasons and partly because unemployment is a lagging indicator. However, some improvement is expected during the remainder of the forecast period, although unemployment will still be relatively high (7.7%) at the end of 1976. As the table below shows, this occurs primarily because increases in productivity and the average workweek will account for much of the increased production, and because some increase in the labor force is expected.

UNEMPLOYMENT AND OUTPUT

[Percent change]

| | 1973 | 1974 | 1975 | 1976 |
|---|---|---|---|---|
| Gross national product (1958 dollars) | 5.9 | −2.1 | −3.7 | 6.4 |
| Productivity [1] | 2.6 | −2.7 | −.2 | 3.3 |
| Average workweek [1] | 0 | −1.0 | −1.0 | .6 |
| Civilian labor force | 2.5 | 2.7 | 1.5 | 1.1 |
| Unemployment rate (percent) | 4.9 | 5.6 | 8.7 | 8.0 |

[1] Private sector only.

This slow response of the unemployment rate to the economic recovery follows the normal cyclical recovery pattern. During early stages of recovery increases in productivity are very large and, therefore, increases in employment are normally very small. The productivity rise occurs because employment is not reduced proportionately to output during the recession. Furthermore, some ~~of the overtime work that is cut in downturns is restored during recovery,~~ further reducing the need for new hires.

Since early 1973, productivity has exhibited a significant downward pattern as reductions in employment lagged declines in output (between the first quarter of 1973 and the first quarter of 1975, output per man-hour *fell* nearly 5%). Productivity showed virtually no change during the first half of 1975 but will increase strongly in the third and fourth quarters, and will rise by 3.3% for 1976 as a whole.

*The consumer price index* will increase at an annual rate of 6.2% over the next year and a half, even with the expected economic recovery. While this is high relative to the long-run inflation rate for the U.S., it is about half the rate experienced during 1974, and is low enough to permit some reversal of the recent pattern of declining purchasing power.

The major factors which will hold down the inflation rate during this period are as follows:

(1) There is enormous excess supply of labor and plant capacity at present, so excess demand is unlikely for several years. The table below compares the recession which just ended with prior recessions in the postwar period. As can be seen, the expected recovery under Case I is slower than the recoveries following the 1953/54 and 1960/61 recession periods; it would also have been slower than the recovery from the 1957/58 recession had it not been for the

COMPARISON OF U.S. RECESSIONS

[In percent]

| Recession | Peak to trough decline in real gross national product | Growth in real gross national product: trough plus 6 quarters [1] | In quarter of real gross national product trough: Unemployment rate | In quarter of real gross national product trough: Capacity utilization all manufacturing | In quarter of real gross national product trough: Capacity utilization materials industries |
|---|---|---|---|---|---|
| 1953-54 | 3.4 | 7.3 | 6.0 | 83.7 | 77.5 |
| 1957-58 | 3.9 | 5.7 | 7.4 | 74.3 | 69.9 |
| 1960-61 | 1.5 | 7.0 | 7.0 | 74.2 | 72.7 |
| 1969-70 | 1.4 | 6.3 | 6.0 | 74.2 | 85.5 |
| 1974-75 | 7.8 | [2] 6.7 | 8.9 | 66.5 | 70.2 |

[1] Annual rate.
[2] Forecast.

steel strike in mid-1959. Of most significance, however, is that the expected relatively slow recovery comes after a recession which has been far worse than the others as measured by the drop in real GNP. The unemployment rate and unused capacity in manufacturing have reached higher levels during this recession than any prior one.

(2) The large increases anticipated for grain production will keep grain prices well below the levels of late 1973 and early 1974, assuming exports do not substantially exceed current expectations. This will show up in relatively moderate retail food price increases during the next year.

(3) The U.S. dollar is rising strongly and is likely to continue to exhibit strength during the forecast period. This will prevent a repeat of the large impact that the sharply declining U.S. dollar had on our inflation in 1973 and 1974.

(4) The OPEC oil price increase included in Case I ($1 per barrel) will increase the consumer price index by only about .2% by the end of 1976. This is only a small fraction of the rise caused by the quadrupling of oil prices in 1973 and 1974.

(5) High unemployment is likely to continue to constrain wage increases during the forecast period.

(6) Until labor cost, which combines the effects of compensation rates and productivity, will rise at an annual rate of only 4% over the next six quarters, compared with an 11% rate of increase between the first quarter of 1973 and the first quarter of 1975. This will substantially reduce cost-push pressures on prices. Most of this improvement will occur because of the cyclical behavior of productivity.

The table below, which compares the consumer price index for recession and recovery periods, shows that the pattern expected for this recovery is not unusual. In each of the prior recoveries the rate of inflation was less than during the preceding recession.

CONSUMER PRICE INDEX

[Percent change at annual rates]

| Recession | During recession | During 1st 6 quarters of recovery |
|---|---|---|
| 1953–54 | 0.8 | 0 |
| 1957–58 | 2.8 | 1.1 |
| 1960–61 | 1.5 | 1.2 |
| 1969–70 | 5.7 | 3.4 |
| 1974–75 | 10.6 | [1] 6.2 |

[1] Forecast.

*The Federal deficits* in calendar years 1975 and 1976 will be $78 billion and $67 billion, respectively, on a national income basis. They will be the largest since World War II, both on an absolute basis and relative to GNP. However, most of these deficits are the *result* of the recession, which is reducing tax collections and causing sharply rising expenditures for unemployment benefits and other social welfare programs. The deficit in calendar year 1975 would have been over $50 billion even without any new spending programs or any tax reductions. Because of the excess slack in labor markets and plant capacity, these deficits will not produce any substantial pressures on inflation during this period. A continuation of deficits of this magnitude when the economy gets closer to full employment would, of course, have serious consequences.

Fear has been expressed that the deficits and the expected rising credit demands during the recovery will push interest rates up sharply causing "crowding out" of private borrowers. The Federal Reserve System can easily prevent this. Our calculations indicate that the Case I recovery can be financed with about an 8.5% rise in the basic money supply with only modest increases in interest rates.

*Case II—Base Case Including Assumed Energy Policy Changes*

Superimposed on Case I are the previously described assumptions regarding energy policy changes which at the deadline we set for our computational work seemed a plausible compromise package. The table on the next page shows the estimated price and cost effects of the OPEC price rise assumed in Case I, the additional actions specified in Case II which produce price changes, as well as the impact of immediate decontrol which would raise domestic crude to the present decontrolled price of about $12.75.

The effect on the economy of the changes imposed in this case are summarized in the key indicators below:

COMPARISON OF CASES I AND II

| | 1976—4-quarter level | |
|---|---|---|
| | Case I | Case II |
| Gross national product (billions of 1958 dollars) | 857.0 | 856.4 |
| Unemployment rate (percent) | 7.7 | 7.7 |
| Consumer Price Index (1967=100) | 174.5 | 175.8 |

ENERGY PROGRAM—PRICE AND COST IMPACTS

| | Effect on average price per barrel | Effect on average oil product prices (cents per gallon) | Effect on annual cost to customers (billion) | Estimated total effect on Consumer Price Index [1] (percent) |
|---|---|---|---|---|
| Already Assumed in Case I | | | | |
| 1. OPEC price rise of $1 per barrel Oct. 1, 1975, with no impact on domestic decontrolled | $0.34 | 0.81 | $2.0 | 0.15 |
| Additional Assumptions for Case II | | | | |
| 2. Rise in oil product import fee—from 60 cents per barrel to $2 per barrel, effective Sept. 1, 1975 | .20 | 4.8 | 1.2 | .09 |
| 3. Phased 36-month decontrol of old crude, with presently and newly decontrolled price rising to $13.50 ceiling, effective Jan. 1, 1976 (yearend 1976 effect) | 1.29 | 3.07 | 7.6 | .60 |
| 4. Effect of rise in stripper oil from $13.50 to $15 per barrel, effective Oct. 1, 1975 | .13 | .30 | .8 | .06 |
| 2–4 total, yearend 1976 | 1.62 | 3.85 | 9.6 | .75 |
| Alternative Possibility | | | | |
| 5. Immediate decontrol of crude—price rises to $12.75 | 3.00 | 7.14 | 18.0 | 1.4 |

[1] Includes direct and indirect effects of oil price rises and assumed proportionate price increases for natural gas and coal.

NOTES

1. Assumed present prices: Old crude $5.25 per barrel, "new" crude $12.75 per barrel, duty-paid imports $14 per barrel.
2. Present proportions of U.S. consumption:

| | Percent |
|---|---|
| Imports—total | 34 |
| Crude | 19.5 |
| Refined | 14.5 |
| Domestic—total | 66 |
| Old | 40 |
| New | 26 |
| (Stripper) | 8.5 |

The policy program embodied in Case II raises consumer prices by three quarters of one percent by the end of next year. However, in terms of real GNP, unemployment and the Federal deficit, it produces little net impact. In part, this stems from the specifics of our assumptions. The existing oil tariff increases and the assumed OPEC price rise, with their dampening effect on the economy, are already embodied in Case I. The Case II tax cuts and spending increases are greater than the incremental tax rises to partly offset Treasury receipts from the present tariff. On the other hand, the moderately higher CPI in Case II does serve to inhibit the growth in real output.

Obviously, the effects on economic activity of an energy program depend largely on the degree towhich stimulative offsets are provided. The less the offsets and the later instituted, the greater will be the drag. Larger than assumed increases in OPEC prices if not counterbalanced by expansionary fiscal or monetary policies will also retard economic growth.

Needless to say, as time goes on, the effects of phased decontrol will continue to produce higher prices, and this inflationary impact is of a different nature than that which could be produced by excess demand. Under the Case II assumptions, these price advances yield increases in oil company profits in 1977 and 1978, as only $2 of the $8.25 increase that customers pay for *newly* decontrolled oil is subject to an excise, and plough-back provisions completely offset the "windfall" profits tax. In 1976 this effect is essentially offset by the rollback of the much larger amount of *presently* uncontrolled crude to an effective ceiling of $11.50 ($13.50 less the $2.00 excise) from $12.75, with the price rise for stripper oil moderately increasing oil industry profits.

*Cases III and IV—May 30 Administration Budget Case and More Stimulative Fiscal Policy Case, Both Excluding Energy Policy Changes*

Alternative cases (Cases III and IV) were prepared to illustrate the impact of public policy on economic conditions. A comparison of the fiscal policy measure used earlier is given below:

FISCAL POLICY—CASES I, III, IV

| | (1) Change in Federal expenditures | (2) Change in Federal receipts due to tax changes | (3) (1)−(2) | (4) (3) as percent of gross national product |
|---|---|---|---|---|
| **1975** | | | | |
| Cases: | | | | |
| I | 58.4 | −14.4 | 72.8 | 5.0 |
| III | 55.4 | −14.4 | 69.8 | 4.8 |
| IV | 58.4 | −14.4 | 72.8 | 5.0 |
| **1976** | | | | |
| Cases: | | | | |
| I | 37.7 | 9.0 | 28.7 | 1.7 |
| III | 27.2 | 18.2 | 9.0 | .6 |
| IV | 42.8 | −6.0 | 48.8 | 2.9 |

As can be seen, this fiscal policy indicator is substantially different in 1976. Case III is $19.7 billion less stimulative than Case I, and Case IV $20.1 billion more stimulative. About half of the difference between Case I and Case III is due to tax rate differences and about half is due to the expenditure cutbacks incorporated in the Administration Budget (some of which begin in mid-1975).

In Case III this measure of fiscal stimulus as a percent of the GNP is similar to comparable numbers in 1969 and 1973, years that were followed by recession.

A comparison of key economic indicators for the three cases is provided below.

COMPARISON OF CASES I, III, IV

| | 1976.4 | 1976.4 −1975.4 | 1975.4 −1975.2 |
|---|---|---|---|
| | | Percent annual compound growth rate | |
| **Gross national product (billions of 1958 dollars)** | | | |
| Cases: | | | |
| I | $857.0 | 5.9 | 7.6 |
| III | 841.6 | 4.3 | 7.0 |
| IV | 865.9 | 7.0 | 7.6 |
| **Consumer Price Index (1967=100)** | | | |
| Cases: | | | |
| I | 174.5 | 5.9 | 6.6 |
| III | 174.7 | 6.0 | 6.6 |
| IV | 174.4 | 5.8 | 6.6 |
| **Unemployment rate (percent)** | | Average—during period | |
| Cases: | | | |
| I | 7.7 | 8.0 | 8.9 |
| III | 8.6 | 8.6 | 8.9 |
| IV | 7.4 | 7.8 | 8.9 |

Compared with Case I, the assumptions embodied in Case III produce a significantly lower rate of growth of economic activity during the course of 1976 (1.6% less in real GNP) as well as a smaller rise for the remainder of this year. The lower growth produces higher unemployment (8.6% unemployment rate in the fourth quarter of 1976 versus a 7.7% rate for the base case). The full consequences of the differences in economic policy do not emerge in 1976. There are substantial lags in the response of consumption and investment to changes in economic policy, and in employment to output changes. The relatively low growth rate of Case III for the period from the fourth quarter 1975 to the fourth quarter 1976 suggests additional weakness in 1977.

In the more stimulative Case IV, the growth rate of the real GNP is 1.1% greater than Case I during 1976 and by the last quarter of 1976 the unemployment rate is .3% less. Again, the lags are such that somewhat greater differences will emerge in 1977.

At the high rate of unemployment in all cases, the differences in economic activity produces little effect on the consumer price index. The increase in demand associated with higher activity is offset by lower costs associated with greater productivity.

The table below compares the Federal deficit on a national income basis:

FEDERAL BUDGET DEFICIT—CASES I, III, IV

[National income basis, billions]

| | 1975 | 1976 |
|---|---|---|
| **Federal Receipts** | | |
| Cases: | | |
| I | $279.8 | $328.2 |
| III | 279.3 | 332.6 |
| IV | 279.8 | 316.0 |
| **Federal Expenditures** | | |
| Cases: | | |
| I | 357.5 | 395.2 |
| III | 354.5 | 381.7 |
| IV | 357.5 | 400.3 |
| **Federal Surplus and Deficit** | | |
| Cases: | | |
| I | −77.7 | −67.0 |
| III | −75.2 | −49.1 |
| IV | −77.7 | −84.3 |

Compared with Case I, the Administration Budget case (Case III) shows a $2.5 billion lower deficit in calendar year 1975, reflecting $3 billion less in spending and $0.5 billion less in receipts stemming from slightly weaker economic activity. The main thrust of the program is felt, however, in 1976. Federal receipts are up over the base case by $4.4 billion—with the effect of letting the temporary tax cuts expire outweighing the smaller impact on tax collections from less economic growth. Meanwhile, budgetary reductions and constraints trim Federal expenditures $13.5 billion below the base case with the difference particularly large in grants-in-aid to state and local governments. The net result is a decline in the Federal deficit to $49.1 billion, some $18 below the base case.

The stimulative case (Case IV) contains $5.1 billion higher Federal expenditures in 1976 than in the base case, and Federal receipts are $12.2 billion lower. As a result, the Federal deficit reaches $84.3 billion, or $17.3 billion above the base.

The weaker level of economic activity and smaller Federal deficit in Case III imply lower credit demands and therefore requires about a 7.5% rise in the money supply, less than in the base case. Interest rates will also be somewhat lower.

For Case IV, a 9.5% rise in the money supply is necessary to support the additional credit demands. This growth in the money supply will not be sufficient, however, to prevent some additional rise in short-term rates above the base case.

CASE I.—BASE CASE EXCLUDING ENERGY POLICY CHANGES

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Gross national product, current | $1,416.6 | $1,433.4 | $1,481.7 | $1,530.4 | $1,577.5 | $1,626.4 | $1,670.7 | $1,716.3 |
| Personal consumption expenditures | 913.2 | 938.1 | 964.0 | 987.3 | 1,009.1 | 1,032.4 | 1,055.8 | 1,081.6 |
| Durable goods | 124.9 | 130.0 | 135.4 | 136.8 | 142.2 | 147.7 | 152.5 | 158.0 |
| Nondurable goods | 398.8 | 408.5 | 418.2 | 427.1 | 433.7 | 440.1 | 447.9 | 456.8 |
| Services | 389.5 | 399.6 | 410.5 | 423.3 | 433.2 | 444.6 | 455.4 | 466.8 |
| Gross private domestic investment | 163.0 | 147.3 | 166.5 | 186.4 | 203.5 | 221.4 | 233.5 | 242.9 |
| Fixed investment | 182.2 | 181.1 | 179.9 | 186.2 | 198.7 | 212.1 | 223.6 | 233.0 |
| Nonresidential | 147.0 | 144.6 | 141.3 | 141.9 | 148.2 | 156.3 | 164.3 | 171.6 |
| Structures | 52.8 | 50.2 | 48.3 | 47.6 | 49.5 | 52.6 | 55.6 | 58.3 |
| Producer, durable equipment | 94.2 | 94.4 | 93.0 | 94.3 | 98.7 | 103.7 | 108.8 | 113.3 |
| Residential structures | 35.2 | 36.5 | 38.6 | 44.2 | 50.5 | 55.9 | 59.3 | 61.4 |
| Nonfarm | 34.8 | 35.7 | 37.8 | 43.4 | 49.7 | 55.0 | 58.4 | 60.6 |
| Change in business inventories | −19.2 | −33.8 | −13.4 | .2 | 4.9 | 9.2 | 9.9 | 9.9 |
| Net exports of goods and services | 8.8 | 9.2 | 6.4 | 3.3 | 4.2 | 4.5 | 4.5 | 3.8 |
| Exports | 142.2 | 130.9 | 130.0 | 130.0 | 134.0 | 140.5 | 147.5 | 153.6 |
| Imports | 133.4 | 121.7 | 123.6 | 126.7 | 129.8 | 136.0 | 143.0 | 149.8 |
| Government purchases of goods and services | 331.6 | 338.8 | 344.8 | 353.5 | 360.7 | 368.2 | 376.8 | 388.0 |
| Federal | 126.5 | 128.6 | 130.6 | 135.7 | 138.0 | 140.2 | 143.0 | 148.1 |
| National defense | 84.7 | 85.4 | 86.2 | 89.4 | 90.6 | 91.8 | 93.2 | 96.7 |
| Other | 41.8 | 43.2 | 44.4 | 46.3 | 47.4 | 48.4 | 49.8 | 51.4 |
| State and local | 205.1 | 210.2 | 214.2 | 217.8 | 222.7 | 228.0 | 233.9 | 239.9 |
| Gross national product, 1958 prices | 780.0 | 779.4 | 794.6 | 809.2 | 823.3 | 837.6 | 848.1 | 857.0 |
| Personal consumption expenditures | 531.5 | 539.6 | 547.1 | 552.3 | 557.9 | 563.8 | 568.9 | 574.5 |
| Durable goods | 95.2 | 97.5 | 100.5 | 99.6 | 102.3 | 104.8 | 106.6 | 108.7 |
| Nondurable goods | 222.5 | 225.9 | 228.2 | 231.1 | 232.5 | 233.7 | 235.2 | 236.7 |
| Services | 213.7 | 216.2 | 218.4 | 221.6 | 223.1 | 225.3 | 227.1 | 229.1 |
| Gross private domestic investment | 89.3 | 79.6 | 88.3 | 98.0 | 105.6 | 113.3 | 17.8 | 120.7 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Fixed investment | 101.0 | 98.5 | 96.1 | 97.9 | 102.8 | 108.1 | 112.4 | 115.4 |
| Nonresidential | 83.8 | 81.0 | 77.8 | 77.3 | 79.7 | 82.9 | 86.0 | 88.5 |
| Structures | 25.2 | 23.7 | 22.5 | 21.8 | 22.3 | 23.3 | 24.3 | 25.0 |
| Producing durable equipment | 58.6 | 57.2 | 55.4 | 55.5 | 57.4 | 59.6 | 61.7 | 63.5 |
| Residential structures | 17.2 | 17.5 | 18.2 | 20.6 | 23.2 | 25.2 | 26.4 | 26.9 |
| Nonfarm | 17.0 | 17.1 | 17.8 | 20.2 | 22.8 | 24.8 | 26.0 | 26.5 |
| Change in business inventories | −11.7 | −18.8 | −7.7 | .1 | 2.7 | 5.1 | 5.4 | 5.3 |
| Net exports of goods and services | 11.6 | 11.0 | 9.6 | 9.2 | 9.6 | 9.9 | 10.0 | 9.8 |
| Exports | 66.5 | 61.7 | 60.6 | 59.8 | 60.7 | 62.5 | 64.4 | 65.8 |
| Imports | 54.9 | 50.7 | 51.0 | 50.6 | 51.0 | 52.6 | 54.4 | 56.0 |
| Government purchases of goods and services | 147.6 | 149.4 | 149.6 | 149.7 | 150.2 | 150.6 | 151.4 | 152.0 |
| Federal | 57.4 | 58.5 | 58.5 | 58.7 | 58.8 | 58.8 | 59.0 | 59.1 |
| State and local | 90.2 | 90.9 | 91.1 | 91.0 | 91.4 | 91.8 | 92.4 | 92.9 |
| Gross national product price deflator (1958=100) | 181.6 | 183.9 | 186.5 | 189.1 | 191.6 | 194.2 | 197.0 | 200.3 |
| Industrial wholesale prices (1967=100) | 168.3 | 170.2 | 172.1 | 174.1 | 176.2 | 178.3 | 180.7 | 182.9 |
| Consumer price index (1967=100) | 157.0 | 159.5 | 162.1 | 164.8 | 167.0 | 169.3 | 171.9 | 174.5 |
| Gross national product | 1,416.6 | 1,433.4 | 1,481.7 | 1,530.4 | 1,577.5 | 1,626.4 | 1,670.7 | 1,716.3 |
| Less: | | | | | | | | |
| Depreciation (CCA) | 125.2 | 127.4 | 129.8 | 132.0 | 134.3 | 136.8 | 139.6 | 142.5 |
| Indirect business taxes | 132.2 | 135.2 | 140.8 | 145.1 | 150.4 | 153.8 | 158.4 | 162.2 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Statistical discrepancy | 1.6 | 1.6 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Plus subsidies less surplus | −1.6 | −1.9 | −1.9 | −1.7 | −2.0 | −2.0 | −1.7 | −1.3 |
| Equals national income | 1,150.7 | 1,161.7 | 1,198.7 | 1,241.0 | 1,280.2 | 1,323.0 | 1,360.2 | 1,399.4 |
| Less: | | | | | | | | |
| Corporate profits and IVA | 94.2 | 91.2 | 105.8 | 119.7 | 129.5 | 139.2 | 143.7 | 146.4 |
| Contribution for social security | 104.6 | 105.4 | 106.8 | 108.5 | 112.6 | 114.7 | 116.9 | 119.0 |
| Plus: | | | | | | | | |
| Government transfers | 158.7 | 171.2 | 175.5 | 177.8 | 181.6 | 184.1 | 191.3 | 195.3 |
| Interest paid | 43.7 | 45.0 | 47.0 | 48.8 | 50.2 | 51.1 | 52.0 | 52.9 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.7 | 35.3 | 35.9 | 36.5 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Equals personal income | 1,193.4 | 1,220.8 | 1,247.9 | 1,279.1 | 1,310.2 | 1,345.3 | 1,384.7 | 1,424.5 |
| Less personal income taxes | 178.0 | 142.0 | 177.0 | 182.8 | 189.6 | 197.4 | 207.6 | 215.1 |
| Equals disposable personal income | 1,015.5 | 1,078.8 | 1,071.0 | 1,096.3 | 1,120.6 | 1,147.9 | 1,177.0 | 1,209.4 |
| Savings ratio (percent of disposal income) | 7.6 | 10.7 | 7.6 | 7.6 | 7.6 | 7.7 | 8.0 | 8.2 |
| Consumption ratio (percent) | 89.9 | 87.0 | 90.0 | 90.1 | 90.0 | 89.9 | 89.7 | 89.4 |

CASE I.—BASE CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Private: | | | | | | | | |
| Annual earnings (thousands of dollars) | $9.21 | $9.33 | $9.50 | $9.67 | $9.85 | $10.02 | $10.20 | $10.38 |
| Hourly earnings (dollars) | 4.92 | 4.98 | 5.06 | 5.14 | 5.22 | 5.30 | 5.39 | 5.50 |
| Output per man-hour (1958=100) | 150.6 | 151.3 | 153.2 | 154.9 | 156.3 | 157.4 | 158.0 | 158.6 |
| Unit labor cost (1958=100) | 176.1 | 177.9 | 178.1 | 179.2 | 180.8 | 182.7 | 185.6 | 188.8 |
| Civilian: | | | | | | | | |
| Labor force (millions) | 91.8 | 92.5 | 92.7 | 92.8 | 93.0 | 93.2 | 93.6 | 94.0 |
| Employment (millions) | 84.1 | 84.3 | 84.4 | 84.7 | 85.1 | 85.7 | 86.2 | 86.8 |
| Unemployment rate (percent of labor force) | 8.4 | 8.9 | 9.0 | 8.8 | 8.4 | 8.1 | 7.8 | 7.7 |
| National income | 1,150.7 | 1,161.7 | 1,198.7 | 1,241.0 | 1,280.2 | 1,323.0 | 1,360.2 | 1,399.4 |
| Compensation of employees | 875.6 | 885.5 | 903.9 | 927.5 | 952.1 | 977.2 | 1,003.3 | 1,032.1 |
| Wages and salaries | 765.1 | 773.1 | 788.7 | 809.3 | 829.5 | 851.3 | 873.9 | 899.2 |
| Private | 597.4 | 602.2 | 615.4 | 631.0 | 648.4 | 667.1 | 686.2 | 705.2 |
| Military | 22.0 | 21.9 | 21.9 | 23.4 | 23.6 | 23.7 | 23.9 | 25.3 |
| Civilian government | 145.7 | 149.2 | 151.3 | 154.9 | 157.6 | 160.5 | 163.8 | 168.7 |
| Supplements | 110.5 | 112.4 | 115.2 | 118.2 | 122.5 | 125.9 | 129.4 | 132.9 |
| Rent, interest, properietors income | 180.8 | 185.0 | 189.0 | 193.7 | 198.6 | 206.5 | 213.2 | 220.9 |
| Corporate profits plus IVA | 94.2 | 91.2 | 105.8 | 119.7 | 129.5 | 139.2 | 143.7 | 146.4 |
| Profits before tax | 101.2 | 99.1 | 113.1 | 127.4 | 139.0 | 149.3 | 155.7 | 158.4 |
| Profits tax liability | 39.0 | 38.2 | 43.7 | 49.2 | 53.5 | 57.5 | 59.9 | 61.0 |
| Profits after tax | 62.2 | 60.9 | 69.5 | 78.2 | 85.5 | 91.8 | 95.7 | 97.4 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.7 | 35.3 | 35.9 | 36.5 |
| Undistributed profits | 28.4 | 27.0 | 35.5 | 44.0 | 50.8 | 56.5 | 59.8 | 60.9 |
| Inventory valuation adjustment | −7.0 | −7.9 | −7.3 | −7.6 | −9.4 | −10.0 | −12.0 | −12.0 |
| Memo: New orders, machinery, and equipment | 118.3 | 122.9 | 124.2 | 132.3 | 139.6 | 145.7 | 151.1 | 156.1 |
| Federal Government: | | | | | | | | |
| Receipts | 284.1 | 247.7 | 288.6 | 298.9 | 311.2 | 322.2 | 335.6 | 343.6 |
| Expenditures | 338.5 | 355.3 | 363.6 | 372.7 | 381.2 | 388.2 | 400.2 | 411.2 |
| Surplus or deficit | −54.4 | −107.6 | −75.1 | −73.8 | −70.0 | −65.9 | −64.6 | −67.5 |
| State and local governments: | | | | | | | | |
| Receipts | 219.8 | 225.4 | 233.7 | 242.3 | 252.9 | 261.4 | 269.0 | 276.8 |
| Expenditures | 221.5 | 227.6 | 233.2 | 238.4 | 244.2 | 250.0 | 256.2 | 262.5 |
| Surplus or deficit | −1.6 | −2.2 | 0.5 | 3.9 | 8.7 | 11.4 | 12.9 | 14.3 |

CASE I.—BASE CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| Percent growth (annual rates) | 72.0 | 73.0 | 74.0 | 75.0 | 76.0 |
|---|---|---|---|---|---|
| Gross national product: | | | | | |
| Current dollars | $9.8 | $11.8 | $7.9 | $4.9 | $12.4 |
| 1958 prices | 6.2 | 5.9 | −2.1 | −3.7 | 6.4 |
| Price deflator | 3.4 | 5.6 | 10.3 | 8.8 | 5.7 |
| Industrial Wholesale Prices | 3.4 | 6.8 | 22.2 | 11.3 | 4.9 |
| Consumer Price Index | 3.3 | 6.2 | 11.0 | 8.9 | 6.1 |
| Private: | | | | | |
| Hourly earnings | 5.3 | 6.5 | 8.4 | 7.8 | 6.6 |
| Annual earnings | 5.8 | 6.5 | 7.4 | 6.7 | 7.3 |
| Workweek | .5 | 0 | −1.0 | −1.0 | .6 |
| Productivity | 3.5 | 2.6 | −2.7 | −.2 | 3.3 |
| Unit labor cost | 3.1 | 6.3 | 10.9 | 7.7 | 3.7 |
| Civilian: | | | | | |
| Labor force | 2.8 | 2.5 | 2.7 | 1.5 | 1.1 |
| Employment | 3.2 | 3.4 | 1.9 | −1.8 | 1.9 |
| Unemployment (percent of labor force) | 5.6 | 4.9 | 5.6 | 8.7 | 8.0 |
| New orders, machinery ,and equipment | 16.0 | 21.6 | 11.7 | −10.0 | 19.0 |
| Corporate profits before taxes | 18.6 | 23.7 | 14.7 | −21.7 | 36.6 |
| Business fixed investment | 11.7 | 17.1 | 9.1 | −3.7 | 11.4 |
| Nonresidential structures | 8.4 | 14.3 | 10.7 | −4.5 | 8.5 |
| Producers durable equipment | 13.6 | 18.6 | 8.2 | −3.2 | 12.9 |
| Inventory investment (billions of dollars) | 8.6 | 15.3 | 14.3 | −16.5 | 8.5 |
| Residential construction | 26.0 | 6.2 | −19.7 | −15.9 | 47.0 |
| Disposable personal income | 7.5 | 12.6 | 8.4 | 8.7 | 9.9 |
| Consumption | 9.3 | 10.5 | 8.9 | 8.4 | 9.2 |
| Durable goods | 14.0 | 10.0 | −2.1 | 3.3 | 13.9 |
| Nondurable goods | 7.6 | 12.8 | 12.5 | 8.7 | 7.6 |
| Services | 9.2 | 8.4 | 9.5 | 10.0 | 10.9 |
| Savings ratio (percent of disposable income) | 6.6 | 8.3 | 7.9 | 8.3 | 7.9 |
| Net exports (billions of dollars) | −6.0 | 4.0 | 2.1 | 6.9 | 4.2 |
| Federal Government | 7.4 | 1.6 | 9.7 | 11.5 | 9.2 |
| Defense spending | 5.1 | −.5 | 5.8 | 9.8 | 7.7 |
| State and local government | 10.4 | 12.6 | 13.3 | 10.1 | 9.1 |

## CASE II.—BASE CASE INCLUDING ASSUMED ENERGY POLICY CHANGES

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Gross national product, current | $1,416.6 | $1,433.4 | $1,481.7 | $1,530.3 | $1,583.2 | $1,634.9 | $1,681.4 | $1,729.5 |
| Personal consumption expenditures | 913.2 | 938.1 | 964.1 | 987.3 | 1,012.4 | 1,037.5 | 1,062.7 | 1,090.3 |
| Durable goods | 124.9 | 130.0 | 135.4 | 136.8 | 143.1 | 148.8 | 153.7 | 159.4 |
| Nondurable goods | 398.8 | 408.5 | 418.2 | 427.1 | 435.2 | 442.9 | 452.0 | 462.0 |
| Services | 389.5 | 399.6 | 410.5 | 423.4 | 434.1 | 445.9 | 457.0 | 468.9 |
| Gross private domestic investment | 163.0 | 147.3 | 166.5 | 186.2 | 204.0 | 222.9 | 235.4 | 245.6 |
| Fixed investment | 182.2 | 181.1 | 179.9 | 186.1 | 199.0 | 213.0 | 225.1 | 235.1 |
| Nonresidential | 147.0 | 144.6 | 141.3 | 141.9 | 148.4 | 157.0 | 165.6 | 173.5 |
| Structures | 52.8 | 50.2 | 48.3 | 47.6 | 49.5 | 52.8 | 55.9 | 58.9 |
| Producer durable equipment | 94.2 | 94.4 | 93.0 | 94.3 | 98.9 | 104.2 | 109.7 | 114.7 |
| Residential structures | 35.2 | 36.5 | 38.6 | 44.2 | 50.6 | 56.0 | 59.5 | 61.6 |
| Nonfarm | 34.8 | 35.7 | 37.8 | 43.4 | 49.7 | 55.2 | 58.6 | 60.7 |
| Change in business inventories | −19.2 | −33.8 | −13.4 | .1 | 5.0 | 9.9 | 10.3 | 10.4 |
| Net exports of goods and services | 8.8 | 9.2 | 6.4 | 3.3 | 4.2 | 4.3 | 4.4 | 3.7 |
| Exports | 142.2 | 130.9 | 130.0 | 130.0 | 134.0 | 140.5 | 147.5 | 153.6 |
| Imports | 133.4 | 121.7 | 123.6 | 126.7 | 129.8 | 136.2 | 143.1 | 149.9 |
| Government purchases of goods and services | 331.6 | 338.8 | 344.8 | 353.5 | 362.7 | 370.2 | 378.8 | 389.9 |
| Federal | 126.5 | 128.6 | 130.6 | 135.7 | 139.2 | 141.4 | 144.2 | 149.2 |
| National defense | 84.7 | 85.4 | 86.2 | 89.4 | 91.4 | 92.6 | 94.0 | 97.4 |
| Other | 41.8 | 43.2 | 44.4 | 46.3 | 47.8 | 48.8 | 50.2 | 51.8 |
| State and local | 205.1 | 210.2 | 214.2 | 217.8 | 223.5 | 228.8 | 234.7 | 240.7 |
| Gross national product, 1958 prices | 780.0 | 779.4 | 794.5 | 808.9 | 824.7 | 838.8 | 848.4 | 856.4 |
| Personal consumption expenditures | 531.5 | 539.6 | 547.1 | 552.1 | 558.6 | 564.3 | 569.0 | 574.1 |
| Durable goods | 95.2 | 97.5 | 100.5 | 99.6 | 102.7 | 105.1 | 106.7 | 108.15 |
| Nondurable goods | 222.5 | 225.9 | 228.2 | 231.0 | 232.7 | 233.8 | 235.2 | 236.6 |
| Services | 213.7 | 216.2 | 218.4 | 221.5 | 223.3 | 225.4 | 227.1 | 229.0 |
| Gross private domestic investment | 89.3 | 79.6 | 88.3 | 97.9 | 105.7 | 113.7 | 118.2 | 121.2 |
| Fixed investment | 101.0 | 98.5 | 96.1 | 97.8 | 102.9 | 108.3 | 112.5 | 115.6 |
| Nonresidential | 83.8 | 81.0 | 77.8 | 77.2 | 79.7 | 83.0 | 86.2 | 88.7 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Structures | 25.2 | 23.7 | 22.5 | 21.8 | 22.3 | 23.4 | 24.3 | 25.1 |
| Producing durable equipment | 58.6 | 57.2 | 55.4 | 55.4 | 57.4 | 59.7 | 61.9 | 63.6 |
| Residential structures | 17.2 | 17.5 | 18.2 | 20.6 | 23.2 | 25.2 | 26.4 | 26.9 |
| Nonfarm | 17.0 | 17.1 | 17.8 | 20.2 | 22.8 | 24.8 | 26.0 | 26.5 |
| Change in business inventories | −11.7 | −18.8 | −7.7 | 0 | 2.8 | 5.5 | 5.6 | 5.6 |
| Net exports of goods and services | 11.6 | 11.0 | 9.6 | 9.2 | 9.5 | 9.7 | 9.7 | 9.4 |
| Exports | 66.5 | 61.7 | 60.6 | 59.7 | 60.6 | 62.4 | 64.1 | 65.3 |
| Imports | 54.9 | 50.7 | 51.0 | 50.6 | 51.1 | 52.6 | 54.4 | 56.0 |
| Government purchases of goods and services | 147.6 | 149.4 | 149.6 | 149.7 | 150.9 | 151.1 | 151.6 | 151.7 |
| Federal | 57.4 | 58.5 | 58.5 | 58.6 | 59.2 | 59.1 | 59.2 | 59.1 |
| State and local | 90.2 | 90.9 | 91.1 | 91.0 | 91.7 | 92.0 | 92.3 | 92.6 |
| Gross national product price deflator (1958=100) | 181.6 | 183.9 | 186.5 | 189.2 | 192.0 | 194.9 | 198.2 | 202.0 |
| Industrial Wholesale prices (1967=100) | 168.3 | 170.2 | 172.2 | 174.4 | 176.9 | 179.4 | 182.2 | 185.1 |
| Consumer Price Index (1967=100) | 157.0 | 159.5 | 162.1 | 164.8 | 167.2 | 169.9 | 172.8 | 175.8 |
| Gross national product | 1,416.6 | 1,433.4 | 1,481.7 | 1,530.3 | 1,583.2 | 1,634.9 | 1,681.4 | 1,729.5 |
| Less: | | | | | | | | |
| Depreciation (CCA) | 125.2 | 127.4 | 129.8 | 132.0 | 134.3 | 136.8 | 139.7 | 142.6 |
| Indirect business taxes | 132.2 | 135.2 | 140.8 | 146.1 | 154.9 | 158.7 | 164.7 | 169.0 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Statistical discrepancy | 1.6 | 1.6 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Plus subsidies less surplus | −1.6 | −1.9 | −1.9 | −1.7 | −2.0 | −2.0 | −1.7 | −1.3 |
| Equals national income | 1,150.7 | 1,161.7 | 1,198.7 | 1,239.9 | 1,281.3 | 1,326.6 | 1,364.5 | 1,405.7 |
| Less: | | | | | | | | |
| Corporation profits and IVA | 94.2 | 91.2 | 105.8 | 118.8 | 130.1 | 141.5 | 146.2 | 150.4 |
| Contributions for social security | 104.6 | 105.4 | 106.8 | 108.5 | 112.7 | 114.8 | 117.0 | 119.2 |
| Plus: | | | | | | | | |
| Government transfers | 158.7 | 171.2 | 175.5 | 177.8 | 181.6 | 184.1 | 191.3 | 195.3 |
| Interest paid | 43.7 | 45.0 | 47.0 | 48.8 | 50.2 | 51.1 | 52.1 | 52.9 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.7 | 35.4 | 36.1 | 36.9 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Equals personal income | 1,193.4 | 1,220.8 | 1,247.9 | 1,278.9 | 1,310.8 | 1,346.7 | 1,386.6 | 1,427.2 |
| Less personal income taxes | 178.0 | 142.0 | 177.0 | 182.8 | 185.2 | 193.0 | 203.2 | 210.6 |
| Equals disposable personal income | 1,015.5 | 1,078.8 | 1,071.0 | 1,096.1 | 1,125.6 | 1,153.7 | 1,183.4 | 1,216.5 |
| Savings ratio (percent of disposable income) | 7.6 | 10.7 | 7.6 | 7.6 | 7.7 | 7.7 | 7.9 | 8.1 |
| Consumption ratio (percent) | 89.9 | 87.0 | 90.0 | 90.1 | 89.9 | 89.9 | 89.8 | 89.6 |
| Private annual earnings (thousands of dollars) | 9.21 | 9.33 | 9.50 | 9.67 | 9.85 | 10.03 | 10.21 | 10.4 |
| Private hourly earnings (dollars) | 4.92 | 4.98 | 5.06 | 5.14 | 5.22 | 5.31 | 5.40 | 5.50 |

CASE II.—BASE CASE INCIUDING ASSUMED ENERGY POLICY CHANGES—CONTINUED

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Private output per man-hour (1958=100) | 150.6 | 151.3 | 153.2 | 154.9 | 156.4 | 157.6 | 158.0 | 158.51 |
| Unit labor cost (1958=100) | 176.1 | 177.9 | 178.2 | 179.2 | 180.5 | 182.6 | 185.7 | 189.3 |
| Civilian labor force (millions) | 91.8 | 92.5 | 92.7 | 92.8 | 93.0 | 93.2 | 93.6 | 94.0 |
| Civilian employment (millions) | 84.1 | 84.3 | 84.4 | 84.7 | 85.2 | 85.7 | 86.3 | 86.8 |
| Unemployment rate (percent of labor force) | 8.4 | 8.9 | 9.0 | 8.8 | 8.4 | 8.1 | 7.8 | 7.7 |
| National income | 1,150.7 | 1,161.7 | 1,198.7 | 1,239.9 | 1,281.3 | 1,326.6 | 1,364.5 | 1,405.7 |
| Compensation of employees | 875.6 | 885.5 | 903.9 | 927.5 | 952.5 | 978.1 | 1,004.6 | 1,033.7 |
| Wages and salaries | 765.1 | 773.1 | 788.7 | 809.3 | 829.9 | 852.1 | 875.1 | 900.7 |
| Private | 597.4 | 602.0 | 615.4 | 631.0 | 648.8 | 667.9 | 687.4 | 706.6 |
| Military | 22.0 | 21.9 | 21.9 | 23.4 | 23.6 | 23.7 | 23.9 | 25.3 |
| Civilian government | 145.7 | 149.2 | 151.3 | 154.9 | 157.6 | 160.5 | 163.8 | 168.7 |
| Supplements | 110.5 | 112.4 | 115.2 | 118.2 | 122.6 | 126.0 | 129.5 | 133.0 |
| Rent, interest, proprietors income | 180.8 | 185.0 | 189.0 | 193.6 | 198.8 | 207.0 | 213.8 | 221.6 |
| Corporate profits plus IVA | 94.2 | 91.2 | 105.8 | 118.8 | 130.1 | 141.5 | 146.2 | 150.4 |
| Profits before tax | 101.2 | 99.1 | 113.2 | 127.1 | 140.9 | 152.6 | 159.5 | 164.2 |
| Profits tax liability | 39.0 | 38.2 | 43.7 | 49.0 | 53.1 | 57.5 | 60.1 | 61.9 |
| Profits after tax | 62.2 | 60.9 | 69.5 | 78.0 | 87.8 | 95.1 | 99.4 | 102.3 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.7 | 35.4 | 36.1 | 36.9 |
| Undistributed profits | 28.4 | 27.0 | 35.6 | 43.8 | 53.0 | 59.7 | 63.2 | 65.5 |
| Inventory valuation adjustment | −7.0 | −7.9 | −7.4 | −8.2 | −10.8 | −11.1 | −13.3 | −13.8 |
| Memo: New orders, machinery, and equipment | 118.3 | 122.9 | 124.3 | 132.2 | 140.5 | 147.2 | 152.9 | 158.6 |
| Federal Government: | | | | | | | | |
| Receipts | 284.1 | 247.7 | 288.6 | 299.7 | 310.5 | 322.0 | 336.7 | 345.5 |
| Expenditures | 338.5 | 355.3 | 363.6 | 372.7 | 383.2 | 390.2 | 402.3 | 413.2 |
| Surplus or deficit | −54.4 | −107.6 | −75.1 | −73.0 | −72.7 | −68.1 | −65.6 | −67.7 |
| State and local governments: | | | | | | | | |
| Receipts | 219.8 | 225.4 | 233.7 | 242.3 | 254.2 | 263.0 | 271.0 | 279.1 |
| Expenditures | 221.5 | 227.6 | 233.2 | 238.4 | 245.0 | 250.8 | 257.0 | 263.3 |
| Surplus or deficit | −1.6 | −2.2 | .5 | 3.9 | 9.2 | 12.3 | 14.0 | 15.8 |

CASE II.—BASE CASE INCLUDING ASSUMED ENERGY POLICY CHANGES—Continued

| Percent growth (annual rates) | 72.0 | 73.0 | 74.0 | 75.0 | 76.0 |
|---|---|---|---|---|---|
| Gross national product: | | | | | |
| Current dollars | 9.8 | 11.8 | 7.9 | 4.9 | 13.1 |
| 1958 prices | 6.2 | 5.9 | −2.1 | −3.7 | 6.5 |
| Price deflator | 3.4 | 5.6 | 10.3 | 8.8 | 6.2 |
| Industrial wholesale prices | 3.4 | 6.8 | 22.2 | 11.3 | 5.6 |
| Consumer price Index | 3.3 | 6.2 | 11.0 | 8.9 | 6.6 |
| Private: | | | | | |
| Hourly earnings | 5.3 | 6.5 | 8.4 | 7.8 | 6.7 |
| Annual earnings | 5.8 | 6.5 | 7.4 | 6.7 | 7.4 |
| Workweek | .5 | 0 | −1.0 | −1.0 | .6 |
| Productivity | 3.5 | 2.6 | −2.7 | −.2 | 3.4 |
| Unit labor cost | 3.1 | 6.3 | 10.9 | 7.7 | 3.8 |
| Civilian: | | | | | |
| Labor force | 2.8 | 2.5 | 2.7 | 1.5 | 1.1 |
| Employment | 3.2 | 3.4 | 1.9 | −1.8 | 1.9 |
| Unemployment (percent of labor force) | 5.6 | 4.9 | 5.6 | 7.8 | 8.0 |
| New orders, machinery, and equipment | 16.0 | 21.6 | 11.7 | −10.0 | 20.4 |
| Corporate profits before taxes | 18.6 | 23.7 | 24.7 | −21.7 | 40.1 |
| Business fixed investment | 11.7 | 17.1 | 9.1 | −3.7 | 12.1 |
| Nonresidential structures | 8.4 | 14.3 | 10.7 | −4.5 | 9.1 |
| Producers durable equipment | 13.6 | 18.6 | 8.2 | −3.2 | 13.7 |
| Inventory investment (billions of dollars) | 8.6 | 15.3 | 14.3 | −16.6 | 8.9 |
| Residential construction | 26.0 | 6.2 | −19.7 | −16.0 | 47.4 |
| Disposable personal income | 7.5 | 12.6 | 8.4 | 8.7 | 9.8 |
| Consumption | 9.3 | 10.5 | 8.9 | 8.4 | 10.5 |
| Durable goods | 14.0 | 10.0 | −2.1 | 3.3 | 14.8 |
| Nondurable goods | 7.6 | 12.8 | 12.5 | 8.7 | 8.4 |
| Services | 9.2 | 8.4 | 9.5 | 10.0 | 11.3 |
| Savings ratio (percent of disposable income) | 6.6 | 8.3 | 7.9 | 8.3 | 7.8 |
| Net exports (billions of dollars) | −6.0 | 4.0 | 2.1 | 6.9 | 4.2 |
| Federal Government | 7.4 | 1.6 | 9.7 | 11.5 | 10.1 |
| Defense spending | 5.1 | −.5 | 5.8 | 9.8 | 8.6 |
| State and local government | 10.4 | 12.6 | 13.3 | 10.1 | 9.5 |

## CASE III.—MAY 30 ADMINISTRATION BUDGET CASE EXCLUDING ENERGY POLICY CHANGES

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Gross national product, current | $1,416.6 | $1,433.4 | $1,480.4 | $1,523.2 | $1,559.4 | $1,599.9 | $1,640.9 | $1,685.9 |
| Personal consumption expenditures | 913.2 | 938.1 | 983.2 | 986.1 | 1,001.7 | 1,022.3 | 1,044.0 | 1,068.0 |
| Durable goods | 124.9 | 130.0 | 135.3 | 137.2 | 138.9 | 143.2 | 147.0 | 152.0 |
| Nondurable goods | 398.8 | 408.5 | 417.8 | 426.3 | 431.2 | 436.6 | 443.8 | 451.8 |
| Services | 389.5 | 399.6 | 410.1 | 422.6 | 431.6 | 442.5 | 453.2 | 464.2 |
| Gross private comestic investment | 163.0 | 147.3 | 166.2 | 185.3 | 200.1 | 214.8 | 225.3 | 234.2 |
| Fixed investment | 182.2 | 181.1 | 179.8 | 185.8 | 197.3 | 209.3 | 219.3 | 227.6 |
| Nonresidential | 147.0 | 144.6 | 141.3 | 141.7 | 147.1 | 154.0 | 160.7 | 166.7 |
| Structures | 52.8 | 50.2 | 48.3 | 47.6 | 49.4 | 52.3 | 55.0 | 57.3 |
| Producer curable equipment | 94.2 | 99.4 | 93.0 | 94.1 | 97.7 | 101.7 | 105.7 | 109.4 |
| Residential structures | 35.2 | 36.5 | 38.5 | 44.1 | 50.1 | 55.3 | 58.6 | 60.9 |
| Nonfarm | 34.8 | 35.7 | 37.7 | 43.3 | 49.3 | 54.4 | 57.7 | 60.0 |
| Change in business inventories | −19.2 | −33.8 | −13.6 | −.5 | 2.8 | 5.5 | 6.0 | 6.6 |
| Net exports of goods and services | 3.8 | 9.2 | 6.4 | 3.5 | 4.8 | 5.7 | 6.4 | 6.1 |
| Exports | 142.2 | 130.9 | 130.0 | 130.0 | 134.0 | 140.5 | 147.5 | 153.6 |
| Imports | 133.4 | 121.7 | 123.6 | 126.5 | 129.2 | 134.8 | 141.1 | 147.5 |
| Government purchases of goods and services | 331.6 | 338.8 | 344.6 | 348.3 | 352.8 | 357.1 | 365.3 | 377.5 |
| Federal | 126.5 | 128.6 | 130.7 | 133.9 | 135.9 | 137.2 | 140.0 | 146.9 |
| National defense | 84.7 | 85.4 | 86.7 | 89.3 | 90.0 | 90.9 | 92.3 | 97.1 |
| Other | 41.8 | 43.2 | 44.0 | 44.6 | 45.9 | 46.3 | 47.7 | 49.8 |
| State and local | 205.1 | 210.2 | 213.9 | 214.4 | 216.9 | 219.9 | 225.3 | 230.6 |
| Gross national product, 1958 prices | 780.0 | 779.4 | 793.9 | 806.6 | 814.4 | 824.4 | 833.4 | 841.6 |
| Personal consumption expenditures | 531.5 | 539.6 | 546.6 | 551.7 | 553.3 | 557.6 | 561.8 | 566.7 |
| Durable goods | 95.2 | 97.5 | 100.5 | 99.9 | 100.0 | 101.6 | 102.9 | 104.7 |
| Nondurable goods | 222.5 | 225.9 | 227.9 | 230.6 | 231.1 | 231.8 | 232.9 | 234.1 |
| Services | 213.7 | 216.2 | 218.2 | 221.2 | 222.2 | 224.2 | 226.0 | 227.9 |
| Gross private domestic investment | 89.3 | 79.6 | 88.2 | 97.4 | 103.7 | 109.7 | 113.4 | 116.3 |
| Fixed investment | 101.0 | 98.5 | 96.0 | 97.6 | 102.1 | 106.6 | 110.1 | 112.8 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Nonresidential | 83.8 | 81.0 | 77.8 | 77.1 | 79.1 | 81.6 | 84.0 | 86.0 |
| Structures | 25.2 | 23.7 | 22.5 | 21.8 | 22.3 | 23.2 | 24.0 | 24.6 |
| Producing durable equipment | 58.6 | 57.2 | 55.3 | 55.3 | 56.8 | 58.4 | 60.0 | 61.4 |
| Residential structures | 17.2 | 17.5 | 18.2 | 20.5 | 23.0 | 25.0 | 26.1 | 26.7 |
| Nonfarm | 17.0 | 17.1 | 17.8 | 20.1 | 22.6 | 24.6 | 25.7 | 26.3 |
| Change in business inventories | −11.7 | −18.8 | −7.8 | −.3 | 1.6 | 3.1 | 3.3 | 3.6 |
| Net exports of goods and services | 11.6 | 11.0 | 9.6 | 9.3 | 9.9 | 10.4 | 10.8 | 10.8 |
| Exports | 66.5 | 61.7 | 60.6 | 59.8 | 60.7 | 62.6 | 64.5 | 65.9 |
| Imports | 54.9 | 50.7 | 51.0 | 50.5 | 50.8 | 52.1 | 53.7 | 55.1 |
| Government purchases of goods and services | 147.6 | 149.4 | 149.5 | 148.3 | 147.6 | 146.7 | 147.4 | 147.7 |
| Federal | 57.4 | 58.5 | 58.5 | 58.7 | 58.6 | 58.3 | 58.5 | 58.6 |
| State and local | 90.2 | 90.9 | 91.0 | 89.6 | 89.0 | 88.4 | 88.8 | 89.1 |
| Gross national product price deflator (1958=100) | 181.6 | 183.9 | 186.5 | 188.8 | 191.5 | 194.1 | 196.9 | 200.3 |
| Industrial Wholesale Prices (1967=100) | 168.3 | 170.2 | 172.1 | 174.2 | 176.2 | 178.3 | 180.4 | 182.5 |
| Consumer Price Index (1967=100) | 157.0 | 159.5 | 162.1 | 164.8 | 167.1 | 169.5 | 172.0 | 174.7 |
| Gross national product | 1,416.6 | 1,433.4 | 1,480.4 | 1,523.2 | 1,559.4 | 1,599.9 | 1,640.9 | 1,685.9 |
| Less: | | | | | | | | |
| Depreciation (CCA) | 125.2 | 127.4 | 129.8 | 132.0 | 134.2 | 136.7 | 139.5 | 142.3 |
| Indirect business taxes | 132.2 | 135.2 | 140.6 | 145.0 | 149.3 | 152.3 | 156.6 | 160.2 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Statistical discrepancy | 1.6 | 1.6 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Plus subsidies less surplus | −1.6 | −1.9 | −1.9 | −1.7 | −2.0 | −2.0 | −1.7 | −1.3 |
| Equals national income | 1,150.7 | 1,161.7 | 1,197.5 | 1,233.9 | 1,263.2 | 1,298.0 | 1,332.3 | 1,371.2 |
| Less: | | | | | | | | |
| Corporate profits and IVA | 94.2 | 91.2 | 105.0 | 116.1 | 120.4 | 126.5 | 131.3 | 135.0 |
| Contribution for social security | 104.6 | 105.4 | 106.8 | 108.4 | 112.2 | 114.0 | 115.9 | 117.7 |
| Plus: | | | | | | | | |
| Government transfers | 158.7 | 171.2 | 172.3 | 174.0 | 178.9 | 181.1 | 189.5 | 192.0 |
| Interest paid | 43.7 | 45.0 | 47.0 | 48.7 | 50.0 | 50.6 | 51.2 | 51.6 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.1 | 34.4 | 34.8 | 35.2 | 35.7 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Equals personal income | 1,193.4 | 1,220.8 | 1,244.4 | 1,271.9 | 1,299.6 | 1,329.9 | 1,366.8 | 1,403.7 |
| Less personal income taxes | 178.0 | 142.0 | 176.9 | 182.2 | 196.1 | 204.5 | 214.3 | 221.7 |
| Equals disposable personal income | 1,015.5 | 1,078.8 | 1,067.5 | 1,089.6 | 1,103.5 | 1,125.4 | 1,152.6 | 1,182.0 |
| Savings ratio (percent of disposable income) | 7.6 | 10.7 | 7.4 | 7.1 | 6.8 | 6.8 | 7.0 | 7.3 |
| Consumption ratio (percent) | 89.9 | 87.0 | 90.2 | 90.5 | 90.8 | 90.8 | 90.6 | 90.4 |

CASE III.—MAY 30 ADMINISTRATION BUDGET CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Private annual earnings (thousands of dollars) | 9.21 | 9.33 | 9.50 | 9.67 | 9.84 | 10.01 | 10.18 | 10.35 |
| Private hourly earnings (dollars) | 4.92 | 4.98 | 5.06 | 5.14 | 5.23 | 5.30 | 5.39 | 5.48 |
| Private output per man-hour (1958=100) | 150.6 | 151.3 | 153.2 | 154.6 | 155.3 | 156.0 | 156.6 | 157.4 |
| Unit labor cost (1958=100) | 176.1 | 177.9 | 178.3 | 179.5 | 182.1 | 184.4 | 186.9 | 189.8 |
| Civilian labor force (millions) | 91.8 | 92.5 | 92.7 | 92.8 | 93.0 | 93.2 | 93.6 | 94.0 |
| Civilian employment (millions) | 84.1 | 84.3 | 84.4 | 84.6 | 84.9 | 85.2 | 85.6 | 86.0 |
| Unemployment rate (percent of labor force) | 8.4 | 8.9 | 9.0 | 8.8 | 8.7 | 8.6 | 8.5 | 8.6 |
| National income | 1,150.7 | 1,161.7 | 1,197.5 | 1,233.9 | 1,263.2 | 1,298.0 | 1,332.3 | 1,371.2 |
| Compensation of employees | 875.6 | 885.5 | 903.7 | 924.9 | 946.4 | 968.1 | 991.0 | 1,018.6 |
| Wages and salaries | 765.1 | 773.1 | 788.5 | 806.8 | 824.2 | 842.8 | 862.5 | 886.9 |
| Private | 597.4 | 602.0 | 615.3 | 630.3 | 645.6 | 661.7 | 678.3 | 694.9 |
| Military | 22.0 | 21.9 | 21.9 | 22.6 | 22.8 | 22.9 | 23.1 | 25.3 |
| Civilian government | 145.7 | 149.2 | 151.3 | 153.9 | 155.9 | 158.2 | 161.1 | 166.7 |
| Supplements | 110.5 | 112.4 | 115.2 | 118.2 | 122.2 | 125.3 | 128.5 | 131.6 |
| Rent, interest, proprietors income | 180.8 | 185.0 | 188.8 | 192.8 | 196.5 | 203.5 | 210.0 | 217.6 |
| Corporate profits plus IVA | 94.2 | 91.2 | 105.0 | 116.1 | 120.4 | 126.5 | 131.3 | 135.0 |
| Profits before tax | 101.2 | 99.1 | 112.3 | 123.8 | 129.9 | 136.2 | 142.8 | 146.5 |
| Profits tax liability | 39.0 | 38.2 | 43.4 | 47.8 | 51.8 | 54.3 | 57.0 | 58.5 |
| Profits after tax | 62.2 | 60.9 | 69.0 | 76.0 | 78.1 | 81.9 | 85.8 | 88.0 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.1 | 34.4 | 34.8 | 35.2 | 35.7 |
| Undistributed profits | 28.4 | 27.0 | 35.1 | 41.8 | 43.7 | 47.1 | 50.6 | 52.3 |
| Inventory valuation adjustment | −7.0 | −7.9 | −7.3 | −7.6 | −9.5 | −9.7 | −11.5 | −11.5 |
| Memo: New orders, machinery, and equipment | 118.3 | 122.9 | 124.0 | 131.4 | 136.4 | 141.0 | 145.9 | 150.5 |
| Federal Government: | | | | | | | | |
| Receipts | 284.1 | 247.7 | 288.2 | 297.1 | 316.4 | 326.6 | 339.6 | 347.8 |
| Expenditures | 338.5 | 355.3 | 360.3 | 363.8 | 370.5 | 373.7 | 386.2 | 396.4 |
| Surplus or deficit | −54.4 | −107.6 | −72.0 | −66.6 | −54.1 | −47.1 | −46.6 | −48.6 |
| State and local governments: | | | | | | | | |
| Receipts | 219.8 | 225.4 | 233.2 | 238.5 | 245.2 | 250.6 | 257.3 | 264.1 |
| Expenditures | 221.5 | 227.6 | 232.9 | 235.0 | 238.4 | 241.9 | 247.6 | 253.2 |
| Surplus or deficit | −1.6 | −2.2 | .3 | 3.5 | 6.8 | 8.7 | 9.8 | 10.9 |

CASE III.—MAY 30 ADMINISTRATION BUDGET CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| Percent growth (annual rates) | 72.0 | 73.0 | 74.0 | 75.0 | 76.0 |
|---|---|---|---|---|---|
| Gross national product: | | | | | |
| Current dollars | 9.8 | 11.8 | 7.9 | 4.7 | 10.8 |
| 1958 prices | 6.2 | 5.9 | −2.1 | −3.8 | 4.9 |
| Price deflator | 3.4 | 5.6 | 10.3 | 8.8 | 5.7 |
| Industrial wholesale prices | 3.4 | 6.8 | 22.2 | 11.3 | 4.8 |
| Consumer price index | 3.3 | 6.2 | 11.0 | 8.9 | 6.2 |
| Private: | | | | | |
| Hourly earnings | 5.3 | 6.5 | 8.4 | 7.8 | 6.5 |
| Annual earnings | 5.8 | 6.5 | 7.4 | 6.7 | 7.1 |
| Workweek | .5 | 0 | −1.0 | −1.0 | .5 |
| Productivity | 3.5 | 2.6 | −2.7 | −.3 | 2.5 |
| Unit labor cost | 3.1 | 6.3 | 10.9 | 7.8 | 4.4 |
| Civilian: | | | | | |
| Labor force | 2.8 | 2.5 | 2.7 | 1.5 | 1.1 |
| Employment | 3.2 | 3.4 | 1.9 | −1.9 | 1.2 |
| Unemployment (percent of labor force) | 5.6 | 4.9 | 5.6 | 8.8 | 8.6 |
| New orders, machinery, and equipment | 16.0 | 21.6 | 11.7 | −10.2 | 15.5 |
| Corporate profits before taxes | 18.6 | 23.7 | 14.7 | −22.5 | 27.3 |
| Business fixed investment | 11.7 | 17.1 | 9.1 | −3.7 | 9.4 |
| Nonresidential structures | 8.4 | 14.3 | 10.7 | −4.5 | 7.6 |
| Producers durable equipment | 13.6 | 18.6 | 8.2 | −3.3 | 10.4 |
| Inventory investment (billions of dollars) | 8.6 | 15.3 | 14.3 | −16.8 | 5.2 |
| Residential construction | 26.0 | 6.2 | −19.7 | −16.0 | 45.7 |
| Disposable personal income | 7.5 | 12.6 | 8.4 | 8.5 | 7.3 |
| Consumption | 9.3 | 10.5 | 8.9 | 8.4 | 8.8 |
| Durable goods | 14.0 | 10.0 | −2.1 | 3.4 | 10.2 |
| Nondurable goods | 7.6 | 12.8 | 12.5 | 8.6 | 6.8 |
| Services | 9.2 | 8.4 | 9.5 | 9.9 | 10.5 |
| Savings ratio (percent of disposable income) | 6.6 | 8.3 | 7.9 | 8.2 | 7.0 |
| Net exports (billions of dollars) | −6.0 | 4.0 | 2.1 | 7.0 | 5.8 |
| ~~Federal Government~~ | 7.4 | 1.6 | 9.7 | 11.2 | 7.8 |
| Defense spending | 5.1 | −.5 | 5.8 | 9.9 | 7.0 |
| State and local government | 10.4 | 12.6 | 13.3 | 9.7 | 5.8 |

CASE IV.—MORE STIMULATIVE FISCAL POLICY CASE EXCLUDING ENERGY POLICY CHANGES

| | 75.1 | 75.2 | 75.3 | 75.4 | 76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Gross national product, current | $1,416.6 | $1,433.4 | $1,481.7 | $1,530.4 | $1,585.4 | $1,637.8 | $1,685.5 | $1,732.6 |
| Personal consumption expenditures | 913.2 | 938.1 | 964.0 | 987.3 | 1,014.4 | 1,038.8 | 1,064.0 | 1,091.0 |
| Durable goods | 124.9 | 130.0 | 135.4 | 136.8 | 144.4 | 150.3 | 155.8 | 161.8 |
| Nondurable goods | 398.8 | 408.5 | 418.2 | 427.1 | 435.3 | 442.2 | 450.7 | 460.1 |
| Services | 389.5 | 399.6 | 410.5 | 423.3 | 434.7 | 446.3 | 457.5 | 469.2 |
| Gross private domestic investment | 163.0 | 147.3 | 166.5 | 186.4 | 205.2 | 225.1 | 238.5 | 248.5 |
| Fixed investment | 182.2 | 181.1 | 179.9 | 186.2 | 199.4 | 213.9 | 226.4 | 236.3 |
| Nonresidential | 147.0 | 144.6 | 141.3 | 141.9 | 148.7 | 157.7 | 166.8 | 174.9 |
| Structures | 52.8 | 50.2 | 48.3 | 47.6 | 49.4 | 52.6 | 55.8 | 58.7 |
| Producer durable equipment | 94.2 | 94.4 | 93.0 | 94.3 | 99.2 | 105.0 | 111.0 | 116.2 |
| Residential structures | 35.2 | 36.5 | 38.6 | 44.2 | 50.7 | 56.3 | 59.6 | 61.4 |
| Nonfarm | 34.8 | 35.7 | 37.8 | 43.4 | 49.9 | 55.4 | 58.8 | 60.5 |
| Change in business inventories | −19.2 | −33.8 | −13.4 | .2 | 5.8 | 11.2 | 12.1 | 12.2 |
| Net exports of goods and services | 8.8 | 9.2 | 6.4 | 3.3 | 4.0 | 3.9 | 3.6 | 2.5 |
| Exports | 142.2 | 130.9 | 130.0 | 130.0 | 134.0 | 140.5 | 147.5 | 153.6 |
| Imports | 133.4 | 121.7 | 123.6 | 126.7 | 130.0 | 136.6 | 143.9 | 151.1 |
| Government purchases of goods and services | 331.6 | 338.8 | 344.8 | 353.5 | 361.9 | 370.0 | 379.3 | 390.5 |
| Federal | 126.5 | 128.6 | 130.6 | 135.7 | 139.2 | 142.0 | 145.5 | 150.6 |
| National defense | 84.7 | 85.4 | 86.2 | 89.4 | 90.6 | 91.8 | 93.2 | 96.7 |
| Other | 41.8 | 43.2 | 44.4 | 46.3 | 48.6 | 50.2 | 52.3 | 53.9 |
| State and local | 205.1 | 210.2 | 214.2 | 217.8 | 222.7 | 228.0 | 233.9 | 239.9 |
| Gross national product, 1958 prices | 780.0 | 779.4 | 794.6 | 809.2 | 828.0 | 844.2 | 856.4 | 865.9 |
| Personal consumption expenditures | 531.5 | 539.6 | 547.1 | 552.3 | 561.2 | 567.8 | 573.8 | 579.9 |
| Durable goods | 95.2 | 97.5 | 100.5 | 99.6 | 103.9 | 106.7 | 108.9 | 111.3 |
| Nondurable goods | 222.5 | 225.9 | 228.2 | 231.1 | 233.4 | 234.8 | 236.7 | 238.4 |
| Services | 213.7 | 216.2 | 218.4 | 221.6 | 223.9 | 226.2 | 228.2 | 230.2 |
| Gross private domestic investment | 89.3 | 79.6 | 88.3 | 98.0 | 106.5 | 115.3 | 120.5 | 123.7 |

See footnotes at end of table.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Fixed investment | 101.0 | 98.5 | 96.1 | 97.9 | 103.3 | 109.1 | 113.9 | 117.1 |
| Nonresidential | 83.8 | 81.0 | 77.8 | 77.3 | 80.0 | 83.7 | 87.4 | 90.3 |
| Structures | 25.2 | 23.7 | 22.5 | 21.8 | 22.3 | 23.4 | 24.4 | 25.1 |
| Producer durable equipment | 58.6 | 57.2 | 55.4 | 55.5 | 57.7 | 60.4 | 63.0 | 65.1 |
| Residential structures | 17.2 | 17.5 | 18.2 | 20.6 | 23.3 | 25.4 | 26.5 | 26.9 |
| Nonfarm | 17.0 | 17.1 | 17.8 | 20.2 | 22.9 | 25.0 | 26.1 | 26.5 |
| Change in business inventories | −11.7 | −18.8 | −7.7 | .1 | 3.3 | 6.2 | 6.6 | 6.6 |
| Net exports of goods and services | 11.6 | 11.0 | 9.6 | 9.2 | 9.5 | 9.7 | 9.7 | 9.3 |
| Exports | 66.5 | 61.7 | 60.6 | 59.8 | 60.7 | 62.5 | 64.4 | 65.7 |
| Imports | 54.9 | 50.7 | 51.0 | 50.6 | 51.1 | 52.8 | 54.7 | 56.4 |
| Government purchases of goods and services | 147.6 | 149.4 | 149.6 | 149.7 | 150.8 | 151.4 | 152.5 | 153.0 |
| Federal | 57.4 | 58.5 | 58.5 | 58.7 | 59.4 | 59.6 | 60.1 | 60.1 |
| State and local | 90.2 | 90.9 | 91.1 | 91.0 | 91.4 | 91.8 | 92.4 | 92.9 |
| Gross national product price deflator (1958=100) | 181.6 | 183.9 | 186.5 | 189.1 | 191.5 | 194.0 | 196.8 | 200.1 |
| Industrial wholesale prices (1967=100) | 168.3 | 170.2 | 172.1 | 174.1 | 176.1 | 178.3 | 180.7 | 183.0 |
| Consumer price index (1967=100) | 157.0 | 159.5 | 162.1 | 164.8 | 166.9 | 169.2 | 171.7 | 174.4 |
| Gross national product | 1,416.6 | 1,433.4 | 1,481.7 | 1,530.4 | 1,585.4 | 1,637.8 | 1,685.5 | 1,732.6 |
| Less: | | | | | | | | |
| Depreciation (CCA) | 125.2 | 127.4 | 129.8 | 132.0 | 134.3 | 136.8 | 139.7 | 142.6 |
| Indirect business taxes | 132.2 | 135.2 | 140.8 | 145.1 | 141.1 | 154.8 | 159.6 | 163.7 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Statistical discrepancy | 1.6 | 1.6 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Plus subsidies less surplus | −1.6 | −1.9 | −1.9 | −1.7 | −2.0 | −2.0 | −1.7 | −1.3 |
| Equals national income | 1,150.7 | 1,161.7 | 1,198.7 | 1,241.0 | 1,287.3 | 1,333.4 | 1,373.7 | 1,414.1 |
| Less: | | | | | | | | |
| Corporate profits and IVA | 94.2 | 91.2 | 105.8 | 119.7 | 134.5 | 145.7 | 151.3 | 153.6 |
| Contributions for social security | 104.6 | 105.4 | 106.8 | 108.5 | 112.7 | 114.9 | 117.3 | 119.5 |
| Plus: | | | | | | | | |
| Government transfers | 158.7 | 171.2 | 175.5 | 177.8 | 183.7 | 186.6 | 194.3 | 198.1 |
| Interest paid | 43.7 | 45.0 | 47.0 | 48.8 | 50.3 | 51.6 | 52.8 | 53.9 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.8 | 35.6 | 36.4 | 37.2 |
| Business transfers | 5.4 | 5.5 | 5.5 | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 |
| Equals personal income | 1,193.4 | 1,220.8 | 1,247.9 | 1,279.2 | 1,314.6 | 1,352.2 | 1,394.5 | 1,436.0 |
| Less personal income taxes | 178.0 | 142.0 | 177.0 | 182.8 | 178.7 | 186.5 | 195.6 | 203.0 |
| Equals disposable personal income | 1,015.5 | 1,078.8 | 1,071.0 | 1,096.3 | 1,135.9 | 1,165.7 | 1,198.8 | 1,233.0 |
| Savings ratio (percent of disposable income) | 7.6 | 10.7 | 7.6 | 7.6 | 8.4 | 8.6 | 8.9 | 9.2 |
| Consumption ratio (percent) | 89.9 | 87.0 | 90.0 | 90.1 | 89.3 | 89.1 | 88.8 | 88.5 |

CASE IV.—MORE STIMULATIVE FISCAL POLICY CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| | 75.1 | 75.2 | 75.3 | 75.4 | .76.1 | 76.2 | 76.3 | 76.4 |
|---|---|---|---|---|---|---|---|---|
| Private: | | | | | | | | |
| Annual earnings (thousands of dollars) | 9.21 | 9.33 | 9.50 | 9.67 | 9.85 | 10.02 | 10.21 | 10.39 |
| Hourly earnings (dollars) | 4.92 | 4.98 | 5.06 | 5.14 | 5.21 | 5.30 | 5.40 | 5.50 |
| Output per man-hour (1958=100) | 150.6 | 151.3 | 153.2 | 154.9 | 156.8 | 158.2 | 158.9 | 159.4 |
| Unit labor cost (1958=100) | 176.1 | 177.9 | 178.1 | 179.2 | 180.0 | 181.8 | 184.6 | 188.0 |
| Civilian: | | | | | | | | |
| Labor force (millions) | 9.18 | 92.5 | 92.7 | 92.8 | 93.0 | 93.2 | 93.6 | 94.0 |
| Employment (millions) | 84.1 | 84.3 | 84.4 | 84.7 | 85.2 | 85.8 | 86.5 | 87.1 |
| Unemployment rate (percent of labor force) | 8.4 | 8.9 | 9.0 | 8.8 | 8.4 | 7.9 | 7.6 | 7.4 |
| National income | 1,150.7 | 1,161.7 | 1,198.7 | 1,241.0 | 1,287.3 | 1,333.4 | 1,373.7 | 1,414.1 |
| Compensation of employees | 875.6 | 885.5 | 903.9 | 927.5 | 953.3 | 979.9 | 1,007.7 | 1,038.0 |
| Wages and salaries | 765.1 | 773.1 | 788.7 | 809.3 | 830.7 | 853.8 | 877.9 | 904.7 |
| Private | 597.4 | 602.0 | 615.4 | 631.0 | 649.5 | 669.6 | 690.2 | 710.6 |
| Military | 22.0 | 21.9 | 21.9 | 23.4 | 23.6 | 23.7 | 23.9 | 25.3 |
| Civilian government | 145.7 | 149.2 | 151.3 | 154.9 | 157.6 | 160.5 | 163.8 | 168.7 |
| Supplements | 110.5 | 112.4 | 115.2 | 118.2 | 122.6 | 126.2 | 129.8 | 133.4 |
| Rent, interest, proprietors income | 180.8 | 185.0 | 189.0 | 193.7 | 199.5 | 207.7 | 214.8 | 222.5 |
| Corporate profits plus IVA | 94.2 | 91.2 | 105.8 | 119.7 | 134.5 | 145.7 | 151.3 | 153.6 |
| Profits before tax | 101.2 | 99.1 | 113.1 | 127.4 | 143.7 | 156.0 | 163.4 | 165.8 |
| Profits tax liability | 39.0 | 38.2 | 43.7 | 49.2 | 52.4 | 56.9 | 59.7 | 60.5 |
| Profits after tax | 62.2 | 60.9 | 69.5 | 78.2 | 91.2 | 99.0 | 103.8 | 105.3 |
| Dividends | 33.8 | 33.9 | 33.9 | 34.2 | 34.8 | 35.6 | 36.4 | 37.2 |
| Undistributed profits | 28.4 | 27.0 | 35.5 | 44.0 | 56.4 | 63.4 | 67.4 | 68.1 |
| Inventory valuation adjustment | −7.0 | −7.9 | −7.3 | −7.6 | −9.2 | −10.2 | −12.2 | −12.2 |
| Memo: New orders, machinery, and equipment | 118.3 | 122.9 | 124.2 | 132.3 | 142.0 | 149.0 | 155.2 | 160.5 |
| Federal Government: | | | | | | | | |
| Receipts | 284.1 | 247.7 | 288.6 | 298.9 | 299.1 | 310.6 | 323.2 | 331.1 |
| Expenditures | 338.5 | 355.3 | 363.6 | 372.7 | 384.6 | 392.8 | 406.3 | 417.4 |
| Surplus or deficit | −54.4 | −107.6 | −75.1 | −73.8 | −85.4 | −82.2 | −83.2 | −86.3 |
| State and local government: | | | | | | | | |
| Receipts | 219.8 | 225.4 | 233.7 | 242.3 | 253.9 | 262.7 | 270.7 | 278.8 |
| Expenditures | 221.5 | 227.6 | 233.2 | 238.4 | 244.2 | 250.0 | 256.2 | 262.5 |
| Surplus or deficit | −1.6 | −2.2 | .5 | 3.9 | 9.6 | 12.7 | 14.6 | 16.2 |

CASE IV.—MORE STIMULATIVE FISCAL POLICY CASE EXCLUDING ENERGY POLICY CHANGES—Continued

| Percent growth (annual rates) | 72.0 | 73.0 | 74.0 | 75.0 | 76.0 |
|---|---|---|---|---|---|
| Gross national product: | | | | | |
| Current dollars | 9.8 | 11.8 | 7.9 | 4.9 | 13.3 |
| 1958 prices | 6.2 | 5.9 | −2.1 | −3.7 | 7.3 |
| Price deflator | 3.4 | 5.6 | 10.3 | 8.8 | 5.6 |
| Industrial wholesale prices | 3.4 | 6.8 | 22.2 | 11.3 | 4.9 |
| Consumer price index | 3.3 | 6.2 | 11.0 | 8.9 | 6.0 |
| Private: | | | | | |
| Hourly earnings | 5.3 | 6.5 | 8.4 | 7.8 | 6.6 |
| Annual earnings | 5.8 | 6.5 | 7.4 | 6.7 | 7.3 |
| Workweek | .5 | 0 | −1.0 | −1.0 | .7 |
| Productivity | 3.5 | 2.6 | −2.7 | −.2 | 3.8 |
| Unit labor cost | 3.1 | 6.3 | 10.9 | 7.7 | 3.2 |
| Civilian: Labor force | 2.8 | 2.5 | 2.7 | 1.5 | 1.1 |
| Employment | 3.2 | 3.4 | 1.9 | −1.8 | 2.1 |
| Unemployment (percent of labor force) | 5.6 | 4.9 | 5.6 | 8.7 | 7.8 |
| New orders, machinery, and equipment | 16.0 | 21.6 | 11.7 | −10.0 | 21.9 |
| Corporate profits before taxes | 18.6 | 23.7 | 14.7 | −21.7 | 42.7 |
| Business fixed investment | 11.7 | 17.1 | 9.1 | −3.7 | 12.7 |
| Nonresidential structures | 8.4 | 14.3 | 10.7 | −4.5 | 8.9 |
| Producers durable equipment | 13.6 | 18.6 | 8.2 | −3.2 | 14.8 |
| Inventory investment (billions of dollars) | 8.6 | 15.3 | 14.3 | −16.5 | 10.3 |
| Residential construction | 26.0 | 6.2 | −19.7 | −15.9 | 47.6 |
| Disposable personal income | 7.5 | 12.6 | 8.4 | 8.7 | 11.1 |
| Consumption | 9.3 | 10.5 | 8.9 | 8.4 | 10.7 |
| Durable goods | 14.0 | 10.0 | −2.1 | 3.3 | 16.2 |
| Nondurable goods | 7.6 | 12.8 | 12.5 | 8.7 | 8.2 |
| Services | 9.2 | 8.4 | 9.5 | 10.0 | 11.4 |
| Savings ratio (percent of disposable income) | 6.6 | 8.3 | 7.9 | 8.3 | 8.8 |
| Net exports (billions of dollars) | −6.0 | 4.0 | 2.1 | 6.9 | 3.5 |
| ~~Federal Government~~ | 7.4 | 1.6 | 9.7 | 11.5 | 10.7 |
| Defense spending | 5.1 | −.5 | 5.8 | 9.8 | 7.7 |
| State and local governments | 10.4 | 12.6 | 13.3 | 10.1 | 9.1 |

Chairman HUMPHREY. We will listen now to Mr. Klein, of the Wharton School of Finance, and I believe, Mr. Klein, that we asked you to give us some picture of the outlook for the world economy, as well as the domestic economy. I know that you follow the world economy very closely, and you are the leading developer of the link model, which attempts to link together forecasts for the major countries, so we will pick up on the note that Mr. Karchere just left, and we will come to you.

## STATEMENT OF LAWRENCE R. KLEIN, BENJAMIN FRANKLIN PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA

Mr. KLEIN. Thank you, Senator Humphrey.

As you indicated, I am going to concentrate on the international aspects, both from the point of view of the world economy and its impact on the United States. I would say that I think I can agree quite heartily with what Mr. Karchere has given in his analysis of the domestic picture. The Wharton forecast might disagree on little points here and there, shaving one index point or one growth rate point here and there, but by and large, I find his analysis quite compatible with ours.

The Wharton econometric model forecast for the American economy in the months ahead estimates a steady, moderate path of recovery. The rate of expansion should, by the end of the year, be well above the long-term normal growth rate of this economy. But it will not be vigorous enough to bring down the unemployment rate to acceptable levels. And certainly I would be thinking in terms of getting back in the near term to figures that we would call 4 or 5 percent for unemployment. Nor will it be vigorous enough to correct the strong deficit position of the Federal Government for some years to come.

This recovery pattern, following administration policies and targets, should take place in an environment in which there is greatly reduced inflationary pressure, in comparison with the immediate past, and a great deal of industrial slack.

The Wharton index of industrial capacity utilization presently stands at about 77 percent, and the rate of inflation accompanying it at about 5 to 6 percent does not appear likely to accelerate greatly until the recovery begins to put pressure once more on available capacity. According to my calculations, this should not occur before late 1977 or 1978, and I would say that there is comfortable room for expansion.

One reason why the recovery appears to be proceeding at a moderate pace is that many customary sources of strength in such cyclical phases are held in restraint today, for a wide variety of reasons. These areas are residential construction, automotive production, and business fixed capital formation. These areas will not necessarily be under restraint at all times, but they will be at least for the short run.

I would like to address my remaining remarks today to another area where some of the dynamism of recovery might lie. This is in the area of external economic relations in the United States. It is well known that we are in the grip of worldwide recession not limited to the United States, and that, while the domestic economy has undoubtedly just changed course, we cannot find such definite signs yet in the world economy. This country, and our main trading partners, have been and are in, the first synchronized world recession since 1957–58, and this synchronization contributed to the worsening of the situation. By the same token, synchronized recovery would do much for the whole Western world and Japan.

Just to give a brief sketch of the world economic situation as it exists and the likely prospects for each main bloc, let me subdivide the nations of the world into groupings of countries as follows: First, Western Europe, North America, and Japan. They are generally bothered with inflation, low growth, falling real output, rising unemployment, tight credit, and poor trade performance.

Second: socialist countries in eastern Europe, U.S.S.R., and China. They are having quite favorable economic prospects, except, of course, for possible bad harvests in the U.S.S.R. The Soviet Union and eastern European economies are growing at a rate believed to be in excess of 6 percent per annum, and are not bothered by inflation to the extent that the Western nations are.

The strong earnings of the Soviet Union from favorable markets in oil, gas, armaments, gold and other basic commodities has enabled them to keep imports at a high level and, oddly enough, to provide a nice cushion for Western export sales in a sagging world market.

Third: developing countries with oil resources. Although oil production has fallen in 1975, as a consequence of the world recession and high oil prices, this group of developing countries is naturally doing very well in terms of purchasing power of foreign earnings.

The more diversified of these nations are also growing strongly in many lines. As in the case of the Soviet Union, they provide substantial export support for the industrial nations.

Fourth: the final grouping covers developing countries without oil resources. These nations face the worst situation of all. Their export markets are weak because of the world slump. Their fuel imports are very expensive. Their purchases from the industrial nations reflect the inflation of recent years. The prices of basic commodities other than oil which are concentrated among the exports of these countries have fallen sharply in the last 12 months. They are squeezed on both sides.

In this economic environment, the outlook for our external trading and exchange position is mixed. On the favorable side—and that means favorable in terms of exports, from our viewpoint—there are strong markets in socialist and OPEC countries. If our harvest results turn out to be as good as expected and the Soviet Union continues to order grain, it would boost a segment of our export trade that has been sagging. This export sale would be considerably more favorable than in 1972.

By that, I mean we have certainly learned a few lessons since that experience. And, presumably, we can get some advantage from these sales, in terms of a moderate gain in exports, without depleting our stocks, as long as we are monitoring the situation, to the point where ~~it sends a real spiraling price increase in the grain markets.~~

Chairman HUMPHREY. I just want to caution, at the moment that is the point of sensitivity. It is the question of careful monitoring.

Mr. KLEIN. It needs a balance. I think it is a great opportunity. There are two things at play. One is our export position, and the other is our domestic inflation position. I think we should not look at one to the disregard of the other, which is essentially what happened in 1972.

The net export position of the United States held firm in the past quarter, but only because imports were cut back severely during the recession. Both exports and imports fell sharply from the first to the second quarter, with somewhat stronger price declines on the import than on the export side.

The net export position of the United States may improve some more during this year, but ought to begin deteriorating next year for three important reasons. First, there is a strong possibility that we shall experience another turn of the screw in oil prices. Our fuel imports are now running at an annual rate of $25.6 billion. For every 10 percent OPEC price increase, we can expect to spend more than an additional $2 billion in fuel imports. Unless this is offset in the domestic economy through policy action, it might cost us another 100 to 200 basis points in the inflation rate.

While Mr. Karchere was talking about a sort of $1 a barrel increase, the main calculation that we are now making in the Wharton group is based on a $1.50 increase. And, of course, it could go up to $2. This is something that we simply have to watch and cannot pinpoint with great accuracy.

Second: Apart from an increase in the country's import bill, as a consequence of higher fuel prices, there tends to be a natural expansion associated with reviving activity at home. As we pull out of the recession, imports should start to rise faster than exports.

Third: Exports to our main trading partners, apart from those to socialist and OPEC countries, are experiencing resistance because of the world recession.

Since I wrote this, I have been thinking about another reason that I wanted to refer to later, and that is the upward drift in depreciation of the dollar. In many respects, that might look as though it is quite welcome. The dollar is strong in the currency markets, but as the dollar depreciates, our goods are going to become somewhat more expensive. I think this is going to work to hold back our export position a little bit. I do not think we should try to defeat this movement, but it is something that we have to watch.

Chairman HUMPHREY. Do you not think the dollar has been underpriced?

Mr. KLEIN. Yes, it has been. The latest thinking in the Wharton group in making up our new forecast is that the dollar could appreciate another 5 to 10 percent.

Chairman HUMPHREY. We have actually been subsidizing exports with the depreciated dollar?

Mr. KLEIN. Right. I agree. It will reflect back on our own position if we can show great leadership in bringing the industrial nations out of the slump. They are looking to us for a solid recovery.

The industrial nations showed great resiliency and stability in coming through the oil embargo and OPEC pricing as well as they have, but the other industrial nations, besides the United States, do not appear to be as far along on their recovery path as we are. We have much at stake in fostering the stability of the system, as well as aiding our export customers. Therefore, it is imperative that we exhibit a strong economy to the rest of the world immediately.

Two pivotal countries in the nonsocialist world economy are Germany and Japan. Economic analysts following trends within those two economies have marked down their prospects month by month, much as we did in this country as the recession unfolded in 1974. By now, they both show very close to zero growth in prospect for 1975, with much better outlooks for 1976. There is every indication that we shall be leaders, followed closely by Germany, Japan, Canada, France, Australia and other countries in Western Europe.

Italy and the United Kingdom continue to tread a more uncertain path, although Italy appears to have come through the crisis in far better condition than was expected last year, it resulted in import restrictions and rising unemployment. The growth prospects for Italy do not appear to be as good as those for other countries in Western Europe.

As for the United Kingdom, they must come through a deceleration of inflation that has already taken place in most of the other industrial countries, but not yet in Britain. Growth prospects there are dull.

Chairman HUMPHREY. I would like to interrupt just a minute there. No one has taken the time to explain to me or to any other Member of the Congress that I know of just what the impact would be of a further decline in Britain of the pound, in terms of its currency, but also of its production, and its general economy. We have been so closely tied with Britain over a long period of time.

Do deeper troubles for the United Kingdom have any direct bearing upon us of any appreciable degree, and do they have any direct bearing upon the Common Market countries?

Mr. KLEIN. Yes; they certainly do. Britain is a very big market for the United States on both sides of the transaction, both as an importer and as an exporter. And they play an important role in the Western European economy.

I do not think that Britain is the key country now, but it would certainly mean a lot to the whole OECD world and the whole Western industrial world if Britain has further trouble. I think the only thing that really has to come, as I have said in the statement, is that Britain must come around on the price level and get in step with all the other leading industrial countries. There has been a remarkable decrease in the rate of inflation throughout the world, but the British inflation just continues to go on and on.

Chairman HUMPHREY. It is 25 percent right now, is it not?

Mr. KLEIN. At least 25 percent. It may be very much a case of the high rate of wage increases. Some kind of understanding between the Government and trade union movements is going to have to be reached, because the British exports cannot continue to survive in the ~~world when their prices are going up at that rate.~~

Chairman HUMPHREY. We will come back to that in a little while.

Mr. KLEIN. While, we cannot yet cite statistics of recovery in Germany, Japan and other industrial countries we find evidence of monetary and fiscal policies designed to stimulate the economy that ought to have the same effect with short delay that such policies have had in the United States.

Just as Mr. Karchere indicated that our massive fiscal input from early this year is beginning to show up in our consumer statistics of the second quarter, and hopefully, continuing, I think the same kinds of stimuli in Germany and Japan and France and the other Western countries will take hold according to the same line of analysis.

The rest of the world, however, is also looking to a strong economic performance by the United States. We cannot rely on our export position to give an added boost, although it is holding up well; so the obvious alternative is to seek somewhat more powerful domestic stimuli. In all this trade analysis, what are the prospects for our capital position and the dollar exchange rate? The petrol deficit, while formidable, is not proving to be overwhelming. This is partly due to high imports in the OPEC countries, curtailed demand for oil and reinvestment of oil revenues in our assets. Under these circumstances, the dollar should continue to gain strength in world markets. Our problem will be to demonstrate leadership in real growth. It means growth of real operations in the economy. The dollar should benefit by this during the next year or two. If we can make some real headway in expanding our own energy supplies, the strength of the dollar should continue even beyond that brief horizon.

Since you mentioned in the introduction, the international link project, I will just comment that in the last 2 weeks, we have just completed a new round of preliminary calculations, with that world system. The indications are that the real volume of world trade, which is one of the essential things that we monitor, is going to show an extraordinarily low performance for 1975, just a little bit better than zero growth, maybe between 1 or 2 percent growth. And that is a statistic that in good years has been growing at 10 percent and even more in some cases.

However, the general forecast for all of the major industrial countries and socialist countries, too, put together with our own, indicates that there ought to be a substantial improvement in 1976 and even carrying on into 1977.

It is not likely that world trade will start expanding above 10 percent again, in volume terms, but certainly it should get above 5 percent, between 5 and 10 percent.

Chairman HUMPHREY. In 1976?

Mr. KLEIN. It should improve in 1976 and improve again in 1977.

Chairman HUMPHREY. What would you attribute that to?

Mr. KLEIN. It is the general recovery that we are expecting in the industrial nations. When the industrial nations went down their whole trading pattern went down, and of course, some of the industrial nations are fighting desperately hard for export markets in this situation and that is holding things up. And as I stated earlier in my presentation, there is a big cushion coming from the socialist countries and the OPEC countries which is a stimulus or at least a support to the export position.

Chairman HUMPHREY. In other words, the demands of those countries on the western countries is going to have a stimulating impact. That is something that it would be well to have the American people understand. I have a very simple rule about trade with the eastern countries—I am willing to sell them anything they cannot shoot back. I think that we have simply got to have some better understanding of all of this. The amount of prejudice of our sales of anything to the eastern European countries, particularly the Soviet Union, is incredible.

I think it is important for people to understand that increasing our sales to eastern European countries is one way we can help stimulate our recovery.

I have always felt that if we could get their money to stimulate our economy, it was better than using our money in deficit financing to stimulate our economy.

I was at a question and answer session in one of the cities in my State with top business and finance people. I am surprised at the number of questions that were hostile to any kind of economic dealings with eastern European countries.

Now, Mr. Synnott, I wanted to get you into the mood of this discussion and we welcome you here. As vice president and senior economist of the United States Trust Co. of New York City, you are very familiar with that city's problems. Do you have anything to tell us about New York City? We would welcome that too.

## STATEMENT OF T. W. SYNNOTT III, VICE PRESIDENT AND SENIOR ECONOMIST, UNITED STATES TRUST CO., NEW YORK, N.Y.

Mr. SYNNOTT. Senator Humphrey, I am most grateful to have the opportunity to present our forecast.

After so much has been said this morning already on the shape of the economic outlook, I would like to concentrate on perhaps a somewhat different perspective.

We are a large investment institution focusing on long-term capital markets, primarily. So I find myself, whenever discussions of capacity come up, trying to say that there is another dimension of capacity aside from labor and plant and materials; and that is the capacity to provide long-term finance, which is something that is not created by the Federal Reserve, but does stem from the flow of savings of individuals and the willingness of those individuals to assume risks.

And one of the basic points in our outlook is that this capacity to generate long-term finance has been severely damaged in the last few years.

I am trying to address the important question that you posed of how strong and sustained can this recovery be. And so, I am going to try to look a little bit beyond 1976 on some critical points.

We do believe that this particular slump that now appears to be ~~ending is different from previous postwar recessions, and I will just~~ mention some of the reasons for that, and in the time for questions, we can discuss that in more detail. First of all, there has been a dramatic and unprecedented change in the relative prices of many basic commodities—oil prices and food prices are at the top of the list. But the point extends to many other commodities as well.

This is also true with respect to prices for many consumer goods and services, like electricity, especially relative to wages; and it is unreasonable to think, with such changes in relative prices, that things will go on in the same pattern that they have in the past.

Second, as I mentioned before, we have lost many of the usual reserves of liquidity, of long-term financial capacity in the economy, in the business sector and the banking sector and State and local governments. There is enough news in the headlines to make us aware of that every day. But even in the consumer sector, there has been a loss of liquidity, a loss of ability to assume risk. This has set in motion a strong, broad-based drive to rebuild liquidity, which we think will dilute the momentum that Al Karchere referred to earlier on the expansion side, or the real side, of the economy.

Larry Klein began to get into the important changes in the international sphere. I will just say that we think there are some developments here, particularly with respect to the United Kingdom, that pose substantial risks for the U.S. recovery itself, next year in particular. And finally, I mentioned earlier the way in which high but differing expectations on the part of business, labor, consumers, foreign investors, and so on, increased the riskiness of long-term investments in the minds of both the borrowers and lenders.

Again, we have reduced our ability to finance the long-term capital investment that really is required to build and sustain economic expansion. We would like to assume that some bold, new policies would come forth, but we have had so much experience with bold policies in the last 5 years that, as prudent bankers, we are not assuming, at least in the short run, anything more than an extension of the kind of, let us say, sensible groping toward solutions that has been going on so far during the last year or so. This is consistent with the set of policy assumptions that Mr. Karchere was referring to. There are some additional specific ones I might just mention.

We are assuming no significant new Federal Government spending programs in 1975—that is to say, that would really have an impact on 1976, either. We expect the Federal budget deficit on a national income accounts basis to be about $85 billion this calendar year, and somewhere between $65 billion and $75 billion in calendar year 1976.

We are assuming, in our base forecast, a continuation of the present $12 billion annual rate of reduction in income tax withholdings, which includes the temporary tax reduction as far as the withholding schedules are concerned, but not the tax rebate—the present schedules contain a speed-up in the withholding reduction because of the desire to reduce the taxes over an 8-month period, where the legislation was for a 12-month reduction; that is kind of a technical point, but it means a $1 or $2 billion reduction.

We believe that State and local governments will be pressed to hold down spending this year, and that this pressure will continue into 1976. As far as monetary policy is concerned, we are estimating that M1 will increase about 8 percent during calendar year 1975, and 7 to 8 percent during calendar year 1976. The broadly defined money supply, including large bank CD's, is likely to increase about 7 percent in 1975, and 9 to 10 percent in 1976.

Chairman HUMPHREY. You apparently have not talked with Mr. Burns lately.

Mr. SYNNOTT. Well, it is hard to gage the difference between 7½ and 8 percent and so on. But we would definitely be looking at the upper end of the range that he has been talking about.

Chairman HUMPHREY. Yesterday, he said they would level off.

Mr. SYNNOTT. Well, perhaps we should come to the implications of that as we look at that scenario. But we are assuming continuing caution on the part of the consumer, and believe that the savings rate will average 9 percent over the second half of 1975, and almost at that level in 1976.

As far as key commodity prices go, it would seem to have quite an impact on consumers' expectations of inflation; and I think this is where grain price movements enter more importantly than in actual impact on food prices. We are assuming gradually decontrolled old oil prices, and about a dollar a barrel increase in OPEC prices over the average price level in the second quarter of 1975, there are various price shadings that have gone on since.

We are estimating not too much inflationary impact from these oil price increases. We do expect farm product prices to go back down to approximately the level and average that they were in mid-June.

Chairman HUMPHREY. We are just talking about farm products?

Mr. SYNNOTT. Yes. The figure that we are using specifically, Senator Humphrey, is the Bureau of Labor Statistics index of nine spot commodity farm prices.

Chairman HUMPHREY. Well, keep an eye on that, because if in 10 days there is no rain in Iowa, southern Minnesota, and Indiana and Illinois, that might change. I am not worried too much about wheat, but we could have a major disaster in the corn crop unless we get substantial moisture in the next 10 days.

Mr. SYNNOTT. This would have a significant impact.

Chairman HUMPHREY. You know, corn is the base feed for poultry, hogs and cattle; and soybeans. We could have a very major disaster unless something happens. This is what I keep arguing with Secretary Butz about. He does not keep in touch with the weatherman. This morning there is evidence of the cyclical weather patterns, particularly in the corn belt, that runs from 3 to 5 years every hundred years, of substantially reduced rain. We are in one of those periods, just like we were in the thirties.

I have been saying this to the Senate Committee on Agriculture and Forestry. We do not get the impact in the winter wheat, because it is the July weather phenomena. This is the same thing that hits the Soviet Union. Much of the Ukraine, has the same kind of climatic condition that we have in certain parts of the midwest.

I hope people will keep an eye on that. I hope and pray I am dead wrong. But corn is key because everything in agriculture is related to feed, what we call the corn-hog ratio. That is the central, pivotal point of agricultural economics, which is seldom talked about in these hallowed halls. We have a system a government where they talk agriculture over at the Department of Agriculture and do not tell anybody else about it until it is all over.

Mr. SYNNOTT. I am very glad you have made that point. We have found it essential in our analysis of the economy, and what is going on even in the stock market, to follow such prices on a weekly basis. And we have been doing that now for the past 2 or 3 years. Hopefully, eventually we will be back in on environment in which prices stop fluctuating to the extent that you do not have to do that.

Chairman HUMPHREY. As long as you are in a short supply situation and the reserve is low with weather variants you are going to have high fluctuations in agricultural prices, and fluctuations in agricultural prices always add up to higher consumer prices. Because once they rise, they never decline. To the degree that the downswing takes place, it is just automatic appreciation of the prices.

Mr. SYNNOTT. I think the point you have made illustrates the difficulty almost, one might say the presumptuousness, of single point forecasts. I am going to present you some single point forecasts but primarily so that we can sketch out a fairly full picture of how we see the economic pattern developing and you will have to recognize that by the time you have made all these assumptions the world could be quite different.

We have come up with a slightly different reaction to the second quarter GNP numbers from some of the forecasters. There was a huge addition to real disposable income in the second quarter coming from the tax rebates, and coming from the special $50 payment to pensioners. Welcome as that was, it is temporary and we think it will be a mistake to assume that the second quarter income levels are the base from which we now go on.

And we are, therefore, assuming a decline in personal disposable income in the third quarter; not a great magnitude, but a decline. We also believe the present level of interest rates, when you adjust for the significant slowdown in inflation which has occurred, are quite high in real terms and both theoretically and historically this is having an impact on long-term capital investment. Now if you turn to table 1 of my prepared statement. which sketches some quarterly patterns, I think it is clear that we are looking at a much more gradual and sluggish recovery than most forecasters.

Again, I hope we are wrong but it seems, given reasonable assumptions about wage gains, about the growth in employment from here on, about the disappearance of the tax rebates and so forth, continuing caution on the part of consumers that you cannot really look for consumer spending in the second half to be higher in real terms than it was in this second quarter. So, we think that some of the expectations that the whole business is now on a firm uptrend will be called into question as the quarter goes on.

Now, we have already seen quite a downward revision in people's expectations for housing starts following this fairly pronounced runup in interest rates that has occurred in the last 6 weeks. And it would not be surprising to see more downward revisions, particularly as 1976 is concerned and it is difficult to see a very strong recovery or a very sustained one without some turnaround in housing. And where we are looking for a significant improvement——

Chairman HUMPHREY. Let me just interrupt you there. Secretary Carla Hills testified and her statement was, I believe I quote it correctly, "That housing will follow the recovery." It was my judgment, and I said it to her at the time, that I felt that housing would have to be a significant element in the recovery. That is, there hád to be some sharp forward, upward movement in housing and other construction to stimulate recovery. Is that you view?

Mr. SYNNOTT. It has been traditionally and I think you can have a recovery without that occurring, Senator, but it will not be as strong. And I think we are in effect saying that without strong recovery in those areas——

Chairman HUMPHREY. I see what you mean. I follow that.

Mr. SYNNOTT. In some areas of construction, office buildings and shopping centers. there seems to be enough of a glut, that just on the demand side, it is very hard to see much of a pickup there. In fact, there could even be further declines in real terms and this contributes to our belief that this recovery will be really quite sluggish. The favorable element in all of this is that we do see inflation falling to a lower level than most forecasters.

And I think that creates the opportunity for some of the kinds of traditional long-term investment programs in both the public and private sector which enable the economy to respond to the kinds of sharp, relative price changes that we have had in the last 3 or 4 years. Energy prices are the obvious, huge change. Energy is no longer cheap and that should require significant investments to economize on energy and use either more labor or more capital to do the job. Lower inflation rates, and presumably, ultimately lower interest rates would encourage that kind of thing to occur.

There are so many specific numbers that I think I prefer to leave those until we come to a specific question. I would like to call your attention to chart 1 of my prepared statement, which shows a long-term upward trend, not only in long-term interest rates but also in the Treasury bill rate. And if it turns out that the low point was reached in early June, then in effect, we will have confirmed another link in this pattern of progressive rise in the level of short-term interest rates. Now, this has occurred in other countries in the last 10 or 15 years, but it is perhaps only now becoming embodied in the expectations of investors who are basically now saying that in each successive 3- or 4-year period the level of all interest rates will be higher than it is at the present and, therefore, anyone who buys bonds is asking for trouble.

Now, with that kind of expectation, it is going to be awfully hard to get some of these basic industry investments or basic construction investments financed at any kind of reasonable interest rate structure.

That is a direct consequence of the acceleration of inflation over the last 10 or 15 years, 10 years in particular. Larry Klein brought out very well the shift in expectations which has occurred abroad, which has perhaps lagged developments in the United States by some 6 months. I thought it was interesting in comparing the OECD's forecast for different countries that whereas they forecast a one-half percent increase in real GNP for OECD countries in 1975—last January; they revised that downward to a decline of 1 1/2 percent in mid-July. In their most recent forecast in July, moreover for the specific case of Germany that change has been from +2.5 percent to –2.0 percent.

That is a major change. We are not used to thinking about real GNP in terms of its customary changes, but a 2 percent change in real GNP is probably more important than a 20 percent change in the price of wheat in terms of the usual volatilities. And I would go further and say that in the United Kingdom, it seems quite clear that bringing inflation under control will bring about a fairly severe slump which will have an impact on the rest of the industrial world, how much of an impact is impossible to guess at this point.

But it is an element in our thinking that we are not going to have the very strong export position next year that we have had this year.

My last chart, chart 2 in my prepared statement, does show the extraordinary change that has occurred in the last month in the trade-weighted value of the dollar, and I think that is worth looking at because it is the kind of change that one usually associates with commodity prices and not currencies, and that would be an element in my thinking, again, that some part of the United States relatively better performance in foreign trade accounts this year has been due to other economies lagging behind us and that this part of the process will be reversed as we go into 1976.

I did want to make a final point about investment needs. An investment tax credit was introduced to help business investment, and some other measures are being discussed, and I think this is an important thing. It has to be given a high social priority to improve the investment consumption balance. Our forecasts show basically flat aftertax corporate profits over this whole 3- or 4-year period and flat capital spending in current dollars, which means a significant decline in real terms.

And so it is quite clear that the corporate sector will have difficulty generating the real volume of investment necessary to respond to the changed economic conditions. It may be necessary in some basic industries where capital requirements are very large to consider what I believe was a successful program in the mid-1950's; namely, the certificate of necessity, under which new plant construction could be written off it, I think, a very short period of 5 years or so for a specific project, whether it be a large utility or a basic metals plant or whatever it may be that is deemed important in the national interest.

We would also like to go beyond the business investment sector and suggest that the time has come perhaps to encourage some consumer investment, and our reasoning there is that with so many uncertainties in the minds of business and where financial markets are such an important consideration, one way to stimulate some direct investment in energy-saving techniques of one kind or another would be through investment tax credits for consumers. Something of this sort, I believe, is being discussed as far as installation of storm windows, solar heating, and so on.

But one could go beyond that, thinking in terms of the optional replacement of excessive energy-consuming equipment of one kind or another that might be replaced by more efficient stuff, as well as—and I think this might be an important thing for the housing industry—the rehabilitation of existing inner-city housing, where it is perhaps best dealt with on an individual consumer-oriented level.

Well, Senator, I am not sure I presented you as organized a picture as I might have wished, but that is our forecast of the next 18 months.

Chairman HUMPHREY. Your remarks and your statement are very helpful for us. Of course, your entire prepared statement with all of the charts and statistical data will be printed as part of the record.

[The prepared statement of Mr. Synnott follows:]

PREPARED STATEMENT OF T. W. SYNNOTT III

THE ECONOMIC OUTLOOK AT MID-YEAR

*Introduction*

The U.S. economy has bottomed out. Where it goes from here is now the key question. To be really useful, the answer must look beyond the next 12 to 18 months. We believe that to do this requires a more-than-economic judgment about the nature of the recent slump.

Our view of the economic outlook is based on our belief that the recent slump in business activity is different in character from previous post-war recessions. The most important reasons for this judgment are as follows:

1. The dramatic and, in some instances, unprecedented changes during 1973 and 1974 in relative prices of basic commodities and in many consumer prices relative to wages.

2. The exhaustion of many of the usual reserves of liquidity in business, in the banking sector, in state and local governments and even in the consumer sector. This has set in motion a strong, broad-based drive to rebuild liquidity.

3. Changed international monetary and economic relations which have loaded a major part of the oil deficit onto the weaker credit risks in the international economy. As this unsustainable process ends there will be additional deflationary forces at the international level.

4. The way in which high but differing expectations of inflation increase the riskiness of long-term investments in the minds of both borrowers and lenders.

Despite strong Federal Government support of the private sector through tax cuts an increased transfer payments necessitating unprecedented deficits, we believe that the combination of low business and consumer confidence, financial constraints and genuine uncertainties about the future price of energy, will keep the recovery slow, at least in its early stages. While it is difficult to be precise about timing, we anticipate an acceleration in the recovery in early 1976. This raises the threat, unless various economic and financial bottlenecks can be eliminated in the meantime, of another round of excess demand, and very high inflation and interest rates developing in late 1977 or early 1978. There are, of course, many risks to this forecast which I will discuss briefly later.

*Assumptions*

Present economic conditions appear to call for bold policies which can reconcile conflicting political objectives, improve the consumption/investment balance, reduce inflation and unemployment, and so on. But after the experience with wage/price controls and floating exchange rates, theoretical economists and practical politicians are rightly skeptical about bold policies. In developing our economic projections we have, therefore, assumed no new policy initiatives on the part of Government but rather a continuation of the process of groping toward solutions. On the other hand we have not assumed that any economic earthquakes will occur such as war or drastic political change in an important trading partner.

Our specific assumptions are set forth below:

*Consumer Attitudes.*—We assume continued caution on the part of consumers and believe the savings rate will average 9% in the second half of 1975, and nearly that level in 1976.

*Fiscal Policy.*—We assume no significant new Federal Government spending programs in 1975. We expect the budget deficit on a national income accountbasis to be about $75 billion in calendar 1975 and $65–$75 billion in calendar 1976. We assume a continuation of the $12 billion annual rate of reduction now embodied in the present income tax withholding schedule. Financial pressures are likely to hold the growth in state and local government spending to about 10% in 1975 and about 8% in 1976, well below recent rates of increase. In addition, some state and local governments will be forced to raise taxes and this will offset some of the stimulus coming to the economy from the Federal Government.

*Monetary Policy.*—We assume that the Federal Reserve will continue to hold to its monetary targets and that M1 will increase about 8% during calendar 1975 and 7%–8% during calendar 1976. Corresponding figures for the broadly-defined money supply, including large CDs, would be 7% for 1975 and 9%–10% for 1976.

*Key Commodity Prices.*—We assume gradual decontrol of old oil prices and action by OPEC increasing import prices by $1 per barrel over the 1975 second quarter average, during the fourth quarter of 1975. We estimate that the inflationary impact of these oil price increases will be about .5% to 1% in 1976. We expect farm product prices as a whole, after the harvest materializes, to retrace the recent runup and end the year approximately at the mid-June level. We expect the consumer index for food at home to fluctuate around present levels during the second half of 1975.

*Economic Projections*

Table 1 shows our tentative projections for the next six quarters. It follows the essential pattern of our May Quarterly Outlook, while incorporating recently released GNP data for the second quarter of 1975. As will be obvious from a lok at our forecasts, we believe in a sluggish recovery pattern through at least the next two quarters. The two most important reasons for this view are: 1) that we anticipate a decline in personal disposable income in the third quarter now that the effect of the tax rebates and special payments is past and, 2) that we believe the present level of real interest rates, adjusted for current rates of inflation, is a significant negative force for both inventory accumulation and long-term capital investment. Putting all this together, it looks as though the recovery in consumer spending will be diluted by continued sluggishness in housing and by weakness in capital spending in the second half of 1975. Furthermore, instead of bottoming out in the fourth quarter of 1975, capital spending in real terms could well decline somewhat further in the first half of 1976.

TABLE 1.—QUARTERLY PATTERNS

| | 1975 | | | | 1976 | | | |
|---|---|---|---|---|---|---|---|---|
| | IA | IIP | IIIE | IVE | IE | IIE | IIIE | IVE |
| Real gross national product: | | | | | | | | |
| Billions of 1958 (dollars) | 780.0 | 779.4 | 784.0 | 790.0 | 799.0 | 809.0 | 821.0 | 833.0 |
| Percent change | −11.4 | −.3 | 2.5 | 3.1 | 4.6 | 5.0 | 5.9 | 6.0 |
| Inflation—annual rate (percent): | | | | | | | | |
| Gross national product deflator | 8.5 | 5.1 | 6.0 | 5.5 | 5.0 | 4.0 | 5.0 | 5.0 |
| Consumer Price Index | 8.0 | 6.0 | 5.5 | 5.0 | 4.5 | 4.0 | 4.5 | 5.0 |
| Unemployment rate | 8.4 | 8.9 | 9.2 | 9.4 | 9.4 | 9.3 | 9.2 | 9.0 |
| Broadly defined money: Supply (percent change) | 8.2 | 7.0 | 7.1 | 7.7 | 8.0 | 8.5 | 9.0 | 9.5 |
| Current gross national product: Billions of dollars | 1,417 | 1,433 | 1,464 | 1,495 | 1,531 | 1,565 | 1,609 | 1,656 |
| Aftertax Corp. profits: Billions of dollars | 62.3 | 60.0E | 62.0 | 66.0 | 69.0 | 71.0 | 73.0 | 75.0 |
| Personal Disposable Income: | | | | | | | | |
| Billions of dollars | 1,016 | 1,079 | 1,070 | 1,082 | 1,102 | 1,124 | 1,152 | 1,180 |
| Annual rate of change (percent) | 2.7 | 27.4 | −3.3 | 4.5 | 7.4 | 8.0 | 10.0 | 9.7 |
| Housing starts: Millions of units | 1.00 | 1.06 | 1.20 | 1.35 | 1.45 | 1.60 | 1.70 | 1.80 |
| Plant and equipment: | | | | | | | | |
| Expenditures | | | | | | | | |
| Billions of dollars | 114.6 | 113.4E | 110.0 | 110.0 | 110.0 | 111.0 | 114.0 | 118.0 |

NOTES

These figures do not assume a repition of the 1975 tax rebate, although they do assume a continuation of the $12 billion annual rate of reduction embodied in the present income tax withholding schedule.

Tentative projections based on preliminary 2d quarter 1975 gross national product data.

Table 2 shows our key economic projections on the customary annual basis, and it is useful to contrast these year-average figures with the quarterly projections shown in Table 1. Perhaps the most striking point is the differing patterns in incomes, real output and inflation. While incomes and prices have continued to grow during the slump, although at a reduced pace, the fall-off in real output, production and employment was much sharper than in previous post-war recessions. The consequence of this, in our view, is to give the real side of the economy something close to an L-shaped pattern in 1975 and a steady, although historically slow, advance in 1976.

*The Second Quarter Data.*—These figures raise as many questions as they answer. Until we have revised data in late August for such key variables as real consumer spending, the projections in the table above must be regarded as somewhat tentative. We do not think that the strong final demand figures in the second quarter should be taken as the base for economic expansion from here on. First, while real consumer spending increased at a 6% rate, this was clearly in response to the extraordinary stimulus provided by special payments to pensioners and to tax rebates, which added to disposable income at a $40 billion annual rate. The record-high savings rate and recent consumer sentiment surveys continue to suggest a cautious consumer attitude. Once consumer incomes return to their normal trend line, we are likely to see a much slower rate of growth in spending in real terms. The very high rate of inventory

TABLE 2.—HIGHLIGHTS[1]

| | 1973 | 1974 | 1975E | 1976E | Percent change 1974–73 | 1975–74E | 1976–75E |
|---|---|---|---|---|---|---|---|
| Gross national product | 1,294.0 | 1,397.4 | 1,452.0 | 1,590.0 | 7.9 | 3.9 | 9.5 |
| Personal consumption expenditures | 805.2 | 876.7 | 939.0 | 1,007.0 | 8.9 | 7.1 | 7.3 |
| FRB index of industrial products (1967=100) | 125.6 | 124.3 | 111.2 | 117.5 | −1.0 | −10.5 | 5.6 |
| Corporate profits after taxes | 72.9 | 85.0 | 62.6 | 72.0 | 16.6 | −26.4 | 15.0 |
| Housing starts (millions of units) | 2.1 | 1.34 | 1.15 | 1.64 | −36.2 | −14.2 | 42.6 |
| Personal income | 1,055.0 | 1,150.5 | 1,228.0 | 1,325.0 | 9.1 | 6.8 | 7.9 |
| Real gross national product | 839.2 | 821.2 | 783.5 | 815.8 | −2.1 | −4.6 | 4.1 |
| Producers' durable equipment | 89.8 | 97.1 | 94.3 | 96.6 | 8.1 | −2.9 | 2.4 |
| Money supply[2] (billions of dollars) | 609.0 | 676.0 | 731.3 | 792.0 | 11.0 | 8.2 | 8.3 |
| Unemployment rate (percent) | 4.9 | 5.6 | 9.0 | 9.2 | | | |
| Gross national product price deflator (1958=100) | 154.3 | 170.2 | 185.3 | 195.0 | 10.3 | 8.9 | 5.2 |
| Consumer price index (1967=100) | 133.1 | 147.7 | 160.5 | 168.3 | 11.0 | 8.7 | 4.9 |
| Wholesale price index (1967=100) | 134.7 | 160.1 | 173.3 | 180.6 | 18.9 | 8.2 | 4.2 |
| Plant and equipment expenditures | 99.74 | 112.4 | 112.0 | 113.3 | 12.7 | | 1.1 |

[1] Billions of dollars unless otherwise noted.
[2] Includes currency in circulation, demand and time deposits, and large CD's.

Note.—Tentative projections based on preliminary 2nd quarter 1975 Gross national product data.

liquidation has been cited by some observers as suggesting that inventory accumulation is just around the corner. We disagree and continue to believe that whatever revised data for this volatile series show, inventory liquidation has somewhat further to go. Finally, when the 9.6% rate of consumer price inflation in June is incorporated into the revised GNP accounts we may well see some downward revision of the real consumer spending figures.

*Financial Factors.*—In the first half of 1975, the Treasury raised approximately $38 billion in cash to finance the deficit. Contrary to earlier fears, a significant proportion, near 50%, of the newly issued Government securities were purchased by non-commercial bank holders. This enabled the Federal Reserve, throughout nearly all of the first half, to support the Treasury's financings and at the same time contain monetary growth within its targets. During the second half of the year, it is likely that the commercial banking system, including the Federal Reserve Banks, will have to absorb a greater proportion of an equally large cash deficit. This presents the Federal Reserve with something of a dilemma, which will most likely be resolved by maintaining a high-enough short and intermediate-term interest rate structure to induce non-bank financial intermediaries, including foreigners, to continue acquiring a substantial portion of new government issues. In all likelihood, the monetary authorities will also try to make yields in the one-to-three year maturity range attractive enough to induce the commercial banks to make significant purchases of these securities which are less liquid than Treasury Bills.

During the last 10 or 15 years, there has been a pronounced upward trend in both short-term and long-term interest rates. It is particularly pronounced for short-term rates, with the cyclical low points moving progressively higher over time. For example, the Treasury Bill rate during the 1960–1961 recession reached a low point of 2.3%. In 1969–1970, the low point was 3.3%, and it appears that the low point during the present cycle was 5%. (See Chart 1). Thus, the acceleration of inflation over this period has been reflected in short rates as well as long-term rates incorporating a rising inflation premium. As might be expected, there has been a steady reduction in the willingness of investors to buy long-term bonds at the same time as there has been an increased desire on the part of borrowers for long-term credit. As a result, long-term bond yields have become increasingly sticky in the downward direction and increasingly vulnerable to upward moves in tune with the fluctuations in short-term rates and with Federal Reserve policy.

*The Risks in the Forecast*

During the last few weeks new uncertainties have come into the economic outlook. First the sharp run-up in grain prices, associated with Russian wheat purchases, calls into question the improvement in food price inflation upon which we, and many other forecasters, have relied for a continued reduction in inflation in 1976. There is also significant uncertainty about oil prices. Perhaps most important is the growing recognition that economic recovery abroad will lag behind that in the United States. This is in sharp contrast to expectations at the beginning of this year, when the OECD estimated that total OECD real growth would be .5% in 1975. The organization now forecasts a *decline* of 1.5%. In the case of a specific country, Germany, the change is even more startling—from +2.5% to −2%. When one considers that, in the United Kingdom, prices are rising at unprecedented rates and the monetary authorities have recently tightened credit, it must be admitted that there is a significant chance of strong deflationary forces being generated abroad. In appraising the U.S. economic outlook, one must constantly bear in mind that domestic inflation and output are not entirely determined in the United States.

*Implications of the Forecasts*

A look at Table 2 reveals two striking trends—flat aftertax corporate profits, 1973 through 1976, and flat capital spending, 1974 through 1975. Considering the rapid rate of inflation which has occurred, and is still continuing, in capital goods prices (15% over a year ago and 7½% rate for the last quarter) it is clear that the corporate sector will have difficulty generating the real volume of investment necessary to respond to changed economic circumstances and move the economy as a whole into a sustainable long-term expansion. Furthermore, recent developments in the financial markets threaten the profitability and increase the uncertainty of long-term investments in basic industries. Given the relatively strong performance of consumer spending during the last two quarters, specific attention should be given to high priority investment spending. A device useful in the past has been accelerated depreciation under a certificate of necesity program for specific investment projects in the overall economic interest, such as in railroads, energy production and key industrial materials.

A dramatic change is occurring in the relative prices of consumer goods and services. Conditions are ripe, therefore, for consumer investments in equipment and facilities that will reduce, for example, the use of scarce and expensive energy resources. Consumer investment tax credits for solar heating systems, insulation and storm windows have already been proposed in Congress. This would seem a most effective way to stimulate the manufacturing sector of the economy and speed up the necessary shift in the composition of economic output which must occur. Consideration shold ge given to extending the idea to the early replacement of high energy-using appliances, automobiles and heating systems, as well as to home food production and the rehabilitation of inner-city housing.

CHART 1: **INTEREST RATES**

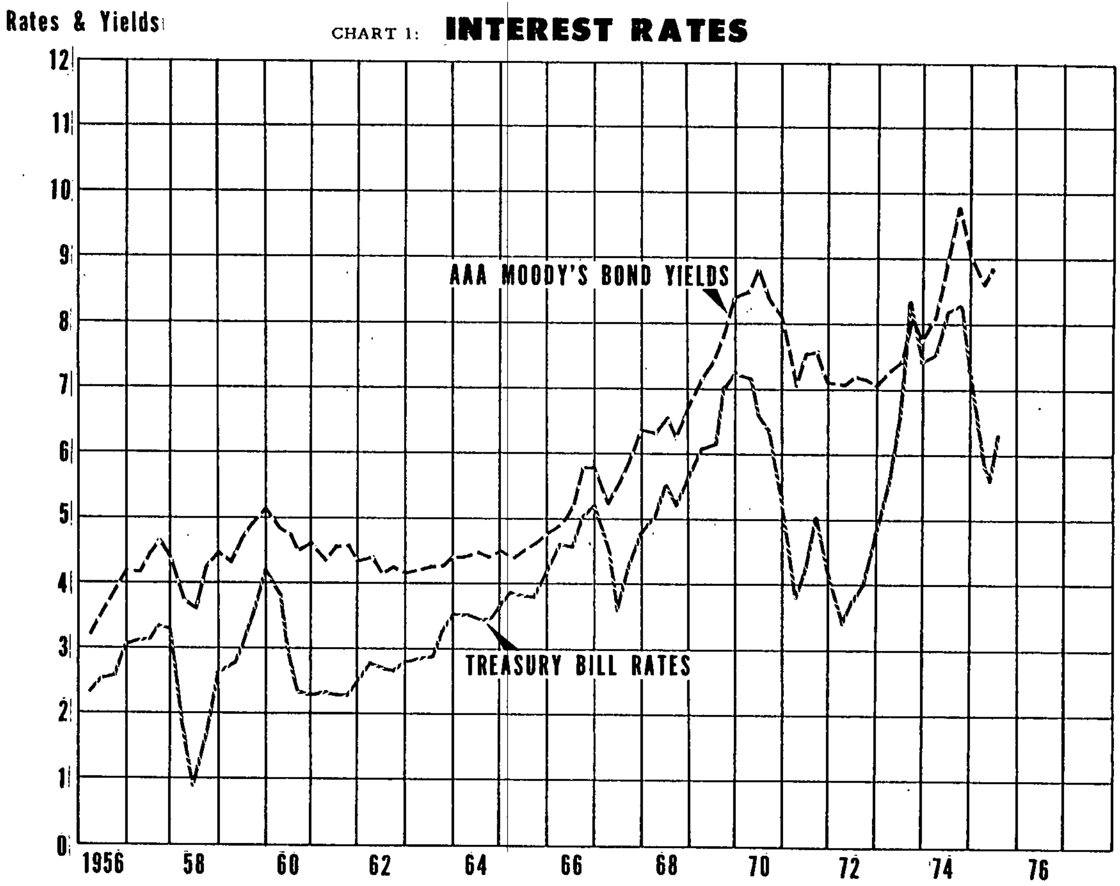
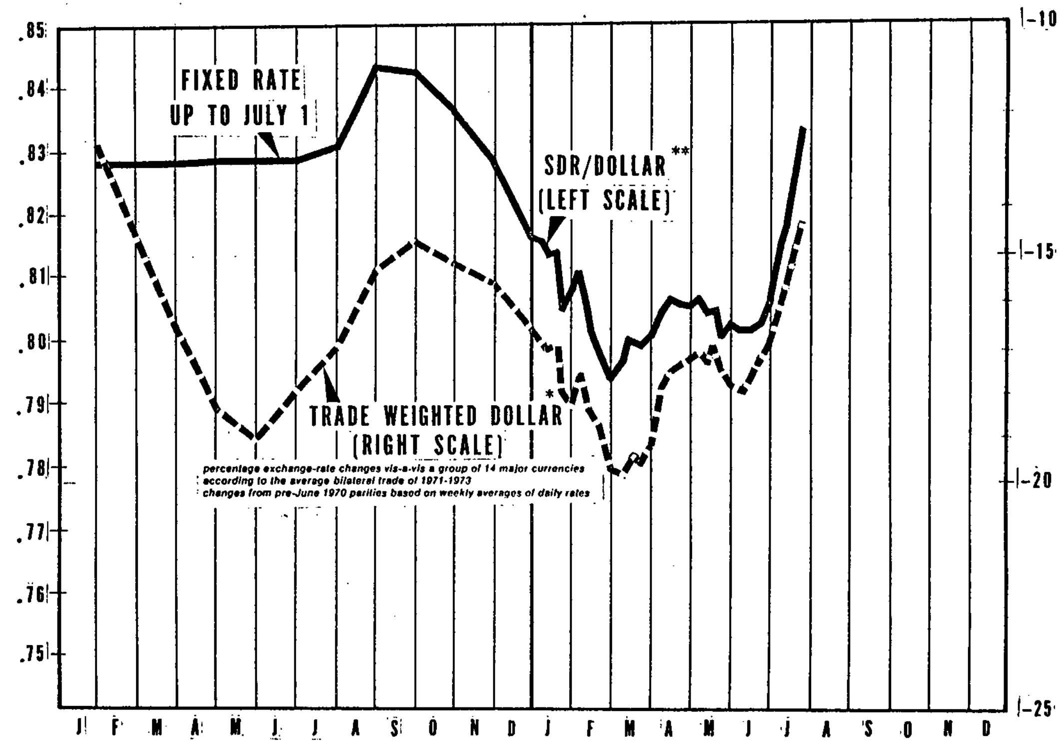


CHART 2:

## SDR/U.S. DOLLAR RATE VS. TRADE WEIGHTED DOLLAR




1974 1975

* Calculated by Morgan Guar. Trust Co.
Weekly Average of Daily Rates.

** End of week.

Chairman HUMPHREY. As I understand it, Mr. Synnott, you are a little bearish on the rate of recovery, or sustained recovery in the third and fourth quarters of 1975?

Mr. SYNNOTT. Yes.

Chairman HUMPHREY. The reason being that you figured there was an unusual bounce, so to speak, in the second quarter, due to the tax rebates, the withholding, the reduction in taxes—primarily, though, the fiscal stimuli?

Mr. SYNNOTT. On an annual rate, there was approximately $40 billion added to personal disposable incomes, which will not be there in the third and fourth quarters.

Chairman HUMPHREY. Now, do you feel that because of your projections that there ought to be considerations for an extension of the tax reduction into 1976?

Mr. SYNNOTT. I think in some form—and perhaps I would slant it toward this investment tax credit notion.

Chairman HUMPHREY. What about the withholding tax?

Mr. SYNNOTT. In our forecast, we have assumed those basic reductions would continue, yes.

Chairman HUMPHREY. Mr. Klein, do you agree with Mr. Synnott that the third and fourth quarters of 1975 are not going to experience as strong a recovery as has been indicated in other circles?

Mr. KLEIN. Well, I would rather talk in terms of numbers. I would expect the growth rate to be above what we would consider a long run norm, which is 4 percent, not very terribly high, but at least in the neighborhood of 5 or 6 percent, and as Al Karchere indicated earlier, that is not going to be enough unless it is sustained to bring down the unemployment rate, so it is not a terribly strong economy but I suppose if you were to attach adjectives to it, it is not quite as pessimistic as Tom Synnott's, but it is on the low side.

Chairman HUMPHREY. How do you feel about the continuation of the tax reduction?

Mr. KLEIN. There is not any doubt that I would be strongly in favor of all of the temporary tax changes being extended as if they were being made permanent. I was against the temporary nature of the tax legislation in the first place because that always dilutes the effect.

Chairman HUMPHREY. That is how I feel. How do you feel about the investment tax credit for business enterprises? Do you feel that it ought to be on a longer than 1-year basis?

Mr. KLEIN. I think the investment tax credit is a special tax. It is associated with longrun decisions, longrun planning. It should not be used for cyclical analysis, but should be used for longrun expansion possibilities, and I would agree with Tom Synnott that the energy field gives us an opportunity in this country to do something that is really going to help us solve some other problems and at the same time come on stream when we have got so much slack in the economy; it would do double duty.

Chairman HUMPHREY. The administration's witnesses who have come before us really are opposed at this time to any further extension of the tax reduction and withholding. That would mean a tax increase at the end of the year.

Yesterday, Mr. Burns was much more optimistic about the upward swing of the economy in the balance of 1975, I believe I am not exaggerating when I say that Mr. Greenspan, Chairman of the Council of Economic Advisers, felt the same way, but I have been of the mind that the rate of recovery is not so rapid—its momentum is not forceful enough to be able to keep going without stimulation.

How do you feel about this, Mr. Karchere?

Mr. KARCHERE. I think the fundamentals really have to do with the residue of the inflation that we are still faced with. We are expecting the Consumer Price Index to rise at a 6-percent rate, and wage rates to rise around 7½ percent, so this really gives very little in the way of a margin of increase for real wages and, as a consequence, real income does not grow very rapidly; and in addition we come off the platform, as Mr. Synnott said, of these temporary tax cuts where their influence begins to wear down.

In our forecast we have disposable income from here on out, rising at a rate that is substantially under the rates that we have had in previous recoveries, so we are left in terms of growth with, in my view, with a very substantial problem, and I think this is reflected in the forecast that I have talked about.

Chairman HUMPHREY. Do you all agree with Mr. Karchere's evaluation that the amount of disposable income is substantially lower than in other recovery periods?

Mr. KARCHERE. The rate of growth.

Chairman HUMPHREY. Give me that again.

Mr. KARCHERE. The rate of growth of disposable income from here on out will be substantially lower than it has been in previous recoveries.

Chairman HUMPHREY. How about that? How do you feel about that, Mr. Klein?

Mr. KLEIN. That is right.

Chairman HUMPHREY. Do you agree, Mr. Synnott?

Mr. SYNNOTT. In real terms?

Chairman HUMPHREY. In real terms, that is all that counts. Now, do I understand that that factor alone will lead a rather sluggish response in terms of economic recovery? Is that your view, Mr. Karchere?

Mr. KARCHERE. That is.

Chairman HUMPHREY. Mr. Klein.

Mr. KLEIN. That is.

Chairman HUMPHREY. Mr. Synnott.

Mr. SYNNOTT. Yes.

Chairman HUMPHREY. Do I find that all three of you agree that there ought to be at a minimum a continuation of the withholding tax reductions? I am not talking about rebates now, but the temporary tax reduction of this year. Do I understand a tax reduction ought to be continued?

Mr. Karchere.

Mr. KARCHERE. Even though the tax reductions are continued, we wind up in a latter part of 1976 with a substantial slowdown of the rate of growth of the economy.

Chairman HUMPHREY. And a very high level of unemployment.

Mr. KARCHERE. That is exactly right.

It is very clear to me that we need a growth rate in excess of 6 percent to decrease the unemployment rate, and we are not going to get it, in my judgment, even if we do maintain the temporary tax cut.

Chairman HUMPHREY. All right, what do you think, Mr. Klein?

Mr. KLEIN. I think that there is no question that the temporary cuts should be extended, or made permanent for an indefinite time until there is the turnaround in the economic situation, and that we should be looking at other stimuli, particularly with energy impact, to bring the economy along even better.

Chairman HUMPHREY. Such as tax credits or energy and, of course, also new construction in the energy field for alternate sources of fuel?

Mr. KLEIN. And I must say that it is not all tax, tax policy is but one side of it.

Chairman HUMPHREY. I understand.

Mr. KLEIN. There are just a number of things on the expenditure side, or on the side of R. & D. that are needed to push along the energy program.

Chairman HUMPHREY. Exactly, now one of the problems that we have been confronting in this committee with our witnesses is long-term finance. I believe, Mr. Synnott, what you had to say was that investors in long-term bonds are getting more scarce, right?

Mr. SYNNOTT. Yes.

Chairman HUMPHREY. That there is a much greater desire for long-term financing?

Mr. SYNNOTT. Yes, sir.

Chairman HUMPHREY. And your rationale for these conclusions is that there seems to be a general appreciation or increase in interest rates and, therefore, the investor in the long-term bond looks upon that investment as not being a very productive one.

Mr. SYNNOTT. That is exactly right. I might also mention that there has been increased volatility in interest rates, particularly in short term interest rates, which has quite significantly tempered at least, the willingness of people to buy mortgages, so that it is the volatility, as well as the upward trend, that is having its effect on people's willingness to move out into the longer term end of the market.

Chairman HUMPHREY. Yet, savings are offered at a very high rate, are they not, in thrift institutions and in bank accounts?

Mr. SYNNOTT. Yes, but the way the thrift institutions would argue is that if, in 1 month, for example, the rate on intermediate term governments can jump 100 basis points or a full percent, then why should not they expect that sort of thing to continue in the future? How can they be sure that consumers who put money in when government securities were yielding 6 1/2 percent will leave the money there if government securities are yielding 7½ or 8, and they can, of course, buy government securities themselves.

So I think you have substantial increase in uncertainty, in the minds of the investors, just in the last 6 weeks. I think at the beginning of June, or certainly in the middle of May, there was quite an expectation that interest rates would trend downward, and the first glimmerings of a revival of peoples willingness to go out to the longer term end of the market. That would largely disappear now. These markets are volatile and investors feelings change frequently. At least, that is the way it is at the moment.

Chairman HUMPHREY. I have felt that what is needed more than anything else, regarding tax rates or the growth of the money supply, is some continuity, some certainty. I believe that all of you indicated that it is the impreciseness of policy that has had an adverse effect, particularly when it comes to investment.

Is that the way you look at it, Mr. Karchere?

Mr. KARCHERE. I think the Chairman of the Federal Reserve Board has been very clear about his concern about the effect of the tax cut on the money supply and the need to give a psychological signal that the Federal Reserve Board was not going to allow an excessive rate of growth in the money supply.

Chairman HUMPHREY. That is what he said yesterday.

Mr. KARCHERE. One can argue about that. I guess from my point of view, I would argue that the reaction of the Fed over the short period need not have been quite as aggressive as it apparently has been.

Chairman HUMPHREY. Well, that is my view. Again, it seems to me that that was a destabilizing decision. When the Federal Reserve started to sell Treasury bills, sopping up credit, so to speak; and this was a form of tightening just as the time that things started to look like they were beginning to move in the economy.

Now, of course, the Fed says the reason they did this was that they say some indications of the economy heating up again. But that seems to be an overly cautious response.

Mr. Karchere, in your prepared statement, you used the change in Federal spending, plus the change in receipts of the tax law changes taken as a percentage of the GNP, as a measure of the economic stimulus being provided by the budget.

Now, one of the alternatives which you analyzed is one in which the spending recommendations made by the President are observed and the tax cuts are not extended. You point out that if this were done, the fiscal stimulus in 1976 would be equal to only about 0.6 of 1 percent of the GNP, and you say that this would be comparable to 1969 and 1973, both years that were followed by a recession.

Am I stating you accurately?

Mr. KARCHERE. You are, very accurately.

Chairman HUMPHREY. Therefore, if they were to follow the administration's budget recommendations—which, by the way, were reiterated just the day before yesterday by Simon and Lynn—the recession twins, would we be flirting with the danger of a new recession in 1977?

Mr. KARCHERE. In my judgment, the answer is yes.

Chairman HUMPHREY. The thing that amazes me, gentlemen, and I say this with great sincerity and concern, is that almost without exception, no matter where we go to bring in witnesses, without ever asking them their political persuasion, their economic philosophy, we find pretty much the same conclusions or observations. I begin to think that either you people do not have any contact with the folks that are making public policy or they have cut you out of their social circle, because it is just incredible that there is so little agreement. The media exacerbates the situation by only carrying administration witnesses. Do you gentlemen see any way that we can open the lines of communication with the administration?

Mr. KARCHERE. Senator, I think the answer is in a genuine difference of opinion. I think what these gentlemen are concerned about—and they say so—is a resumption of the inflation. I think that what they are referring to is the experience after the 1969–70 recession, and they fail to see it in historical perspective. I think this is basically what the issue is.

Chairman HUMPHREY. I do not impugn their motives; do not misunderstand me. I do not feel that they sit up nights figuring out how they can get the country in trouble. I think it comes very naturally to them. [General laughter.]

What bothers me is that we have got volumes of testimony from the best minds in this country and with very few exceptions they are all pretty much on the same wavelength. Now, they may disagree, for example, Mr. Synnott, with your estimates on the third and fourth quarter, because of inventory and liquidation and a number of other things that have taken place, but most everybody comes down to the same line that has been brought to our attention here.

Gentlemen, I have a serious choice to make, as to whether I want my picture in the Senate Pictorial Directory or whether I want to learn from you. It is getting down to a point where I am affraid you are going to have to fade out of the picture. [General laughter.]

There are questions which I have here; you answered most of them. I know, Mr. Klein, you feel very strongly that it is necessary for us to lead in the world community, and that you feel that an expansive policy is necessary in the coming year, at least. Is that correct?

I think it is reassuring that our recovery rate has been appreciably better than others. But it is very disturbing to see the new OECD reports. That, to me, is maybe one of the most disturbing international developments that we have had. And the projected growth of GNP is down to what?

Mr. SYNNOTT. Minus 1.5.

Chairman HUMPHREY. That is not encouraging.

Would you gentlemen be willing, if I should send you a modest amount of questions to answer them in writing? I know that is an imposition on your time, but we will not ask too much. There are a couple of points that I would like to refine for the record.

I thank you very, very much for your willingness to come here and share this information with us. It is brought, may I say, to the attention of the Congress. We put this information out in a Joint Economic Committee newsletter. It is submitted to the mayors of all the major cities, the Governors, the legislative leaders, the finance writers all across the Nation. We are attempting to use your testimony as a means of public information and education on these economic matters. And we thank you very, very much for your cooperation.

At this point, I will place in the hearing record a study by Professor Martin Schnitzer entitled, "Coping With Inflation: West German

Economic Policy, 1969–1974." The purpose of this study is to examine economic stabilization policies used in West Germany during the period 1969–1974.

[The study follows:]

## Coping With Inflation: West German Economic Policy, 1969–1974

(By Martin Schnitzer) [1]

### INTRODUCTION

The purpose of this study is to examine economic stabilization policies used in West Germany during the period 1969–1974. The year 1969 can be used as sort of a benchmark year in that the current inflation in West Germany gained impetus in that year, in part as a result of expansionary monetary and fiscal policies initiated during the 1967 recession and continued over into 1968. Moreover, the period 1969–1974 reflects the break in economic policy that occurred during 1967—a break from a policy of free markets in which priority was given to the interplay of market forces and from a rather conservative budget policy in which deficits were generally avoided, to an acceptance of Keynesian economic measures and more direct government intervention to stimulate the economy.

The remarkable performance of West Germany's economy since the 1948 Currency Reform and extending up to 1967 is well known. In terms of growth without inflation, the country's record was one of the best in the non-Communist world. During the postwar period the German economy relied on market forces instead of controls to accomplish recovery from the war's devastation. Anti-inflationary and sound currency policies were pursued by the government. To channel profits into investment and saving, income tax rates were modified to favor savers and investors. A policy of free markets was adopted, but was by no means applied uniformly to all sections of the economy. Its guiding concept was Soziale Marktwirtschaft, or social market economy, which was originally formulated by a group of scholars at the University of Freiburg during the war. The leader of the group, Walter Euchen, set forth the principles upon which the social market economy was based.

To some extent there is a mystique surrounding Germany—both East and West. Much reference has been made to the "economic miracle" that occurred in West Germany during the immediate postwar period, when the country literally "rose from the ashes" to become a world industrial power. The same thing also occurred in East Germany, only it took a longer period of time. Given their vaunted discipline, the Germans are supposed to be able to do things right. It is said that East Germany is the most successful Communist country, for only the Germans could make Communism work. By the same token, the West Germans also have the reputation of making things work. However, the German reputation for discipline and efficiency may be overrated.

This study will adhere to the following organizational framework: Chapter 1 considers the basic institutional arrangements of the West German economy. These arrangements affect the use of fiscal and monetary policies. The performance of the West German economy, particularly with respect to inflation, will be evaluated. Some attention also will be given to the subject of unemployment. Chapters 2 and 3 will examine West German economic policies, with Chapter 2 concentrating on fiscal policy and Chapter 3 focusing on monetary policy. Although monetary and fiscal policy are thus discussed separately a continuous effort is made to present each in the context of the other, since obviously they have been interrelated. Chapter 4 will present the important conclusions that the study makes with respect to West German economic policies.

Particular emphasis will be placed on the use of a wide variety of special stabilization instruments, created by the Stabilization Law of 1967, which have been used to counter undesirable cyclical movements in certain segments of the West German economy. These instruments provide an element of flexibility in the use of general fiscal and monetary policy measures. For example, the German government can, by means of ordinances and with the agreement of the Bundesrat, vary personal and corporate income taxes by 10 percent above or

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below their existing rates. It can also introduce special depreciation allowances for a limited period, and similarly restrict allowances if need be. In time of recession the possible incentives that may be granted are enormous, namely, an investment premium of up to 7.5 percent over and above 100 percent depreciation. But these measures, by themselves, do not indicate the range and direction the government can take in order to ensure economic growth and stability in the West German economy.

On balance the performance of the West German economy with respect to controlling inflation has been better than other major industrial countries including the United States. The Stabilization Law provided a number of instruments designed to change fiscal policy at a short notice in an anticyclical sense. It is difficult to say to what extent the relative success of the Germans in holding the rate of inflation to around 7 percent a year can be attributed to the judicious use of these policy instruments coupled with the use of monetary policy by the Bundesbank. There is an interplay of fiscal and monetary measures, which makes it difficult to isolate the effects of any one measure. It is possible, however, to examine the use of fiscal and monetary policies during the inflationary period of the 1970's, and this basically is the objective of the paper.

## Chapter 1—The West German Economy

### Introduction

During the depression of the 1930's, unemployment was the paramount economic problem in Western society. This shift of emphasis in economics and economic policy was one reaction to the collapse of the capitalist laissez-faire market economy as it then functioned. Ecoonmic theory and public policy changed from an emphasis on expanding supply to concentration on expanding demand. Previously, clasical economics had assumed that human wants were insatiable and that the job of a market economy was to supply goods and services to meet as many of those wants as possible. The traumatic experience of the depression changed the major emphasis to assuring job availability—the goal of full employment. This historic shift, along with emphasis on government responsibility to assure full employment, has typified economic thinking since the end of the Second World War.

However, in recent years the economies of the United States, France, the United Kingdom, and other Western countries have been involved with another economic problem for which no satisfactory solution has been found. The problem is one of inflation, which has created both economic and social costs. To some extent, this inflation can be attributed to the very high priority governments have placed on the maintenance of full employment. Public attitudes have over the years been conditioned to achieving national employment objectives. But inflation can also be attributable to other factors which have nothing to do with government economic policies aimed at the creation of full employment. Emphasis now has to be placed on the development of economic policies that will curb inflation, but not cause mass unemployment.

West Germany, like other major industrial countries, has suffered from price inflation. This phenomenon is not new to the Germans; the inflation of 1922–1923 was one of the most disastrous of all times. Memories of that inflation and the concomitant social unrest are indelibly stamped on the German mind, and have contributed to current efforts to keep price changes within manageable limits. In comparison to other countries, West Germany has been at least moderately successful in its fight to control inflation. The Stabilization Law of 1967 provided the country with some interesting fiscal policy devices which could have some application in the United States.

### Institutional Arrangements

The West German economy is a mixed system in which there is both private and public ownership of the agents of production. A large nationalized sector exists with a market economy. The bulk of German industry is in private hands, and pricing decisions are determined in the marketplace. Nevertheless, there is a traditional reliance on state intervention in economic affairs that goes back wel into the nineteenth century. The role of the public sector, which includes the federal, state, and local governments can be emphasized by the fact that government expenditures, government consumption of goods and services and transfer payments amount to one-third of the gross national product.

West Germany is a federal republic, with political powers assigned either specificaly to the federal government or concurrent between the federal and state governments. The West German economic and political system is somewhat similar to that of the United States. Both West Germany and the United States have a tripartite tax structure, meaning that legislative authority over tax matters is divided between federal, state, and local governments, and certain taxes are regarded as the prerogative of each. Politically, the national governments of each country have a bicameral legislative body. The West German Parliament consists of a lower house (Bundestag) and an upper house (Bundesrat). The Bundestag, which is elected by popular vote, passes the laws and exercises supervision over the executive branch of the government. The Bundesrat, members of which are appointed by the ten state governments, has the right of veto over legislation involving state taxes and territory.

FISCAL SYSTEM

It is impossible to comprehend West German fiscal and monetary policies without first having some familiarity with the fiscal and monetary system. The West German tax system is characterized by a multiplicity of taxes. Altogether some 50 different types of taxes, mose of which are excises, are used in West Germany. The bulk of tax revenues, however, is derived from a half-dozen major taxes, the most important of which are the value-added and income taxes. Direct taxes, indirect taxes, and social security contributions are evenly balanced with respect to their overall contribution to total public sector revenues. In 1973, direct taxes amounted to DM126.5 billion, of which DM102.7 billion came from taxes on individuals and DM23.8 billion came from taxes on businesses. Indirect taxes, most of which are broad-based taxes on consumption, amounted to DM128.3 billion, and social security contributions amounted to DM136.6 billion.[1]

The two main German taxes are the value-added tax and the personal income tax. The value-added tax is levied at a general rate of 11 percent of value added at each stage of the production process. Since the value-added tax is fully passed on to the consumer, it is not an element of cost to the manufacturer or trader. The German personal income tax is progressive, with rates ranging from 19 percent to 53 percent of taxable income.[2] Family relief is partly given through income-splitting which implies that, for a married couple the total tax is calculated as twice the tax on half of the combined income. The income tax on wages and salaries (Lohnsteuer) is withheld at the source and is subject to adjustment at a final assessment based on declarations. For personal income not withheld at the source, there is a system of prepayments. Either way, there is a lag between the earning income and the final tax. This lag opens up a possibility for contracyclical fiscal policy which has been exploited by the government. Moreover, with consent of the Bundestag and Bundesrat, the federal government can order by decree a 10 percent increase or decrease in personal income tax.[3]

The tripartite arrangement of the German tax system presents some problems in terms of fiscal policy. There are three distinct levels of taxes and expenditures, with federal, state, and local governments given certain prerogatives. Certain taxes are shared by the federal and state governments. For example, the value-added tax is a shared tax. Moreover, income taxes are also shared between the federal and state governments. with the states serving as the collection agency. Starting in 1970, the federal share of the personal income tax has been progressively increased to the point where it's share is now in excess of 50 percent. One reason for the increase is to give the federal government more leverage in the use of fiscal policy.

Under the provisions of the German Constitution, the budgets of the federal and state governments are supposed to the autonomous and independent of each other. To some extent, this independence has circumvented the effective use of fiscal policy, even though the Constitution also provides that the fiscal man-

[1] Deutsches Bundesbank, Monatsberichte der Deutschen Bundesbank, (Frankfurt am Main, March 1974) p. 22.

[2] There is a special 3 percent surcharge on taxable incomes in excess of DM16,020 for single persons to DM32,040 for married persons. The regular rate ranges from 19 percent on taxable income of DM8,009 or less (single), DM16,018 or less (married) to 53 percent on taxable income in excess of DM1110,039 (single) and DM220,078 or more (married).

[3] The consent needs only a simple vote.

agement of federal and state budgets must take into consideration the requirements of overall economic stabilization. General government expenditures on goods and services are about evenly divided between federal, state, and local governments, thus complicating the problem of central management of expenditures. Moreover, public investment expenditures are also divided among the three levels of government, with investments on the part of local governments constituting the most important share. On the tax side, taxes on consumer spending are fragmented. In fact, they are split up into more than a dozen separate taxes on commodities and services and are collected primarily at the level of production.

The importance of the federal government cannot be minimized. Control over the social security system is vested in the federal government as well as the tax revenues of the states and localities. In order to maintain uniform economic conditions and to permit fiscal, monetary, and social policy on a national scale, the Constitution permits federal legislation even in the areas of those taxes whose proceeds are assigned to the states or to the localities. Within the field of concurrent tax jurisdiction, the exercise of legislative power by the federal government displaces the exercise of this power by the states. Expressed differently, the power of the states to regulate a certain tax comes to an end once the federal government has preempted the field.

## BANKING SYSTEM

In West Germany government control over the institutions of money and credit is considerable. In pursuit of specific policy objectives, the government has deliberately intervened in economic affairs to further its aims. Money and credit are particularly important areas, for they provide the nexus through which transactions are carried on. The instruments of money and credit provide, in a number of ways, a contrast to those of public finance. The federal budget is a single, once-a-year operation, and the measures are clear. The picture of ~~money and credit policy is much more confused, however.~~ Control is normally divided between the central bank and the federal government. There is direct government intervention in the flow of credit from the financial institutions to the various sectors of the economy through the provision of savings out of budgetary surpluses that are made available out of capital formation.

West German banks can be differentiated with respect to their scope of operations. The Deutsche Bundesbank yerforms functions similar to central banks in other countries. There are commercial banks of three types: nationwide banks; state, regional, and local banks; and private banks. Savings banks and central giro institutions represent a third category of banks. There are banks that act as pure financial intermediaries without power to create money. The mortgage bank is the prime example. Other banking groups include the agricultural and industrial credit cooperatives. These institutions provide credit for farmers and small businesses; they do this primarily through direct credits. Finally, there are the specialized credit institutions, including government agencies and the postal savings banks.

## THE DEUTSCHE BUNDESBANK

The central banking system of West Germany consists of the Deutsche Bundesbank and ten central banks of the states (Landeszentralbanken). The Bundesbank, unlike central banks in most countries, operates with a considerable degree of autonomy with respect to open market operations and credit policy. It is, however, obliged to advise the government on all matters of importance in the area of monetary policy and to support general economic policies of the government, particularly in the area of currency stability. However, it is independent of the federal government with respect to its statutory power.

The Bundesbank exercises control over monetary policy through various instruments that it can use to regulate the availability of credit and the liquidity of the banking system.

1. It has control over the rediscount rate and the rate it charges for advances on commercial paper. Commercial banks are also allowed to borrow on the basis of bonds as security, for a period of three months. They receive liquid funds at a rate of interest that is usually set at 1 percent above the prevailing rediscount rate. The quantity of commercial paper the Bundesbank stands ready to discount is subject to limits, which are normally three times the liable capital plus the reserves of any given institution.

The extent of recourse to rediscounting by banks is limited through the use of rediscount quotas. The Bundesbank uses standard quotas based on the banks' capital structure and reserves and differentiated according to categories of financial institutions. The rediscount quotas are fixed by the boards of management of the Landeszentralbanken for the banks located in their area. The quota arrangement also applies to the rediscounting of bills abroad. The use of the rediscount quota is a common instrument of West German monetary policy.

2. Through open market operations the Bundesbank can expand or contract the supply of liquid funds in the banking system. The Bundesbank purchases and sells in the open market for its own account and at the rates fixed by it the Treasury bills and discountable Treasury bonds issued through it and the medium-term notes of the federal and state governments. Also included in the open market arrangement are medium-term notes of the federal railways, the federal Post Office, prime bankers' acceptances, and bonds submitted to the official stock exchange.

3. It can encourage or discourage the placement of banking funds abroad by making it less or more expensive for commercial banks to make covered investments in the foreign-exchange market, thereby increasing or decreasing the supply of funds available in the domestic market.

4. It has control over minimum legal reserve requirements for commercial banks and other credit institutions. This control is considered a very effective tool in that it directly affects banks' ability to extend credit because they are expected to maintain a certain amount of deposits in legal reserves at the Bundesbank. Legal reserve requirements depend on the size of the bank and the type of deposit. The marimum reserve limits are 30 percent for sight deposits and call money, 20 percent for time deposits, and 10 percent for savings accounts. Any credit institution that fails to meet reserve requirements is subject to a penalty surcharge that is usually set at 3 percent of the rate charged by the Bundesbank on advances.

5. After more than 40 years of regulation, interest rates were freed from official government control on April 1, 1967. The freeing of interest rates had a mixed reception from bankers, who argued that it would severely complicate monetary policy. Under the old system, there was a largely automatic link between interest rates and the Bundesbank's discount rate. After 1967, however, the Bundesbank has had to rely to a greater degree on other instruments of monetary policy, such as reserve requirements, discount quotas for individual banks, and open market operations. It has also had to use what is called a "swap" policy as a means of influencing bank liquidity. This policy has increased in importance during the 1968–71 period. It is suited for West Germany as a country that imports and exports large amounts of capital in highly liquid form.

Since the German mark is fully convertible into foreign currencies, the government has no means at its disposal to control the impact of foreign currencies on the German money market. In other words, freely entering foreign currencies have served to inflate the money supply in Germany, which in turn, has resulted in higher prices as availability of money induces consumers to buy and industries to invest. Both factors combined generate an inflationary effect that is difficult to control. The flow of foreign funds will accelerate because the booming German economy offers high returns. The end result is that the equilibrium of the national economy is distributed by an inflow of funds that are not based on any trade flow. In the absence of regulatory tools, such as no interest rates on foreign investments or limited currency convertibility, the Bundesbank uses a "swap" policy.

Basically, a swap is a means of insurance against exchange risks. The cost of this type of hedging is expressed as an interest rate per annum and is generally offered in swap points in relation to the respective exchange rate. Hence, swapping may produce a discount or a premium on an exchange rate. By manipulating the swap points, the Bundesbank attempts to induce banks to export or import funds. Raising the costs of such operations tends to diminish capital outflows, of course, while lowering the costs encourages inflows. A swap policy, however, cannot significantly influence the flow of foreign currencies, as events during the 1968–71 period have indicated.

6. Another monetary policy instrument involves the use of the Lombard rate, a unique means of refinancing for banks that allows them to attain liquid funds from the Bundesbank by assignment of bonds. On this basis, funds are made available up to a maximum period of three months at a cost usually 1 percent above the discount rate. Lombard is usually the last resort for a bank in obtaining liquid funds to bridge a temporary shortage of cash. Banks refrain from using this device if possible, as the high cost of refinancing absorbs their profits.

The primary input of the Bundesbank's instruments of monetary policy is on the liquidity position of the banks and on the costs they incur when obtaining central-bank funds, but their ultimate aim is to influence overall conditions on domestic credit markets. Looking beyond the Bundesbank and commercial bank relationships, it is easy to recognize the actual workings of the system. Credits extended by banks are usually taken up, to a very great degree at least, by various industries, primarily for investment purposes. It is common knowledge that investment spending, in contrast to consumer spending, stimulates an economy by an amount far greater than the amount originally injected by the individual investment. Hence, Bundesbank policies that acect the liquidity of the banking system also affect investment spending on the part of industry. Changes in bank liquidity also cause changes in the overall level of interest rates, which forms an important control lever in the transmission system of monetary policy.

PERFORMANCE OF THE ECONOMY

The performance of the German economy can be divided into two time periods. The first period extends from the end of World War II to 1967; the second period extends from 1967 to the present. The first period included a recovery from war-time devastation to a major economic power. At first, priority was given to reconstruction. The restoration of free exchange, which was accompanied by the monetary reform of 1948, and the subsequent removal of price controls were stimuli that contributed to a rapid increase in the rate of economic growth. The gross national product of West Germany increased from DM 70.2 billion in 1948 to DM 136.6 billion in 1952.[4] The period 1952–1960 marked a return to normality. The time of reconstruction was over, and the refugees from other areas were assimilated into the population. The annual real rate of growth was around 8 percent, the highest for the Western European countries Gross national product increased from DM 136.6 billion in 1952 to DM 279.8 billion by 1960.[5] From 1960–1967, the rate of economic growth, although solid, became erratic, prices rose, and the rate of employment stabilized at less than 2 percent of the labor force.

West German fiscal policy was conservative. There was no attempt to use the federal budget to offset short-term fluctuations in the level of economic activity. Instead, reliance was placed almost exclusively on monetary policy, which was aimed primarily at the maintenance of price stability and a favorable balance of payments. Priority was given to three basic goals in terms of descending order of their importance: full employment, price stability, and economic growth. Success in maintaining price stability enhanced West Germany's position in the world markets. From 1952 onward, helped by its comparatively low price level, the country began to pick up enormous export surpluses. As a result, by 1957 cest Germany's monetary reserves reached the point where the increase in its gold reserves alone exceeded that of all other Western European countries put together. Continued prosperity during the early 1960's was accompanied by an inflow of capital from abroad.

From 1965 to early 1966 the balance-of-payments surplus disappeared. The growth rate began to drop as the momentum that had propelled the economy forward began to decline, and a recession occurred during the latter part of 1966. The Erhard government was replaced by a coalition.

During most of the period up to 1969, particularly after reconstruction of the economy had been finished, West Germany scored high marks with respect to accomplishing the basic policy goals of full employment, price stability, and economic growth. The rate of unemployment was for a number of years the lowest among all major capitalist countries. Memories of the disastrous inflation in the period following World War I made acceptance of the goal of price stability easy to take for most Germans. The growth rate was the envy of Western Europe, and for that matter, most of the world. There were, however, extenuating circumstances which helped to contribute to the German performance. For one thing, the economy had to do a large amount of technological catching up to compensate for war losses.

The German economy became unstuck in 1966 and 1967 when the boom period finally came to an end. The rate of unemployment hit a decade high of 3.1 percent during part of 1967, and the rate of economic growth declined to 2.4 percent for 1966 and 1.1 percent for 1967.[6] However, in 1968 recovery from the

[4] Statistisches Bundesamt. Statistisches Jahrbuch fur die Bundes-Republik Deutschland, 1962 (Wiesbaden: W. Kohlhammer Verlag), p. 27.
[5] *Ibid.*, p. 27.
[6] Statistisches Bundesamt, Statistisches Jahrbuch fur die Bundesrepublik Deutschland, 1970 (Wiesbaden: W. Kohlhammer Verlag), p. 490.

recession was rapid, thanks to a considerable degree to the use of new fiscal policy instruments. The rate of economic growth increased to 7.2 percent and the rate of unemployment averaged 1.1 percent for the year. But economic policies initiated in 1968 helped to sew the seeds of the subsequent inflation in West Germany that really started in 1969. The year 1968 can be considered as the most stable of the recent years of German performance even though it was a recovery year.

From 1969 to 1974 the performance of the economy has been somewhat erratic, but generally better than the other major industrial countries. During this period, inflation has become a worldwide phenomenon. During the period July 1973 to July 1974 the rate of inflation for the 24 countries belonging to the OECD increased to 13.3 percent. Among the larger countries, West Germany had the best record—6.7 percent—while rates for Japan, Italy, and the United Kingdom increased by more than 15 percent. The inflation rate for the United States was 12.2, while the rate for Sweden was 8.1 percent. Most of the price acceleration occurred in the wake of currency depreciation, and enormous increases in the prices of food, fuel, and fertilizer. One of the important concerns of policymakers in the OECD countries is that this rate of inflation was not accompanied by much in the way of gains in economic growth.

It is generally agreed that contemporary economic policy goals should be aimed at providing full employment, general price stability, and economic growth. Each of these goals is subject to some latitude in terms of interpretation. On balance, the performance of the German economy with respect to the goals has been the best of the major industrial countries in this decade. The rate of unemployment has been the lowest of all OECD countries, averaging out at an annual rate of 1.1 percent for the period 1970 to August 1974.[7] However, the Germans are helped by having a very static population and labor force and have had to rely on importing workers from Yugoslavia, Italy, and other countries.

A slow rate of economic growth accompanied by price inflation has been a problem in this decade. This development can be called "stagflation," or the existence of economic stagnation and unemployment side-by-side with excessive inflation. This situation could not occur in the Keynesian model—one or the other problem could occur, but both could not occur at the same time. Economic policy is presented with a dilemma which apparently defies solution. In attempting to cure slow growth and unemployment through the use of standard fiscal and monetary policies, governments run the risk of further exacerbating the inflation problem; in attempting to curb inflation, governments run the risk og increasing the rate of unemployment. The challenge to economic policy is to find ways of slowing down inflation, resuming economic growth, and keeping unemployment at a politically acceptable level, all at the same time.

Comparisons can be made of the rate of economic growth, the level of prices, and the rate of unemployment for West Germany and other major industrial countries. Two time periods are used—an average of the period from 1959–1960 to 1971–1972, and changes from the previous year, 1973–1974. A different time period is used for the rate of unemployment, 1962–1972. The consumer price index is used as the measure of price stability, and reflects, among other things, the vulnerability of the Japanese economy to the oil crisis as evidenced by the sharp decline in the rate of economic growth and rapid price increases. On balance, the performance of the West German economy has been the best of the major OECD countries with respect to the policy goals of high employment, price stability and economic growth as Tables 1 and 2 indicate. A solid, but average in comparison to all OECD countries, growth rate has been accompanied by a superior performance in maintaining full employment and stable prices.

Comparisons of inflation rates can also be made for the same six countries using different base periods. Dcring the period 1963–1972 with 1963 used as the base period of 100 percent, the consumer price index increased by 36.6 percent in the United States, 38.5 percent in Canada, 34.0 percent in West Germany, 46.6 percent in France, 62.2 percent in Japan, 58.6 percent in the United Kingdom, and 42 percent in Italy.[8] Most of the gain in the consumer price index was recorded during the period, 1969–1972. When 1970 is used as the base period and set equal to 100 percent, the West German consumer price index increased

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[7] Deutsche Bundesbank, Monataberichte der Deutschen Bundesbank (Frankfurt am Main, October 1974), p. 56.

[8] International Monetary Fund, International Financial Statistics, December 1973, p. 35.

TABLE 1.—A COMPARISON OF GROWTH RATES AND PRICE LEVEL CHANGES FOR MAJOR OECD COUNTRIES 1959–60 TO 1971–72, AND PREVIOUS YEARS 1973–75

[Percent]

| Countries | Average 1959–60 to 1971–72 | From previous years 1973 | 1974 |
|---|---|---|---|
| **Real Rate of Economic Growth** | | | |
| Canada | 5.0 | 6.8 | 3.7 |
| United States | 4.1 | 5.9 | −2.1 |
| Japan | 11.0 | 10.2 | −1.8 |
| France | 5.8 | 6.5 | 3.9 |
| Germany | 4.9 | 5.3 | .4 |
| Italy | 5.5 | 6.3 | 3.4 |
| United Kingdom | 3.1 | 5.4 | .3 |
| Average for OECD countries | 5.4 | 6.3 | .2 |
| **Consumer Price Changes** | | | |
| Canada | 2.3 | 6.1 | 10.5 |
| United States | 2.4 | 5.6 | 11.4 |
| Japan | 5.5 | 11.8 | 24.4 |
| France | 4.3 | 7.1 | 13.7 |
| Germany | 3.0 | 7.1 | 7.3 |
| Italy | 4.1 | 10.8 | 19.1 |
| United Kingdom | 3.8 | 8.5 | 14.6 |

Source: The OECD Observer, "Highlights From OECD Economic Outlook," December 1974, pp. 31–35, and OECD "Economic Outlook," July 1975.

by 19.6 percent by the third quarter, 1973. The comparable percentage for the United Kingdom was 28.8, for Japan 25.8, the United States 15.6, Canada 21.2. France 21.0, and Italy 24.4.[9] This comparison does not reflect the energy crisis which added a new dimension to the food and fuel problem, and which contributed to a jump in the consumer price indices of these countries in 1974.

The performance of the West German economy in the maintenance of full employment has been the best of the major OECD countries, even after allowing for variations in measurements of unemployment. Beginning in 1959 an ascent into boom conditions occurred. The flow of manpower from the eash had declined and a condition of overfull employment was reached. By 1961 the rate of cnemployment was less than 2 percent of the labor force, and remained so, with the exception of the 1966–1967 recession, for the rest of the decade. In fact, the supply of labor was so short that workers had to be imported from Yugoslavia, Italy, and other countries. World War II losses and a low birth rate kept German entrants into the labor force on a par with departures from the labor force; in an expanding economy the German labor supply did not keep up with labor demand.

TABLE 2.—UNEMPLOYMENT RATES IN SELECTED OECD COUNTRIES

[Percent of labor force seasonally adjusted]

| Countries | Average 1962–72 | 1973 | 1974 |
|---|---|---|---|
| Canada | 5.1 | 5.6 | 5.4 |
| United States | 4.7 | 4.9 | 5.6 |
| Japan | 1.2 | 1.3 | 1.4 |
| France | 1.7 | 2.1 | 2.3 |
| Germany [1] | 1.0 | 1.3 | 2.6 |
| Italy | 3.4 | 3.5 | 2.9 |
| United Kingdom [2] | 2.3 | 2.6 | 2.5 |

[1] Percent of dependent labor force.
[2] Percent of total employees.

Sources: The OECD Observer "Highlights From OECD Economic Outlook," December 1974, pp. 31–35 and OECD "Economic Outlook" ,July 1975.

[9] *Ibid.*, p. 35.

## CAUSES OF INFLATION IN GERMANY

No single explanation will suffice to explain the complex subject of inflation. In the inflation characteristic of the contemporary world economies, including West Germany, elements of both demand-pull and cost-push inflation are present. In West Germany expansionary fiscal and monetary policies launched during the 1967 recession and continued during 1968 acelerated a boom period and contributed to demand-pull inflation. As prices increased, labor union and other groups pressed for higher wages, and business firms were able to pass costs on to consumers in the form of higher price. Elements of cost-push inflation set in. Moreover, there were exogenous factors that contributed to the upward trend of the general price level. For example, one can cite the oil crisis which caused higher fuel prices in West Germany.[10]

The problem of imported inflation has become a major issue in West Germany. Increased liquidity in the economy caused by surplus foreign exchange has been transferred into inflationary demand. Orthodox monetary policy is at a disadvantage. First, the increased liquidity from abroad gives private credit institutions greater independence from the Bundesbank, thus making it more difficult for the latter to use restrictive measures effectively. Second, if the Bundesbank attempts to use higher bank rates to combat imported inflation, it only aggravates the problem of attracting more capital from abroad. It has been difficclt to counter imported inflation through standard monetary policy measures without creating disequilibrium in the balance of payments. The standard response to an increase in reserves is to let internal prices rise until the net inflow of foreign exchange is checked. The addition of internal price stability as an equal or superior objective therefore makes it impossible to maintain balance-of-payments stability by orthodox measures.

A partial explanation for inflation in West Germany and other countries is one that is stressed by monetary economists, namely, the failure of central banks to limit the growth in their domestic money supply to non-inflationary levels. This assumes a direct—and in some instances proportional—relationship between the money supply and the price level. It is argued that money growth in the past few years in the developed countries has been at rates that are clearly excessive in relation to real output of goods and services. During the period 1967–1972, the money supply in Japan increased at a rate of 130 percent compared to 50 percent in West Germany. Over this five-year period, the consumer price index increased by an average rate of 5.9 percent in Japan in comparison to 3.1 percent in West Germany.[11] During the period December 1971 to June 1974, the German money supply increased from DM196.6 billion to DM241.7 billion—an increase of 23 percent. The consumer price index during the same period increased 8.3 percent.[12]

## POLICY PROBLEMS

The cures for inflation depend on the causes. If the cause of inflation is demand-pull, the remedy is fairly simple. It is necessary to reduce aggregate money demand or increase aggregate real output. The latter is hard to do, particularly in the short run when an economy is operating at a level of full employment of available resources. If this is the case, reliance is placed on standard monetary and fiscal policy measures to reduce the level of aggregate demand downward. If the cacse of inflation is cost-push, the remedies are far more complex. Cost-push inflation can occur when large companies, unions, or both, succeed through monopoly power in raising the prices for either their products or services above the levels that would prevail under competitive conditions. In cost-push inflation, restrictive monetary and fiscal policies are not appropriate. Such measures have their immediate impact upon aggregate demand, but cost-push inflation is not the result of aggregate demand pushing against full-employment outpct. Reform of the institutions responsible for cost-push, say through antitrust policies, is a slow process which could create problems as difficult as the one that is being attacked.

However, regardless of the cause or causes of inflation, there is an economic policy dilemma which the governments of all Western industrial nations must

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[10] The drastic raising of crude oil prices in the autumn of 1973 and early in 1974 changed the balance of payments situation and the assessment of monetary reserves everywhere in the world. Even so, the effect of the oil crisis on Germany's balance of payments was relatively modest, particularly as regards imports.

[11] International Monetary Fund, "International Financial Statistics," October 1973.

[12] Deutsche Bundesbank, "Monatsberichte der Deutschen Bundesbank," August 1974, p. 60.

face. In order to fight inflation and the social disruption is causes, governments must at least in part restrain aggregate demand through the use of standard fiscal and monetary policy measures, and thus risk triggering a recession that would cause cnemployment and social unrest. To a considerable degree, economic policy in West Germany, the United States, and other Western countries remains tied to the traumatic experience of the Great Depression. The highest priority has been placed on the achievement of full employment. It would be difficult for the governing party in these countries to tolerate unemployment even at rates that would be low by comparison with the current rate in the United States. This has meant that governments have had to accept at least some amount of price instability as opposed to the use of stringent fiscal and monetary policy measures that would increase the unemployment rate above a politically acceptable level.

But West Germany on balance has done a reasonably effective job in achieving a rate of inflation which is lower than the other OECD countries, while maintaining low unemployment rates, at least until the winter of 1974. Monetary policy was given the general responsibility for maintaining price stability, while fiscal policy was much more selective in terms of its application. The use of these selective devices could have sofe application to the United States. West Germany, much more than the United States, is affected by external world forces, such as the oil embargo. This means that both monetary and fiscal policies are going to be affected by not only conditions in the domestic markets, but by world prices for exports and imports as well.

## Chapter 2—Fiscal Policy

### POLICY CHANGES

As was mentioned previously, the year 1967 can be considered as a point of demarcation in terms of West German economic policy. Prior to 1967 reliance had been placed primarily on monetary policy to accomplish the goals of full employment, price stability, and economic growth.[1] Fiscal policy was secondary in terms of its importance as a policy instrument. This was, of course, consistent with the principles of a free market economy. However, the recession of 1966–1967 caused a shift in attitude toward the role of fiscal policy as a stabilization instrument. The Erhard government was dissolved and a coalition government represented by the two major political parties, the Christian Democratic Union and the Social Democrats, was formed. Convinced of the need for active countercyclical measures, the government introduced a provisional contingency budget in the spring of 1967. This bcdget provided expenditures of DM2.5 billion for investments in the national railroad system, postal services, and road building. Despite these additional investments, the impact of the contingency budget was diluted and more than counterbalanced by state and local government contractions in budgetary spending. A reform of the German budgetary system was needed.

### FISCAL INSTRUMENTS

It was, then, against the background of a failing economic boom that a reform of the German budgetary system occurred. This reform is significant for two reasons. First, it provided a series of fiscal instruments that were not available during the Erhard period, although a start had been made toward budgetary reform during his leadership. In 1964 a special commission had been created to study needed reforms and its recommendations eventually were incorporated into law. Second, the reform introduced what can be called medium-term financial planning, the purpose of which is to draw cp the federal budget within a framework of a five-year financial plan. It sets forth projected expenditures and revenues over this period and relates each to the probable development of the economy's productive resources.

### THE LAW FOR PROMOTING STABILITY & GROWTH IN THE ECONOMY

In June 1967 the Bundesrat passed the Law for Promoting Stability and Growth in the Economy.[2] In connection with the law, both houses gave approval

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[1] The proponents of a free or social market economy (Soziale Marktwirtschaft) believed that its implementation would obviate the need for countercyclical fiscal policy measures, e.g., the active manipulation of taxes or public expenditures. If competition in the marketplace were widely established, and monetary policy conducted on the basis of price stability, then economic fluctuations would automatically disappear.

[2] Deutscher Bundestag, "Gesetz zur Forderung der Stabilität und des Wachstums der Wirtschaft," Bonn, June 8, 1967.

to a required change in the Federal Republic's Basic Law. The provision for independent budgeting processes of the state and federal government, which heretofore had been an important obstacle to an effective countercyclical fiscal policy, was altered to permit coordination of fiscal and economic policy actions at all levels of government. A new era in West German economic policy began, for the federal government now was provided with a number of Keynesian policy instruments.

The Law for Promoting Stability and Growth (Stabilization Law) marked a new era in German economic policy in that it provided the federal government with a number of economic policy instruments. The more important ones can be summarized as follows:

1. The federal government has the power to skim money from the economy during boom periods and to pump it back during recession. For this purpose, the federal government as well as the state governments are required during boom periods to make deposits in the form of business cycle reserves with the Bundesbank. The Stabilization Law requires the federal and state governments to keep interest-free conjunctural accounts (Konjenkturausgleichstrucklagen) with the Bundesbank. The federal government, with the approval of the Bundesrat, can instruct federal and state authorities to place up to 3 percent of the previous year's tax revenue in the fund.[3] Apart from this, increased revenue caused by a contracyclical raising of income taxes is supposed to be paid into the fund automatically. The deposits only may be withdrawn for contracyclical expenditures, conditional on the approval of the federal government and the Bundesrat.

The cyclical reserve is somewhat like the Swedish investment reserve. In Sweden the government has attempted to influence the timing of private investment projects throcgh special tax concesisons to firms willing to postpone their particular investment projects in order to fit them into a more stable pattern. The investment reserve is used to encourage private corporate savings in periods of prosperity and private capital expenditures in periods of unemployment. Companies are encouraged to deposit part of their pretax profits in the Bank of Sweden (Sveriges Riksbank); if these funds are used for investments in buildings, machinery, and inventories during a period when investment is needed for employment purposes, substantial tax privileges are attainable. Of course, the German cyclical reserve is a tax reserve of the federal and state governments, but the objectives of the two types are basically the same. In each country the release of the reserves is permissible only for the purpose of avoiding a weakening of overall economic activity that endangers the poal of a high level of employment.

2. The skimming of money can also be accomplished through discretionary increases in personal and corporate income taxes, through suspension of depreciation allowances, and through other tax devices. Conversely, when the economy needs stimulating, taxes can be lowered and accelerated depreciation liberalized.

3. The Stabilization Law also provides that the federal government must plan its budgets for a period of five years and must prepare an investment program with a priority scale. It may run budgetary deficits up to DM5 billion to stimulate the economy, and may cut back public projects in order to dampen demand in the building industries. The state and local governments are also required to prepare long-range budgets, particularly for investment projects.

4. The federal government must establish wage guidelines, although adherence is voluntary for both business and unions.

5. The federal government may temporarily limit the line credit of state and local governments.

The federal government made extensive use of the powers granted by the stabilization law during the 1967–1968 period. and the impact on the economy was considerable. It is estimated that the 2.5 billion DM increase in budget expenditures in April 1967 caused gross national product to increase by 5.3 billion DM.[4] Subsequent measures involved pumping more than 2 billion DM in the economy during late 1967 and early 1968. Part of the funds were funneled into the construction industry to alleviate the chronic housing shortage.

## MEDIUM-TERM PLANNING

The Law for Promoting Ctability and Growth in the Economy also reformed the German budgetary system. Both houses of Parliament gave approval to a

[3] "Gesetz zur Forderung," Section 8.
[4] Deutscher Bundestag, Jahresgutachten, 1968 (Bonn: Drucksache V/1630), p. 12.

required change in the Federal Republic's Basic Law (Constitution). The provision for independent budgeting processes of the federal and state governments was altered to permit coordination of fiscal and other economic policy actions at different governmental levels. German expenditure policy moved in a direction which brought it close to elements of French economic planning. This planning, however, is fiscal in nature and is designed to mesh governmental expenditures more closely with desired economic goals.

As has been noted, the federal budget supposedly is drawn up within the framework of a five-year financial plan.[5] It must set forth the projected develment of expendiutres and revenues over the planning period and relate each to the likely development of the economy's resources. The plan is prepared by the Federal Ministry of Finance and is adjusted and rolled forward each year. In the event of a weakening in the general level of economic activity, the planning of suitable investment projects is to be accelerated in such a way that they can be implemented on short notice. In addition to the financial plan, the federal government must submit to the Bundestag and Bundesrat an annual economic report which includes a declaration of its economic and fiscal policy objectives for the coming year.

The Medium-Term Plan was the offshoot of a study prepared by the Economics Ministry in 1966 for the European Economic Community as a projection of economic prospects in Germany through 1970. The study was transmitted to all federal ministries and to the states to be used as a common basis for medium-term budget plans. The plan actually was developed for the period 1968–1972, but was applied for the first time in the budget estimates for 1969. It consisted of a series of projections or forecasts, as well as a plan of action for the economy until 1971.[6] Gross national product and private consumption were projected to increase at the rate of 4 percent a year. The individual components of investment were expected to increase at a differential rate. Public investment, because of anticipated further heavy demand for infrastructure and social investment was to increase by 5.5 percent a year, while private investment in plant and equipment was to increase by 3.7 percent.[7] For the labor force, an absolute decline was projected, attributable to a decrease in the rate of population growth.

The plan gives equal priority to the following economic policy goals: price stability, full employment, stable economic growth, and a balance-of-payments equilibrium. Federal and state budgets are to be drawn up and managed in accordance with these objectives, and expenditures, particularly on investment, are to be adjusted yearly to conform to the economic situation. If aggregate demand should be excessive, provision is made in both budgets for allocation of funds to a special cyclical equalization reserve held by the Bundesbank. If economic activity should decline, additional expenditures can be financed out of funds available in the reserve.

It is to be emphashized that the Medium-Term Fiscal Plan is rolled forward each year. In other words, the base year is moved ahead one year for each plan. Within the framework of the budget plan, the federal government can vary personal and corporate income taxes by 10 percent. It also can introduce special depreciation allowances for a limited period, or restrict allowances if need be. Thus, planning in West Germany is limited to the use of the federal budget as a device to counter undesirable cyclical movements. In particular, the plan is based on medium-term investment programs developed by the various departments of the federal government. Any rise of federal expenditures, aside from debt repayment, should correspond roughly to the rate of gross national product growth during the period.

## OTHER FISCAL POLICY DEVICES

As an anti-inflationary measure, the West German government has used several temporary tax devices. One such device involves a variation in depreciation allowances, which have been increased during periods of declining activity so as to encourage investment and lowered during periods of inflation to discourage investment. There is little doubt that variations in depreciation would have some impact on investment, because one result is to raise a business firm's tax bill in the immediate period (inflation is presumed) and lower it in the next

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5 Bundesministerium der Finanzen, Drei Jahr Neuer Finanzpolitik (Bonn, 1969), pp. 19–11.

6 Bundesministerium der Finanzen, Die Finanzplanung des Bundes, 1968–1972 (Bonn: 1969), p. 18.

7 *Ibid.*, p. 21.

period when profits are lower. Its use presents several problems, notably from the standpoint of timing and equity. The time lag between the decision to increase or decrease the depreciation allowance and the decision by business firms to postpone or increase investment may be considerable. Also there would be discrimination in favor of business firms that acquired assets in a period immediately before a decrease in depreciation allowances is put into effect, and against firms whose assets are wearing out and have to be replaced during the period in which decreased depreciation allowances are in effect.

A direct tax on investment has also been used as an anti-inflationary device. It is a temporary tax on certain capital expenditures, in particular expenditures for machinery and equipment. The investment tax is an extra burden on the investments of business firms and may be placed in the category of taxation on expendiutres. The imposition of the tax on a business firm entails a worsening of its liquidity and its profit earnings capacity. The tax is tantamount to an increase in costs. Marginal, or less-profitable investment, will not be carried out. Dividend pay-out policies would be affected to the extent that a firm would have to secure a higher yield from its investment to maintain its dividends, or else reduce its dividends. The imposition of the tax will cause some investment to be postponed to a more desirable time.

A third temporary device is a stability surcharge (konjunkturaufschlag). This surcharge is levied primarily on middle and upper income earners and on corporations. For example, in May 1973 a stability surcharge of 10 percent was levied on the corporation income tax and on personal income taxes affecting all single persons with an annual income of at least DM24,000 ($10,000) and married persons with an annual income of at least DM48,000 ($20,000). The purpose of the surcharge was to deprive some private consumers, but particularly investors, of purchasing power and incentives to invest.

### AUTOMATIC STABILIZERS

Automatic stabilizers may be defined as provisions in the fiscal system which go into effect "automatically" rather than in the basis of discretionary action. The major tax stabilizers are the personal and corporate income taxes, excise taxes, and social security contributions. These stabilizers help restrain an economy during a period of inflation mainly by reducing the rate of an initial increase in aggregate demand. There is also a multiplier effect on the economy through further declines in expenditures for personal consumption. For example, an increase in income increases tax liability, after-tax incomes drop by more than if there were no increase in tax liability. Private expenditures also drop by more than if there were no increase in tax liability. The multiplier effect accomplishes more than the initial drop in incomes and expenditures.

### FISCAL POLICY DURING THE 1969–1970 BOOM

Initial application of the Stabilization Law occurred in 1967–1968 when the policy objective was to lift the economy out of a recession. Recovery was rapid and by v969 boom conditions had developed. Fiscal policy became more restrictive as a result of the recovery and corresponding pressures on prices. The 1969 expenditure plans of the federal government were reduced by about DM1.8 billion, while personal and corporate income taxes were hiked by an increase in the amount of prepayments.[8] The Business Cycle Council (Konjunkturrat) recommended that the federal and state governments set up a contracyclical reserve in accordance with the Stabilization Law.

During 1969 the Bundesrat approved the creation of a contracyclical reserve of DM3.6 billion. This had a restrictive impact on bank liquidity since the monetary base of the economy was reduced by the amount of the reserve. In addition, the treasury and other public authorities pursued a less liquid debt management policy. Short-term debt, primarily in the form of treasury bills, was reduced by about DM6 billion, and the amount of long-term debt was increased by almost DM4.5 billion.[9] A surplus was run in the budgets for all levels of government for 1969 compared to a deficit for 1968. Moreover, in the public sector as a whole, personal and corporation income taxes, which exercise an automatic stabilizer effect, increased by 11 percent over 1968, and total

[8] Institut Finanzen und Steuern, *Der Bundeshaushalt* (Bonn, 1970), p. 30.
[9] Deutscher Bundestag, *Jahresgutachten 1969* (Bonn :Drucksache V/3630) p. 12.

receipts increased by 16 percent.[10] Total public sector expenditures increased only by 9 percent, and public sector surplus, or savings, amounted to DM9.1 billion compared to a deficit of DM4.1 billion for 1968.

Despite moderately restrictive fiscal and debt management policies, the boom continued into 1970. In 1969 real gross national product rose by 11.5 percent. In spite of growing demand pressures, price increases remained moderate until mid-1969, after which they began to rise; the expansion of demand continued at a high rate into 1970. Inflationary tendencies in the economy were exacerbated by failure to revalue the deutsche mark prior to 1969. Fiscal policy measures in 1970 called for an original restriction in the federal budget to around 8.5 percent. The Business Cycle Council put into effect a further increase in the contracyclical reserve of DM2.5 billion. A tax reduction for wage and salary earners, originally set for the beginning of 1970 was postponed temporarily. For the public sector as a whole, total receipts were set to be in excess of expenditures by some DM14 billion, creating a surplus in the budgetary accounts.

By the middle of 1970, additional restrictive fiscal policy measures became necessary, and in May a reduction of DM2.1 billion in federal budgetary appropriations was made. In July measures designed to reduce the volume of consumption and investment expenditures also were introduced, and accelerated depreciation was suspended on investment goods ordered between July 5, 1970 and January 31, 1971. It was estimated that this curtailment resulted in a reduction of around DM4 billion in business gross fixed investment. A 10 percent surcharge on personal and corporate income taxes went into effect from August 1, 1970 to June 30, 1971.[11] It was estimated that the surcharge brought in an additional DM 2.4 billion increase in income tax revenues for the last five months of 1970, and DM 2.8 billion in revenues for the first half of 1971.[12]

## FISCAL POLICY 1971–1972

~~In 1971 a slowdown in productivity growth and a continued increase in the~~ price level contributed to a situation of "stagflation." The strong and prolonged upswing that followed the 1967 recession lost its momentum. A severe profit squeeze developed which weakened the boom in private investment. In part this squeeze was attributable to the 1969 revaluation of the deutsche mark, which resulted in a decrease in the growth of exports, and in part to a series of high wage settlements which occurred in 1969 an d 1970. In 1971 money gross national product increased by 9.5 percent, but real gross national product increased by only 3.0 percent.[13] The index of industrial production, particularly after mid-year, reflected a downturn in the level of economic activity. For the whole year, the quantity index went up 1.8 percent over the preceding year, while the price index of industrial production went up 5.0 percent.[14] The rise in the consumer price index was 5.8 percent. The surplus on the current account of the balance of payments disappeared in the second half of 1971, and there was a sharp outflow of short-term non-bank capital.

Fiscal policy measures in 1971 were initially designed to stimulate aggregate demand, particularly investment. Accelerated depreciation allowances were reintroduced in February. Budgetary plans of the federal, state, and local governments were designed to have a moderately expansionary effect. There was a modification of these plans in April 1971, when regulations were designed to block certain expenditures in the federal budget. After a decision to float the deutsche mark, fiscal policy measures were made more restrictive. In May a reduction in both federal and state expenditure authorizations occurred. However, a reversal in fiscal policy measures occurred during the latter part of 1971 as a decline in industrial production developed. The contracyclical reserves (Konjunkturausgleichsrucklage) were released to the state governments

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[10] Bundesministerium der Finanzen, *Finanzbericht, 1971* (Bonn: The Ministry, September, 1971), p. 21.

[11] Bundesministerium der Finanzen, Drei Jahr Neuer Finanzpolitik (Bonn: the Ministry, 1971), pp. 10–11.

[12] Bundesministerium der Finanzen, *Bundeshaushaltsplan fur das Haushaltsjahr 1971* (Bonn: the Ministry, March 1971), p. 3209.

[13] Deutsches Institut fur Wirtschaftsforschung, "Wochenbericht," Vol. 1, No. 2, West Berlin, January 7, 1972, pp. 2–4.

[14] Deutsche Bundesbank, "Monatsberichte der Deutschen Bundesbank, December 1971, appendix, p. 65.

for use on road construction. The amount was DM 700 million. The federal government released blocked appropriations also for road building programs in an effort to stimulate the construction industry.[15]

The year 1972 began with an economic upswing which was maintained during the year. This upswing was based primarily on an increase in consumer demand. This increase was facilitated by three economic policy measures which were as follows.[16]

1. There was repayment of the temporary 10 percent surcharge levied on personal and corporate income taxes during the period, August 1970 to June 1971. This increased consumer and corporate income by DM 5.7 billion.
2. There was a release of the public sector contracyclical reserves which amounted to DM 4 billion. The benefits to consumers came in the form of wages and salaries for construction work.
3. Recipients of social security pensions received in one lump-sum extra benefits that accrued as a result of advancing from the beginning of 1973 to mid-1972 the annual increase in social security expenditures.

However, there were some flaws in the 1972 economic upswing.[17] Consumer prices increased at a rate of 5.8 percent. The utilization of plant capacity was high, and the rate of unemployment was less than 1 percent, leaving few labor reserves. The margin for economic growth was small even at the start of the upswing; it was largely limited to an increase in the expansion and productivity of fixed capital. Labor cost per unit of output increased at a rate of 6 percent for the year. Export prices also increased during the latter part of 1972 as the revaluation of the deutsche mark toward the end of 1971 had made German goods more costly abroad. By the end of the year, the federal government revised its borrowing and spending estimates downward.

## FISCAL POLICY, 1973–1974

For German economic policymakers, 1973 was a year of struggle for price stability. At the beginning of the year, unrest in the international exchange markets threatened to jeopardize the success of domestic stabilization policies. Internally, an investment boom occurred which was fueled by increased demand from abroad. Available industrial capacity could no longer satisfy the expansion of demand. This caused a piling-up of orders, which, in turn, brought about price increases. In February 1973, the federal government decided on several stability measures which were designed to decrease the level of investment. It became necessary to expand these measures as the danger of inflation became more pronounced, so a second set of measures were adopted in May 1973. Both sets of measures can be summarized as follows: [18]

1. The federal government levied a stability surcharge of 10 percent on personal and corporate income taxes for a period of 12 months. At first, the stability surcharge was applied to only persons in the highest income groups—DM 100,000 (approximately $35,000) for single persons and DM 200,000 (approximately $70,000) for married persons. These amounts were drastically reduced in May to DM 24,000 for single persons and DM 48,000 for married. The purpose of the surcharge was to discourage investment.[19]
2. A temporary investment tax was introduced which in effect increased the cost of all capital projects by 11 percent. This investment tax was to last for a period of two years.
3. Special depreciation allowances and other investment incentives were suspended. In particular, diminishing balance depreciation on movable assets and residential buildings and special allowances given for regional development were suspended. Special tax incentives to encourage residential construction were discontinued. The deduction of debt interest for tax purposes was also suspended. The purpose of all these measures was to reduce the profitability of planned investment and thus encourage the deferment of new projects.

The results of the stability measures were mixed. Only the stability surcharge brought in considerable receipts—DM 1.6 billion in 1973 and an estimated

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[15] Specifically, the measure involved the unblocking of spending authorizations debiting future budgets.
[16] Deutsche Bundesbank, *Geschaftsbericht der Deutschen Bundesbank, 1972*, April 1972, p. 7.
[17] *Ibid.*, pp. 2–4.
[18] Bundesterium der Finanz *Chronik der Finanz und Wahrungspolitik 1973* (Bonn: The Ministry, 1974), p. 12.
[19] The federal government can also release or return the surcharge.

DM 2.4 billion in 1974.[20] In contrast, the investment tax yielded around DM 0.3 billion in 1973. The other measures designed to curb investment did not influence the cash position of German firms, given the time lag between the earning ofincome and the assessment of the income tax. Both the receipts from the stability surcharge and the investment tax were frozen in the Bundesbank.

The main weight of fiscal measures was on the receipts side of the federal budget. However, an attempt was also made to curb government spending. Planned federal spending on joint federal-state projects was cut by approximately DM 1.7 billion. In addition, the federal government blocked 5 percent of all expenditures appropriations, with the exception of those to which it was legally committed. In September, the federal government adopted the draft budget for 1974 and the Medium-Term Fiscal Plan for 1973–1977. The draft budget was set to increase by 10.5 percent over the 1973 budget.[21] The plan projected an increase in the federal budget at a rate of 9.5 percent a year through 1977—a rate commensurate with the projected average annual increase in money gross national product.

The oil crisis which began in October 1973 caused a termination of anti-inflationary fiscal policy. By the beginning of 1974 the price of crude oil imported into Germany was three times as high as at the beginning of 1973. Toward the end of the year the index of industrial production levelled off and the rate of unemployment started to increase. The mounting cost of crude oil caused the balance of payments current surplus to decrease. So in December 1973, the federal government suspended the use of the investment tax, reinstated accelerated depreciation allowances on machinery and other equipment ordered after November 30, 1973, and also reinstated special depreciation allowances for housing construction started after December 31, 1973. The stability surcharge was retained, but special credit programs were reinstated for the benefit of small and medium-sized business firms.[22] Public works programs were also planned as a precautionary measure. In early 1974 a special public works program of DM 1 billion was initiated in areas with above-average unemployment.

The performance of the German economy, ~~at least through September 1974,~~ was somewhat flat. The oil shortage, however, did not have as much of an adverse impact on the economy as was anticipated. It had been feared that any major cuts in delivery would soon lead to a decline in production and employment in those industries which are dependent on oil. Uncertainty as to future supplies of petroleum products led to a decline in the domestic sales of passenger cars. However, the supply situation of oil eased progressively as measures used by the federal government to conserve fuel proved to be somewhat successful. In July 1974 the stability surcharge was discontinued. Since the investment tax and stability surcharge were introduced in July 1973, a total of DM 4.1 billion was collected and deposited in special accounts. In the first half of 1974, the federal government had a comparatively small deficit of DM 0.8 billion in the budget, but compared with the same period of the previous year the cash position deteriorated by DM 2.2 billion.

## AN EVALUATION OF WEST GERMAN FISCAL POLICY

German fiscal policy measures are primarily used on the revenue side of the federal budget. Such measures as the investment tax and the stability surcharge are aimed mainly at correcting an undue expansion of private demand and less at curtailing government spending. Experience has shown that there are problems involved in manipulating the expenditure side of the budget. Expenditure plans which have been deferred in order to promote stability are hard to make good at a later date without doing harm to contracyclical fiscal policy, if—as in 1970 and 1971—the downswing is only brief and moderate and therefore leaves little scope for an expansion of government spending. On the expenditure side of the budget, only investments are capable of contracyclical manipulation; however, even here, persistent intervention in the investment sphere can damage long-term objectives in the development of the economy. Revenue measures, such as the use of additional taxes, are easier to dovetail with monetary policies operating in the same direction.

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[20] *Chronik der Finanz und Wahrungspolitik*, p. 13.

[21] *Ibid.*, p. 17.

[22] There are two special credit banks involved—The Reconstruction Loan Corporation, with capital provided from the federal and state governments, and the Equalization of Burdens Bank, which provides loans to small and medium-sized firms from funds made available from the European Recovery Program Fund.

There is a problem involving the use of variations in depreciation allowances and a tax on investments. The time lag between the decision to increase or decrease depreciation allowance, or to impose or discontinue the investment tax, and the decision by business firms to postpone or increase investment may be considerable. It is very difficult to quickly turn on or off the stream of capital expenditures, since investment decisions can only be translated into positive final action over long periods. Also a considerable hiatus exists between the points in time when the need to take action is recognized and actual execution of fiscal action is taken. Nevertheless, there is evidence that measures designed to effect changes in the level of investment were successful. For example, the 10 percent stability surcharge on personal and corporate income taxes and the 11 percent investment tav, both of which were imposed in February 1973, created a total reduction of aggregate demand of DM 11.1 billion—an amount equivalent to 1.25 percent of the German gross national product for 1973.[23]

No reference has been made to the impact of the income tax and other measures that are built into the operation of the German budget system. The main stabilizer should be the progressive income tax, with rates that vary from 19 to 53 percent. However, income is divided into two categories—income from wages and salaries, which is subject to a withholding tax, and income from self-employment and other sources, which is subject to tax assessment at the end of the tax year. Income taxes withheld weekly and monthly would provide the stabilizer effect, rising and falling with increases or decreases in gross national product and personal income.

Table 3 presents yearly changes in the volume of tax revenues and gross national product expressed on a percentage basis for the period 1966–1974. This period covers the 1966–1967 recession and the rapid recovery of 1968 and 1969, and the subsequent period of "stagflation" and eventual recovery. There is no clear-cut pattern as to the overall stabilization effect of the German tax system. When taxes are isolated as to types, personal and corporate income taxes generally exerted a stabilizing effect, with revenues increasing at a rate lower than the rate of gross national product during the 1966–1967 downswing. During the recovery and boom period 1968–1970 income taxes exerted no clear-cut stabilizing effect; moreover, during the period 1971–1974, the personal and corporate income taxes on occasion tended to be at cross purposes. In general, the income taxes exerted a stabilizing effect, increasing at a more rapid rate than gross national product. The other major German tax, the value-added tax, if anything, tended to counterbalance the stability effect of the personal income tax by generally increasing at a lower rate than increases in gross national product. The value-added tax was introduced in 1968, replacing the turnover tax.

The social security system of Germany also tends to act as an automatic stabilizer as pensions paid under government schemes are adjusted to wage adjustments with a considerable time lag. Social security taxes account for around one-third of government revenues from all tax sources—a high ratio in comparison with other countries. That part of social security payroll taxes that is levied on employees is very much like an income tax. The effect is that of an addition to withholding under the personal income tax. The rate is high (9 percent in 1974) on a ceiling which is also high (DM 2,200 in 1974) and is well above average monthly earnings.[24] Social security contributions have increased at a higher rate than both gross national product and personal income for the period 1969–1974. Surpluses have been maintained in the social security accounts which are kept separately from regular federal revenues.

It is necessary to reemphasize the fact that the use of fiscal policy as an anticyclical weapon was very rudimentary in Germany up to 1967. In fact, the role of fiscal policy under Soziale Marktwiertschaft was completely downplayed. In 1967 an economic stabilization law was passed to privide the government with a number of Keynesian fiscal policy instruments in order to attain an overall equilibrium of stable prices, full employment, and a stable trade balance—an equilibrium that has proved most difficult to achieve. Most fiscal policy instruments are on the tax side of the federal budget as opposed to the expenditure side. There has been some reluctance to use deficits and surplus in the budget as an anticyclical weapon. There is still some political adherence

[23] Deutsches Institute fur Wirtschaftsforschung, "Der offentliche Haushalt 1974–75," *Wochenbericht*, September 5, 1974, p. 316.

[24] Both the rate and the ceiling have been subject to frequent changes.

TABLE 3.—PERCENTAGE COMPARISONS OF YEARLY CHANGES IN GROSS NATIONAL PRODUCT AND MAJOR GERMAN TAXES, 1967–74

| Year | Gross national product [1] | Wage tax [2] | Income tax [2] | Corporate income tax | Value added tax |
|---|---|---|---|---|---|
| 1967 | 1.0 | 2.6 | −1.8 | −8.2 | −1.8 |
| 1968 | 9.0 | 12.9 | 3.1 | 21.1 | −15.1 |
| 1969 | 12.1 | 22.5 | 4.4 | 27.4 | 35.2 |
| 1970 | 13.3 | 29.7 | −5.8 | −20.0 | 1.4 |
| 1971 | 10.9 | 22.0 | 14.6 | −17.8 | 15.2 |
| 1972 | 9.2 | 16.3 | 26.2 | 18.5 | 10.6 |
| 1973 | 11.6 | 23.1 | 14.3 | 28.2 | 2.3 |
| 1974 | 9.4 | 20.0 | 5.9 | 1.0 | 2.5 |

[1] Money gross national product.
[2] As mentioned previously, the personal income tax falls into 2 categories—the tax on wages and salaries (Lohnsteuer) which is withheld at the source, and the tax on self-employed persons (Einkommensteuer) which is paid at the end of the tax year.

Source: Bundesministerium der Finanzen, Finanzbericht 1975 (Bonn, The Ministry, August 1974), pp. 37, 39, and 170.

of public to traditional budget-balancing principles. Although the Stabilization Law increased the power of the federal government to influence the fiscal behavior of state and local governments, consent of the Bundesrat which consists of representatives of the state governments is required on many matters. State and local governments still determine their expenditures independently of the federal government unless the latter, with the consent of the Bundesrat, invokes special contingency clauses of the Stabilization Law.

During the period 1969–1974, total federal, state, and local government expenditures have exceeded revenues in all but one year, 1969.[25] As for the federal budget, a surplus was run in only 1970.[26] This excess of expenditures over revenues can be attributed to several factors. For one thing, the demand for public services has tended to accelerate, helped along by increases in tax revenues. Local government capital investment, which accounts for the bulk of public capital investment, in particular has increased. Local governments are subject to local political pressures and are far removed from federal control in Bonn. Many local governments have operated their budgets close to stipulated debt ceilings. State government regulation of local governments' debt policies limit the extent to which debt servicing may absorb local revenues. This means that local governments' borrowing capacity is effectively determined by debt servicing/current revenue ratios- Typically, local government expenditures on construction have been down during a recession and up during inflation. For all levels of government there appears to have been a lagged adjustment of public expenditures to cyclical changes in revenue.

German contracyclical fiscal policy operates under certain constraints. Annual budget bills usually do not include proposals for tax changes. The Stabilization Law does give the federal government discretionary power to raise or lower personal and corporate income taxes by up to 10 percent. However, this power has not been utilized. The basic reason is political. So a repayable 10 percent surcharge on personal and corporate income taxes has been used on two occasions. The blocking of tax revenues in contracyclical reserves has also been used. Manipulation of depreciation allowances has been one of the most commonly used fiscal instruments; however, there is always the problem of timing. The federal government has also "speeded up" advance payments of personal and corporate income taxes. A tax on investment has also been used. On the expenditure side, cuts have been made. For example, in 1969 the federal government reduced expenditures on public consumption and investment by DM 1.8 billion. The federal government has also attempted to keep the growth of spending consonant with increases in nominal gross national product.

SUMMARY OF WEST GERMAN FISCAL MEASURES

Table 4 presents a summary of the more important fiscal policy measures used by West Germany during the 1969–1974 period. Listed in the table are the volume of revenues derived from the use of such fiscal instruments as the

[25] Bundesministerium der Finanzen, Finanzbericht 1975 (Bonn: The Ministry, August 1974), p. 41.
[26] *Ibid.*, p. 43.

stability surcharge, which was a 10 percent surcharge levied on personal and corporate income taxes, and the investment tax. It is also necessary to point out the shared relations that exist between the federal government and the state governments in the field of taxes. For example, all income taxes are shared between the federal and state governments, with the states serving as the collection agencies. This share is not a fixed percentage, but varies at the discretion of the federal government, with the approval of the Bundesrat. The basic reason for this arrangement is to give the federal government more leverage in the use of fiscal policy It is also necessary to mention the fact that the business cycle reserves (Konjunkturausgleichsrucklage) are frozen accounts at the Bundesbank to be used only in a serious downturn in economic activity. There are also specific release conditions attached to all of the other stability measures, with the exception of the stability loan (Stabilitatsanleihe).

TABLE 4.—AMOUNTS COLLECTED THROUGH VARIOUS FISCAL POLICY MEASURES FOR THE FEDERAL AND STATE GOVERNMENTS (1969-74)

| Instruments | Amounts collected in millions of DM | | | | | |
|---|---|---|---|---|---|---|
| | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 |
| Federal: | | | | | | |
| Cyclical reserve 1970 | | 1,500 | | | | |
| Cyclical reserve 1971 | | | 1,000 | | | |
| Stability surcharge | | | | | 718 | 845 |
| Investment tax | | | | | 221 | 378 |
| Stability loan | | | | | 2,500 | |
| Freezing of tax yields | | | | | [1] 610 | [1] 610 |
| Total | | 1,500 | 1,000 | | 4,049 | 663 |
| State: | | | | | | |
| Cyclical reserve 1969 | 436 | | | | | |
| Cyclical reserve 1970 | | 1,000 | | | | |
| Cyclical reserve 1971 | | | [2] 195 | [2] −195 | | |
| Stability surcharge | | | | | 878 | 1,105 |
| Investment tax | | | | | 114 | 222 |
| Freezing of tax yields | | | | | [3] 80 | [3] −80 |
| Total | 436 | 1,000 | 195 | −195 | 1,072 | 1,247 |
| Federal and State total | 436 | 2,500 | 1,195 | −195 | 5,121 | 1,910 |

[1] Dissolved in April 1974.
[2] Dissolved in April 1972.
[3] Dissolved in February and July 1974.

Source: Bundesministerium der Finanzen, "Konjunkturelle Rucklagen von Bund und Landern," Sept. 17, 1974.

## CHAPTER 3—MONETARY POLICY IN WEST GERMANY

### INFLATION AND MONETARY POLICY

There is no unique economic policy that will serve to stabilize the price level. It would be convenient if the behavior of the general price level could be attributed in some simple manner to changes in the supply of money, for control of the price level would be simple in principle. The price level could be prevented from rising by appropriate regulation of the quantity of money without affecting the level of employment. Similarly, appropriate monetary policies to control inflation would be more self-evident if a rising general price level originated solely from an imbalance between the level of aggregate demand and the productive capacity of the economy. The issue in principle is again clear, for if prices were increasing, this would imply that demand was outstripping the rate of increase of production, and by use of the gamut of conventional monetary and fiscal controls demand should be reduced until balance between aggregate demand and aggregate supply is restored.

If an economy is characterized primarily by a downward rigidity in the prices of goods and labor, the removal of excess demand does not guarantee the removal of inflation. The avoidance of excess demand does not guarantee that wages will be not pushed up too rapidly in relation to the requirement for price stability. If demand restriction is pushed far enough, there is no doubt that a point will be reached at which deflationary pressure will become sufficiently great to check the rise in wages and prices, but only at the cost of unemployment. However, the problem is that both elements of cost-push and demand-pull inflation exist, so that the actual rate of inflation in West Germany and other countries is a composite of monetary demand and cost factors. It is not appropriate to restrict attention to either alone from the point of view of policy prescription. Prices will rise if excess monetary demand exists but they can also rise if it does not. Thus, it is also necessary to pay attention to the need to alter the cost generating structure of an economy by some interference with the pricing mechanism.

Monetary policy works primarily through controls exercised over the supply of money. In an advanced economy, such as West Germany, this basically means control over the volume of bank lending. The objective in controlling the money supply, including bank lending, is indirectly to control spending. More specifically, control over the money supply will be reflected in changes in interest rates, which, in turn, will have an impact on spending. The brunt of this impact will be borne by investment expenditure, as neither the consumption or investment component of aggregate demand is readily linked to the rate of interest.

MONETARY POLICY

The Bundesbank has recourse to the standard instruments of monetary policy (control over the rediscount rate, control over minimum reserve requirements, and open-market operations) to accomplish stabilization objectives. Its influence on credit, however, has been obviated considerably during most of the postwar period through the existence of several factors that have been present in the German economy. For one thing, the interest elasticity of investment has been low, reflecting a strong investment demand, and interest rate changes via the rediscount rate have had little effect. Furthermore. German banks have also possessed considerable excess liquidity during the postwar period and have not had to resort to rediscounting commercial paper to any significant extent. The existence of an export surplus has provided the foreign exchange to enhance the liquidity of the banking system. High interest rates have attracted foreign accounts that in turn have increased bank liquidity, thereby circumventing attempts at effective discount policy.

The effectiveness of monetary policy has also been subverted in that savings of households are channeled into savings deposits at savings banks, building and loan shares, and insurance companies. Most personal savings flow through these investment channels, but only a part of them flow into capital investments. This has meant that central-bank monetary policy has had little influence over the flow of savings, for the reason that the institutions receiving them do not channel them into the capital market.

During the 1960s prosperity within Germany has been accompanied by an inflow of capital from abroad. When the Bundesbank gave first priority to restraining the boom at home by using a tight money policy, the balance-of-payments problem was exacerbated through the attraction of more liquid funds from abroad. In Mach 1961 West Germany revalued the mark by 4.7 percent. This caused a large movement of capital out of the country, and an overall deficit of DM 1.9 billion appeared in the balance of payments. The rediscount rate during this period was set at 3 percent. Trade with inflationary foreign countries, however, led to rising prices at home and caused payment surpluses to accumulate. In 1964 the Bundesbank introduced a variety of measures to discourage the inflow of foreign capital and to stimulate the outflow of German capital and later that year used minimum reserves and rediscount quotas to restrict internal liquidity.

From 1965 to early 1966 the balance-of-payments surplus disappeared. Internal prices increased, and the Bundesbank raised the rediscount rate from 3 to 5 percent.[1] Then the growth rate began to drop as the momentum that had propelled the economy forward began to decline, and a recession occurred during the latter part of 1966. The Erhard government was replaced by a coalition of two major political parties. This coalition brought into office men, such as Econòmics Minister Karl Schiller, who were disposed toward dropping the free market economic doctrine of former Chancellor Erhard and adopting a more Keynesian policy of deficit spending and other fiscal measures. The Law Pro-

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[1] Deutsche Bundesbank. *Geschaftsbericht der Deutschen Bundesbank fur das Jahr 1967* (Frankfurt am Main), pp. 7–11.

moting Stability and Growth of the Economy, passed in 1967, provided the federal government with a number of Keynesian fiscal policy instruments.

In 1967 the Bundesbank pursued a policy of monetary ease that brought the rediscount rate down from 4.5 percent to 3 percent and released a total of DM 1.6 billion through reductions in the minimum reserve requirements of commercial banks.[2] After a considerable amount of the resultant increased bank liquidity was diverted into increased exports of capital, the Bundesbank entered the foreign-exchange markets with measures designed to inhibit the outflow of funds and preserve sufficient liquidity in the domestic money market. An interplay of fiscal and monetary policies measures also developed with the creation of special investment budgets and other fiscal measures.

In 1968 the rediscount rate remained at 3 percent for the entire year, and minimum reserve requirements were lowered. Despite a greatly increased supply of capital the interest rate level did not drop as much as expected because of tendnecies to rising interest rates on international capital markets. The interest rate differential made the West German capital market very attractive to foreign borrowers. Long-term capital exports did not suffice to offset the foreign-exchange inflow originating in trasactions and short-term capital movements. Short-term capital imports resulted primarily from the reduction of banks' foreign assets and from the deposit of foreign money in German banks as a result of the speculation about a revaluation of the Deutsche Mark. The Bundesbank counteracted this inflow by offering foreign-exchange guarantees at costs far below the market rates.

MONETARY POLICY DURING THE 1969–1970 BOOM

During 1969 the Bundesbank pursued a generally restrictive monetary policy.[3] The discount rate was raised three times. In April the rate was raised from 3 to 4 percent, and the advance rate was raised from 4 to 5 percent. In June the Bundesbank's discount rate was raised from 4 to 5 percent, and the advance rate from 5 to 6 percent. In August special advance rates of 7 and 8 percent were introduced to counteract increased resort to advances. In September the Bundesbank's discount rate was raised from 5 to 6 percent and the advance rate from 6 to 7.5 percent. Special advance rates were abolished. In December the advance rate was raised from 7.5 to 9 percent. In addition, rediscount quotas based on banks' liabilities and differentiated according to the type of lending institution were used. In April 1969 rediscount quotas were reduced by 20 percent for most banks.

Reserve requirements were also altered several times during 1969. In May the minimum reserve ratios for domestic liabilities were raised by 15 percent, and those for external liabilities by 50 percent. This had the effect of decreasing the free liquid reserves of the banks by roughly DM 2.5 billion. In July the minimum reserve ratio was increased by 10 percent, with a resulting decrease in banks' liquid reserves of DM 1.6 billion. Moreover, a 100 percent reserve was placed on all additions to external liabilities. In November the 100 percent reserve requirement was abolished, and reserve ratios for foreign liabilities were brought into line with those for domestic liabilities. During the year minimum reserve requirements were increased by DM 4 billion.

Over the whole of 1969 bank liquidity was reduced by DM 17.9 billion. The free liquid reserves of banks were reduced from DM 37.7 billion at the end of 1968 to DM 19.8 billion at the end of 1969. The greatest reduction was in the banks' rediscount margin at the Bundesbank; unused rediscount quotas decreased by DM 7.9 billion. The financial transactions of the federal and state governments resulted in a contraction of bank liquidity by DM 5 billion. To some extent this was attributable to federal government expenditure cuts decided on for reasons of anticyclical policy. Bank liquidity was reduced through the use of measures designed to reduce the amount of short-term debt. Liquidity was also reduced by the cyclical rise in the circulation of notes and coins, which was mainly due to the growth in personal income.

The most important monetary development of 1969, however, was the revaluation of the Deutsch Mark. In October the federal government fixed the new gold parity of the Deutsche Mark at a level corresponding to a dollar parity of

[2] Deutsche Bundesbank, Geschäftsbericht der Deutschen Bundesbank fur das Jahr 1968 (Frankfurt am Main), pp. 5–7.

[3] Deutsche Bundesbank, *Geschaftsbericht der Deutschen Bundesbank fur das Jahr 1969* (Frankfurt am Main), pp. 3–4. All 1969 data is taken from this annual report.

DM 3.66 instead of the former DM 4.00. The domestic result of revaluation was that bank liquidity was reduced. The loss of funds immediately after revaluation was due primarily to the return of speculative money—i.e., to the outflow of short-term funds that had been sent from other countries to banks and other institutions in Germany before revaluation. So that German banks would not be exposed to the full force of the externally induced liquidity outflow, the Bundesbank lowered their minimum legal reserve requirements by 10 percent in November.

In 1970 the Bundesbank took further measures to dampen down the level of economic activity in the West German economy.[4] It became apparent in early 1970 that the revaluation of the Deutsche Mark was not strong enough to contain inflationary pressures that had developed. In the fourth quarter of 1969, the cost of living index increased by 3.1 percent, compared to 2.7 percent for the full year. In the first quarter of 1970, the cost of living index increased by 3.5 percent. In March 1970 the Bundesbank raised its discount rate from 6 percent to a postwar record of 7.5 percent and introduced additional minimum reserve requirements on banks' foreign liabilities. The purpose was to decrease excess demand by exerting a restrictive impact on private fixed investment and to deter the banks from borrowing abroad, thereby keeping bank liquidity tight.

In addition, the Bundesbank attempted to counteract the inflows of bank liquidity by means of open-market operations. This reduced free liquid reserves only to the extent that long-term debt in the form of public authority bonds from the Bundesbanks' portfolio was sold, and short-term debt was passed on to nonbank institutions. Altogether, just under DM 2.5 billion of liquid reserves was withdrawn from the banks in 1970 by open-market transactions in long-term debt securities, and by selling short-term commercial paper to nonbank institutions.

Between July 1970 and March 1971 the discount rate was lowered four times.[5] With interest rates declining in other countries, it became increasingly difficult to maintain a high level of domestic rates. The Bundesbank felt that differences in interest rates would cause an inflow of funds into Germany and would be detrimental to the pursuit of restrictive domestic monetary policy. In July the discount rate was reduced from 7.5 to 7 percent, and the advance rate from 9.5 to 9 percent. In November the discount rate was lowered to 6.5 percent. There was no internal relation of monetary policy measures, however. Minimum legal reserve requirements were increased in August and November. In December the discount rate was lowered from 6.5 to 6 percent, and the advance rate from 8 to 7.5 percent. In March 1971 the discount rate was reduced to 5 percent and the advance rate to 6.5 percent. There was also a 10 percent reduction in minimum reserve requirements. During the latter part of 1971 there was an increase in the total volume of bank credit. Consumer expenditures on goods and services increased, whereas investment expenditures showed a decline over the first half of 1971.[6] Monetary policy had to contend with a less than buoyant economy in which inflation existed along with a general downturn in the level of economic activity. The index of industrial production in the investment goods industries increased 2.2 percent in July, decreased 7 percent in August, and decreased 0.6 percent in September.[7] Preliminary estimates indicated a decrease for October.

### MONETARY POLICY DURING THE 1971-1972 "STAGFLATION" PERIOD

Bundesbank monetary policy had to contend with a less than buoyant economy troubled by inflation and a general downturn in the level of economic activity. Moreover, monetary policy had to run into external pressures. Although German interest rates declined, they lagged behind the fall in international rates, so that the differentials actually tended to increase. This led to an inflow of short-term capital imports as the business sector took advantage of lower external interest rates. The foreign exchange that entered Germany in 1970—DM 20.2 billion—was the largest amount ever recorded in a single year. This was attributable to two factors—money imports of the banking system and external bor-

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[4] Deutsche Bundesbank, *Geschaftsbericht der Deutschen Bundesbank fur das Jahr 1970* (Frankfurt am Main), pp. 3–14. All 1970 data is taken from this annual report.
[5] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank* (Frankfurt am Main, April 1971), p. 3.
[6] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank* (Frankfurt am Main, November 1971), Appendix, p. 44.
[7] *Suddeutsche Zeitung* (Munich), December 13, 1971, p. 14.

rowing of nonbank institutions. As a result, the free liquid reserves of the German banking system increased from DM 19.8 billion at the end of 1969 to DM 25.4 billion by the end of 1970.[8] The great bulk of the increase took place during the fourth quarter of 1970.

In 1971 the pattern was continued. From January to March internal bank liquidity declined by DM 8 billion,[9] but this decline was more than counterbalanced by an inflow of foreign funds to the extent of DM 22 billion and was transferred into rising internal prices. In using discount rates to combat inflation, the Bundesbank had succeeded in attracting additional capital from abroad. In the period June through December 1971 domestic liquidity declined by DM 7 billion, while there was also a turnabout in the flow of foreign capital.[10] On balance there was an outflow of DM 12 billion during the last seven months of 1971. Overall for 1971 there was a net gain in bank liquidity of DM 2 billion. The growth of money supply began to slow down around the middle of the year, reflecting an outflow of short-term funds and, to a lesser extent, renewed credit restraint.

The year 1972 marked the second consecutive year of relatively moderate growth, with a strong economic upswing occurring toward the end of the year. There were no significant surpluses in the current account of the balance of payments. On the other hand, capital transactions with foreign countries continued to cause problems. Large and speculative foreign exchange inflows at times forced the Bundesbank to make massive supportive purchases on the exchange market, thereby leading to an inflation of the domestic money circulation. Private consumption expanded during the first half of 1972, reflecting union demands for higher wages in the organized sector of the economy, and refunding of part of the contracyclical surcharge which had been frozen in the Bundesbank. However, capital investment on the part of enterprises contributed little to the general upswing, increasing 2 percent over 1971.

Bundesbank policy in 1972 was geared to the aim of achieving price stability, although external factors created problems.[11] Monetary policy was caught between conflicting domestic and external objectives. Given the price rises, the appropriate course was to apply internal monetary constraints. However, large inflows of foreign exchange during the first part of 1972, following the currency alignment, dictated that domestic policy take second place to the protection of the exchange rate. The expansion of the money supply resulting from money inflows from abroad had to be curbed. The purpose of the Bundesbank's monetary policy was to prevent interest-rate induced capital inflows. In addition, the Bundesbank had to try to neutralize the increase in the banking system's liquidity caused by the exchange inflows to ensure at least that there were no undesirable secondary effects. Minimum reserve requirements for domestic liabilities were raised 20 percent in July and 10 percent in August, and minimum reserve requirements on banks' external liabilities were also made more stringent.[12] Rediscount quotas were cut by 10 percent in February and June. The discount and Lombard rates, which had been reduced in February to 3 and 4 percent respectively were raised to 4.5 and 6 percent by November, when it became apparent that a deliberate policy of low interest rates did not prevent speculative inflows of foreign funds.[13]

In the latter part of 1972 the Bundesbank was able to adopt a more restrictive stance in domestic policy. When interest rate differentials between Germany and other countries were reversed in the business sector, priority was given to increasing the domestic rate level. As mentioned above, the discount and Lombard rates were raised. However, the demand for credit increased in response to the upswing that had developed in the construction industry and in the export sectors of the economy. However, the upswing did not have the latitude

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[8] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank*, October 1971, p. 7.

[9] *Ibid.*, p. 5.

[10] *Süddeutsche Zeitung* (Munich), December 13, 1971, p. 14.

[11] For example, in June 1973 a monetary crisis centering on the pound sterling developed. The Bundesbank had to spend DM 5.3 billion to support the pound, and the sterling rate was floated. Currency unrest also spread to the U. S. dollar, so that the Bundesbank had to take in substantial quantities of dollars. The foreign currency exchanges were closed from June 23 to June 27.

[12] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank*, August, 1972, p. 5.

[13] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank*, November 1972, p. 3.

of previous cyclical upswings in that it developed from a comparatively high level of resource utilization. Industry was operating at 90 percent of capacity and the rate of unemployment was low. The rise in the cost of living continued to be a problem.

MONETARY POLICY, 1973-1974

During 1972 monetary policy had generally resolved the problem of inflows of foreign exchange even though interest rates in Germany were low in comparison to rates in other countries. Measures designed to restrict capital movements were successful, and it was possible for the Bundesbank to introduce a more restrictive domestic monetary policy during the second half of 1972. The money supply rose by only 7.5 percent between August 1972 and January 1973 compared to 17.5 percent between January 1, 1972 and August 1972.[14] However, in January and early February of 1973 the international monetary situation deteriorated rapidly, and the Bundesbank was exposed to a massive influx of foreign exchange which was set in motion by a lack of confidence in the U.S. dollar. Within seven business days the Bundesbank had to purchase foreign exchange equivalent to DM 18.5 billion in order to support the rate of the dollar.[15] It was important to neutralize with credit policy instruments the expansive effects the inflow of foreign exchange was having on bank liquidity.

The influx of foreign funds led to a sharp increase in the liquidity of business and industry. However, prior to the influx, the Bundesbank, by its restrictive policy, had reduced banks' free reserves, i.e., the excess balances plus the liquid assets that can be converted into central bank money, to a very low level. By means of further restrictive measures in February and March, the Bundesbank was able to neutralize in a comparatively short time the rise in bank liquidity resulting from the transfer of the incoming foreign exchange from non-banks via banks to the Bundesbank. Minimum reserve ratios were raised to almost 100 percent on the increase in banks' external balances and rediscount quotas were ~~made stringent.[16] These and other measures resulted in the banks' free reserves~~ contracting to near zero in the spring of 1973.

An essential precondition for effective monetary policy was created when the Bundesbank was released from the obligation to intervene in favor of the U.S. dollar.[17] For a start, the Deutsche Mark was revalued by 3 percent in March. Releasing the Bundesbank from the obligation to intervene against the dollar and later on against the French franc, reduced the importation of inflation via inflows of money from abroad and thus paved the way for a stability-oriented monetary policy. Combating internal inflation then became the prime desideratum of Bundesbank policy. In May the Bundesbank raised the discount rate to 6 percent and the Lombard rate to 8 percent. At the same time, the federal government introduced its stability program, leaving a 10 percent surcharge on income taxes on all persons with an annual income of at least DM 24,000 (single) and DM 48,000 (married), an 11 percent investment tax, and suspension of accelerated depreciation for movable assets and buildings. Monetary policy was given direct support by the stability program in that these additional tax funds were frozen in the Bundesbank. In addition, DM 700 million of general tax revenues were placed by the federal and state governments with the Bundesbank to be frozen.

However, even under flexible exchange rates, the Bundesbank was not able to avoid entirely the problem of imported inflation as inflationary tendencies are transmitted not only through the liquidity mechanism but also through prices. However, the repercussions of the world-wide inflation on prices in Germany were much smaller—at least up to the oil crisis—than they would have been without the revaluation of the Deutsche Mark. This was particularly true with respect to imports, with unit values increasing by only 3 percent up to the

[14] Money supply, or money stock represents currency and sight deposits. There is a more broadly defined money stock, which includes time deposits for up to four years.

[15] Deutsche Bundesbank, *Monatsberichte der Deutschen Bundesbank*, March 1973, p. 2.

[16] Deutsche Bundesbank, *Geschaftsbericht der Deutschen Bundesbank fur das Jahr 1973*, p. 31.

[17] This step was taken in March 1973 by all industrial countries which had been adhering to fixed exchange rates against the dollar. The exchange rates were allowed to float. At the same time, the European Economic Community countries, excluding the United Kingdom, Italy, and Ireland, along with Norway and Sweden, agreed to let the exchange rates of their currencies fluctuate in relation to each other within a narrow margin only.

oil crisis.[18] The consumer cost of living index increased by 6.9 percent for the year compared to 11.7 percent for Japan, 9.2 percent for the United Kingdom, 10.8 percent for Italy, and an average of 8.7 percent for all countries in the European Economic Community.[19]

Nevertheless, the objective of moderating the upswing in prices was not achieved; in fact, at the end of 1973 the growth rate of most price indices was higher than at the beginning of the year. The production output curve levelled off and the rate of unemployment increased. A decline in demand for automobiles and the slackening of activity in the construction industry created fears of an economic setback. Pessimism and uncertainty were created as a result of the oil crisis. Although the impact of the crisis was far less than was anticipated, the price situation in Germany deteriorated in 1974. The main cause of price increases in industry were cost pressures derived from a rise in the price of imported raw materials, in particular crude oil. Wage increases averaging 12 to 14 percent over the preceding year also contributed to the price increases. Enterprises were not able to offset these higher costs by increasing productivity, or through absorption in profit margins. In the period 1969 to 1974, the profit ratio of the average German enterprise had declined from 5.5 percent of turnover to 4 percent. So enterprises came under increased compulsion to raise prices.

German monetary and fiscal policy in the first nine months of 1974 had to pursue a course, which, on the one hand, limited the scope for price and cost increases, and on the other, selectively counteracted any decline in employment. The latter proved to be somewhat of a problem, as by September 1974, the rate of unemployment in Germany increased to 2.6 percent—the highest rate since the recession of 1967. However, the basic course of the Bundesbank was pretty much determined before 1974 began, with priority given to the achievement of control over the domestic price level. By keeping central bank money tight, thus stimulating a rise in interest rates, the Bundesbank had managed at least during 1973 to restrict monetary expansion to an extent that made it more difficult for business firms to pass on to consumers increases in prices and costs. During the first half of 1974 the growth of money aggregates was relatively small. For example, the money supply between December 31, 1973 and July 1, 1974, increased at an annual rate, with allowances for seasonal adjustments, of 5.5 percent.[20]

However, the price stability-unemployment dilemna presented a recurring problem. The relative success of monetary and fiscal policy in at least stabilizing internal prices was counterbalanced to some extent by an increase in the rate of unemployment. The solution to this problem was largely fiscal. In February 1974 the federal government decided on a special DM 600 million expenditure program for areas with unemployment rates above the national average. This program was financed from blocked funds in the Bundesbank derived from increases in the gasoline tax in 1973.[21] These funds were to be spent on projects to create jobs in the construction industry. A second expenditure of DM 300 million occurred in June as unemployment continued to rise. Additional expenditures were announced in September 1974 and are to amount to DM 950 million.[22] Part of the expenditure is to be on the German railway system and another part on increases in defense orders. Major expenditures are to be made in the states of North-Rhine-Westphalia and Bavaria.

Brief mention should be made of debt management policy. In June 1974 the debt of the federal government was DM 61.4 billion (approximately $22 billion).[23] The debt was diffused into a wide variety of debt instruments, most of which do not readily lend themselves to manipulation for debt management purposes. A part of the debt is locked into funds for special purposes, such as social insurance, and another part is that issued by various government companies such as Ruhr Coal and Saarbergwerke. The debt actually related to the credit market amounted to DM 43.3 billion. Of this total, the most liquid debt, the

[18] Deutsches Institute fur Wirtschaftsforschung, "Grundlinien der Wirtschaftsentwicklung 1974," *Wochenbericht*, Berlin, December 20, 1973, p. 468.
[19] *Ibid.*, p. 36.
[20] Deutsches Bundesbank, *Monatsberichte der Deutschen Bundesbank*, August 1974, p. 3.
[21] Institute Finanzen und Steuern, *Zur Verbesserung des konjunkturpolitischen Instrumentariums* (Bonn: The Institute, November 1974), pp. 27–29.
[22] *Ibid.*, p. 36.
[23] Bundesministerium der Finanzen, "Verschuldung der Bundesrepublik," Bonn, August 1974, p. 1.

Treasury bill, amounted to DM 1.9 billion.[24] Another part of the debt consists of the so-called "stability bond" sold to the public as an antiinflationary measure. The proceeds from the sale of this type of bond have been frozen at the Bundesbank.

### SUMMARY

The purpose of this chapter has been to summarize the goals of German monetary policy during an inflationary period, 1969–1974. Probably the most important problem confronting monetary policy has been the danger of imported inflation. Effective monetary management has been hindered by an increase in foreign exchange reserves originating from balance-of-payments surpluses largely out of control of the Bundesbank. Bank liquidity and especially money holdings outside of the banking system have been abundant, primarily as a result of these large inflows from abroad. These freely entering foreign currencies have served to inflate the money supply in Germany, which, in turn, has resulted in higher prices as availability of money induces consumers to buy and businesses to invest. The external surplus of foreign currencies has been translated into liquid reserves for the banks. Thus, it has been incumbent upon the Bundesbank to affect the liquidity ratio, i.e., the ratio between total deposits and the free liquid reserves of the banks. Bundesbank measures, specifically changes in the rate of interest, minimum reserve requirements, and rediscount quotas have been designed to influence the propensity of banks to hold free liquid reserves and to lend to domestic nonbanks.

## CHAPTER 4—CONCLUSIONS

The Law for Promoting Stability and Growth of the Economy (Stabilization Law) is the most important economic measure taken in West Germany since the Currency Reform of 1948 and the introduction of the social market economy. It provides the federal government with a number of fiscal policy instruments; it links the three levels of government budgeting more closely together; and it has brought greater coherence into the formulation of the federal budget. The federal government must plan its budgets for periods of five years and must prepare an investment program with a priority scale. State and local governments, which in the past had been practically and legally free from federal interference in budget matters, are now required to prepare long-range budgets, particularly for investment projects, and discuss them with federal authorities. A Council for Anti-Cyclical Policy was created by the Stabilization Law to bring together representatives of all levels of government and the Bundesbank. It has the right to be consulted over the restriction of credit and over payments into and out of the cyclical reserve fund.

The two most innovative and important parts of the Stabilization Law involve the use of business cycle reserves and medium-term fiscal planning. An anticyclical reserve fund has been established at the Bundesbank, and the federal government as well as the states are required during boom periods to make deposits of up to 3 percent of their tax revenues of the previous year into the fund. Apart from this, increased revenue caused by anticyclical raising of the personal and corporate income taxes is automatically paid into the fund. Money in the fund can only be used for anticyclical expenditures. Medium-term fiscal planning aims at regulating federal spending. Any rise in federal expenditures, other than for repayment of debt, is supposed to correspond roughly to the rate at which gross national product is rising during the period of the plan. If the economic equilibrium is in danger, the federal government must counteract this danger by bringing about a change in receipts and expenditures and hence, in deficits. If, for example, the economy and consequently revenue grows more rapidly than planned, the additional revenue would not be used to meet expenditures but to reduce net borrowing.

West Germany has also used several temporary tax measures to regulate the level of economic activity. These measures have merit in that they are selective rather than general, and thus can be applied to a certain sector of the economy that is out of balance with other sectors. For example, the federal government in December 1974 adopted measures to stimulate capital investment, which was one of the weakest points of economic activity. To stimulate the propensity to invest on the part of business firms, new investment bonuses were introduced,

[24] *Ibid.*, p. 3.

as a general reflationary measure for a limited period, but also for an unlimited period in the special case of the promotion of energy-conserving investments. The major investment bonus was an investment credit of up to 7.5 percent of the cost of new depreciable fixed assets which is directly deductible from the personal or corporate income taxes. At times a direct tax on investment has been used to discourage investment, and a stability surcharge has been levied on both personal and corporate incomes. Depreciation allowances have also been used as an anticyclical device.

It is hard to translate the German experience with anticyclical fiscal and monetary policies in terms of practical application to the United States. The performance of the West German economy with respect to the inflation-unemployment dilemna has been superior to that of the United States. The unemployment rate in West Germany in 1973 was one-third of the rate for the United States; in 1974 and in early 1975 the rate for Germany was less than half the American rate. It appears that the Germans are able to maintain a lower inflation-unemployment trade-off than the United States. But the Germans are helped by a very stable labor force caused by war losses and a low birth rate, by social security measures that encourage early retirement from the labor market, and a cushion of foreign workers who are often the first to be laid off.

Some general conclusions are in order. It is apparent that there is more of a willingness on the part of the German government to accept some unemployment as a cost of curbing inflation than is true in most other major industrial countries. To some extent this willingness has been reflected in the leadership of Chancellor Willy Brandt, but more particularly in the current leadership of Chancelor Helmut Schmidt. The feeling has been expressed by both Schmidt and his policy advisers that price stability is the basic desideratum of economic policy, and if achieved, full employment and economic growth will follow. Some success has been achieved in stabilizing prices, unemployment has increased, particularly since the fall of 1974, and the Social Democrats have lost some state elections which have turned on the issue of economic policy. Nevertheless, the government has remained committed to a goal of price stability.

However, it can be added that the Germans have much more latitude in the trade-off between inflation and unemployment than is true in the United States. It is much easier to implement anti-inflationary measures when the unemployment rate is 2 percent rather than 7 percent. In February 1975, the number of unemployed persons in West Germany amounted to 3.7 percent of the total labor force, and 5.1 percent of wage and salary earners, the highest rates in 20 years. Some of the unemployment is attributable to a decline in the level of construction activity, and some to a decline in exports of German products. The impact of unemployment is cushioned to some extent by liberal unemployment compensation which permits a worker to receive unemployment benefits of up to 90 percent of his regular wage or salary for a period of a year. Moreover, the brunt of unemployment has been carried by foreign workers who represent one-tenth of all wage and salary earners, but who also represent around 40 percent of the unemployed. From September 1974 to December 1974, the number of unemployed workers increased by 389,000; of this total 170,000 were foreign workers.

What the Germans apear to have done reasonably well is to coordinate monetary and fiscal policies. Monetary policy has been directed more toward achieving general price stability, while fiscal policy has been used on a much more selective basis. It has been the task of fiscal policy to counteract excessive inflationary or recessionary trends in some sectors of the economy by selective measures. For example, when the oil crisis of late 1973 made it necessary to modify the planned course of economic policy, fiscal policy measures adopted in the spring of 1973 to curb investment were suspended. Thus the investment tax was abolished and both the diminishing balance depreciation on plant and equipment and special depreciation allowances were readmitted; only the stability surcharge on personal and corporate income taxes continued to be levied up to mid-1974. It was further decided to expedite the placing of orders provided for in the federal budget and to make available additional funds for publicly supported residential construction.

The Stabilization Law provides the federal government the authority to initiate concerted action (konzertierte Aktion) with representatives of management and labor. When ever price or wage increases endanger economic stability, the federal government invites business and union representatives to a conference, presents the facts, and sometimes is successful at arriving at a common judgment. The dialogue between labor, management, and the federal government is not limited to just wages and prices; it also includes much broader issues, such as the federal budget. The dialogue has some merit in that it has improved the labor-management climate in German economic life, but it has not necessarily held wages in check, for wages have increased at an average annual rate of 12 percent since 1970. This fact can not be attributed to aggressive union activity; three-fourths of the German labor force do not belong to unions.

Chairman HUMPHREY. Thank you, gentlemen. The committee stands recessed.

[Whereupon, at 11:50 a.m., the committee recessed, to reconvene at 10 a.m., Thursday, July 31, 1975.]

# MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

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**THURSDAY, JULY 31, 1975**

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey and Proxmire; and Representative Long.

Also present: John R. Stark, executive director: John R. Karlik, Loughlin F. McHugh, Courtenay M. Slater, Lucy A. Falcone, Robert D. Hamrin, and Jerry J. Jasinowski, professional staff members; M. Catherine Miller, minority economist; and Michael J. Runde, administrative assistant.

## OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. Gentlemen, we will proceed this morning.

As I have indicated to you personally, let me say for the record I apologize for the lack of attendance here. Our colleagues, as you can see, are at a mandatory quorum.

I am most grateful to all three of you for coming. We are attempting to round out the testimony that will relate to our midyear economic review. We have with us a very distinguished panel of experts on financial markets and monetary policy. No question is more critical to this country's economic health during the next year than the question of monetary policy.

A great deal of time has been given in the current Congress to discussing budget policy and the energy policy. Today we will review military procurement and other items. Those are vital and important questions.

But it is my judgment that we should not forget that monetary policy is equally important to our budgetary and fiscal policy. The availability of credit can make or break what is at present a fragile and a hesitant economic recovery.

I noted this morning, however, that the reports on construction are encouraging. There seems to be some movement. Most forecasts, indeed, I believe all of the private forecasts which have recently been presented to this committee assumed that the money supply would grow more rapidly than the 5 to 7½ percent range which the Federal



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Reserve has announced as its target. Even with that, their predictions are for only a moderate or a sluggish recovery, rather than the strong rebound needed to bring unemployment down more rapidly.

Recent analysis by the Congressional Budget Office indicates that a 10 percent growth of the monetary supply rather than 7 percent could add $25 billion to real output by the end of next year, and reduce the unemployment rate by 0.6 percent. I must say that is still a very small amount. The public has a hard time understanding why it takes so long to get an unemployment rate down when it did not take long to get it up.

I do not wish to place too much emphasis on any one single variable. Monetary policy is a highly flexible tool. The monetary growth target can, and I hope will be, adjusted as is necessary.

But, what concerns me far more than any particular quantitative target is the degree of commitment of the Federal Reserve System to a strong and sustained economic recovery.

Recently, the Federal Reserve Board has acted to tighten monetary policy and push up interest rates. I am not the only one who feels that this was a premature action. Private witnesses appearing at these hearings last week and yesterday shared my concern. So did many others.

I found a very interesting editorial in the latest issue of Business Week. It read as follows: "The first faint signs of economic recovery seem to have thrown the Federal Reserve into another fit of anxiety about future inflation. It is not even certain yet that an uptrend has begun. but the money managers are swinging back toward tight credit as though they were dealing with a roaring boom."

"In its present, hesitant stage, the recovery needs nurturing. It needs ample credit at moderate rates, and it needs some assurance that policy will not change abruptly in the near future. The erratic, stop-go course the Fed has been following could easily abort the upturn and give the country a 'double-dip' recession."

Gentlemen, I think if I had made that statement that I would have had a rash of editorials across the country accusing me of monetary and fiscal irresponsibility. This is Business Week speaking, a good, solid, and I want to say a middle-of-the-road or a conservative business publication.

I will place the complete editorial from the August 4 issue of the Business Week in the record at this point, and I also want to place in the record at this point the article in this morning's Washington Post by Mr. Hobart Rowen entitled "The Myth of the Federal Deficit."

[The above-mentioned material follows:]

[Editorial from Business Week, Aug. 4, 1975]

CLAMPING DOWN TOO SOON

The first faint signs of economic recovery seem to have thrown the Federal Reserve into another fit of anxiety about future inflation. It is not even certain yet that an uptrend has begun, but the money managers are swinging back toward tight credit as though they were dealing with a roaring boom.

This week the Fed sold Treasury bills out of its portfolio, a heavy-handed move designed to push interest rates up and shrink the bank reserves that are the basis of the nation's money supply. As a result, bank lending rates went up, with New York's First National City Bank leading the way to a 7½% prime rate.

This is a dangerously high rate for an economy just turning the corner of the worst recession in nearly four decades. Loan demand is still soft. Home-building, which usually leads the economy out of a slump, is still flat on its back. Capital spending is lagging. Money should be cheap; instead, it is so dear that borrowers already worry about the possibility of another credit crunch before yearend.

The Fed can point out that earlier this year the money supply was growing considerably faster than the 5% to 7½% target it has set for the 12 months ending in March, 1976. Slow growth is necessary now to bring the average into line with the goal.

But the basic duty of the Fed is to promote the economic health of the nation, not to make the statisticians happy. The 5% to 7½% growth rate was probably too low to begin with. If the economy needs faster growth to finance recovery, there can be no excuse for treating the old numbers as though they were graven on stone.

In its present, hesitant stage, the recovery needs nurturing. It needs ample credit at moderate rates, and it needs some assurance that policy will not change abruptly in the near future. The erratic, stop-go course the Fed has been following could easily abort the upturn and give the country a "double-dip" recession.

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**[From the Washington Post, July 31, 1975]**

## THE MYTH OF THE FEDERAL DEFICIT

(By Hobart Rowen)

Nothing worries Congress as much as the size of the federal budget deficits. It doesn't matter whether he's a Republican or a Democrat, the average congressman gets sweaty palms when Treasury Secretary William E. Simon rolls out a boxcar number like $88 billion as a possibility for the next fiscal year.

Why? He knows that he is going to get mail from his constituents raising hell about government spending and the consequent threat of inflation.

Take Rep. George Mahon, chairman of the House Appropriations Committee, a reasonable, responsible conservative Democrat. At a session sponsored by the Democratic caucus to hear a critique of Fordonomics, Mahon had this to say to former Economic Council Chairman Walter W. Heller:

"I find people I talk to in and out of Washington, in and out of Texas, are wondering where this country is headed. How long can we go on with the debt now at $534 billion? It is going on up toward $600 billion and upward to $1 trillion.

'That doesn't worry some economists, I am sure, but it worries the average guy because he is not an economist and he can't understand the economists because the economists don't agree with each other.

". . . many people think we are going down the drain as a result of our insatiable desire to spend and spend and spend and spend."

Heller and Gardner Ackley, another former Chairman of the CEA under Democratic Presidents, laid out a fairly standard liberal response:

First, in relation to the total output of the country, federal expenditures have not risen: in 1954, federal spending was 19.4 percent of the GNP. Twenty years later, in 1974, federal spending was only 19.2 percent.

Second, coming down to what is happening at the moment, the federal deficit is almost totally the product of recession; about $50 billion in lost tax revenue is the result of reduced activity, to which $20 billion in unemployment compensation and related recession expenditures must be added.

In fact, Heller said, a budget deficit in the vicinity of $69 billion—the ceiling set up by Congress—"is a next-to-no stimulus budget. It cushions, but it does not propel."

Heller wants to boost the deficit by an extension of the tax cut into next year, a provision for temporary job-creating programs, and additional tax cuts to offset the loss of purchasing power caused by any new boosts in oil prices.

That's enough red ink to give Bill Simon a heart attack. Like Federal Reserve Chairman Arthur Burns, Simon is warning of a renewed threat of inflation, even though unemployment remains close to 9 per cent, and industry is operating at only three-fourths capacity levels.

Heller, along with economists Otto Eckstein and Frank Schiff, argue that this ultra-conservative approach is the "worst enemy" of basic conservative doctrine.

The super-caution represented by the Ford-Simon-Burns philosophy—symbolized by tight money and a tight fiscal policy—caused the recession, caused the current huge deficit, and will cause a new recession if allowed to continue, they say.

It is difficult to contest the liberals' argument that the second Nixon recession, which started 18 months ago, stems from the fiscal and monetary "overkill" of 1973 and 1974.

Despite the general impression of excessive federal spending, actual outlays in real terms adjusted for inflation have declined since late 1972—a fact that Eckstein first brought out during last year's summit.

But prior to 1972—which not coincidentally was a pre-election period—the Nixon administration was pouring excessive fuel into an economy already moving ahead. We had a boom, and then the bust with its whopping deficit. But the spending didn't cause the deficit. Recession caused the deficit. And mistaken government policy caused the recession.

Nevertheless, as Mahon suggests (and the liberal economists will concede in private), if you run an explanation of this deficit up the flagpole in Peoria, no one will salute.

"Not many members of Congress can go back to their constituents and say, 'We are not spending enough federal money; we need to increase the deficit.'" Mahon warned the economists "He would get a cool reception in most places in Middle America."

Mahon is right. As President Kennedy discovered at Yale in 1962, the cliche that "deficits automatically bring inflation" is too solidly embeded in American political thinking.

Chairman HUMPHREY. We have today three witnesses, Mr. Robert Bethke, president of the Discount Corporation of New York, Robert Eisner, chairman of the Department of Economics at Northwestern University, and, Mr. Sherman Maisel, former member of the Federal Reserve Board of Governors and now a professor with the the University of California at Berkeley. It goes without saying that each of you gentlemen possess a wealth of experience and expertise, and I am very pleased and grateful that you have taken the time to come here and share your thoughts with us.

I believe we will begin with Mr. Bethke and then move along to Mr. Maisel and Mr. Eisner, and after that we will have some questions.

You have received the general sense of direction that we want you to pursue, I gather, from our letter of communication.

## STATEMENT OF ROBERT H. BETHKE, PRESIDENT, DISCOUNT CORPORATION OF NEW YORK

Mr. BETHKE. Thank you very much. Yes, indeed.

Chairman HUMPHREY. Thank you very much.

Mr. BETHKE. Well, Mr. Chairman, as an officer of a major firm that specializes and deals in prime money and bond market instruments, I welcome this opportunity to discuss with your distinguished committee the beliefs, worries, and hopes of market participants—as they specifically relate to monetary policy, debt management, and economic recovery.

Clearly, we are all here today seeking actions that will assure a sustained rise in business, further cuts in inflation, more jobs, better facilities, and renewed faith in our country.

As a market practitioner, I would remind you that whenever people buy or sell anything—be it Treasury securities, shirts, autos, commodities, or services—three big forces affect their appraisal of values and appetite:

One: the availability of money and credit—which means Federal Reserve policy.

Two: shifts in relative supply—scarcity, or surplus—which means Treasury debt management and deficit financing policy, to money and bond markets.

Three: expectations of the future—which relate to actions of the Congress, administrative leadership, and the moods of people—both here and abroad.

My views on these points are based on many, ongoing, daily discussions and transactions by our corporation with lenders, investors, other dealers, and the Fed's' open market desk. I am not speaking for any particular special interest. I think you know, as we do, that the markets perform a function that is important to the well-being of our country.

For perspective, you should realize that every day the needs of this vast country result in buying and selling in the Treasury and Federal agency securities marketplace, alone, that averages $4.5 billion. In volume of transactions, the Treasury and the agencies markets alone are four times the value of all of the stocks traded on the New York Exchange each day.

Now, I want to make some observations on Federal Reserve policy. First, in preparation for today's hearing, over the past 2 weeks I took a widespread poll of leading market participants on how they view monetary policy actions so far in 1975. Not surprisingly, they give Federal Reserve officials unbelievably high marks. I concur in this judgment.

History will commend the system for persistently easing money through May, when the sliding general business and money supply were worrisome. Equally appropriate is the recent slight firming of monetary policy—a skillful adjustment to emerging signs of economic recovery and a spurt in the monetary aggregates.

Market people would also report to you that there seems to be a tremendous new dedication in the Federal Reserve System to handle monetary policy in ways that will nurture a sound, noninflationary recovery. It is refreshing to observe this nonpartisan approach.

Encouraging, too, are impressions that Fed officials, and many leaders of the Congress, seem to be probing harder for the right answers; you are certainly communicating better. All this increases the odds for prudent action. This all is sound for markets.

While you, and we in markets, know that the Fed is constantly adjusting policies to keep money growth on the right path, officials also are monitoring interest rate reactions and general credit conditions. So far in 1975 their first priority has been "money supply," which obviously is paramount over the long haul. Failure to discipline the growth rate of money will give rebirth to double-digit inflation. In turn, both short- and long-term interest rates would increase sharply. As a result, sooner than any would believe or hope, economic recovery would be stalled.

Even though right now one hears few cries of high interest rates, I believe that come this November or December there may be sincere concerns about rising interest costs. By then, or early 1976, you, Fed officials, and market people may well be worrying about the rate impact of a scenario that goes like this: Sizable real growth in GNP, accompanied by renewed demand for bank loans, higher fuel, food and other commodity prices, approach of new wage contract negotiations, and continuing fiscal stimulus.

Turning to more technical aspects of monetary policy actions, I have four observations:

One: the recently announced shift by the Fed of the base for next year's growth in money supply to the second quarter of 1975—rather than the month of March 1975—gives the System a little more room and flexibility on the upside—a change I suspect you welcome, for the present.

Two: the Fed's open market desk seems to be frequently varying the rate level where it intervenes to put, or take out, reserves. This finer tuned, nonmechanistic action must be aimed at assuring a more precise weekly average cost of Federal funds, which in the marketplace is pure money. Such action will tend to make yield changes on short-term prime money market issues more volatile. But, it is the nature and job of marketmen to learn how to live with, and to smooth out, volatility.

Three: even with the finest tuning—because of leads and lags, and free choices open to holders of money as to how they invest or deposit funds—history, let alone logic, says that the Fed will frequently miss its shortrun money supply growth targets. This is not catastrophic. Rather, it is why Fed policy and market tone must constantly be counteradjusted.

Four, certainly you are aware that in the past 7 months the Fed has bought many more notes and bonds—instead of short Treasury bills—when it has had reason to supply permanent reserves. As a result, note and longer bond yields are now slightly lower than they would have been otherwise. Likewise, there have been fewer technical overhangs of supply in longer maturity areas. Finally, the System's buying has made better receptions possible for huge Treasury debt extension offerings.

I would like to next turn to some observations about the Federal budget and debt management policies.

In the wisdom of the President and the Congress, the deficit put in place for fiscal 1976 seemed necessary and appropriate. Now, however, many citizens worry that, even with first evidence of business recovery, congressional actions still seem bent on increasing the deficit more. Unfortunately, budget spending is not something that can easily be turned down.

From a financing viewpoint, even a $60-billion deficit means that the Treasury has to borrow an average of over $1 billion a week of new money. I might add, in the fall of the year, or the last 6 months of 1975, because seasonal tax receipts are lower, the Treasury will be borrowing an average of $2 billion new money a week. Because Treasury debt is quadruple "A" in quality and appeal, that pace of new financing is heavy competition for funds that might otherwise be invested in equities, corporate, State and city debt, and mortgages.

Even in the past year, under a most skillfull debt management team, Treasury debt maturing within 2 years or shorter, has risen $50 billion. This has happened in spite of Treasury actions that have pushed debt extension offerings to the edge of market practicality. Should this increase in the volume of outstanding short-term Treasury debt continue, a potentially explosive stockpile of investments will exist—which could easily be converted to cash to buy goods, should inflationary expectations arise anew.

Thus, steps to continue to extend the debt must continue. The Treasury has no choice but to continue to tap all maturity areas, and to minimize reliance on short-term Treasury bills. If the Treasury is stymied in this effort, a distasteful market truth will emerge: That the shorter the Treasury finances, the shorter term will managers of bond portfolios want to stay, because they know general rate increases would soon occur.

Recent accolades to sound debt management have been possible because investors have been enticed to extend by an upward sloping yield curve—which means simply that the further out one invests in Treasury bill's, the higher are yields. Such a yield curve must be maintained.

Furthermore, so far in 1975 the largest amounts of deficit offerings have been bought by domestic banks—as a replacement for declining loan volume—and by foreigners who have accumulated dollars—largely oil-producing nations.

Soon, as the economy recovers, banks may no longer be in a position to eagerly buy Treasury issues. Rather, their resources will be called upon to extend credit to business and consumers. This suggests that quite soon, the continuing deficit will have to be financed by new techniques and new categories of buyers, to get this deficit financing job done.

Now, I would like to make a few comments on "crowding out." What are the facts?

In common useage, "crowding out" suggests that sizable Government deficit financing will usurp and displace private credit needs. While this is close to target, it is also true that markets are always crowding out somebody. This comes about partly by shifts in quality preferences. You will recall the shunning by investors of new "hot" stock offerings after 1969, when such stocks fell flat—and the difficulties of marginal businesses getting loans in 1974—and the financing problems right now of matured cities. "Crowding out" also occurs whenever expectations of inflation increase, as is expressed by the recent tendency of some pension fund officials to prefer 10 year bonds, rather than 25 year issues.

For you congressional leaders, and debt managers, "crowding out" is a corollary of bigger than necessary deficits. Since the Treasury has no choice but to extend its debt, it competes with private sector borrowers. The sheer size of Treasury offerings lifts interest rates higher than they would be otherwise. In turn, higher rates particularly inhibit the financing of housing, utilities, and emerging businesses. Obviously, in the months ahead the Government's built-in deficit will have to be financed along with rising private sector credit needs. This makes some of us worry that the Treasury's deficit financing will soon elbow out, push around, and fill-in spots that other borrowers will wish they had. To me, crowding out is not just talk—it may soon become a big fact of life.

Now, some recommendations for action.

Taking into account the principles and trends reported above, my recommendations are:

One: that your committee encourage communication, cooperation, and flexibility in relationships with the Federal Reserve Board. Do not cast their feet in cement by insisting on rigid, mechanistic money supply actions. Changing economic facts of life require adaptation. I think you will find that they will be as quick to meet these situations, as you are to sense them.

Two: that you promote consideration of extending Reserve System authority on reserves to nonmember financial institutions of deposits.

Three: that you keep up the fight against inflationary actions by special interest groups—and there are plenty of them.

Four: that you monitor and keep on top of the weaker aspects of private credit, such as REIT's, mature cities, tanker loans, airlines, and others. Any sizable problems in this area could inhibit economic recovery.

Five: that you hold back on additional deficit spending, until there is more conclusive evidence that additional fiscal stimulus is required.

Six: that you support Treasury efforts to finance the debt outside the banking system, thereby minimizing monetization of the deficit. To do this, my seventh recommendation follows.

Seven: that you vote to renew Treasury authority to issue prudent amounts of bonds with 10 year and longer maturities. The current authority has almost been used up.

Eight: that you vote to change the maximum maturity of a Treasury note from 7 years to 10 years, to give more flexibility to debt managers.

Nine: that you encourage legislation to permit the Treasury to earn interest directly on temporary surplus cash operating balances, rather than forcing the Treasury, as is true today, to do this by moving balances in and out of its account in the Federal Reserve.

Ten: that you support changes in tax policy that will encourage new facilities in plant and equipment, with an aim to providing more jobs, increase supply of goods, more energy, and less inflation.

Eleven: that you explore whether rent control—there is a strong trend in this direction—usury interest rate ceilings are inhibiting the construction of new multifamily housing.

In my statement to you and your committee, Mr. Chairman, I have purposefully not used a lot of supporting statistics. You and your staff know all the numbers well, as do market people. Judgments are made on how data are interpreted.

Gentlemen, this concludes my observations and recommendations. I stand ready to respond to questions.

Thank you.

Chairman HUMPHREY. We will certainly come back to you for questions, because those recommendations, I would say, some are provocative in some instances, and a subject for discussion and debate.

The next witness is Mr. Sherman Maisel of the University of California at Berkeley and co-director of the National Bureau of Economic Research, West.

## STATEMENT OF SHERMAN J. MAISEL, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY, AND CODIRECTOR, NATIONAL BUREAU OF ECONOMIC RESEARCH, WEST

Mr. MAISEL. Thank you, Mr. Chairman.

I am pleased to have this oportunity of testifying before the Joint Economic Committee at a period when the entire basis upon which this committee was formed—the idea that we can and should have an economy with optimum levels of growth, output, jobs, and prices—is being sharply questioned.

If I may, I would like to summarize my views expressed in my more complete prepared statement, which I will present for the record.

Chairman HUMPHREY. Yes, we will accept and welcome your full prepared statement, and it will be printed as a part our testimony at the end of your oral statement.

Mr. MAISEL. They will differ somewhat with Mr. Bethke's recommendations. I agree with the majority, but not all of his recommendations by any means.

In my view, we will see a sharp recovery this fiscal year although one not as strong in real terms as the average of postwar recoveries.

A more critical question is what rate of growth will exist in the economy for the 1977 and 1978 fiscal years. Will we have a weak ~~expansion, excess employment, and large losses in output as in the~~ 1930's, or will we meet the goals of the Employment Act of 1946? Current policies appear somewhat harmful for this longer period.

What role does monetary and credit policy have to play in achieving the desired expansion? We must first recognize that there is still a severe shortage of bank liquidity. While our capacity to produce goods and services has expanded by 8 or 9 percent in the past 2 years, the money in real terms available for the transactions necessary to produce such an output has fallen by a similar amount. The level of total reserves in the Federal Reserve System, which had expanded at an average 6.5 percent annual rate over the past 15 years, has barely changed over the past year. It is well below the level reached 6 months ago.

Long-term interest rates remain not far from and in a few cases above their previous highs.

A growth rate of 7 to 9 percent per year in real output will be a minimum to meet the Nation's goals. Some seem to believe that such a rate is too rapid. They seem to feel that a long period of relatively high unemployment is necessary if price increases are to be slowed. Policymakers must pick a proper tradeoff between unemployment, lost output, and price changes. While, as with any choice, this one contains uncertainties and risks, I believe that as a minimum you should shoot for reaching full employment by the start of 1979. Such a rate of growth will not have much adverse effect on prices.

Basically, although the statement is somewhat strong, I agree with what Secretary Dunlop was reported to have testified here a week ago: "Unemployment does not have any serious moderating effect on wage or price levels." We will still have too high a rate of inflation but it will not result from too much demand. It will occur because of the noncompetitive features of our economy.

Furthermore, such a rate of real increase in real output need not exceed the capital market's ability to finance growth. The fear of "crowding out" and inadequate money has been greatly weakened. With proper policies, it need not return.

I do not believe current monetary policy is likely to abort this year's recovery. Inventories simply cannot be runoff for long periods. The end of negative inventory investment will give a sharp boost to the economy. The tax rebate and tax cut are raising consumption. Housing will make a partial recovery.

However, if adequate liquidity is not forthcoming, interest rates will rise still more and future investment will suffer. This year's recovery will be somewhat reduced and future expansion will suffer even more.

What monetary growth should be adequate to finance a desirable level of output? I do not feel that an increase in the monetary aggregates summarized by a 5 to 7½ percent growth in $M_1$ is likely to be sufficient this year. This money must support both the hoped for growth in real output and also those price increases which occur from the supply side. For example, it would be poor policy to force a cutback in production and jobs by failing to furnish sufficient liquidity if national policy decrees a rapid increase in energy prices or if there is a rapid increase in grain prices. How to pay for an energy program and who should pay for higher grain prices should be decided by Congressional action and legislation, not by monetary policy. In other words, it seems to me clear that that is a national decision and that if we decide that as a result of policy we will have higher energy prices, the money for those additional energy expenditures should be furnished, they should not come at the expense of employment elsewhere in the system.

We will not get the expansion we need and want if we fail to take into account in policymaking the key role of interest rates. While difficult, with proper monetary and fiscal policies we can have interest rates stabilized at rates considerably below those now prevailing. To do so requires furnishing a more adequate level of liquidity and better fiscal policy.

More critical for an adequate expansion is reducing the uncertainty which arises from recent excessive uses of monetary policy to hold down demand. While effective, monetary policy is an extremely inefficient technique to obtain the results we all desire. We should rely far more on an adequate flexible fiscal policy in the future.

We have now built-in large risks in long-term lending. Interest rates low enough to support the high level of required capital investment will be possible only with a reduction in these risks and an adequate supply of reserves.

It has been suggested artificial tax concessions be legislated to aid capital investment. I believe it would be far better to use our normal market mechanism under which capital investments increase as interest rates fall. A policy based on a lower level of interest rates has the added advantage of making Government surpluses more likely when they become desirable.

While a policy based on low interest rates is most preferable, it will not be easy to obtain. The range within which market rates can be influenced is not large. Holding rates down will require that as we approach full employment, we reduce excess demand through Government surpluses rather than tight money. This will be in complete contrast to the past 10 years. Many people believe that a shift in our policies is impossible. I believe we can and must make the necessary changes. Unless we do, the cost in lost jobs, lost output, and gross inquities will be extremely high.

Thank you, Mr. Chairman.

Chairman HUMPHREY. I thank you very much. And is this the prepared statement that you wish to have embodied in the record?

Mr. MAISEL. Yes, sir.

Chairman HUMPHREY. Thank you. It will be placed in the record at this point.

[The prepared statement of Mr. Maisel follows:]

PREPARED STATEMENT OF SHERMAN J. MAISEL

The United States is starting to recover from the longest and deepest recession in the post-war period. Financial developments and monetary policy have a major role to play in assuring that the coming expansion is adequate to meet our country's goals.

Let me summarize my current views:

1. We are starting on the path to recovery. For the next year, it will be quite rapid. Recent monetary policy, if maintained, will have a somewhat, but not a large, curtailing effect on output in this fiscal year.

2. Current policies carry greater threats of a weaker expansion, larger losses of output, and greater unemployment in the following year. They are also more likely to lead to a reduced level of investment and capacity. Reaching an adequate rate of expansion will be far more probable if interest rates are low enough to insure necessary investments. For interest rates to decrease and not shot back up, monetary reserves must expand in step with increases in the GNP, and our budget and tax system must be reformed so that it will produce surpluses as we approach the full employment level. Fighting inflation and insuring a proper growth of output is possible if we succeed in finding a monetary policy which can achieve stable interest rates and, in combining it with a flexible fiscal policy that engineers, through government surpluses, considerable savings at full employment.

3. Changing good policies now, as at most times, is not simple. There are no easy answers. Every policy contains grave risks. Policy makers must decide what risks they are willing to run of adding to price increases in order to get more output and more jobs. However, in considering alternatives, it is important to recognize that policy decisions are concerned with incremental changes from the existing situation. Neither inflation nor high unemployment will end this year or next. The problem is to find policies which will increase output and jobs with minimal additional pressures on prices.

Two possible monetary policies can be compared. In one, the level of money and credit is restricted somewhat below that required for a 7 to 9 percent a year growth in real output. In the second, sufficient reserves are furnished for such an expansion. The critical question is what difference will the alternative policies make by 1979 or 1980 in the price level, in the amount of goods produced, and in the number of jobs. No one knows; we have only informed guesses.

The difference in output and jobs will be considerable. The difference in price levels is far less obvious. Those who believe that inflation can only be halted by large exceses of capacity and unemployment will favor the restrictive monetary policy. Those who believe that demand has little price effect if excess capacity remains ample, and that increased investment and capital have a depressing effect on prices, will support the opposite.

It seems to me that with the existing slack in the economy, monetary policy is being unduly restrictive. It threatens a slow-down in the rate of expansion of output and jobs. It should be more responsive to the needs of the economy for adequate liquidity. Great progress is possible if we can substitute more stable and lower interest rates for existing policies which create rapidly fluctuating rates around higher average levels.

### THE INITIAL RECOVERY

My projection for this fiscal year—assuming that adequate money and credit are available and that the tax reduction is maintained—is for a very rapid rate of expansion in current dollar GNP. Even so, the rate of expansion in real output will not be as large on average as in the first year of other post-war expansions. As a result, the decrease in unemployment will be small and we will be wasting or failing to produce well over $20 billion per year in output.

What is the relationship of this forecast to money and credit? It assumes that inventory investment rises to norma levels, that residential construction exands rapidly, and that consumers spend a somewhat larger share of their increased income. All such forces are likely to be reduced if uncertainties arise in the money and credit sphere.

It could note that if past relationships hold, this expansion would require a 10 percent increase in the money supply ($M_1$). But I hesitate to do so since I believe that too much attention is being paid to $M_1$ and particularly to minor wiggles in it that have but slight connections to economic reality. Monetary operations seem to be ordered because of small estimated movements in $M_1$. It is not obvious what is gained by following unimportant short-term changes in $M_1$. They tend to increase long-term interest rates and cause a growing lack of confidence in our finacial markets. (I would not be surprised to find that recent operations were triggered by an inexact seasonal adjustment.)

I would prefer to emphasize what has *not* been happening: to long-term interest rates, to monetary reserves, and to the real money supply ($M_1$ corrected for changes in the price level). Long-term interest rates are very close to where they were at their highs a year ago. The real money supply is about at the level reached at the end of 1974, which was 9 percent below mid-1973. While our capacity to produce goods and services has expanded by 8 to 9 percent in the past two years, the money available for the transactions necessary to produce such an output has fallen by a similar amount. (It is the real money supply which enters into most monetary theories.) The level of total reserves, which had expanded annually on the average by 6.5 percent over the past fifteen years, has barely changed over the past year. It is well below the level reached six months ago.

All of these facts are related. Even as the private sector has fought to build liquidity, monetary policy has sharply curtailed the flow of resrves. Participants in financial markets seem to believe that the government has opted for a regime of continued high interest rates and have reacted accordingly. If existing policies are maintained, it would tend to hold the expansion down below my current expectations. It would lower the probable level of investment and would adversely affect consumers' expectations and their willingness to spend.

### FURTHER EXPANSION

The outcome for this coming year is not to dependent on policy. Because the inventory run-off wil not continue at recent rates, and housing starts will not stay at their current depressed levels, and because of the tax cut, the recession will end and the recovery start. The problem for policy is to buill a base now for a strong further expansion. More than half of the expected recovery this fiscal year will be sparked by those factors related to the upward turning point. The problem is to insure that other forces take their place as they lose their forward momentum. This year's monetary and fiscal policies will leave their major impact on spending and output in later years.

It is always difficult to see in advance the forces which will take the place of those losing their thrust. That is why expansions tend to be underestimated. We can be certain, however, that a satisfactory expansion will not occur unless we improve our monetary and fiscal policies. We will need an expansion in both investment and consumption.

What is needed is a recognition that the nation's goals require an annual growth in real output of 7 to 9 percent for a minimum of four years. This will not raise total demand beyond capacity. Nor, with adequate investment in particular industries, will it create specific shortages and problems. Unfortunately, however, even though such demand will not be excessive, sizable inflationary price increases will persist as a result of the non-competitive structure of our economy.

Future expansion at a desirable rate is already threatened by lack of confidence. Most worrisome are statements of the type carried in *Business Week* two weeks ago that the Prudential Insurance Co., because of fear of higher interest rates and inflation, had failed to commit about 30 percent of its 1976 anticipated cash flow, plus all of that for 1977, and was keeping its purchases of assets to as short-term as possible.

Such views are not untypical of many businesses and investors. They fear for the future. This is a disastrous result of the fluctuating policies of the past several years. At current interest rates, demand is curtailed; yet a majority of lenders fear to make long-term commitments because they assume rates will rise again. There is a large short-fall of demand below potential output; yet prices are still rising rapidly.

Except for fear, we would not expect our current outlook to be so unfortunate. Several months ago it appeared that rates were being held up by talk of highly-placed officials of the danger of "crowding out." So far, the crowding out effect has not occurred. We have had no shortage of funds, even with banks contributing little or nothing to the demand for loans and investments. The market has absorbed a record level of corporate bonds and government debt without difficulty. The situation is what one would expect in a recession, except for the fact that long-term rates have not followed short-term rates down.

Why is this so? One probable explanation is the existence of a residual effect from the past statements. Crowding out did not appear to be a problem that the government wanted to avoid, but rather a policy that was looked upon as desirable. Iw we assume that government policy-makers believe higher long-term rates are necessary to hold down spending, output, and price increases, then the long-term market is dangerous. Logical investors will avoid it. They will return only if convinced that policies can and will stabilize future rates. This is why a clear shift to a policy which will utilize fiscal surpluses and not high interest rates is so vital.

Since a strong economic recovery, after the initial turn, depends on increased capital investment in plant, equipment, and housing, it is unlikely to be adequate if long-term rates remain high. We will need a change in the expectations of long-term lenders. In addition, we will need increased lending by commercial banks. They, in turn, will need more reserves. If inadequate reserves are forthcoming to finance the desirable increase in the GNP, the market will reach equilibrium through higher interest rates, disintermediation, and a fall in demand. This would be poor policy.

I might note parenthetically that another critical policy choice which needs analysis is how to obtain a desired level of capital formation. I believe that it would be far better to use our normal market mechanism under which capital investments increase as interest rates fall, rather than to legislate artificial tax concessions. A policy based on a lower level of interest rates has the added advantage in that it increases the likelihood that the tax system will create surpluses when they become desirable as we come closer to full employment.

I recognize that to many, hope for sound monetary and fiscal policies appears a utopian view. They believe responsible governmental policies can never be achieved. If this is the case, the economy will continue to suffer through repeated monetary crises with higher and higher interest rates and rising prices, followed by recessions, low output, and prices rising yet again. Such views are particularly prevalent in business today, where they reduce the desire to invest and to expand capacity. The fear that 1978 will be a year of contraction rather than expansion is already beginning to permeate business planning. It is a major threat to the economy. It can be offset only by confidence in a strong and proper future policy, based on stable rather than gyrating interest rates. For rates to remain stable and low requires agreement that we will avoid unnecessary use of contractory monetary policy, depending instead on a proper fiscal program.

We now face a period of weak expansion, similar to those which led to the Employment Act of 1946, which will leave a sizable gap between actual and potential output. This Committee was established to help insure coordinated government policies in attacking just such a situation.

Different rates of expansion entail acceptance of varying degrees of risk. Regardless of what plan is selected, no program can promise certainty of success. Inflation, although reduced, and unemployment will remain high, and policy makers will be blamed no matter which is chosen.

Recognizing these difficulties, I think that we ought, as a minimum, to set a goal of reaching the full employment level by the start of 1979. Such a goal will require a greater expansion in money and credit than has been set as the target for this coming year. Such a monetary policy must be accompanied by a responsible fiscal policy which will bring the federal government back into surplus in 1978.

Chairman HUMPHREY. Mr. Eisner, please proceed.

## STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, NORTHWESTERN UNIVERSITY

Mr. EISNER. Thank you very much. I am very pleased to be here. I also would like to submit my complete prepared statement for the record and summarize it considerably as I proceed.

Chairman HUMPHREY. Thank you. Your prepared statement will be placed in the record at the end of your oral statement.

Mr. EISNER. The statement will appear, perhaps, rather sharp and caustic. I am most critical of policies that have led us to the current situation of 9 percent unemployment, of the loss in output at current rates of some $250 billion per year. That amount I find staggering.

A quick picture of it may be gathered by recognizing that all of the expenditures for our tragic misadventures in the Southeast of Asia, over all of the years, amounted to less than that, at least in terms of the usual Treasury estimates.

There are a number of things that we can criticize about the economy, in the way of unwarranted market interference by Government and monopolistic elements, but the major criticisms I would like to offer at this point relate to fiscal and monetary policy.

This is not to suggest that I have a notion that fiscal and monetary policy can cure all. I have written a number of articles over the years suggesting the pitfalls the difficulties, the limitations. But fiscal and monetary policy do influence the level of economic activity. They are so intended.

There is a law of the land that we should have maximum employment and endeavor to do that. That law, I can recall, was not vetoed in 1946. I consider that law being violated day by day by the words and deeds of the highest spokesmen for our fiscal and monetary policy.

Chairman HUMPHREY. Mr. Eisner, may I say that I have stated that repeatedly. In this period of time, when everybody is looking around for lawbreakers, people seem to forget that the Employment Act of 1946 is the law of the land. And day after day, right before this committee, people come in and openly defy the law, publicly, people that have taken an oath to uphold the laws of the United States and support its Constitution. They do not recommend that we repeal the law, they simply say we will not abide by the law. If that happened to the Internal Revenue Service, they would put you in jail.

Mr. EISNER. Well, I am very glad to hear you say that, Mr. Chairman.

Chairman HUMPHREY. Well, I have said it repeatedly, and I am glad to hear some man come from the university circle and say exactly the same thing. But, for some peculiar reason if some small farmer does not put on a guardrail, the Department of Labor, under OSHA, comes in and fines him. But when we have Cabinet officers come in and simply tell us that we ought to have 8 percent unemployment or

9 percent unemployment as a way of curing inflation, even though it is a total violation of the statutory law of this land, nothing is done.

Mr. EISNER. That is precisely right.

Chairman HUMPHREY. And he ought to be fired.

Mr. EISNER. That is precisely my statement.

Chairman HUMPHREY. And that would be the minimum penalty that he ought to have.

Mr. EISNER. In the prepared statement, I suggest that I would leave it to others to raise the question on whether it is an impeachable offense.

Chairman HUMPHREY. I am not sure whether it is impeachable, but it is intolerable.

Mr. EISNER. I quite agree. If we go back into the history of the situation, we see that in 1973, we had unemployment hovering about 5 percent, as compared to a level of 3½ percent reached in 1969. We had a rate of inflation which struck some as high. It was running at about 6.1 percent at the beginning of the year and rose to 8.6 percent, as measured by the GNP price deflator by the end of 1973.

And in response to this, policies were developed and launched obstensively to battle against inflation. The battle against inflation was a battle to be undertaken at the expense of employment, output, and prosperity. Now, I can add that one of the most shocking things, as we look at it, is that as the economy slipped into recession, as the economy slowed and sputtered, and as the seeds of the current recession took deep root, the administration nourished these seeds by an amazing swing in the full employment budget surplus from $7.7 billion in the third quarter of 1973 to $30.4 billion by the third quarter of 1974. This is a very considerable punishment to inflict upon even as strong an economy as our own.

In addition to that, there was an estimated $37 billion added to the annual cost of petroleum products used in the United States by the end of 1974. This, of course, also meant a heavy drain upon purchasing power.

We have the ironic situation of increases in prices, which were increases in supply prices, increases brought on by the cost of imported petroleum products, by crop shortages, and these increases in prices were viewed most foolishly by the administration, and apparently by those setting monetary policy, as a kind of a demand inflation to be cured by reducing aggregate demand.

The role of monetary policy in all of this was not only not to correct the mistakes in the fiscal policy which I consider basic, but actually to aggrevate the problem. From December 1972 to December 1973, the narrowly defined money stock, $M_1$, grew at a 6-percent annual rate, this in a period when the money value of gross national product grew at a rate of 12 percent.

In the next year, from December 1973 to December 1974, $M_1$ grew at an annual rate of 4.6 percent, while the money value of the gross national product rose at a rate of 6.4 percent.

Perhaps the sharpest indication of the pernicious monetary policy that we were following, in my view, was that in 1974, when we had a drop in real gross national product of 5 percent, our sharpest recession since the Great Depression; we had a monetary policy that far from trying to be expansionary and counteract this drop——

Chairman HUMPHREY. Mr. Eisner, may I interrupt just a moment. Congressman Gillis Long is here. I have to go and cast a vote, but I will be right back. I am going to ask Congressman Long to preside while I am away, and I will be back for questioning.

Mr. EISNER. Right.

I continue then to point out that in this period of 1974 when real gross national product declined by 5 percent, the real money supply actually declined by 7 percent.

The consequence of this was high short-term interest rates, and then rising short-term interest rates, which brought with them rising long-term interest rates, depressing investment particularly by electric power companies and creating havoc in the housing markets, in large part because of our queer constraints on rates of interest that can be paid by thrift institutions and by banks, so that the amounts of deposits flowing into thrift institutions plummeted, and housing starts fell along with them.

In 1974, when we should have looked for stimulus, in the 6-month period ending 1974, while price inflation ran to the 13-percent rate, the bank reserves of member banks of the Federal Reserve System increased by less than 1 percent. Again, a clear indication that the monetary policy, far from stimulating the economy, was vastly depressing, adding to the depressing of the situation by not offering increases in reserves anywhere near commensurate with the needs for transactions indicated by both inflation, and for a while, the still rising money value of the gross national product.

A point I would like to stress, which I find particularly shocking, is that of late May 1975 we have estimates that the full employment budget of this economy was running, would be running a surplus of $4.6 billion for fiscal 1975. Now, we take it as axiomatic that in a period of recession you want a fiscal policy to stimulate the economy. The measure of the stimulation or the repressing restrictions of the economy we take to be the full employment budget surplus or deficit. To run a full employment budget surplus in a period of sharp recession is a contradiction of everything that makes sense in modern economics.

As if that is not bad enough, the forecasts are that the full employment budget will have a surplus that rises to $12.6 billion in fiscal 1976, and the latest available issue of the Survey of Current Business, the June issue, reports that on a quarterly basis the full employment budget is in deficit in the second and third quarters of 1975 and shifts to substantial and increasing surplus thereafter.

Now, the apparent rationale of this restrictive policy, fiscal and monetary, is that we must fight inflation. I submit that in the first instance the nature of the inflation is quite misconceived. You do not fight inflation, which is stemming essentially from shortages of supply, from increases in supply prices, whether of petroleum products working their way through the economy, or of agricultural products, by choking off aggregate demand. That policy is virtually certain to create significant unemployment with minimal effects on restricting the increase in prices.

I have been asked to pay attention to the matter of the Federal budget deficit and its effects upon credit markets. I would suggest that the notion that Federal budget deficits will cause a shortage of supply of savings in our current situation is essentially a mirage. The large Federal budget deficit, and as now indicated it may approach $80 billion or exceed that in fiscal 1976, is a deficit which is the result of the current recession. Certainly, the financing of that deficit can absorb private saving. It can also readily be financed by the Federal Reserve making available increasing reserves for bank loans.

The alternative to running this large a budget deficit would not be more saving and investment, but less, because it would mean that either the Government would have to raise taxes, thus taking away from people income that would otherwise go into saving, or reducing their expenditures, which would further reduce income and output and reduce saving.

In fact, gross private domestic investment is far down, but it is down precisely because of the recession. It is down because businessmen find, with hugh excess capacity, with an actual decline of output rather than a growth, that they have every reason to curtail capital expenditure plans, and they will continue to do that unless the economy recovers.

The way to stimulate investment and saving is to have a full employment economy. I might add my objection to Mr. Maisel's against Government incentives in the way of tax giveaways. I would call them weak tools to encourage business investment. The way to encourage business investment is to have a full employment economy, and then leave it to business to decide, in a free market, how much it wants to invest in terms of what is profitable, given, of course, a monetary authority that has not artificially constrained the supply of money and made interest rates too high.

I see little hope of an appropriate monetary policy from the reiterated statements of the Chairman of the Board of Governors of the Federal Reserve System, and all those that give us an indication of what monetary policy will be, statements that the rate of money supply growth will be kept in a 5 to 7½ percent area with the usual measure of $M_1$. I consider that to be a statement which is forecasting and forewarning of a grave inadequacy in the money supply, and a conflict between what should be a target of full employment and the means of financing that full employment.

Meaningful estimates indicate that to reduce unemployment from its current level of 9 percent to 6 percent over the next 2 years, a very modest goal indeed, real gross national product would have to grow some 17 percent, or at an average annual rate of over 8 percent. Even if inflation is reduced and held to an annual rate of 5 percent over this period, we would require a 14-percent-per-year growth in the money value of gross national product.

If we recognize that we must grow more rapidly or start our push for growth more rapidly initially and then taper off to reach our target, it becomes clear that a minimum target for increase in the monetary supply over the next year would be on the order of 15 percent per year. And this should be adjusted where appropriate to try to maintain interest rates low, as Mr. Maisel suggested, so that there will be no shortage of funds going into thrift institutions for housing markets, and so business investment can proceed with as low interest costs as are feasible.

Now, I might finally indicate that there seems to be a curious myth that you can stimulate an economy by cutting taxes, and everybody seems to like the idea of cutting taxes, and that will not be inflationary. But stimulating the economy by an easing of monetary policy, we are told, will be inflationary. That argument, I find, simply does not hold water. Either fiscal policy through higher government expenditures or lower taxes or monetary policy, whichever one of these we apply, will be effective to the extent that it increases effective demand. If a policy does not increase effective demand, it will not bring about higher incomes, employment, output. If it does, it will, and it runs some risk of raising the rate of price inflation, but that risk is minimal when we are at the state of unemployment and excess capacity which currently exists.

I could add that monetary policy, when it is easier in some ways, actually can lower costs, interest costs, and that has a direct impact of lowering the cost of living: For example, for mortgage loans, and interms of various kinds of production where interest costs loom large.

Of course, a similar argument can be made for certain kinds of fiscal policy. If you cut taxes, excise taxes, sales taxes, you will be directly lowering the cost of living at the same time that you are increasing real purchasing power and real demand.

Another proposal I have made along those lines, I might mention again briefly here, is to reduce the payroll tax, which is a major element of cost for American business, and also a major drain on the incomes and purchasing power of virtually all of the American working people. One modest proposal would be to have the Treasury pay into the social security fund an amount equal to the taxes that would be paid on the first $14,1000 of covered earnings for all employees under the age of 22. This, it would seem, would be a way of reducing costs of production for business, of increasing take-home pay of young workers, and of encouraging the hiring of young where unemployment is so critically great, thereby giving the young workers experience, training, and investment in human capital, which I consider to be the vital foundation of the growth and prosperity of this country, the one area of investment where there is a major role for government support and encouragement in a free economy.

I thank you.

Representative LONG [presiding]. Thank you very much, Mr. Eisner, for your statement.

[The prepared statement of Mr. Eisner follows:]

PREPARED STATEMENT OF ROBERT EISNER

"Optimistic" Administration statements place us now at the bottom—of the worst economic recession since the great collapse of the Thirties. This recession is man-made—indeed made largely in Washington. It is the direct result of disastrously misguided economic policies. Unless those policies are reversed, the bottom and the recovery from it promise to be long and costly.

The fundamental fact to be squarely faced is that the United States economy is currently sacrificing $250 billion of annual output that would be produced if we had kept close to a full employment growth path over the past two and one-half years. This loss in a single year is comparable to the cost over all the years of our tragic misadventure in Southeast Asia. It makes a mockery of claims that the nation cannot afford programs for health, education, mass transportation and protection of the environment. The tens of billions of dollars that might be added in these areas are lwarfed by the waste of our currently idled factories and underemployed labor.

There is considerable waste and misallocation of resources brought on by unprincipled market interference, by monopolistic combines or cartels on the one hand and most importantly and not necessarily separately, by governmental regulations, controls, tariffs and a variety of restrictions on the other. But these pale before the shocking fiscal and monetary policies which have tolerated and largely encouraged and brought on the current recession.

In a number of professional articles I have pointed to the limitations of fiscal and monetary policy.[1] Very briefly, on fiscal policy, tax changes that affect personal income normally show only slow results in personal consumption. This should come as no surprise in light of the permanent income theory of Milton Friedman and the similar life-cycle hypotheses associated with Franco Modigliani and his collaborators. Changes in business taxation may similarly go into business saving rather than add to the total investment of the economy, unless anticipated profits on additional investment are altered. And I am even more ready to remind all, in regard to the efficacy of monetary policy, of lessons from the Great Depression taught us by John Maynard Keynes, lessons still ignored at our peril. These relate essentially to the considerable elasticity of demand for money or liquidity with respect to the interest rate or the measures of the cost of capital. This elasticity lengthens the path and reduces the ultimate impact of changes in the money supply on the expenditures for goods and services which are our ultimate concern.

But with all qualifications noted, fiscal and monetary policies do influence the level of economic activity, the gross national product, the rate of employment and prices. The nature of their pursuit over the last several years and the recommendations for their pursuit in the future can be explained only by an abysmal ignorance of all we have learned of economic processes or by a set of values which must certainly be remote from the interest of the vast majority of the American people. I rather fear that the explanation involves an unholy combination of both.

The law of this land, established in the unvetoed employment act of 1946 and never amended by subsequent legislation, makes it national policy to achieve maximum employment. In statement after statement by the highest levels of the Administration and our monetary authority, that law is forgotten or defied. Rather we are told that we must tolerate considerable levels of unemployment, now recognized as likely to persist for many years under existing policies, in the presumed interest of reducing the rate of inflation. I shall shortly discuss the economic rationale, largely faulty, in achieving that purpose. But we should not forget that a policy of consciously deviating from maximum employment, for whatever purpose, is a violation of the law. I will leave to others the question of whether it is an impeachable offense.

Let us be clear as to the issues, of a few years ago and of the moment. In early 1973 the rate of inflation, while small now in hindsight, seemed to be accelerating. As measured by the implicit GNP price deflator, inflation increased from an annual rate of 6.1 percent to 8.6 percent through 1973. The economy was sluggish and unemployment hovered around 5 percent, as compared to a level of 3.5 percent reached in 1969. Proper dedication to goals of maximum employment in 1973 would have dictated extreme prudence in any efforts to restrict aggregate demand. Warnings against the perils of attempted "fine-tuning" are sound. But if we are committed to full employment and maximum output, we must read these warnings to mean that it is improper to jeopardize full employment by ill-conceived restrictive policies mistargeted at misidentified inflationary forces. Even in situations where we can see a clear tradeoff between employment and price inflation and we can know both the underlying economic factors at work and the effects of our own actions, we must recognize the large shadow of uncertainty as to the future consequences of governmental actions which by their nature cannot be immediate in their effect. Since we are bound to err in varying degrees, it is our economic, moral and legal obligation to err in the direction of preserving maximum employment and output. That lesson is all too often forgotten.

[1] In particular, "Fiscal and Monetary Policy Reconsidered," *American Economic Review*, December 1969; "What Went Wrong?" *Journal of Political Economy*, May/June, 1971; "The Aggregate Investment Function," *International Encyclopedia of Social Sciences*, Macmillan, 1969, Vol. 8; and with Robert H. Strotz, "Determinants of Business Investment," *Impacts of Monetary Policy*, prepared for the Commission on Money and Credit, 1963.

The battle against price inflation, as many other economic battles, should be waged as far as posible, when it is to be waged, without reducing employment and output. This means that price inflation is to be fought by restoring competition, by anti-trust action, by removing the dead hand of government regulations and ending the policies of government agencies which take it as their duty and normal functioning to maintain or raise prices. It means removing protective tarigs, quotas and other interferences with free international trade. It means lowering and removing taxes which both reduce the supply of output and raise the cost of production. And it means seeing to it that those economic resources claimed by government are applied to investing in the capital, frequently human capital, of our nation and in provision of public and private goods clearly perceived as efficiently produced to add to the social welfare. But again, none of this should be accomplished by or along with reduction of total employment and output properly measured.

Through 1973 and 1974 government policy was largely directed elsewhere. In October of 1974 the Administration presented a restrictive fiscal program which has been aptly characterized by Arthur Okun "as the most misconceived stabilization package of the past generation."[2] That package was wrong not merely because most economic forecasters were wrong, as indeed they were. It was wrong rather because no Administration has the right, on the basis of admittedly unreliable forecasts, to plan or even to risk creation of unemployment to combat inflation.

The simple measure of calamitous government fiscal policy is that while the United States economy slowed and sputtered; as the seeds of the current recession took deep root the Administration nourished them by an amazing swing in the full employment budget surplus from $7.7 billion in the third quarter of 1973 to $30.4 billion by the third quarter of 1974, and then introduced a "WIN" package for further restrictive fiscal measures. Fortunately these further restrictions were aborted shortly after conception, as they were rapidly overtaken by the unfolding of events. But in that history of a $23 billion increase in the full employment budget surplus, in the light of the sharp recession that ensued we see an ironic confirmation that fiscal policy does indeed have some effect. Huw much punishment of this type can even an economy as strong as that which has produced by far the greatest gross national product of any nation in the history of the world be expected to take?

That is of course only part of the picture. In addition to the drag on the economy brought on by the increase in the government's full employment budget surplus, an estimated $37 billion was added to the annual cost of petroleum products used in the United States by the end of 1974.[3] With much of the payment going to foreign producers or to domestic oil companies that use little of it to add to spending on American goods and services, the recessionary impact was huge. Governmental response to this was largely to argue about energy crises, tell us what kinds of cars to ride, encourage further increases in the price of gasoline and quite ignore the resultant market effects on real demand. For the increase in prices brought on by changes in the world supply of oil, like increases in the prices of agricultral products brought on by increases in foreign demand and crop shortages, clearly are quite the opposite of the textbook case of inflation from excessive aggregate demand and "overfull" employment. This was an inflation stemming from shortages of domestic supply or increased supply prices. The thrust of government policy should have been to finance meeting of these costs in the most non-inflationary manner feasible but above all to see to it that the costs were met without diminishing real aggregate demand and hence reducing total outpue and employment. Since this was not done, increased prices of petroleum and agricultural products served essentially as an increased tax on the American people, reducing the purchasing power available to buy all the other goods and services that the economy was capable of producing.

But now, finally, where was monetary policy through all of this. Far from mitigating the deleterious effects of an overly restrictive fiscal policy, or the higher costs of petroleum and agricultural products, the monetary authority

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[2] *Brookings Papers on Economic Activity*, 1975–1, page 219.

[3] George L. Perry, "The Petroleum Crisis and the U.S. Economy," paper prepared for the Conference on the Impact of Higher Oil Prices on the World Economy (Brookings Institution, November 1974; processed), cited by Perry in *Brookings Papers on Economic Activity*, 1975–1, p. 223.

contributed to a significant aggravation of the damage. Indeed it is hard to see how monetary policy of the recent past or the present can be defended by any contemporary school ofeconomic thought—by the monetarists, of which I am not one, or by those in what is still, I believe, the main body of professional economic thinking, which views the role of money as operating not independently but through its effects on the various components of aggregate demand and aggregate supply of goods and services.

From December 1972 to December 1973, the narrowly defined money stock, $M_1$, grew as a 6 percent annual rate, this in a period when the money value of gross national product grew at a rate of 12 percent. From December 1973 to December 1974, $M_1$ grew at an annual rate of 4.6 percent while the money value of gross national product rose at a rate of 6.4 percent. Clearly at no time was monetary policy stimulatory. Through 1973, as the economy reached its peak and began to slip, the money supply, far from being sustaining, was a decided drag. In 1974 when major increases in the money supply were in order to limit if not reverse the sharp drop in real gross national product which occurred, the real money supply (nominal money supply divided by the GNP deflator) actually fell some 7 percent, thus declining even more than the 5 percent fall in real GNP over this period.

The consequence of the monetary policies underlying this monetary growth were to be found in interest rates, in equity markets, and above all, in terms of our proper concern, in the dismal and fluctuating record of housing starts. First, short-term interest rates, already extremely high, rose sharply through the first six months of 1974, from about 9 percent to close to 12 percent. With them rose long-term corporate bond rates, leading to some curtailment of busines investment, particularly among electric power companies. They, for a variety of reasons of which interest costs were a significant element, found capital financing almost prohibitively expensive or virtually unavailable. But most seriously, given our institutional arrangements including unfortunate constraints on payment of interest by thrift institutions as well as banks, the soaring short-term interest rates, which had brought a drastic reduction of monthly deposits into thrift institutions in the latter half of 1973, brought down those deposits again. With them fell housing starts (along with expenditures on mobile homes).

In the latter half of 1974 the precipitous decline in business caused a sharp reduction in the demand for money. An appropriate counter-cyclical monetary policy would have entailed a sharp increase in the supply of money and an endeavor to drive interest rates as low as possible, thus stimulating whatever investment might be undertaken in a declining economy and removing the crippling constriction in the demand for houses. But rather, the monetary authority did not even stick to the monetarists' prescription of a modest steady growth of the money supply. It now appeared concerned to maintain "orderly" movements in interest rates. Thus member bank reserves grew at a rate of only 0.9 percent in the six month period ending December 1974, a period when prices, as measured by the GNP price deflator, were rising at a 13 percent rate.

Where does all this leave us now and what are we to say for the future? First, as to fiscal policy which, bad as monetary policy has been, remains because of its greater potency a more major culprit, the situation is appalling. It is hard to read, without a sense of shock, that after all we have presumably learned in modern economics, according to Council of Economic Advisers estimates of late May 1975, we were running a full employment budget surplus on national income and product accounts of $4.6 billion in fiscal 1975. We should pause and reflect hard on this. One can argue as to whether at full employment the budget should be balanced or there should be a surplus or deficit. But the one thing that should be clear is that in a period of recession when the purpose of government policy is to stimulate and not further contract the economy, the full employment budget should move sharply to deficit. For we must always recall that in a recession the actual deficit will almost inevitably be great. The measure of whether government fiscal policy is stimulatory or restrictive is to be found in the full employment budget surplus or deficit. To have a set of fiscal policies at this time of recession such that if we had full employment we would be running a budget surplus is nothing short of astonishing.

And to cap the fiscal 1975 full employment budget surplus, in fiscal 1976, according to the May estimates of the Council of Economic Advisers, that surplus is to rise to $12.6 billion! According to the June 1975 issue of the

*Survey of Current Business* (page 7), "On a quarterly basis, the full-employment budget is in deficit in the second and third quarters of 1975, and shifts to substantial and increasing surpluses thereafter."

What compounds the folly is the continued insistence by the Administration, in words and deed, that federal expenditures must be held down to avoid inflation! There are many god arguments against wasteful federal expenditures, or wasteful expenditures of any kind for that matter. But the argument against them on grounds of contributing to inflation makes absolutely no sense. Since the problem of the recesion, of unemployment and lost output, is a problem of inadequate demand, any expenditures which increase demand are on that score beneficial. An increase in demand from the federal government in this context as desirable as an increase in expenditures by business for plant or equipment or by households for consumer goods. Inflation has of course subsided greatly in the current year. But the major recent inflation that we have had and what inflation we have now, cannot meaningfully be related to excess demand in a situation where output is some $250 billion below full employment capabilities and 9 percent of an already recession-reduced labor force is totally unemployed. To cut aggregate demand in order to combat inflation brought on by huge increases in the prices of oil and by fluctuating prices of agricultural products is like combatting overweight by cutting off a person's legs.

As to the impact of the actual federal budget deficit, now anticipated as possibly approaching $80 billion in fiscal 1976, this need not in itself adversely affect credit markets. It is important that the monetary authority assist in the orderly financing of the deficit. But, as is sometimes forgotten, the deficit is a coin with two sides. Borrowing to finance the deficit absorbs private saving; the coresponding excess of government expenditures over government receipts creates private income which is the source of private saving. To the extent that income is not immediately saved but is spent, it adds to further production, income and tax receipts.

One may indeed ask what the consequences would be of a reduction in the deficit by increasing tax rates or decreasing federal expenditures. The direct effect would be a reduced federal need for borrowing. But along with that would be reduced private income out of which the supply of funds for borrowing would be forthcoming. The further effect of a more depressed economy would then bring a greater deficit and an increased federal need for borrowing.

The whole notion of federal budget deficits causing shortages of the supply of saving under recessionary conditions is essentially a mirage. As I indicated in a recent newspaper column submitted as an attachment to this statement, the supply of saving, however financed, will equal investment as a matter of definition. The greatest factor by far in influencing the rate of saving and investment is the general level of the economy as measured in the rate of gross national product and national income. Whether credit needs can be expected to be met adequately in credit markets depends upon the rate of investment demand as well as saving. Given the sharp recession, investment demand is low. Hence recent forecasts, even without an easing of monetary policy, have not pointed to a credit shortage as measured by increasing nominal interest rates. A reduction in the actual federal budget deficit as a consequence of an improving economy, however, would in fact be associated with an increase in a demand for credit. This in turn would require a much easier monetary policy and a faster growth of the money supply to avoid aborting recovery.

The projected growth of the money supply within a 5 to 7½ percent range, however, must prove appallingly inadequate to all who are seriously concerned with maximizing the probability of rapidly and significantly reducing our excessive unemployment. None of us can properly claim to forecast accurately the future paths of the economy. But the odds against a 7½ percent rate of growth of the money supply proving consistent with a sufficiently rapid recovery to bring us back to even moderately acceptable rates of unemployment are so great that it is impossible to believe that its proponents have any such goal in mind. Rather it becomes apparent from forecasts of those in authority over both our monetary and fiscal policies that the rise from the "bottom" so exuberantly proclaimed is projected to be long and gradual.

Meaningful estimates indicate that to reduce unemployment from its current level of 9 percent to 6 percent over the next two years, a very modest goal indeed, real GNP would have to grow some 17 percent, or at an average annual rate of over 8 percent. Even if inflation is reduced and held to an annual rate of 5 percent over this period, we would require a 14 percent per year annual growth in the money value of gross national product. It takes no higher economics or even very high arithmetic to see that a 7½ percent per year rate of growth of $M_1$ would entail sharply increasing interest rates, if a 14 percent growth in gross national product were to be attained. In fact, such a sharp increase in interest rates would, without a vastly more expansionary fiscal policy than is likely to be seriously entertained, make the target rate of growth of real GNP quite unattainable. (I might add, parenthetically that, contrary to some conventional wisdom, the higher interest costs actually make some direct contribution to *increasing* inflation even while they retard real output presumably in the interest of ultimately reducing inflation.) It may further well be argued that, given the lags associated with monetary policy, an attempt to reduce unemployment from 9 percent to 6 percent over the next two years calls for more substantial stimulation now with the stimulation tapering off as we approach our target. Thus, with an appropriately stimulatory fiscal policy, which is nowhere in sight, our immediate target for the increase in money supply should be in excess of 15 percent per year, more than double the upper bound prescribed by the Chairman of the Board of Governors of the Federal Reserve System.

I might add, in conclusion, a few words on the general issue of inflation versus employment which lurks as the devil in rational policy-making. First, our recent problems of inflation and whatever remains of them are not of a demand variety. They relate to external shocks of supply impinging upon an economic system with such rigidities that increases in relative prices almost inevitably increase the general level of prices. Some prices go up but few if any go down. Direct remedies for this are hard to come by but they do involve structural reforms which most economists view as desirable. I have alluded to them earlier: measures to improve competition, domestic and foreign, and to free and perfect markets.

But second, there is nothing unique about stimulatory monetary policy in ~~bringing on price inflation. If monetary policy has any effect at all on the~~ markets for goods and services then it has that effect by increasing or decreasing demand or supply. Essentially we look to a stimulatory monetary policy to increase the demand for certain kinds of goods, particularly, by lowering interest rates, increasing the demand for capital goods. My own extensive research in the determinants of business investment buttresses my conviction that the impact of monetary policy and lower interest rates in stimulating capital expenditures is limited. But however limited it is, this stimulation operates by increasing real effective demand. It is hence no more and no less inflationary in this impact on demand than an equal increase in real exective demand brought on by any other means. One can argue that the increase in demand brought on by lower interest rates entails reduction in capital costs which will, at least in the long run, actually tend to reduce inflation. The same argument, however, can be made for various kinds of stimulatory fiscal policy. Lower taxes may also decrease costs and certain government expenditures which enhance productivity may do likewise.

In a period of great excess capacity and substantial unemployment there is little evidence and little reason to believe that increases in demand will contribute significantly to higher rates in inflation. Where they do, this would very likely relate to unacceptable exercise of monopoly power which should be combatted directly. When unemployment is again approaching 4 percent and less, when the ranks of discouraged workers who have reduced our measure of the labor force have receded, and when the numbers of those also not counted as unemployed but involuntarily working less than full time have been cut back proportionately, we can begin to worry about the impact of increasing demand on prices. To do so now is akin to starving a new born infant because of fears of obesity at middle age.

But in the interests of efficiency and equity and reducing political opposition to the necessary stimulatory policies, we may well search increasingly for fiscal measures which can combine downward pressure on prices with increases in real effective demand. These would include, for example, reduction or elimination of excise and sales taxes which contribute directly to the cost of goods and services. Some of this can of course be accomplished by the federal government. A broader program would entail federal payments to states and municipalities to compensate them for eliminating the sales and excise taxes which they impose. This would involve an increase in real demand for goods and services with lower prices and constant money incomes. It would thus bring about the best of all possible combinations, higher employment and output and lower (or no) inflation.

Another measure which would reduce prices by decreasing costs and at the same time directly stimulate employment would be the reduction of payroll taxes which now come to 11.7 percent of up to $14,100 of the annual salary or wages of all covered employees. I have indeed elsewhere proposed specifically a job development credit which would entail substituting direct Treasury payments into the social security fund for taxes on the first $14,100 of earnings of those under 22 years of age. This would prove a small but significant step in the direction not only of lowering costs and prices but of stimulating employment of youth, where unemployment now runs over one-third. It would encourage the investment in human capital which proves the soundest foundation of our nation's prosperity and economic growth.

Attachments.

[From the Chicago Tribune, July 21, 1975]

ECONOMICS '75—SHORTAGES OF INVESTMENT CAPITAL—REAL OR MYTHICAL?

(By Robert Eisner)

The cries are reaching a crescendo. American industry faces a critical shortage of capital. Unless we have further massive tax "relief" to encourage business investment, economic growth will be stifled.

These appeals for new intervention in the economic system by way of extended and increased equipment tax credits, still faster depreciation allowances for tax purposes, and other measures come, without apparent concern for inconsistency, from William E. Simon, secretary of the Treasury, and other apostles of free enterprise and low federal budget deficits.

What is their merit?

Gross private domestic investment in real terms is indeed far down. In the first quarter of 1975, it was off almost 39 per cent from its fourth quarter 1973 peak.

Much of that drop, it is true, was in inventory investment, which shifted from a heavily positive to a heavily negative figure. And residential construction showed a very high percentage decline of 42 per cent.

But still, the remainder of nonresidential investment in structures and producers durable equipment declined by almost 13 per cent in real terms from the fourth quarter of 1973 and by slightly more from its peak in the second quarter of 1974.

Does any of this indicate a capital shortage? In the conventional sense, not at all!

The sad fact is that business investment is way down not because there is a shortage of capital but because, given the sharp recession and fall-off in general demand, many businesses find themselves with a great amount of excess capacity and accordingly have cancelled or curtailed sharply their plans for expansion.

But in a deeper sense, what meaning can we attach to the notion of a capital shortage?

Gross private domestic investment in current dollars stood at $163.1 billion in the first quarter of 1975. With continued but lesser inflation and the beginning of business recovery, the Wharton Econometric Model forecast of July 2 projects gross private domestic investment at an annual rate of $198.7 billion in the first quarter of 1976 and, with continuing recovery, at $254.9 billion in the first quarter of 1977.

This indicates an increase in the rate of gross private domestic investment of no less than $91.8 billion in two years. Where, alarmists may cry, can it possibly come from?

The answer is very simple, to the last penny. By these Wharton projections, $24.8 billion of the increase will come from personal saving, $33.7 billion from a growth in undistributed corporate profits [including the corporate inventory valuation adjustment] and $17.3 billion from increased capital consumption allowances, thus a total of $76.7 billion from increasel gross private saving.

The combined federal and state and local budget deficit will actually be $6.4 billion less and the "statistical discrepancy" $1.4 billion less, and net foreign investment will swing from a positive to a negative figure, absorbing $10.2 billion less of gross private saving.

The total of increased saving available to finance the increase in gross private domestic investment, $76.7 billion plus $6.4 billion minus $1.4 billion plus $10.2 billion, equals $91.9 billion. exactly [except for rounding errors] the amount of increased gross private domestic investment.

To anyone familiar with national income accounting, this is no surprise. Saving, with proper adjustment for government budget deficits must equal investment by definition or the meaning of the terms. In this sense there is never a "shortage" of savings.

Individually businesses may well feel in a prosperous economy that if more capital funds were available more cheaply they would find it profitable to undertake more investment. But this in a sense is like saying that individual consumers would be happy to consume more if they had more income.

There is no such thing as a free lunch for consumers or investors. Given the general economic situation, each business is competing for funds with every other business and with government and consumers.

Given everybody's preferences, no individual business should expect or is "entitled" to invest in projects which are not sufficiently profitable to cover the cost of capital.

One measure of the cost of capital is the rate of interest. In fact, the Wharton Model projects a very slight decline in Moody's total corporate bond rate, from 9.39 per cent in the first quarter of 1975 to 9.22 per cent in the first quarter of 1977.

Given the sharp drop in projected rates of inflation, from 8.05 per cent to 5.37 per cent, one may argue that the "real" rate of interest, the nominal or money rate of interest minus the rate of expected inflation, will actually have increased.

But the remedy for this, to the extent one is possible, is clearly an orderly but sufficient increase in the quantity of money to lower money rates of interest. Proponents of more capital investment should certainly oppose a tight money policy.

Those concerned about shortage of funds for capital investment may point next to the anticipated large continuing total government deficit of $55.6 billion which will absorb a coresponding amount of private saving. There are two approaches to this, however.

First, to the extent that the deficit is due to government expenditures, a would-be deficit-cutter must indicate the expenditures to be cut. There is an obvious inconsistency in pointing with horror to a federal budget deficit at the same time one appeals for increased defense expenditures.

If it is other government expenditures to be cut, particularly the huge amounts of education, one must ask whether the costs of reducing this investment in human capital may not outweigh any possible benefits from increased investment in plant and equipment by business. And deficit-reducing tax increases or cuts in transfer payments directly reduce private saving by reducing after-tax incomes.

But second, the one way to eliminate the budget deficit is to return to full employment prosperity.

The latest Brookings Institution volume on "Setting National Priorities, The 1976 Budget" shows that as against a deficit in the actual budget of $52 billion, receipts would be so much higher and outlays less so that, if we had full employment in fiscal 1976, the federal budget would not be in deficit but actually in surplus by $12 billion.

What is more, of course, at full employment, personal saving and undistributed corporate profits, two major volatile components of gross private saving, would both be much higher.

But that leads to the final question. Suppose we have an administration and a set of economic policies wise enough to return to full employment. Will we then have any reason to complain of capital shortages and assert that business should invest more or the public should save more?

The proper answer is a sharp no! In a free economy, there is no prima facie reason for telling the people to save more and consume less. There is certainly no reason to bias the economy in favor of more investing or use of saving by the business sector.

Business should be expected to invest where, without government handouts, it finds investment sufficiently profitable. And it should not be expected to invest where it does not clearly find it profitable.

Government's role should be to see to it that there are optimal amounts of investment in education, training, job experience and know-how. These constitute the human capital which, over 200 years, has been the foundation of this nation's growth.

SAVING AND INVESTMENT, 1ST QUARTER OF 1975 AND WHARTON PROJECTIONS[1] FOR 1ST QUARTERS OF 1976 AND 1977, BILLIONS OF DOLLARS

| | Year and quarter | | | Change from 1975–I to 1977–I |
|---|---|---|---|---|
| | 1975–I | 1976–I | 1977–I | |
| Gross private domestic investment (GPDI) | 163.1 | 198.7 | 254.9 | 91.8 |
| Personal saving | 75.9 | 94.7 | 100.7 | 24.8 |
| Undistributed corporate profits | 28.0 | 46.9 | 64.2 | 36.2 |
| Including inventory valuation adjustment | −7.0 | −6.9 | −9.5 | −2.5 |
| Capital consumption allowances | 126.1 | 132.4 | 143.4 | 17.3 |
| Gross private saving (GPS) | 222.1 | 267.1 | 298.8 | 76.7 |
| Federal budget surplus or deficit (−) | −54.7 | −68.6 | −57.1 | −2.4 |
| State and local budget deficit (−) | −1.7 | .3 | 7.1 | 8.8 |
| Total government budget surplus or deficit (−) (GBS or D) | −56.4 | −68.3 | −50.0 | 6.4 |
| Statistical discrepancy (SD) | 3.0 | 1.6 | 1.6 | −1.4 |
| Net foreign investment (NFI)[2] | 5.7 | 1.6 | −4.5 | −10.2 |
| Gross private domestic saving (GPDS=GPS+GBS or D+SD−NFI) | 163.0 | 198.8 | 254.9 | 91.9 |

[1] Wharton Mark IV Quarterly Model, July 2, 1975: Control Forecast With Anticipations Equations.
[2] Equals net exports minus net Federal Government transfers to foreigners minus net personal transfers to foreigners.

Representative LONG. One general question that perhaps we could get comments from all three of you on, goes to the central theme of the matter that we have been discussing here today, and that is, of course, as you all know, many people out of government have been quite critical of the Fed's moves recently toward a tighter monetary policy. And from looking at Mr. Bethke's statement, I think apparently he takes a rather different view than you other two gentlemen and says, for example, that the recent slight firming up, or slight firming, I guess it is, of monetary policy was a skillful adjustment to emerging signs of economic recovery.

I wonder, Mr. Bethke, maybe to start off this discussion, if you would be good enough to tell us why you feel that the recent Fed action in that regard were both necessary and appropriate and then maybe Mr. Maisel and Mr. Eisner would give us their views as to whether or not these recent actions were appropriate and if not, why not?

Mr. BETHKE. Let us just put a framework around my answer.

Representative LONG. I am sorry, I didn't hear you.

Mr. BETHKE. I will reply by putting a framework around my answer. And all of you will recall that late last fall, and early in 1975, there was very little growth in money supply. To create growth in the money supply, the Federal Reserve System, eased money all the way from January through May; reduced and motivated lower interest rates, ending in a final cut in the discount rate on May 7.

As a result of these easing actions, the money supply started to increase, not only to start but to spurt at a rate of 2 or 3 percent growth to 11 percent over the last 3 months. That is one fantastic jump in money supply. If they continue that rate, people are going to think that once again we are on the way to renewing the inflation, in a process of trying to get a faster business recovery.

Let me also recall that in the first half of 1975, because of declining business, business inventories dropped at a sharp historical record pace. They are now down at a level where, with more supply of money in the economy, people are starting to have better outlooks and to buy. You would sense this all through the economy, if you talk every day, as people in our corporation do, with businessmen, banks and insurance companies across the country.

Let me also ask, what is so wrong if there was no growth in money supply, and then suddenly it shot up to 11 percent, to adjusting the tone in the money market from 5⅛ percent on Federal funds to 6⅛-percent Federal funds. That 1 percent adjustment is not a very big deal. It was what is absolutely necessary, unless you want to scare the dickens out of people who know what the future value of money would be if inflation runs wild again.

Representative LONG. Mr. Maisel.

Mr. MAISEL. Yes, sir. I think really this discussion has to take place at two different levels. One is what we want out of monetary policy. Second is how much unemployment we think is necessary to fight inflation. Are we willing to allow a more rapid growth rate in money and credit in order to get an adequate level of production and output?

It seems to me that those who are arguing against growth are concerned that if we have an adequate level of real output, this will have such a large effect upon prices that we cannot afford it. They believe we must run a large level of unemployment for the next 5 or 6 years to hold down prices.

I think that given the large amount of excess capacity, given the large amount of unemployment in the economy, we can and should grow at a more rapid rate. We should strive for 7 to 8 percent annual growth in real output over the next 2 or 3 years. Such a level of demand will have a minimal effect upon prices. I think we will still have inflation, but it would not be caused by growth of output. It will be caused by other factors, such as energy, such as grain prices and things of that sort. That I think is the second critical problem.

The first problem, and I believe this is inherent in Mr. Bethke's approach, is the belief that we have to continue to use tight money as a way of holding down growth in the economy. As the recovery starts we will automatically want higher interest rates to hold down the rate of expansion. I think if you assume that we can afford a rapid rate of growth over the next several years, then we are much better off saying we cannot and do not want to use tight money to control that level. We want to furnish lower interest rates; we would like to expand capital; we would like to expand housing production. These are really possible only if we get long term interest rates down below where they are now.

Next we come to the technical questions as to whether the 5 to 7½ percent growth rate in money is adequate or not. And second, whether in operating on a day-to-day basis, the Federal Reserve ought to react rapidly, as they did to the May and June increases in the money supply.

My answer to both of those is no. Looking over the last few years, we see that frequently this sort of rapid growth rate in money for

2 months is simply a poor seasonal. In other words, the Fed is reacting to an information series which is not an adequate series, which has lots of noise in it, lots of random movements. It raises a very difficult question for the Federal Reserve as to how fast they want to react to those types of random movements.

Now, Mr. Bethke says in New York they do not recognize how random this series is; that the markets react very rapidly to the failure of the Federal Reserve to react to this sort of situation. As a result, the Federal Reserve is forced, in effect, by the market to react. I think there is something to his argument. But, I think that as Federal Reserve policy becomes clearer, as we know where the Federal Reserve is trying to get, this sort of market reaction is not necessary. This is why I think it is very good that we have the type of hearings that Chairman Proxmire has had, and Chairman Reuss had last week, making clear what Federal Reserve policy is. Because otherwise, and this was a constant problem when I was at the Fed, the Fed is dominated by the market. It says since the market does not know what we are doing, we have to take an action of this sort so that the market will not think we are taking the wrong action. I think this is the reason why we want greater information, why it is so important that policy be out in the open.

Representative LONG. To move from an action-reaction type of situation into a formulated and stated policy by which the appropriate parties could guide themselves.

Mr. MAISEL. That is correct, Mr. Congressman. That is exactly the point.

Finally, we come to the question of the 5 and 7½ growth rate over the next year. Here, I would disagree somewhat with Mr. Eisner. I think he failed to take into account changes in velocity. Normally, during a recovery, we do have increases in velocity. But if you make a rather large assumption as to how sharp those changes in velocity will be, you still come to the fact that a 10 to 11 percent growth rate for money is probably necessary to support the type of real growth that we want over the next 2 years.

So, I think the critical assumption is how do you look at the past history of changes in velocity of money, and how do you predict what will occur this year? If you take history over the entire postwar period, then you find a very, very rapid rate of increase in monetary velocity, and the 7½ percent might give you a minimum necessary level of money.

If, on the other hand, you look at the postwar period and see that the rate at which velocity has increased has decreased steadily; if you recognize that we are starting with much higher interest rates now then we did in the past; that we furnished fewer reserves during this last year than was true in previous recessions; then I think you might well come up with the idea that the rate of increase in velocity of money will be nowhere near as large over the next 2 years as it was in past recoveries. This is how you get into a difference in the estimates of how much money is necessary for the next year.

Representative LONG. Fine. Thank you.

Mr. Eisner.

Mr. EISNER. I certainly feel that the Fed should be increasing the money supply, should not be allowing interest rates to rise, and not allow the Federal funds rate to rise at this point. And I do not know that we can forecast precisely what the needs would be in the money supply.

But, we cannot, to begin with, as I have indicated, approve an increase in the money supply in only the 5- to 7½-percent range. Even with a modest rate of inflation of 5 to 6 percent, to achieve the target rate of real growth of 8 percent or so, to try to achieve a modest reduction in unemployment over the next couple of years, implies an increase in the money value of the gross national product of 14 or 15 percent.

I, therefore, cannot see any incompatibility between that and a money supply which would increase at that rate. If there is some slight trend in the way of reduction of money demand or increase in velocity, all the better. What we wish at this point is to stimulate the economy.

I do agree very much with what Mr. Maisel pointed out, and that is that a critical difference between a lot of people at this point is not their forecast for the future; it is not, I suspect in many cases, their economic analysis. It is a different set of values, and we have to face up to them very honestly and directly. One set of values indicates that we should maintain full employment and try to get back to it as soon as possible, to recognize, as Senator Humphrey pointed out, and I did in my prepared statement, that we are committed to maintaining and achieving maximum employment, and we simply cannot tolerate a set of policies which has other objectives which become incompatible with the maintenance of full employment.

Inflation is a bother, it is a trouble, it has not been a disaster in this country. I would hope very much it can be reduced. There are ways of reducing the rate of inflation which extend to a good many unpalatable things to many special interest groups, including the elimination of protective tariffs, quotas, the action of regulatory agencies that protect prices in many areas. And that is a path to follow to reduce the rate of inflation.

To restrict by monetary or fiscal policies which reduce employment and output, I consider utterly wrong, wrong in terms of the huge loss of output in this country, morally wrong, wrong even in terms of the law of the land.

Representative LONG. Thank you very much, Mr. Eisner.

Senator Proxmire.

Senator PROXMIRE. Gentlemen, this is a very fine panel. Mr. Maisel is an old friend and classmate of mine and I am very happy to see all of you gentlemen here.

Mr. Maisel, would you give us your views on what monetary policy would be appropriate, as specifically as you can delineate it, with respect to our present housing problem. You have developed a fine reputation in the field of housing, and I think there are few people who have had the breadth of experience, both as a Governor of the Federal Reserve Board and as an expert in housing for many years. We are in a housing depression now. The most optimistic forecasts are that at the end of this year we will be lucky to have one and a half million housing starts and many people feel we cannot get to that under present circumstances.

What prescription would you suggest would be the wisest and the best for stimulating this vital area of our economy?

Mr. MAISEL. Well, Mr. Chairman, I think the critical fact is that lenders are afraid to put money into the long-term market. I think this is implicit in a good deal of what Mr. Bethke has said, that the market does believe that as soon as recovery starts we are going to have money tightened and that long-term interest rates are going to rise. If this is so, anybody is foolish to put money into mortgages or any other type of long-term loan, because as interest rates rise, the capital loss you take on that type of lending, is very sharp. Anyone who is running an organization, an insurance company or a savings and loan, simply feels that he cannot afford to put his money out now if he is sure that long-term interest rates are going to be higher a year from now. I think we see this very clearly.

We have had record inflows into the savings and loan industry over the past several months. Mortgage loans are going up, but rates are not coming down very fast. People are still afraid. They are building up their liquidity at a very rapid rate on the assumption that they will be better off making loans next year rather than this year. This is the basic reason that housing is lagging as it does.

If we look at the past two or three recessions, by this time housing starts would have been very high. In fact, typically over past recessions, housing starts have gone up almost from the start of the recession. This has been a very untypical situation with respect to housing. I think it is completely related to this problem that the lenders are concerned about what is going to happen to long-term rates. And I must say that I am concerned myself.

If we assume we are going to run monetary and fiscal policy as we have over the past 10 years, that is a proper worry. If we assume we are primarily going to use monetary policy to cut down on demand, I would not be surprised to see short-term rates of 12 or 14 percent a year or two from now. If we get that sort of a short-term rate, we are obviously going to have long-term rates that are way above where they are now. That means that a lender is better off waiting.

So, I think we have to come to an agreement that such a policy would be wrong. The costs to the economy of trying to hold down demand purely by monetary policy is too high. We must agree that we are going to run a fiscal surplus next time it is necessary to hold down demand; that we are not going to use monetary policy, and that money rates will be more stable. If we get that, then I think we will see long-term rates dropping.

So, the answer to your question again is that we have to convince long-term lenders that they are not going to lose money by putting out mortgage money over the next 6 months or a year. The only way they can be convinced of that is if they are convinced that we will have adequate levels of credit and money during this period, that we will not hit them again with very high short-term rates.

Senator PROXMIRE. Now, the response we get from Mr. Burns, as you know, is that the key to holding down long-term interest rates, is to get a grip on inflation, that it is to reduce the widespread conviction on the part of the lender that inflation is going to be more serious in the future. That is what Mr. Burns says is at the heart of this thing. So, somehow, we have to break the back of inflation.

Now, the very difficult thing for me is that this is not a demand inflation in any way, shape, or form. We do not have the demand for too many houses or too much labor. There is not a shortage of any single significant industrial product or any other product I can think of. It is not a demand inflation. It is inflation most recently that is in the energy area and in the food area, but it is not a generalized demand.

Also, there is some clear imperfections in our marketing system that enables the chemical industry, for example, to increase their prices when they are operating below capacity, and aluminum to do the same thing, others to resist a drop in price which would be normal. Nevertheless, we do have this great difficulty here. We have the people who are in charge of our policies, the President of the United States, the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, all convinced that we have to follow this policy of both fiscal and monetary restraint, even though we do not have a demand-type inflation. And we do not have a wage-push type of inflation either.

Frankly, I am in a dilemma as to what to do about it. My own personal prescription is to follow a policy of as much monetary stimulation as we can, within reason. Obviously we cannot have a huge increase in the money supply, but more substantial, certainly, than Mr. Burns had advocated. Others think, Mr. Heller and other very distinguished economists, argue that we need stimulation in all sectors, fiscal and monetary. I take it that your view is that we should have monetary stimulation more than we have now, and some fiscal restraint about the level that we have at the present time; about a $70 billion deficit.

Mr. MAISEL. Yes. I agree fully with what you have said, Senator. I do.

It seems to me that we are going to face the question of a tax cut again. I urge very strongly that we go the way we did last February, but that we keep it on a temporary basis. At that time, Mr. Heller was on the panel with me, and he felt that we ought to make it a permanent cut. I think it is very important that we keep the tax cut on a temporary basis so that if we do get into a situation where real output is rising rapidly, where unemployment is falling rapidly, that the higher taxes will go back into effect automatically. And I certainly agree with the types of policies you have had of saying that we want to get as much fiscal restraint on the spending of the Government as we can, too.

Senator PROXMIRE. Let me get back just a minute to housing, because you are so highly competent in this area. I cannot see that if we follow a policy even of greater monetary restraint that we are going to get the kind of housing stimulation that we need. I say that because if we had, say, an 8 percent increase in the money supply or an 8½ or even a little more over a year or two, I do not see that as necessarily correcting the problems we have on the long-term interest rates. It would seem to me that something like the emergency housing bill that the President vetoed, a bill that would provide a shallow subsidy, which would provide for perhaps as much as 1 million housing starts. Here you have colossal unemployment in the construction trades, and cement and lumber and so forth. Why would not that kind of a measure be a better answer? It is true that it has been vetoed, but maybe the President would have a change of heart if unemployment continues at a high level and housing continues in the doldrums, and our present policies do not seem to be an answer.

Do you think we should persist in something of this kind, or do you disagree?

Mr. MAISEL. No. I agree, Senator, although I think it is very important to say those subsidies will be temporary. The idea that they phaseout at the end of 5 years or something like that.

Senator PROXMIRE. Oh, yes. The way we had it, we had——

Mr. MAISEL. Both ways.

Senator PROXMIRE. We had the 6 percent subsidy which would go for 5 years, and then it would rise in the market, with the market over the next 3-year period, by way of law, so it was not just a matter of phasing them out, we would have to unless we changed the law.

Mr. MAISEL. I agree. But it seems to me necessary—as I recall, there was an alternative in there.

Senator PROXMIRE. The alternative was 7 percent that would be permanent.

Mr. MAISEL. I would prefer the greater subsidy initially that phased out automatically by law. I might note at the same time there has been a fair amount of testimony before your committee and other committees in which they have added the Government-sponsored agencies into the Government deficit. It seems to me that is simply incorrect. The Government-sponsored agencies, I think, are financial intermediaries, the same as any other type of intermediary. We do not add, in the large deficits of commercial banks, the amount of credit they create, with the Government deficit, and we do not add in the amount of assets the savings and loans are increasing as part of the Government deficit. And I do not think there is any reason to add in the Government-sponsored agencies.

Senator PROXMIRE. My calculations were that that housing program would have reduced the deficit, the economy would be stimulated about $12 billion in additional economic activity, which would have brought about $2 billion in the Treasury, and the cost was about $1 billion, so it would have reduced the deficit by about $1 billion.

Mr. MAISEL. I agree.

Senator PROXMIRE. Here you have almost everything. It cannot be inflationary, because it puts people to work who are otherwise idle, brings additional revenues it, so you would reduce the deficit and it seems to me that it would be a very happy approach. And while there was resistance to it, the resistance was never reasoned. They would never give us the argument, they would never say why it would not work.

Mr. MAISEL. I think it was simply an assumption that we cannot afford a real growth rate of 8 percent a year, that that is too fast. It seems to me this is basically at the heart of the whole housing program. If you look again at housing, my own estimates are that we would be under 1.5 million starts by the end of the year or under 1.8 by the end of next year. Both of those are very low historically, and I think they are very low compared to the need for housing.

Senator PROXMIRE. Far below anything like the goals we set. They may have been a little high, but still, it has gotten to where it is 2.6 million a year, as you know.

Mr. MAISEL. But I would subtract from that the mobile homes, so that would give you 2.1 or 2.2, as a logical goal. And I would agree that we are running far behind those goals. Obviously during the next year, the rate of vacancies is going to drop, and this will have an important effect upon rents and other things.

Senator PROXMIRE. Mr. Chairman, my time is up. Could Mr. Bethke respond?

Chairman HUMPHREY [presiding]. Surely.

Mr. BETHKE. On housing, from the market viewpoint let me stress that the market may be located in New York, but really represents all the people, investors, lenders—and all of us in the room who have savings accounts, etc.—because savings institutions are investing our money. I will respond, with a market point of view, and also as a trustee of a major savings bank in New York City, that has hundreds of millions of dollars invested in mortgages.

First: You should recall that only in 1974, and this year, have double A corporate bonds yields been higher than mortgage yields. So, now it is a lot easier and more inviting to invest money in a double A corporation bond than in mortgages. With mortgages, investors have to worry about collecting interest from individuals or little building owners, instead of dealing in million dollars units with a major corporation.

Second: There is no doubt about it, lenders, having an option to invest in corporate bonds or mortgages, have a tendency not to invest long-term, if they think inflation is going to be here forever.

Third: People, all of us, your neighbors, fear upgrading their housing because they do not have money left over to buy the houses they would like. For example, the average mortgage on a house in California in the last 3 years, or so, has risen from $24,000 to $37,000. That is inflation. It is costing more for new homes one buys, with the same, old square footage.

If you are a savings institution official—this comes back to inflation and to the Treasury deficit—you have had a vast inflow of deposits in the last few months. Are such officials investing in mortgages or corporates? No, they are slowing up on both fronts. Why? Because the Treasury deficit coming into being, suggests fantastic Government note and bond interest rates, available to people, who will wake up to the fact that Treasury rates are better than savings bank rates.

Let me give you an example: You can put money in a savings bank at 5¼ percent or as high as 6½, or so, on term. Yesterday you could buy a Treasury note for 2¾ years for 7⅞ percent.

Senator PROXMIRE. Let me just say I can agree with almost everything you said. What you are saying, I think, is if we just let nature take its course that housing is going to continue to be in trouble, because you are going to have long-term mortgage rates up around 8½ or 9 percent, and at that rate you are not going to get the housing starts you need in the economy to put people to work. This is why you have to have a government program that would get the rates down to a level where you do not have just 30 percent of the people who can

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buy homes, but 70 percent of the people who can buy homes. Now, as you know, only about 30 or maybe 25 percent of the American people can afford to buy a new home.

That is why the program that Mr. Maisel and I were discussing, it seems to me people may be uncomfortable with this kind of a notion, but without it you do not have any practical way to get houses built in the kind of way we need to stimulate this economy.

Mr. BETHKE. I have three conclusions. The practical fact is you'd better get inflation out of the outlook; then more money will go long-term into the mortgages.

Senator PROXMIRE. What do you mean, 5 years of 10 percent unemployment to do that?

Mr. BETHKE. Well, let us not talk that extreme.

Senator PROXMIRE. Well I mean, I just do not see it coming from the long-term unemployment.

Mr. BETHKE. How we get the unemployment down is another problem, but we have to get inflation psychology out first. And second, we have to make mortgages more like securities. The Ginnie Mae and the Fannie Mae are working on this, so that trustees of banks will not hesitate to buy a $1 million unit of mortgages—packaged like a security. How would you like to own two mortgages of some neighbors and have to write them a letter every month to be sure you got your $10,000 of interest and a couple of more dollars of paying down on the mortgage? No. It is too much trouble. Making mortgages more like securities will help.

I also think on many mortgages in savings institutions, officials talk and worry about rent control, which is spreading. You have it here in the District of Columbia, in New Jersey and now, in New York.

Chairman HUMPHREY. That is in the East. The rest of us live differently.

Mr. BETHKE. Right, sir.

Chairman HUMPHREY. Seriously. I mean, it is not even discussed.

Mr. MAISEL. It is in Berkeley, Mr. Chairman.

Chairman HUMPHREY. Well, live out in the heartland of America. We do not talk about things like that.

Mr. BETHKE. Well, you cannot encourage a man to go out and build a new apartment building if he thinks his rent income is going to be frozen. He worries about rising costs in the economy and he says: "Sooner or later I will lose money." And the same thing with the savings institutions who have the mortgages on these buildings, sooner or later they are going to say why am I invested in them.

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

Chairman HUMPHREY. The thing that disturbs me in most of our conversations about economics is the tremendous loss of productivity that occurs because of the recession. We are always talking about the cost of inflation, and I grant you that it is a hidden tax, and it is a very burdensome, but for some reason or another, Government economists and even others that come here never mention that having 8- or 9-percent unemployment, having unused plant capacity, is a terrible drain upon the physical and human resources of this country.

Was it you, Mr. Eisner, that pointed out that $250 billion a year is more than we spent in 10 years in Vietnam in terms of money?

Of course, the tragedy there was greater, far greater than money. However, may I say there is great tragedy beyond money in unemployment and recession, and the great tragedy is what it is doing to people, to wit: Detroit; to wit: New York. We speak about rent control in these cities. That is not the problem. The problem right now is 11.7 percent unemployment in New York, 11.4 percent unemployment in Philadelphia, 25 percent unemployment in Detroit, triple A bonds selling in Philadelphia, 30-year bonds at 8.66 percent. Unbelievable. The city of New York cannot even finance itself.

You know, we have a very difficult problem here in Congress knowing what to do about a city like New York. What New York really needs to salvage itself is an earthquake, and then the Government would save it. If they had a hurricane or an earthquake that really ripped up the city, the Government would throw in unlimited amounts of money. I am not advocating it, but that is one way that they would get some relief. They have got an earthquake today and it is a fiscal earthquake, and every bit as destructive as if it were an act of nature. People are wringing their hands acting like it is just New York, but what has happened to New York City is affecting the municipal bond markets all over the United States.

When I was mayor of Minneapolis, people were so eager to get our triple A bonds that they could scarcely wait for them to be printed. But the reason the municipals are not going up all over the country ~~is because people are beginning at long last to look at the rates of~~ unemployment in these cities, and even though the Federal Government continues to pour in money for public service employment and all kinds of activities, and unemployment compensation benefits are extended by the billions of dollars by the Congress, people look around and see that these cities are afflicted.

The official policy of this Government is to let people rot while we control inflation. Not only are they willing to let people go down the drain on unemployment, the President even vetoes measures to put people to work on public service employment. We have got the most peculiar kind of conservative politics in the United States today. We Democrats have convinced the Republicans that unemployment compensation was good, so they are outdoing us. They now really love it. It is sort of the way that we run our foreign policy, if anything goes wrong with the economy, give them some welfare. Do not do anything about it; just pay them off.

We are firing more police as we complain about the high rate of crime, we are firing the garbage collectors as we complain about the fact that the community services have broken down, and we are letting State and local governments raise their property taxes, raise their sales taxes, and then the Federal Government says what the country really needs is a reduction in taxes. Taxes are taxes. As a matter of fact, the Federal Government's reduction in income tax for a good many States is much less than the rise in the property tax that people have to pay.

Mr. Eisner, there is not a single person or witness who seems to take the Unemployment Act of 1946 seriously, except you, and possibly myself. And we ought to either repeal this law and say that this country is dedicated to the market forces and let it take its toll or enforce it.

But Mr. Greenspan, Mr. Simon, and Mr. Lynn—every Presidential adviser who has testified before this committee—has told us that we are going to have 8-percent unemployment by 1977; and 7½ percent unemployment by 1978. This indicates a total disregard for the Employment Act of 1946.

Mr. Bethke, you said that our committee should encourage communication, cooperation, and flexibility in relationships with the Federal Reserve Board. Now, I realize that one of our witnesses is a former member of the Federal Reserve Board. But I want to tell you something. They have got more secrets in the Federal Reserve Board than the CIA ever dreamed of having. We never know what happens in the Open Market Committee until days after it took place. There is no reason at all why the Federal Reserve Board should not have the same accountability that every Member of Congress is required to have. Do any of you feel that the Federal Reserve Board is above the law of 1946, the Employment Act? I would like you to answer right now down the line. Or do you think that we ought to promote maximum employment incomes, and production, and if so why have they not?

Mr. BETHKE. Well, I came down here believing, and I still hold the view, that over the last months you gentlemen have been having a lot more communication with the Federal Reserve people.

Chairman HUMPHREY. That is because we took them in the woodshed.

Mr. BETHKE. Wherever you took them, you are talking together. That is a beautiful thing.

Chairman HUMPHREY. I grant you that.

Mr. BETHKE. I also have the impression they are trying much harder than ever before to have some measure of understanding across the table. And I further know, and you know, that we are now getting almost monthly, well, with a 45-day lag, releases of the Open Market Committee policy actions. This is a new trend, too.

Markets do not have to be told the next day what the Fed did, or is doing. Its job is to sort out these supply and demand forces.

Chairman HUMPHREY. Let me tell you, Mr. Bethke——

Mr. BETHKE. I think you are getting closer and closer together.

Chairman HUMPHREY. We are getting closer together, but let me tell you, if we permitted the grain trade in this country to withhold their reports on exports for 1 month, we would have another Russian scandal. I am the author of the act that compels them to report every transaction within 24 hours, the amount, the quality, the quantity, to whom it is to be delivered, date of delivery and from what crop year. Why should the Federal Reserve Board have 30 days to report its activities?

Mr. BETHKE. All right, what you and the money markets should know, is, the Fed is really telling everyday, they are striving to accomplish, by the way they handle reserve availability—telling the market by the interest rate level—that they are either putting credit into the market or taking it out. This being the intervention points on Federal funds. This is pretty precise knowledge right now.

Chairman HUMPHREY. That is very helpful.

Mr. BETHKE. The other point is that this buying, selling, or sorting around—call it liquidity preference of our country—is what markets are all about. People have money, some invest each day, and some people need cash. This is what all of this volume of the $4.5 billion a day in Treasuries alone is all about. This liquidity preference tells you a lot about what people in the United States—corporations, people, institutions—are doing with their money—what they see ahead. If the Fed were to tell these people rather bluntly that as of tomorrow money is going to be tighter, I do not think the Fed would have quite as good a reading, nor would they know what people were thinking. Rather, it would be as if somebody told us tomorrow that General Motors is going to sell 5 points higher. Nobody is going to wait 5 days for it to go that much higher; it will be much higher the moment any of us hear it.

I think there is a benefit in the Fed having some finesse. Even though markets think they know every day sort of where monetary policy is going. This is why we just look at the Federal funds. As for you, and the discussions you have, you know an awful lot about Fed thinking.

Chairman HUMPHREY. Yes, I think that has improved. But what bothers me most is that we hear testimony from people from the Federal Reserve Board, and while they ought to be telling us how they are living by the law for maximum employment, and they ought to be in here explaining their problems, they are discussing the $M_1$ rate. The $M_1$ rate doesn't mean a thing to the average citizen.

Congress tries to set certain goals and objectives. We have a housing objective. It is part of the statutory law, and yet the Government agencies pretend that it does not exist. And then they arrest some poor little soul running a small restaurant because he does not take care of the safety standards. It is the same Government and that is the fact. The same departments of Government ignore the Employment Act of 1946, ignore the Housing Act of 1948, or the Housing Act of 1968, absolutely ignore its criteria and its purpose, and they will testify before you that they are going to ignore any act that applies to them, and I get fed up with it. And I see in your testimony you say we ought to keep a monitor on the weaker aspects of private credit. That is what the banking system is for, that is what the Federal Reserve is for. We did not have anything to do with that. It is a fact that the REIT's are a ripoff and it is called a terrible tragedy in the banking system in this country. Of course, the first thing the Federal Reserve Board did was bail out the banks. But they did not bail out a lot of people in this country that were going down the drain, but they had to bail out the banks because if they did not everybody else would go down the drain. My point was they did not watch the banks.

Interestingly enough, the whole emphasis here is upon helping people on the top levels without helping these folks on the bottom levels. I know that we need investment. I like many of your proposals, starting with No. 7 going right on down the line. I think I can support all of your observations. But I am deeply concerned about the casual attitude towards unemployment in the finacial community.

Take, for example, the recent testimony of Mr. Lynn and Mr. Simon; they say the reason there are huge deficits is because the Congress is on a spending spree, which is a lie. The President himself just sent a request this past week for another $2,100,000,000 to build a cruiser, a nuclear cruiser. That $2,100,000,000 was not even in the original budget. And the reason that that deficit is there is because you have a miserable unemployment rate and when you are unemployed you do not pay taxes, and you receive unemployment compensation. This country cannot afford to waste $250 billion of lost production because of unemployment.

I am of the opinion that the banking system failed to do its job. They issued too many tanker loans. It was not Congress that issued them. That is what we have the Federal Reserve System for, and a national Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Do you expect that the Fed will achieve its objective of holding the growth of the money supply between 5 and 7½ percent from the second quarter of this year to the second quarter of next year? I will go down the line.

Mr. BETHKE. They are going to be hard put to do it; the odds are that they are going to be above that target rate. And the simplistic way to look at it is that whether we talk in this room, or you talk with the Council of Economic Advisers, or the Fed, or the Treasury, go to the best other economic minds like Arthur Okun, most of them would tell you that real growth in the economy will be 6 percent, or a good deal higher in the period to next June. Most of them, most everybody in this room, I suspect, would say that we will have maybe a 5 percent inflation. We'll be lucky if it is held to that level.

Chairman HUMPHREY. I would think we would be very fortunate.

Mr. BETHKE. Well then, if you add that up: it's 6 plus 5, or 11 percent. Therefore, the economy is going to require an 11 percent money growth to take care of transactions. Obviously it is going to be a difficult to hold growth in the money suply to 7½ percent, without having tighter money. Now, I know that you can reduce that 11 percent a bit by increased velocity, that Mr. Maisel has talked about.

Chairman HUMPHREY. I think that is important.

Mr. BETHKE. It is important. But, let me remind you that velocity only increases when business activity is going up and when interest rates are rising. That is when people work demand deposits faster, because they are worth more money to them; it costs more money to borrow deposits. So even the velocity factor, which we hope for, and expect, says that no matter what, you are going to be working hard with the Fed questioning whether they can, or should stay, within the 5- to 7½ percent range.

Chairman HUMPHREY. Your judgment is it is mostly likely going to be larger?

Mr. BETHKE. I think it will tend to spurt above that level. Then a decision has to be made whether to choke it back down, or not.

Chairman HUMPHREY. Mr. Maisel.

Mr. MAISEL. I agree basically with Mr. Bethke's point, and as I said earlier, I think it should be higher, and I think the tendency will be for it to go higher.

If I might go back to your two earlier questions, Mr. Chairman, No. 1, all during the time I was on the Federal Reserve Board, and ever since I have believed very strongly that the Open Market Committee ought to issue its report as soon as the meetings are over that day. I know no reason it should not.

Mr. Bethke's arguments are the traditional arguments that the shock would be too hard to take. I do not see that. He has also made the point which I think is the critical one, that he knows within a week what the decision was. Nobody tells him, but the way the system operates in the market makes anybody who has followed the market as long as Mr. Bethke has, and he is one of the tremendous experts on it, able to know within a week what the Fed's decision was, and the chances that he will be wrong are very, very slight.

When I am in San Francisco or Berkeley, not active in the market, and when I read the Wall Street Journal or the New York Times or something like that the following day, I cannot get that same information for 2 or 3 weeks. And even then, I am not as certain as he is. This is, to me, the strongest reason why the Federal Reserve ought to issue its report as soon as the Open Market Committee is completed. Let the people in the country know what the Fed decided as soon as those in the money market. On your other question, Mr. Chairman, I spent a lot of time when I was at the Board looking at the legislative history of the Employment Act of 1946. I feel strongly that in the legislative history the Board was required to coordinate its policy with the President when the President brought his annual report to this committee. It seems to me very clear this was what was required by the act.

I must say that as a result of hearings before this committee between then and now, the committee has slipped and, in effect, it has taken the view that this was not the case. So, I think you would find that if you go back to your own hearings, what was the original, pure view now is no longer.

Chairman HUMPHREY. Adulterated now.

Mr. MAISEL. It has been adulterated as a result of hearings before this committee. But, as I said, when I was on the Board, I went through the legislative history, I went through the hearings of this committee, and I still come to the conclusion that it was meant to be, and the other would be the proper way of doing it. When the President formulates his policy, the way the act was written, he was to get a complete program for all governmental policies to submit to this committee. The committee was then to have its hearings on those policies so that it could recommend to Congress what was to be done. I still think it would be better if there were an official monetary policy part of that report.

Chairman HUMPHREY. That is my judgment, sir. This coming year we will have the 30th anniversary of that act, and it is the intention of this committee to review the act, not only on the basis of memorializing it, but seeking whatever revisions, recommending whatever changes or alterations may be required, reviewing its history, taking a look at how it has been applied or not applied; and I think it will be a worthy exercise.

You have answered my next question.

Senator PROXMIRE. Would the chairman yield on this point?

Chairman HUMPHREY. Yes.

Senator PROXMIRE. Because I think it is very, very critical; the chairman and Mr. Maisel have raised a critical point. Did I understand you, Mr. Maisel, to say your study has convinced you that when the President makes his economic report to the Congress, and the Congress takes action on the report, and this committee makes its report, that this should give a clear message to the Federal Reserve Board as to their policy? Is that what you said?

Mr. MAISEL. I believe that is true, but I think a little stronger than that. In the history of the act, it was clear to me at least, that the President was to ask the Federal Reserve what they viewed the policy to be for the forthcoming year as part of the job of drawing up the report to the Congress.

Senator PROXMIRE. Well, what I am getting at is whether or not you share the views so vigorously expressed by Chairman Humphrey that the Federal Reserve Board has an obligation to provide policies that will give us maximum employment and so forth, as the law spells it out?

Mr. MAISEL. There is no other law of the land.

Senator PROXMIRE. Regardless of what President Ford does; he has not given us that kind of program. That is what I am getting at. The Board might have a little conflict. After all, it is a creature of Congress, the Federal Reserve Board is, and the Congress may say we want to go ahead and provide the kind of expansion that will put our people to work and reduce the unemployment level in accordance with the 1946 law. President Ford may not give us that kind of a program, and then what does the Federal Reserve Board do?

Mr. MAISEL. Then I think the Federal Reserve Board is in the middle. My interpretation is that it is required to coordinate its policy formulation with the President's report to this committee. Then you get into the question of what are the rights of Congress, under the act, compared to the President's. You bring in a report, but it seems to me that the report is not legislation. This is the argument you always get. Unless Congress is willing to legislate, as you nearly did this year, then the Board, it seems to me, is left in the middle, because there is not a single governmental policy. And under the act, the Board, I think, is required to follow a governmental policy. But, if you have an unclear governmental policy because the President and Congress disagree, then I think the Board is left in a very ambiguous situation, and it probably has to formulate its own policy in those cases.

Chairman HUMPHREY. I do not disagree with that. I said yesterday in the hearings that I think Congress has been derelict itself in setting what it considered attainable goals, because once the Congress has laid down the policy, it is not only the Federal Reserve Board that is supposed to take care of it, it is the President, too, you know. Congress is elected to make policy; not to run the Government, but to make policy. And my judgment is that we have been derelict on our side of the fence on implementing the Employment Act of 1946.

Do you feel the Fed's targets for money supply are consistent with a strong and sustained recovery from the present recession?

Mr. MAISEL. No, sir, I do not.

Chairman HUMPHREY. Mr. Eisner.

Mr. EISNER. Yes. I also do not feel they are consistent. I would like to indicate very quickly where I come by the 15-percent figure, because I think that there tends to be a great deal of compromise that develops when a lot of people are confronted with a policy which is foolish. They hesitate as to how far to go.

There is an article in the most recent issue of the Brookings Papers on economic activity, coauthored by Franco Modigliani, president-elect of the American Economic Association, and he points out very well with his coauthor, that in order to recover from a high rate of unemployment we have a substantial path to follow in that the economy will tend to grow at about a 4-percent rate per year if it simply is to keep at the same rate of unemployment. We know when we have high unemployment we have along with that a loss in overtime, lower hours, and less productivity; so with all of that he comes out with the notion that we would require a growth in real output over the next 2 years of 17 percent.

Chairman HUMPHREY. On an annual basis?

Mr. EISNER. No, 2 years, 17 percent, which is an annual rate of growth of 8 percent in order to get unemployment from the 9 percent to 6 percent in 2 years, and 6 percent, I would say, is still not living up to the better or the spirit of the Employment Act of 1946.

Now, that then is 8 percent per year in real growth. All of us are agreed that a 5 percent of inflation would be probably, would be certainly as much as we can hope for, or as little as we can hope for, and that adds up to 8 and 5, and to multiply, comes pretty much to 14 percent.

~~When you add the fact that you want to start the economy moving~~ rapidly, that there are lags, it is pretty rational, I would say, to press the Fed for a rate of growth of the money supply of 15 percent.

I agree with a good bit of what has been said. I agree very much with the thrust of the chairman's remarks on the importance of employment. I think a lot of people, most curiously our neighbors on the other side of Chicago, the University of Chicago, are guilty of what I would only call money illusion. Inflation is something everybody says he is against. I had a cute debate with Milton Friedman a few years ago that I lost.

Chairman HUMPHREY. I would like to have heard that one.

Mr. EISNER. I lost on the issue of "Shall we act now on inflation?" Everybody wants to act against inflation, and if you are in a great depression, people say act against inflation. The fact is, of course, if prices go up even at 12 percent, and money incomes are going up at 16 percent, people on balances are better off. That means real output is going up 4 percent per year. Some people will be suffering, but there would be enough real output to redirect so that you could avoid suffering for everyone you wanted to.

Where you have unemployment, it is not merely the tragedy to the individual unemployed, it is the loss on the output, and there is no way to redistribute lost output, so that you can leave everybody better off. Of course, the public sees inflation as a problem because they say, my God, prices have gone up 5 percent, and my income has not gone up at all. I have lost.

If we had a situation where prices were going up 5 percent, and employment were rising and incomse were rising by like 9 and 10 percent, then people would still grumble about inflation, but it would not be the issue.

I was delighted by the chairman's remarks about $M_1$, and I attempted to make the same point. And while I have agreed with a fair amount of what Mr. Bethke says, I would suggest that I cannot believe the inflation psychology is broader, the fact that Mr. Bethke has observed, because people know that $M_1$ has grown by 11 percent in the last 2 months. Indeed, the inflation psychology will be more if people know that interest rates are rising, because interest rates are a cost that affects them, and they will be affected in the cost of petroleum prices going up, and if you slap another dollar on import taxes, that is going to cause rises in prices to people, and people will see that. They see prices going up.

Now, I would differ a bit with Mr. Maisel, though I would agree with most of what he said, on the matter of fiscal restraint. This is no time for fiscal restraint. And I would also suggest that on the matter of whether tax cuts should be temporary or not, there is an important analytical distinction to be made between two kinds of tax cuts, tax cuts which are cuts on personal income, or on business income generally for that matter, which are cuts are not likely to have a quick effect, and not a substantial effect if they are tempory. Here again, there is a recent theory and experience ironically of both Milton Friedman and Franco Modigliani pointing out that a temporary cut in taxes on personal income is likely to develop largely in the short run an increased rate of savings. Only as people perceive that there incomes are permanently raised, will they consume more.

Now, there are other kinds of tax cuts which, if temporary, can be very effective, and here are curiously the housing issue lies again. I am very much against equipment tax credits and investment tax credits. They are a huge squandering of public funds for a relatively small result. But a temporary tax credit on equipment will be more effective than a longer range one. The same thing could apply, I agree with Mr. Maisel, on certain kinds of housing subsidies. If you tell a man, look, if you buy your house in the next year or two, you will get it for $2,000 less, but after that there is no subsidy, and then he has an incentive to buy it now. And the same thing in business equipment. If you tell a man, look, we are giving you this 10 percent credit, but we are doing it now because of the recession, we are not going to give you a credit for good because you do not deserve a credit for good, and it is not good for the economy. We will give you a credit if you buy the equipment in the next year when we want you to buy it. That kind of temporary tax advantage which affects the cost of items, which affects what we call intertemporal substitution, substitution over time, is desirable. Tax cuts should be temporary there, but in terms of income tax cuts, there is a strong argument to make them permanent. In terms of figures we have pointed out, which, of course, are not mine—they come from the Council of Economic Advisers on the full employment budget surplus—we have much too tight a fiscal policy. You know, it is one thing to say that at full employment we should run a surplus in the budget. That is entirely different from saying that we should have a full employment budget surplus when we are in recession, because when we are in recession we want a fiscal policy such that we are stimulating. And the measure of that is that if we were at full employment, we would be running a deficit, which is to say that we then have to have a full employment budget deficit now. When we get to full employment, then we can shift back to a full employment budget surplus, if we can do that at that time without jeopardizing our goals for employment.

Chairman Humphrey. Just a quick question, yes or no. Do you think they ought to extend the tax cut next year?

Mr. Bethke.

Mr. Bethke. I see no logical facts right now that say that the answer is "yes" or "no". I would wait. I do not see how you could say, or make a decision today, and not likely miss the target of truth.

Chairman Humphrey. Mr. Maisel.

Mr. Maisel. I think we could wait, but the answer clearly looks to be yes at the moment.

Chairman Humphrey. Mr. Eisner.

Mr. Eisner. I would not wait. The argument looks to be yes, and the best way to stimulate the economy is to make that decision clear so that people go ahead, can begin to plan and anticipate so they know they will have the income out of which to spend.

Chairman Humphrey. Let me tell you about a telephone call that I had last night in my office from a businessman at home who had been listening to our discussions on the radio a couple of days ago, and he was concerned about what he ought to do. He wanted to know whether the tax cut would be extended.

This man said if you are going to keep the taxes down I am going to build, but if you are not, I am not going to build, and not only that, the people that are going to do the financing of this program have said if the taxes are going to stay down, they are not going to finance.

Now, there is a practical example right out of the Twin Cities that came to me just last night. This is very interesting and it was in the millions of dollars.

Mr. Eisner. I would argue there, Mr. Chairman, that that is not an accident, that example. That follows consistently from basic economic principles with respect to it.

Chairman Humphrey. Excuse me. Go ahead, Senator Proxmire.

Senator Proxmire. I see we have a quorum call and I will just take a couple of minutes.

I want to follow up on what you said, Mr. Eisner. You expect that after the third quarter of 1975 that we will shift to a substantial full employment surplus, as I understand. Now, would a simple extension of the tax cut, in your view, be enough. I take it that you would want more than that. All that would do, as I understand it would be to give a $12 billion extension, and that would simply keep taxes from going up.

Mr. Eisner. Yes.

Senator Proxmire. Do you want more than that, or what do you want in addition?

Mr. Eisner. I am taking, of course, the Council of Economic Advisers' estimates, reported in the Survey of Current Business, and they are making their estimates on the basis of certain existing legislation in what they are forecasting. So it becomes simply a matter of calculating dollar by dollar now. If you cut taxes below what they are anticipating, you will reduce the surplus or increase the deficit.

Senator PROXMIRE. How much should we cut it? You talk about quite a vigorous stimulation.

Mr. EISNER. I would say a very vigorous stimulation.

Senator PROXMIRE. You would do it entirely in the tax cut area or would you rely on expenditure increases, too?

Mr. EISNER. This becomes partly a political question. I think there are very major needs for Government expenditures, and I am generally sympathetic to the Congress' efforts to make expenditures in areas that are need. And I am appalled at the vetoing of these expenditures on the ground that they will stimulate the economy too much and cause too much inflation.

Senator PROXMIRE. What I am asking is do you have a specific kind of a program, how much of it would be tax cuts and how much of it would be expenditures?

Mr. EISNER. I have not made that division. I should say that expenditures for goods and services have a more immediate and dollar-per-dollar greater impact generally than tax cuts, because if the Government goes out and buys goods and services of any kind, whether it is roads or mass housing or educational services, that is income as the money is spent.

Senator PROXMIRE. You know, we are expected to have a deficit of about—well, it varies. Some say $70 billion, some say $75 billion, and Secretary Simon said it would be $88 billion. How big should it be?

Mr. EISNER. The deficit—you see, that is an interesting question, question, but it is not one, if you will excuse me, to which one can give an unambiguous answer, given the recent state of the economy.

Senator PROXMIRE. I understand that.

Mr. EISNER. It would be much better now to have $88 or $100 billion.

Senator PROXMIRE. Let me ask you how big a full employment deficit we should have, if the economy improves? Obviously, it affects your real deficit, and how big a full employment deficit should we have under the present circumstances?

Mr. EISNER. I have made no calculations, but I just throw out a number, that given the slack that we are talking about, $250 billion in output, given the fact that we are anticipating a full employment budget surplus of $12 billion for the next year, I would say that it would be well within reason to shift that by $30 billion to an $18 billion deficit. That would be modest.

Senator PROXMIRE. $18 billion full employment?

Mr. EISNER. Yes. I am picking that number honestly out of a hat. You know, one feels one's way. The point is——

Senator PROXMIRE. Translated into perhaps a $100 billion deficit in 1 year.

Mr. EISNER. It might be, although the estimates are that if you turn the economy around that the actual deficit will decline. If it does not decline, then we should have a greater full employment budget deficit.

Senator PROXMIRE. Let me ask, unfortunately there is a rollcall and I have to run, let me ask Mr. Bethke one question. I agree with the 11 specific recommendations you make and they are very helpful.

Mr. BETHKE. Thank you.

Senator PROXMIRE. They are well thought out, and I certainly support, as the chairman has said, that he does, most of them. I am particularly concerned with your recommendation, your fourth recommendation, when you say to monitor and keep on top of the weaker aspects of private credit. As the chairman of the Senate Banking Committee, I am very concerned about that. We are being asked to consider financing problems such as New York City and many other areas. Do you have a recommendation with respect to what we do about these private credit problems, as they develop.

Mr. BETHKE. Well, let me taken them in order and just to suggest a few things. On REIT's, the banks today have attitudes that if interest rates do not suddenly skyrocket, with time, REIT's will get healthy because the building properties are backed up by REIT, mortgages will eventually come into use. But, any sharp increase in interest rates would probably say to the bank system—that owns REIT loans—chuck them; they are going to die in the squeeze. So government needs to handle policies in a way that does not shoot interest rates up. I have emphasized to you what I think it would result in this, and what will shoot up interest rates.

~~Now, as for mature cities. It simply~~ boils down that every city, and every person, has got to shape himself up before he is going to get help from his favorite uncle or grandmother. And if you have ever seen a case of not shaping up—just yesterday New York City was supposed to have a 12 o'clock deadline, when everything would be settled. Next day, one reads that "Oh, it has been postponed; we are going to talk about it a little bit more." City managers have got to get going and shape up.

Take airlines. Clearly, there are hundreds of millions in bank credit involved there. Airline losses are a combination of fuel costs and routing. On all of these things, somebody in Washington should be worrying and doing something about them. This is what I mean by monitoring.

Senator PROXMIRE. I understand. So you would suggest that various regulatory agencies with respect to airlines and banks and so forth stay on top of the situation and make recommendations to make sure that the institution remains sound. However, that would not really solve the economic problem, the economic problem of the unavailability of credit in these many areas we are discussing.

Unfortunately, I have got to run for the rollcall. I have not missed one in 9 years.

Chairman HUMPHREY. I thank our witnesses today. You have given so much in your oral testimony that it is exceedingly helpful to us.

I was going to ask a question on the international outlook. I do not know whether any of you want to make any comments on that? Mr. Maisel, do you?

Mr. MAISEL. No.

Chairman HUMPHREY. Mr. Eisner.

Mr. EISNER. No.

Chairman HUMPHREY. Well, thank you very much. We appreciate your helpfulness and your courtesy.

Mr. BETHKE. Thank you for your courtesy.

Mr. MAISEL. Thank you.

Mr. EISNER. Thank you, sir.

Chairman HUMPHREY. The committee stands adjourned.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]

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