788

MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

SECOND SESSION

JUNE 10, 17, 23, AND 30, 1976

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MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

THURSDAY, JUNE 10, 1976

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, Javits, and Percy; and Representatives Reuss and Brown of Ohio.

Also present: John R. Stark, executive director; Courtenay M. Slater, William A. Cox, Lucy A. Falcone, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller and Charles Bradford, minority economists.

Chairman HUMPHREY. Mr. Greenspan, I know that the work that you are involved in is of critical importance, but the Mora High School Band from Mora, Minn., was on the Senate steps at 10 a.m. And I am from Minnesota; there is an election in 1976. I don't believe you can vote in Minnesota, can you? And I went over to see my friends from Mora. Most of them are very good friends. They presented me with a little gift emphasizing their Swedish ancestry. So with that apology, I ask your understanding and forgiveness.

Would you proceed with the good news?

Mr. GREENSPAN. Thank you, Mr. Chairman.

Although I may not vote in Minnesota, I am a music lover, and I'm sorry you didn't invite me.

Chairman HUMPHREY. Well, I'm sorry I didn't think about that. They would have been impressed to meet you.

Thank you.

I have an opening statement, Mr. Greenspan, but I'm going to place it in the record so that we will not take your time, because we need to hear from you.

Did you have a statement, Congressman Reuss?

Representative REUSS. No.

Chairman HUMPHREY. Then I will proceed with inserting my opening statement in the record.

[The opening statement of Chairman Humphrey follows:]

Opening Statement of Chairman Hubert H. Humphrey

This morning the Joint Economic Committee begins its Midyear Review of the Economic Situation and Outlook. We are pleased to welcome as our witnesses Mr. Alan Greenspan, Chairman of the Council of Economic Advisers and Mr. Paul MacAvoy, Member of the Council.

Economic developments in the early months of 1976 on the whole have been encouraging. Welcome reductions in both unemployment and inflation have been achieved. Before our feeling of euphoria bursts all bounds, however, there are two points I would like to make as we begin these hearings.

First, contrary to the impression one gets from press reports, the recovery has not dramatically exceeded expectations. Both the shape and the magnitude of the recovery have been just about in line with the expectations of the Council of Economic Advisers and of private forecasters as expressed in our Annual Hearings last winter. And in line with the expectations of the Committee as described in our Annual Report. The notion which has grown up in some quarters that the economy is experiencing an enormous and unexpected boom is not correct.

The most crucial purpose of these hearings is to assess the outlook. Analysis of past developments and of the policies which brought about those developments is an important and interesting aspect of our review. Far more important, however, will be our attempt to look ahead and form judgements as to the policies which are needed from now on.

There is a general expectation that recovery will continue throughout this year and next. That's good, but it isn't good enough. We have been through the worst recession since 1937. Unemployment is still above the peak levels of most postwar recessions. Inflation is still troublesome. Hence, we cannot settle for just any old recovery. We must have a recovery which is strong, well balanced and sustained. Achieving this objective will require an extraordinarily difficult and skillful job of economic management.

Hence, while we can take satisfaction in the favorable developments of recent months, this is not a time to sit back and relax—not while nearly 7 million persons are still experiencing unemployment, another 3½ million can find only part-time work, and an additional 900,000 or more have become discouraged and ceased to look for work. The job of sustaining an economic recovery is only barely begun. Serious doubts still remain, not about the existence of recovery, but about its prospective strength and durability. These are the questions to be investigated during these hearings.

Chairman Humphrey. Now, Mr. Greenspan, please continue.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY PAUL MacAVOY, MEMBER; AND JOHN DAVIS, ASSISTANT TO THE CHAIRMAN

Mr. Greenspan. Mr. Chairman, looking over the length of my official statement, I think it's a bit long.

Chairman Humphrey. Gentlemen, forgive me for not mentioning the other member of the Council, but thank you very much for your presence here.

Mr. Greenspan. Thank you.

It is a pleasure to appear before the Joint Economic Committee today to review economic conditions at midyear and to discuss the outlook for the balance of the year with you. I am accompained today by Paul MacAvoy. Burton Malkiel is away on business and cannot be with us.

Chairman Humphrey. Who is your associate on your right?

Mr. Greenspan. I'm trying to keep him under cover. This is John Davis, assistant to the Chairman of the Council.

Chairman Humphrey. Fine. Welcome, Mr. Davis. We haven't had a chance to work on you, yet. [General laughter].

It's nice to have you here.

Mr. GREENSPAN. I will warn you, Mr. Chairman, I work on him all day long, and I lose.

In retrospect, the performance of the economy in the first half of the year has exceeded most earlier expectations, including our own. We are all aware of the steady stream of good news and favorable statistical releases of the past several months and I do not plan to cover these in great detail this morning. Instead, I would like to touch on some of the general aspects of the economic devleopments of the recovery to date, to place these in perspective and then turn to some of the policy problems and uncertainties which lie ahead of us.

Over the past three quarters, real gross national product has risen at an annual rate of 8.4 percent. The recovery in employment has also been dramatic. The rate of unemployment, although still high, has declined more rapidly than the most optimistic observers dared hope a year ago, even in the face of a very rapid rate of expansion in the number of people seeking work. Not only has inflation continued to subside, but the recent evidence, after due allowance for the obvious uncertainties involved in such a forecast, suggests that the gains we have made in reducing inflation and inflationary expectations are now being consolidated. It may be that the recent subsiding in the rise of the price indexes will prove to be owing to temporary factors. It may also be true that the risks of inflation are being underestimated. Overall, however, the present evidence suggests that the basic underlying rate of inflation in the United States has been reduced to somewhere in the area of 5 to 6 percent, although perhaps closer to the upper than the lower range of those numbers.

The early phase of the recovery in production and employment has benefited from a sharp increase in inventory investment. The end of the recession last year was marked by an abrupt end to the massive liquidation of excess inventories. The rise in production in the first quarter of this year was accelerated by the beginning of an effort to restore inventories to more normal levels. Nevertheless, the real final demand has continued to rise briskly, increasing at a 4.7 percent annual rate over the past three quarters. We should not expect the rise in output over the next several quarters to match the pace of the past 9 months.

I might say parenthetically, Mr. Chairman, if we exclude net exports from final demand, and in a sense measure the increase in final demand of the domestic sectors, the rate of increase over the last three quarters has been surprisingly high, 5.8 percent.

Not only has the recovery gained momentum but the underlying elements in it have become progressively more solid. The recovery has been well balanced, surprisingly so in view of its rapid pace. Although inventories are being rebuilt, current levels are still low both by historical standards and in relation to sales or production levels. Indeed, despite the inventory swing in the first quarter the ratio of inventories to sales or to output continued to decline, though at a reduced pace.

Perhaps most important of all, the reduction in both the underlying rate of inflation and in unemployment has engendered a substantial restoration in the confidence of consumers and businessmen in the viability of the recovery. As the substantial improvement which has occurred has become recognized, people have again become willing to

commit themselves to the purchase of automobiles, homes, and other durable goods in a fairly extensive way. Business investment, though still lagging, is beginning to pick up. Business intentions or plans for future investment are being revised upward. Consequently, although the pace of the recovery should be expected to subside a bit, there is no evidence that it will face or peter out in the immediate or foreseeable future. Indeed, the general absence of imbalances, the success in reducing inflation and inflationary expectations, the substantial income and employment gains now being registered and the strong underlying demand for capital goods which we expect to emerge by late this year increasingly suggest a sustained and durable recovery.

As of midyear, therefore, there do not appear to be compelling reasons to make major changes in the overall outlook for 1976 which the Council suggested in its economic report in January. As you recall, we suggested the likelihood of a year-over-year increase in real GNP in the 6- to 6.5-percent range. Taking recent developments into account, we would now be inclined to lift our expectations moderately. We would also adjust the 6 percent year-over-year increase in prices which we had expected downward but only slightly. Several of the factors which have been instrumental in the less than expected price rise in recent months, especially the declines in food and energy prices, do not seem likely to continue. Therefore, we expect the basic rate of nearly 6 percent annual rate of inflation to prevail into the near future.

So far, of course, consumer expenditures have provided most of the strength in final demand. Over the past four quarters real consumer outlays have risen by 5.6 percent. Real consumer outlays surged at an 8 percent annual rate of increase in the first quarters as purchases of automobiles and other durable goods rose sharply. Although some of the statistics suggest a pause in retail sales in late April and early May we anticipate continued strength in consumer outlays, but obviously not at the first quarter pace. Over the past year real per capita disposable income rose by 5 percent. Initial gains were bolstered by the tax reductions, but the sharp recovery in employment and hours worked has maintained the rapid pace of income improvement. The savings rate, following the initial subsidence from the very high rate in the third quarter of last year, which followed the tax reductions, has not yet declined markedly. Indeed, despite the substantial improvement in consumer confidence the savings rate is still at quite high levels by past standards. Barring a sudden reversal of some sort in our progress in reducing inflation, we feel confident in extrapolating continued healthy increases in consumer outlays into the near to intermediate term future.

Real business fixed investment actually grew at an 11.9-percent annual rate in the first quarter, adding strength to our belief that fixed investment will be an important factor in the recovery this year. Investment anticipation surveys have been revised upward progressively since last winter. Normal tendencies to underestimate the strength of our recoveries and business capital needs suggest that the rise in actual expenditures will continue to exceed current anticipations. At this point we believe that the 5- to 6-percent increase in business fixed investment which we suggested in the report is still a reasonable projection. Moreover, the improvement in the economy and in the investment climate has strengthened our belief that the latent strong underlying demand for capital goods will continue to materialize in 1977.

The recovery in residential construction has been just slightly slower than anticipated. In January we were expecting housing starts, with much of the recovery concentrated in single-family units, to rise to a 1.7-million rate by late this year. Although starts have fallen back slightly in March and April from the very high February rates, the basic factors underlying the housing markets have continued to improve. Mortgage interest rates, which have declined slightly from the levels of last year, have stabilized at levels which are consistent with the underlying inflation rate. Savings inflows have continued at very high levels, confidence has improved, vacancy rates have declined and we expect the moderate pace of recovery in housing to continue, and don't expect any significant alterations from our previous expectations.

The Consumer Price Index has risen by 6.1 percent in the past year, April 1975 to April 1976, but the rate of increase has been only 3.5 percent in the past 4 months. The sudden and further slowing of inflation in early 1976 was due to significant declines in both food and energy prices.

In the next few months, moderate increases in food prices are expected. In fact, some of our weekly data already indicates increases since the last official report. The expected increase results from the recent farm and wholesale price increases in meats, coffee, and some fresh fruits and vegetables which have not yet been fully passed through to the retail level.

Chairman HUMPHREY. Might I just make a suggestion here on the meat side. It will be on the careful side. You know there is a tremendous liquidation of meat in the Midwest.

Mr. GREENSPAN. Yes, I noticed the reports from South Dakota.

Chairman HUMPHREY. And it might bring that Wholesale Price Index down.

Mr. GREENSPAN. Thank you, Senator.

Nevertheless, the outlook for the rest of 1976 is for continued moderation in the rate of food price increases. And if the United States and world crops as large as currently projected by the Department of Agriculture and by private forecasters materialize, the period of relative food price stability should continue into 1977. Of course, sudden weather-induced changes in the prospective size of this year's grain harvests could alter this situation.

The decision not to raise oil prices by the foreign oil producers reduces the possibility of substantial energy price increases in the next few months.

Much of the increase in consumer prices so far this year has been due to higher prices in the services component which have risen at an annual rate of over 9 percent during the 4 months ending in April. However, service prices eased in April reflecting a slowdown in the rate of price increase in transportation and medical care services.

The slower pace of increase in the CPI has reflected an even more dramatic slowdown in wholesale prices partly because of lower prices for farm products. Over the past 7 months wholesale prices have risen at a 2 percent seasonally adjusted annual rate. There has been some tendency recently for cyclically sensitive industrial commodity prices to rise. It is nonetheless encouraging to note that industrial commodity prices have risen at a seasonally adjusted annual rate of less than 3 percent so far this year.

Underscoring the improvement in the price side is what is occurring in wages. Average hourly earnings of private nonfarm workers, adjusted for overtime and industry shifts, rose at a 6.9 percent seasonally adjusted annual rate between December and May. This, I might add, is somewhat lower than the objective for this period. Difficult labor negotiations nonetheless do lie ahead, but the experience to date this year on the whole has been encouraging. Settlements have been consistent with the overall price track which we have suggested for this year, and in fact, may even be a bit lower.

The evidence suggests that the improvement in the employment situation should also continue. The unemployment rate, as you know, has declined fairly continuously from 8.9 percent in May 1975 to 7.3 percent in May 1976, a decline of 1.6 percentage points. Although the rate is still very high, the decline represents substantial progress and it has been widespread.

Since the March 1975 recession low, employment as reported in the household survey increased by 3.6 million, a rise of 4.3 percent. Within the last 2 months alone, the increase has been 1 million.

The growth in the number of jobs has been accompanied by a sharp increase in the length of the workweek. Average hours of work among production workers were 35.9 in May of 1975, and increased to a peak of 36.5 in January 1976, and have since declined to 36.3. Overtime hours of work in manufacturing have also shown a substantial and nearly continuous increase from 2.4 hours in May 1975 to 3.3 in May of 1976.

What implications for economic policy are contained in this background of encouraging developments?

The recovery is progressing at a better than expected pace. Both unemployment and inflation are still too high. Investment measured by probable future needs is probably still too low. But progress is very clearly being made, and this progress is very likely to continue.

There are several economic policy problems which we have discussed with this committee previously. It is even more important today to recognize that policies which are suitable for recession or early recovery conditions are not suitable for advanced recovery periods. It is important, therefore, to recognize the need to put the fiscal policy transition which is proposed in the President's fiscal 1977 budget into place.

The budget proposals, as you are well aware, have been criticized as being inadequate to maintain the pace of the recovery. The basic argument has been based upon the view that the recovery in private demand would be weaker than our estimates back in January indicated. From this it has been concluded that the reduction proposed in the fiscal 1977 deficit would mean too much restraint and the possible short circuiting of the recovery.

We have disagreed with this view, believing that a strong recovery in private demand is both the most probable and the most desirable outcome. This conclusion requires a marked and progressive shift toward less fiscal stimulus over the next 3 years, beginning in fiscal 1977.

So far the evidence clearly supports the idea that the recovery will continue to be strong. It seems, however, that the argument really involves much more than which forecast is right and which is wrong.

Let us suppose that our forecast is much too sanguine and that private demand expands less strongly than we have forecast. Should this prove to be the case, we do have the capacity to move reasonably quickly with little cost, through cuts in taxes to a lesser degree of fiscal restraint. In effect, this mistake can be corrected fairly easily, and hence it is much less serious than the consequences of being wrong on the other side. A policy based, in effect, upon the expectations of very modest increases in private demand and a corresponding need for greater fiscal stimulus cannot be corrected quickly should it prove wrong. The risks of igniting a new inflationary boom under such a scenario would be quite high because our capacity either to brake Federal outlays or to raise taxes is exceptionally limited. In effect, there would be a massive increase in Federal demands for funds in the capital market in a climate of rapidly expanding private demand.

Economic policy must be based upon the best estimate of what the appropriate policy mix should be. But it must also incorporate the risks that the implicit forecast underlying that policy may be wrong, and the consequences which would result from that mistake. Our inability to cope with the consequences of being too expansionary clearly indicates the desirability of a greater degree of caution in our policies. We believe that the most probable economic outcome calls for fiscal restraint. The economic statistics of the past several months also rather clearly suggest the wisdom of this approach.

The lessons which we have so painfully learned in the recent past surely include the notion that rapid and accelerating inflation is inimical to stable high employment economic conditions. Inflation, once underway, moreover, is brought under control only with great difficulty and with very high costs. We must be doubly certain that the fiscal and monetary policies followed in the period ahead, avoid undue risks of setting off another round of inflation in the future. Unless we can accomplish this we cannot safely count on a continued deceleration in inflation. Indeed, we cannot even count on being able to avoid another serious future recession.

Thank you.

Representative REUSS [presiding]. Thank you, Mr. Greenspan. Your prepared statement will be included in the hearing record.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN

MIDYEAR REVIEW OF THE ECONOMY

It is a pleasure to appear before the Joint Economic Committee today to review economic conditions at midyear and to discuss the outlook for the balance of the year with you. I am accompanied today by Paul MacAvoy. Burton Malkiel is away on business and cannot be with us.

In retrospect the performance of the economy in the first half of the year has exceeded most earlier expectations including our own. We are all aware of the steady stream of good news and favorable statistical releases of the past several months and I do not plan to cover these in great detail this morning. Instead I would like to touch on some of the general aspects of the economic developments of the recovery to date, to place these in perspective and then turn to some of the policy problems and uncertainties which lie ahead of us.

Over the past three quarters real gross national product (GNP) has risen at an annual rate of 8.4 percent. The recovery in employment has also been dramatic. The rate of unemployment, though still high, has declined more rapidly than the most optimistic observers dared hope a year ago, even in the face of a very rapid rate of expansion in the number of people seeking work. Not only

has inflation continued to subside but the recent evidence, after due allowance for the obvious uncertainties involved in such a forecast, suggests that the gains we have made in reducing inflation and inflationary expectations are now being consolidated. It may be that some portion of the recent subsiding in the rise of the price indexes will prove to be owing to temporary factors.. It may also be true that the risks of inflation are being underestimated. Overall, however, the present evidence suggests that the basic underlying rate of inflation in the United States has been reduced to somewhere in the area of five to six percent.

The early phase of the recovery in production and employment has benefited from a sharp increase in inventory investment. The end of the recession last year was marked by an abrupt end to the massive liquidation of excess inventories. The rise in production in the first quarter of this year was accelerated by the beginning of an effort to restore inventories to more normal levels. Nevertheless, real final demand has continued to rise briskly, increasing at a 4.7 percent annual rate over the past three quarters. We should not expect the rise in output over the next several quarters to match the pace of the past nine months.

Not only has the recovery gained momentum but the underlying elements in it have become progressively more solid. The recovery has been well balanced, surprisingly so in view of its rapid pace. Although inventories are being rebuilt current levels are still low both by historical standards and in relation to sales or production levels. Indeed, despite the inventory swing in the first quarter the ratio of inventories to sales or to output continued to decline, though at a reduced pace.

Perhaps most important of all, the reduction in both the underlying rates of inflation and in unemployment has engendered a substantial restoration in the confidence of consumers and businessmen in the viability of the recovery. As the substantial improvement which has occurred has become recognized, people have again become willing to commit themselves to the purchase of automobiles, homes and other durable goods in a fairly extensive way. Business investment, though still lagging, is beginning to pick up. Business intentions or plans for future investment are being revised upwards. Consequently, although the pace of the recovery should be expected to subside a bit, there is no evidence that it will fade or peter out in the immediate or foreseeable future. Indeed, the general absence of imbalances, the success in reducing inflation and inflationary expectations, the substantial income and employment gains now being registered and the strong underlying demand for capital goods which we expect to emerge by late this year increasingly suggest a sustained and durable recovery.

As of midyear, therefore, there do not appear to be compelling reasons to make major changes in the overall outlook for 1976 which the Council suggested in its Economic Report in January. As you recall, we suggested the likelihood of a year over year increase in real GNP in the 6 to 6.5 percent range. Taking recent developments into account, we would now be inclined to lift our expectations. We would adjust the 6 percent year over year increase in prices which we had expected downward but only slightly. Several of the factors which have been instrumental in the less than expected price rise in recent months, especially the declines in food and energy prices, do not seem likely to continue.

So far, of course, consumer expenditures have provided most of the strength in final demand. Over the past four quarters real consumer outlays have risen by 5.6 percent. Real consumer outlays surged at an 8 percent annual rate of increase in the first quarter as purchases of automobiles and other durable goods rose sharply. Although some of the statistics suggest a pause in retail sales in late April and early May, we anticipate continued strength in consumer outlays, but obviously not at the first quarter pace. Over the past year real per capita disposable income rose by 5 per cent. Initial gains were bolstered by the tax reductions, but the sharp recovery in employment and hours worked has maintained the rapid pace of income improvement. The savings rate, following the initial subsidence from the very high rate in the third quarter of last year, which followed the tax reductions, has not yet declined markedly. Indeed, despite the substantial improvement in consumer confidence the savings rate is still at quite high levels by past standards. Barring a sudden reversal of some sort in our progress in reducing inflation, we feel confident in extrapolating continued healthy increases in consumer outlays into the near to intermediate term future.

Real business fixed investment actually grew at an 11.9 percent annual rate in the first quarter, adding strength to our belief that fixed investment will be an important factor in the recovery this year. Investment anticipation surveys

have been revised upward progressively since last winter. Normal tendencies to underestimate the strength of the recoveries and business capital needs suggest that the rise in actual expenditures will continue to exceed current anticipations. At this point we believe that the 5 to 6 percent increase in business fixed investment which we suggested in the Report is still a reasonable projection. Moreover, the improvement in the economy and in the investment climate has strengthened our belief that the latent strong underlying demand for capital goods will continue to materialize in 1977.

The recovery in residential construction has been just slightly slower than anticipated. In January we were expecting housing starts, with much of the recovery concentrated in single family units, to rise to 1.7 million by late this year. Although starts have fallen back slightly in March and April from the very high February rates, the basic factors underlying the housing markets have continued to improve. Mortgage interest rates, which have declined slightly from the levels of last winter, have stabilized at levels which are consistent with the underlying inflation rate. Savings inflows have continued at very high levels, confidence has improved, vacancy rates have declined and we expect the moderate pace of recovery in housing to continue.

The Consumer Price Index has risen by 6.1 percent in the past year (April 1975 to April 1976) but the rate of increase has been only 3.5 percent in the past four months. The sudden and further slowing of inflation in early 1976 was due to significant declines in both food and energy prices.

During the first four months of 1976 food prices fell at an annual rate of 4.4 percent. Energy prices, reflecting the removal of the tariff and the initial price rollback effects of the energy program, declined at an annual rate of 7.2 percent. Gasoline and motor oil prices in April, were 5.8 percent below the level of six months ago. All other items in the CPI rose at an annual rate of 7.5 percent. In the next few months, moderate increases in food prices are expected—the result of recent farm and wholesale price increases in meats, coffee and some fresh fruits and vegetables which have not yet been fully passed through to the retail level. Nevertheless, the outlook for the rest of 1976 is for continued moderation in the rate of food price increases. And if U.S. and world crops as large as currently projected by the Department of Agriculture and by private forecasters materialize, the period of relative food price stability should continue into 1977. Of course, sudden weather-induced changes in the prospective size of this year's grain harvests could alter this situation.

The decision not to raise oil prices by the foreign oil producers reduces the possibility of substantial energy price increases in the next few months. Domestic oil prices, however, are being held substantially below world market levels. Under the new energy legislation domestic oil prices will be allowed to rise gradually over the next three years. An increase of about 10 percent in the composite price for domestic crude oil is scheduled to take place by next March and economic recovery both in the United States and abroad will lift demand and also tend to pull energy prices upward.

Much of the increase in consumer prices so far this year has been due to higher prices in the services component which have risen at an annual rate of over 9 percent during the four months ending in April. However, service prices eased in April reflecting a slowdown in the rate of price increase in transportation and medical care services.

The slower pace of increase in the CPI has reflected an even more dramatic slowdown in wholesale prices partly because of lower prices for farm products. Over the past seven months wholesale prices have risen at a 2.0 percent seasonally adjusted annual rate. There has been some tendency recently for cyclically sensitive industrial commodity prices to rise. It is nonetheless encouraging to note that industrial commodity prices have risen at a seasonally adjusted annual rate of less than 3 percent so far this year.

The major collective bargaining agreements negotiated in the first quarter of the year resulted in average first year wage gains of 8.8 percent. (These settlements covered 270,000 employees under contracts of 1,000 or more workers.) Average hourly earnings of private nonfarm workers, adjusted for overtime and industry shifts, rose at a 6.9 percent seasonally adjusted annual rate between December and May. Difficult labor negotiations lie ahead but the experience to date this year on the whole has been encouraging. Settlements have been consistent with the overall price track which we have suggested for the year.

The evidence suggests that the improvement in the employment situation should also continue. The unemployment rate has declined fairly continuously from 8.9

percent in May 1975 to 7.3 percent in May 1976, a decline of 1.6 percentage points. Although the rate is still very high, the decline represents substantial progress and it has been widespread.

Since the March 1975 recession low, employment as reported in the household survey increased by 3.6 million, a rise of 4.3 percent. Within the last two months alone the increase has been 1.0 million.

The data on the number of private nonfarm payroll jobs indicate an increase of 2.5 million (3.3 percent) since May 1975. In the last two months the increase has been about 370,000 jobs. Although there is some discrepancy between the growth in jobs in the establishment series and the growth in employment from the household survey, both indicate a substantial improvement.

The growth in the number of jobs has been accompanied by a sharp increase in the length of the workweek. Average hours of work among production workers were 35.9 in May 1975 and increased to a peak of 36.5 in January 1976, and have since declined to 36.3 hours. Overtime hours of work in manufacturing have also shown a substantial, and nearly continuous increase from 2.4 hours in May 1975 to 3.3 hours in May 1976.

Since May 1975 the unemployment rate of adult men (age 20 and over) who are disproportionately represented in the cyclically sensitive construction and manufacturing industries, declined fairly continuously by 1.6 percentage points to 5.6 percent. Adult women also experienced a 1.6 percentage point decline in unemployment, to 6.8 percent, with 0.5 percentage point of a decline in the latest month. The teenage unemployment rate declined by 1.1 percentage points from May 1975 to April 1976, and by another 0.7 percentage point in May 1976.

One of the most dramatic changes, however, has been in the long duration unemployment rate, those unemployed 15 weeks or longer as a percent of the labor force. From a level of 2.7 percent in May 1975 it increased to a peak of 3.3 percent in December as the duration of unemployment increased for those who had been laid off during the recession. The long duration unemployment rate had declined to 2.1 percent by May. Thus, the component of unemployment which may represent the most severe financial hardship has also been the component that has shown the greatest improvement in the last six months.

What implications for economic policy are contained in this background of encouraging developments.

The recovery is progressing at a better than expected pace. Both unemployment and inflation are still too high. Investment, measured by probable future needs, is probably still too low. But progress is very clearly being made—and this progress is very likely to continue.

There are several economic policy problems which we have discussed previously. It is even more important today to recognize that policies which are suitable for recession or early recovery conditions are not suitable for advanced recovery periods. It is important to recognize the need to put the fiscal policy transition which is proposed in the fiscal 1977 budget into place.

The budget proposals, as you are well aware, have been criticized as being inadequate to maintain the pace of the recovery. The basic argument has been based upon the view that the recovery in private demand would be weaker than our estimates indicated. From this it has been concluded that the reduction proposed in the fiscal 1977 deficit would mean too much restraint and the possible short circuiting of the recovery.

We have disagreed with this view, believing that a strong recovery in private demand is both the most probable and the most desirable outcome. This conclusion requires a marked and progressive shift toward less fiscal stimulus over the next three years, beginning in fiscal 1977.

So far the evidence clearly supports the idea that the recovery will continue to be strong. It seems, however, that the argument really involves much more than which forecast is right and which is wrong. Let us suppose that our forecast is much too sanguine and that private demand expands less strongly than we have forecasts. Should this prove to be the case we do have the capacity to move reasonably quickly through cuts in taxes to a lesser degree of fiscal restraint. In effect this mistake can be corrected fairly easily, and hence it is much less serious than the consequences of being wrong on the other side. A policy based, in effect, upon the expectations of very modest increases in private demand and a corresponding need for greater fiscal stimulus cannot be corrected quickly should it prove wrong. The risks of igniting a new inflationary boom under such a scenario would be quite high because our capacity either to brake federal outlays or to raise taxes is exceptionally limited. In effect there would be a massive

increase in federal demands for funds in the capital market in a climate of rapidly expanding private demand.

Economic policy must be based upon the best estimate of what the appropriate policy mix should be. But it must also incorporate the risks that the implicit forecast underlying that policy may be wrong, and the consequences which would result from that mistake. Our inability to cope with the consequences of being too expansionary clearly indicates the desireability of a greater degree of caution in our policies. We believe that the most probable economic outcome calls for fiscal restraint. The economic statistics of the past several months also rather clearly suggest the wisdom of this approach.

The lessons which we have so painfully learned in the recent past surely include the notion that rapid and accelerating inflation is inimical to stable high employment economic conditions. Inflation, once underway moreover, is brought under control only with great difficulty and with very high costs. We must be doubly certain that the fiscal and monetary policies followed in the period ahead avoid undue risks of setting off another round of inflation in the future. Unless we can accomplish this we cannot safely count on a continued deceleration in inflation. Indeed we cannot even count on being able to avoid another serious future recession.

Representative REUSS. Mr. Greenspan, the President has recently announced plans for a meeting with the great industrialized nations in the Caribbean someplace later this month, and the agenda, as disclosed by key administration officials, Secretary Simon among them, is that the conference participants will be discussing how to stop inflation. I suggest you ought to change that agenda, and have it how to achieve full employment without inflation.

Isn't that really a better goal?

Mr. GREENSPAN. I think, Congressman, that the specific language was not how to stop inflation but a recognition of the fact that a necessary condition for the balanced growth which is required to achieve a durable condition of full employment throughout the industrialized countries, is to diffuse the inflationary imbalances which are perhaps the major cause of unemployment and economic instability.

So I would certainly argue that we should not view the problem in terms of some dichotomy between fighting inflation on the one hand and attempting to create full employment on the other. These two goals are not mutually exclusive, but must be pursued and attained together.

Representative REUSS. Well, I have listened carefully to what you have said, and it seems to me you simply repeated what I thought was the administration's view, that this conference was to make clear the dangers of inflation. You add, as the administration usually does, that inflation is what causes unemployment, but why don't you change your agenda? Why don't you do as I suggest and make it, one, the attainment of full employment in all the industrialized countries; and two, the containment of inflation in all the industrialized countries?

Mr. GREENSPAN. Well, Mr. Chairman, I wouldn't disagree with that. In effect that is precisely the basic purpose of discussing these issues at the meeting which is scheduled for Puerto Rico later this month.

Representative REUSS. Well, I shall await the upcoming news story on just what the agenda is, but if you agree with what I said——

Mr. GREENSPAN. Remember, I am just indicating the position of the administration and obviously I cannot speak for the other countries.

Representative REUSS. Turning to another subject, in your prepared statement you give the unemployment figures, pointing out that adult male unemployment, that is, has declined, and you give the present

percentage, 5.6 percent; adult female unemployment has declined, and you give the percentage, 6.8 percent. Then you say that teenaged unemployment has also declined, but you don't give the percentage.

Is it not a fact that teenage unemployment is still more than 19 percent?

Mr. GREENSPAN. Why don't I just give you the——

Representative REUSS. Or 18½ percent.

Mr. GREENSPAN. The figure is 18.5 percent. It has come down.

Representative REUSS. But why give the figures for adult men and adult women, but not for teenagers?

Is that because you don't think that is important?

Mr. GREENSPAN. I think we should have. In fact the decline in the teenage unemployment rate was from 20.3 percent in May of 1975, to 18.5 percent in May of 1976, a decrease of 1.8 points.

Representative REUSS. Yes; but is the figure you give me the figure that——

Mr. GREENSPAN. I certainly agree with you. It was an oversight on our part, Congressman.

Representative REUSS. In your prepared statement you say—

> The performance of the economy in the first half of this year has exceeded most earlier expectations, including our own.

Then later you say, and I quote again—

> There do not appear to be compelling reasons to make major changes in the overall outlook for 1976 which the Council suggested in its Economic Report in January.

Can you harmonize those two statements?

Mr. GREENSPAN. Yes. I believe I emphasized the words "major changes," and actually I suspect that when the new forecasts which are now evolving, are presented in the midyear budget review, are likely to show real growth of something in the area of 7 percent for the year. I would characterize that as a moderate and not as a major change in our forecast largely because qualitatively our capacity to forecast real growth within 1 percentage point is, as you know, quite limited.

Representative REUSS. You use a lot of euphoric phrases, "good news," "favorable releases," "dramatic recovery," and so on. Have you looked at the Manufacturer's Hanover, June Newsletter on Quarterly Business Analysis, particularly the part where they compare the increase in real GNP with the real increase in other economic recoveries, and they find that the present increase, a little bit over 7 percent, is well within the range of 4½ percent to 13¼ percent posted during the first year of the five previous business bouncebacks.

Wouldn't that indicate that we really shouldn't be dancing in the streets about the present recovery? That is a good old B− type recovery.

Mr. GREENSPAN. I don't know if I'd describe it as B−, Mr. Chairman. If you recall, as we were coming out of the recession, there was very considerable concern about the recovery being subnormal and there were a number of factors which concerned many analysts. The level of expectations evident in the forecasts made say, in mid to late 1975 twere very much lower than the actual outcome.

So, even with the same evidence regarding past business cycle recoveries, the general conclusion was that this recovery would probably be

subnormal. I would say that it is very encouraging that it has turned out to be a rather normal recovery from a sharp recession.

Representative REUSS. Well, would you accept, then, as a headline from our friends in the press this morning something like "Recovery Less Puny than Earlier Thought," Greenspan Says? [General laughter.]

Mr. GREENSPAN. I have never tried to write the headlines.

Representative REUSS. Representative Brown.

Representative BROWN of Ohio. Thank you, Congressman.

Mr. Greenspan, I wonder if you could address yourself for a minute to whether or not there are specific—whether or not we are far enough along in the recovery to see whether there are specific changes being made in the economy as a result of the major recovery. In other words, what areas seem to be recovering more rapidly and better than others? Are there areas that are lagging behind in terms of what has been a normal balance in U.S. production?

Mr. GREENSPAN. Referring to Representative Reuss' previous comment this recovery is not far from average so far as the overall numerical strength is concerned. It also has many of the other classical characteristics such as strong consumer demand in the early stages, which of course is being buttressed by a major swing in inventory behavior from marked degrees of liquidation to accumulation. Such swings in inventory behavior typically provide a major part of the initial thrust of a recovery. The current recovery is reasonably typical in that respect with the possible exception that capital investment is lagging slightly behind its ordinary pace at this stage of the cycle.

Of course, having come through a very extraordinary period of inflation in 1973 and 1974, the residual rate of inflation and some aspects of the pattern of price behavior are somewhat different, but excluding that, we are looking at a fairly average type of recovery, with large swings in consumer durable goods, in inventories, a fairly good recovery in housing from its lows, and with a lag in the big capital goods markets.

Representative BROWN of Ohio. I want to pursue that point a little further.

We had in this room yesterday another subject of capital investment and capital formation. Some experts—anybody who sits on that side of the table, I guess, by definition is an expert—testified that we had had 5 to 7 euphoric years, years in which industry got so expansive as to invest in capital, invest in plant formation beyond their needs, to invest in certain other parts of the economy beyond reasonable expectations for the markets supporting that.

One example given by one of the experts on this side of the table—me—was that even the banks had gotten a little euphoric in New York and were so optimistic as to loan money to the city of New York—in general, specifically beyond the prospect of New York being able to pay it back.

And the question is, Is that impacting on capital investment now? In other words, are we overbuilt as a result of the 7 years or 5 years or whatever timespan you want to put on it from 1968 to 1974 in terms of plant capacity in some areas?

Mr. GREENSPAN. Mr. Brown, I think we are always overbuilt in some areas in plant capacity. That is the nature of our system. But to con-

clude from that that there will be a lower level of capital investment required in the years ahead is a very narrow conclusion, for the following reasons.

First, a very substantial portion and perhaps even the bulk of capital outlays are not for expansion purposes but for modernization—basically for cost-reduction purposes.

Representative BROWN of Ohio. Improved efficiency and productivity.

Mr. GREENSPAN. Improved efficiency and productivity.

As far as we can determine and largely as a consequence of the extraordinary rise in energy prices since the time equipment was put in place, a great deal of our plant and equipment is not as efficient in the use of energy as would be economical, given the new level of energy prices.

There is a particularly high rate of return now on putting in energy-saving equipment so that there is a latent demand which is now beginning to materialize for energy-saving capital investment.

Then, of course, the whole question of energy availability suggests the need for very significant capital investment in the energy area. A good deal of investment is also being mandated by environmental and safety requirements. Most important of all, of course, is the need for investment to provide productive jobs and a continued improvement in our standard of living. Taking these factors together we have concluded that investment requirements are in excess of 12 percent of GNP during the latter part of the 1970's.

So that even though there are a number of industries which have excess capacity at present—and I might add, a number which do not—that in itself does not invalidate the conclusion that we face very substantial capital investment requirements in the years ahead.

Representative BROWN of Ohio. I have a question related to that, and I have two following questions that relate to it.

First, are we better off in the United States than some of our industrialized competitors in terms of the fact that our recovery has been more rapid than the recovery of some of the industrialized nations?

In other words, are we better prepared to fill the world's needs, consumer needs and market needs, than others are?

Mr. GREENSPAN. Well, there are two parts to that, Mr. Brown. One involves the strength of our recovery relative to those of the other major industrial countries. In certain respects, of course, our recession was also more severe. But in any event, because the United States is such a dominant factor in the world economy, the direction of our country's economy is clearly very important to the rest of the industrialized countries of the world, and does have a major effect upon them.

Representative BROWN of Ohio. But are we better able to take advantage of what seems to be a general, worldwide recovery because we seem to be recovering faster and quicker and more than the other industrialized countries?

Mr. GREENSPAN. I'm sorry, I don't understand the thrust of your question.

The degree of our recovery, per se, is important but not that critical an issue. What is more important, perhaps, is that our labor costs have been behaving a good deal better than most, and that is in part a reflection of the degree of recovery.

Representative BROWN of Ohio. Our inflation rate has also been behaving better than most, too?

Mr. GREENSPAN. Yes. We are looking at basically the same thing. And in that sense our capacity to fulfill the needs of the rest of the world is in reasonably good shape. Whether or not that puts us in a better position to fulfill world needs than our competitors also depends on a number of additional considerations, including exchange rates. As you know, there have been some quite significant changes in the exchange rates of a number of industrial conutries in the last 6 or 9 months.

Representative BROWN of Ohio. Finally, in the cycles that we have been through, just within the last 3 or 4 years, from low rates of unemployment to high rates of unemployment, and now recovery from those high rates of unemployment to some degree, but still of a relatively high rate of unemployment, we have established, I think, that there are certain areas of unemployment that are endemic: Blacks, teenagers, to some extent, females, although that is less true now than it was maybe in previous cycles, and there have been various proposals addressed to this question of unemployment, some of them addressed to 8.4-percent unemployment, even though the recovery is underway.

I don't know that there have been very many addressed to the question of endemic unemployment, of focusing an effort onto getting a job for those people who, in periods of low unemployment and high total unemployment, don't find jobs.

Are you contemplating anything, or shouldn't there be some kind of program addressed to that particular problem?

Mr. GREENSPAN. Well, first of all, Mr. Brown, a number of programs addressed to the question of retraining have evolved over the years and still exist, for example, summer youth employment and a wide variety of the programs already in the budget focus on this particular question.

Representative BROWN of Ohio. But summer youth employment is temporary. I shouldn't ask any more questions because my time is up, but summer youth employment is a temporary program.

Mr. GREENSPAN. I understand, but I do agree in principle with what you are saying, but the real problem that we have to confront is a very sticky one. There has been a great deal of effort, a great deal of thought, and a vast number of programs, as you know, directed at exactly this particular problem. The evidence bearing on the success of most of the programs has been quite mixed. It is nonetheless important that the issues be focused on. The administration's position is that is where the area of focus should basically be. One of the reasons is that when the very difficult pockets of structural unemployment are excluded that overwhelming bulk unemployment generally, more often than not, involves relatively short spells of unemployment, affecting a very large number of people in the work force. The solution to that problem is to improve the economy as quickly as possible, and in the interim, to alleviate the hardships with unemployment insurance. Embarking upon massive programs which would draw these people from the labor force where they will become productively reemployed fairly quickly is not the answer to the short-duration unemployment problem. But I do agree that the problem areas which you have pointed out, especially involving the teenaged population, are very difficult to fashion—that is, providing solutions which are viable.

We have a number of programs with fancy titles and lots of dollars addressed to this question.

Representative BROWN of Ohio. That don't work?

Mr. GREENSPAN. They don't work very well, and we really do not fully understand how to come at this in a viable and straightforward way. We do know that these problems do involve more than economic causes. They involve our educational institutions and the mechanisms by which people pass from education into jobs. We have not really successfully resolved this problem, even though we have looked at it for years. We simply don't have a viable solution to it. But that does not say we should not keep working on it.

Representative BROWN of Ohio. My time is up, Mr. Chairman.

Chairman HUMPHREY [presiding]. Mr. Greenspan, as you can hear by the buzzing here we have a number of votes underway, and I hope you will bear with us. It is difficult for us to conduct a logical and coherent hearing with this kind of interruption.

I have two questions to ask. If my colleagues would like to go down and get their vote registered, and then I'll take the few minutes that I have and turn it over to you for questioning.

I want to ask just a few general questions and then one or two specifics.

In your prepared statement you state that the figure for the annual rate of the GNP growth is 8.4 percent. Is that adjusted?

Mr. GREENSPAN. Seasonally adjusted? Yes, it is.

Chairman HUMPHREY. That is the real growth rate?

Mr. GREENSPAN. Yes, it is.

Chairman HUMPHREY. The growth rate of real GNP?

Mr. GREENSPAN. The growth rate in real GNP.

Chairman HUMPHREY. Fine. I just wanted to get that clear for the record.

You were figuring about, when you were here with us in January or February, that it would be about 6 or 6½ percent.

Mr. GREENSPAN. That is correct, Mr. Chairman.

Chairman HUMPHREY. And I'm happy to say I was even more optimistic at that time than you were on the growth rate.

Now, the second one; in your prepared statement you say, "It may also be true that the risks of inflation are being underestimated." You developed that later on.

Would you give the areas where you think the inflation possibilities might lie? I got your overall picture. You feel that it will stand somewhere around 6 percent at the annual rate. It has been down in the last couple of months around 3½ percent, which is an excellent response, but where do you think the risks lie, Mr. Greenspan, so that we might just kind of look to the future?

Mr. GREENSPAN. This gets to the question of whether or not you think that the level of prices, or the rate of inflation, is a matter of individual prices being somehow determined independently of the overall situation and then added up to the whole, or whether you believe that the inflation and inflationary factors as a whole are determined by essentially financial forces, which then force individual prices to, in fact, move in that direction.

There are arguments on both sides, and I think both are really relevant, rather than one or the other, although I do believe that the

further out you go the more important the financial forces become and in the long run they are by far the most dominant.

My major concern is that we have before us a very substantial Federal budget deficit—far beyond anything we have really had previously. I grant you that our usual adjustments for so-called full employment or normalized deficits seem to make the deficit look less alarming, but those calculations are in large part arbitrary, and the conceptual economic framework upon which they rest, is a little bit shaky.

My conception, though not conclusive at this point, is that those deficits are contributing to inflation in a significant way. We do know that the effect of deficits works its way indirectly through the monetary system, but only after very long lags. My concern is that we will not reduce the deficit sufficiently quickly to reduce the risks on the inflation side in a prudent manner. My basic and fundamental concern is that we are not reducing the rate of increase of Federal outlays sufficiently quickly to reasonably assure the creation of longer term balanced low inflation rates.

Chairman HUMPHREY. Now, how do you see the commodity picture, Mr. Greenspan? I mentioned a moment ago, and possibly Mr. MacAvoy might have some comment on it, what might happen with food prices. It is still conjectural because our country is so vast, and even though you have the drought area in the Midwest, it does not necessarily mean it has too serious an adverse effect upon the total economic picture, agriculturally.

I notice that futures—wheat, soybeans, and corn—are going up rather rapidly. Also, some of the weather reports in other parts of the world are not very encouraging.

But what do you see in other commodities? You say that oil prices are stabilized very well. I see the Libyans are going to increase certain kinds of heavy crude.

Mr. GREENSPAN. Light crude.

Chairman HUMPHREY. Light crude. But do you think other commodities, metals for example, have stabilized?

What is your outlook on that?

Mr. GREENSPAN. Well, I think you have to look at commodity prices from two points of view. One is that historically, normal cyclical recoveries have usually caused cyclically sensitive prices to rise. We also have to distinguish between the present context and that of say, 1955–56—which would have been a relatively minor acceleration by today's context—but would have been large by past standards. We must also recognize, as we talk about the concept of shortages and of cyclical price increases, that we don't mean the type of sharp worldwide acceleration which occurred in 1973 and a good part of 1974. Those were very unusual circumstances. We are in fact now experiencing some cyclical increases in a number of sensitive industrial prices. I would emphasize that these are not large increases by past standards and I would never say that they are major factors in contributing to inflation. On the food price side, I would like to turn it over to my colleague who has done a considerable amount of work on this question.

Chairman HUMPHREY. What do you see, Mr. MacAvoy, in that food-fiber sector? Have you made any forecasts at all?

Mr. MacAvoy. We have been looking closely at four elements—four factors in the food-at-home component of the CPI, Senator Humphrey—grains and cereal products; meat products; fruits and vegetables; and lastly, the very particular situation in coffee at the present time.

If we take full consideration of the outlook for the American grain crops, this production year, then indeed we are going to feel some impact from the drought conditions in the winter wheat crop that have already been realized.

However, most forecasters, whether at the Department of Agriculture, in the universities, or those on the CEA staff, expect that larger acreages for the spring wheat crop together with normal yields would make up for some of the winter wheat shortfall.

The outlook for meat products is very much as you have indicated. I would only add that futures prices also indicate a leveling of meat prices for a few months, at least. If we have record high slaughterings in these coming few months, then it could very well be that this will reduce the supply substantially after the first of the year. So we could have some immediate price softening in the immediate period, followed by substantial increases during calendar year 1977.

The outlook for fruits and vegetables is for an only moderate uptrend with some commodities rising at somewhat more than a 5-percent pace, and some by less.

The coffee outlook is not at all hopeful. We have a substantial crop loss in Brazil last year. At the present time, there are indications of some crop losses occurring again. Inventories worldwide are down. There is some accumulation of inventories by wholesalers and by brokers across the world in anticipation of further price increases.

If you take account of all of these factors and attempt to fashion an across-the-board estimate, because of the favorable conditions in grains and meats, you probably will come to our conclusion that the food prices will increase at a lower rate than the earlier 6-percent forecast by the CEA for this calendar year.

Chairman Humphrey. Thank you.

Mr. MacAvoy. So that is on the low side of the average.

Chairman Humphrey. Thank you, Mr. MacAvoy. I hope to come back to that; but right now I have to go cast my vote.

I want very much to come back and talk to Mr. Greenspan on the rate of investment, unless Senator Proxmire takes that up. I shall be back; so, please go ahead, Senator Proxmire.

Senator Proxmire [presiding]. Mr. Greenspan and gentlemen, in the first place I want to congratulate you on an excellent statement. Again, it is always a very, very fine job.

I do have some sharp differences of opinion, however, with you on your emphasis.

I get a feeling, Mr. Greenspan, that you are far more concerned with inflation than you are about unemployment, and that you have neglected the very real problem we have of unemployment, recognizing as you say, and say rightly, that we have made real progress in reducing unemployment in the last several months.

Still, consider these factors, the factors that you yourself explain in analyzing our recovery. The sharp increase in inventory and investment that we have is leveling off. The pickup in the rise in consumer

spending has been doing well. That was initially provoked by the big tax cut we had. There has been nothing like that since last year's tax cut that is likely to make it increase in the coming months. It is at a high level, but I doubt very much that is going to increase.

Business investment in plant and equipment is flattening out. The report the day before yesterday indicated that we were going to have in real terms no increase in the coming year, or maybe a less than 1-percent increase.

Housing has not been doing well, as you pointed out, in the last couple of months, although it did well before that. And as long as the mortgage rate is at 9 percent, and there is very little indication it is going to go much below that, almost a certainty that it is not going to recover very greatly.

The balance of trade last year was the most favorable in our history. Indications are it will be less favorable this year.

Profit recovery was good, and I hope it can be greater, because we need high profits. But profit recovery is unlikely to be as good in coming months in view of the fact that productivity will slow down somewhat as it always does in the later stages of the recovery.

The energy price drop and the food price fall which you very clearly have highlighted, and which I think helped the recovery greatly and I think helped the consumer greatly and helped hold down inflation, that is unlikely, as you say, to continue.

Auto prices are up, and that is likely to retard the recovery that we had in autos. Ford just announced today, the Wall Street Journal announced, a 6-percent increase.

Steel prices are expected to go up. They announced that they expected to increase.

Furthermore, interest rates, on the basis of testimony of Mr. Burns before our Banking Committee, are expected to increase, and he is following a policy that would do exactly that. Now, that might not affect long-term rates, but certainly short-term rates. Everybody expects that to slow down the recovery.

Now, as I understand it, you say we may grow too fast, with a consequent inflationary result, and I just can't see that at all. I've indicated some of the elements that would give us a greater increase in prices, that is, energy increase in price and food, but this has nothing to do with too much growth.

As long as we have more than 7 percent or more than 6 percent of our work force out of work, as long as we are moving along at 75 or 80 percent of capacity, it seems to me there is ample room for growth, and that this kind of policy which you indicate we should follow in the coming months is one that is going to continue to impose the main burden of fighting inflation on people who are out of work, the inarticulate people who are politically and financially weak, and it will do so to no purpose.

So I wish you would respond to that conclusion on my part.

Mr. GREENSPAN. Senator, I have several items here I jotted down, and I'd like to come back to them one at a time if I may.

First of all both past indications and present evident clearly indicate that a major thrust behind the decline in unemployment that has occurred was the restoration of confidence in the consumer area. In a very substantial part this has been a consequence of the reduction

of inflation. The very considerable interrelationships between inflation, instability, and unemployment suggest to me that we should not pose the problem in terms of unemployment versus inflation. We do not have this choice. As I said previously, the removal of inflationary excesses is a necessary condition for maintaining a stable and durable high employment economy. I doubt very much whether we can maintain that type of low level unemployment through the type of public job creation——

Senator PROXMIRE. Well, I hate to interrupt because I did ask a long question and make a long point, but when you talk about purging the inflationary excesses, precisely how does slowing down the rate of recovery do that under present circumstances? The inflationary excesses come from energy and food, perhaps, not from too much money chasing too few goods.

Mr. GREENSPAN. Well, first of all, that is item 7, so maybe I'll go down to the bottom.

I would not argue that the recovery in production, measured in physical volume terms, is excessive, and therefore it should be slowed down, because it in and of itself will create excessive inflation. I don't believe that. All that you get out of excessive recovery in volume and in bottlenecks, at this stage at least, are the typical cyclical price increases. In the past this type of price increase has not been all that much of a causal factor in the inflation problem.

So I would never argue that we must slow the rate for our economy down in order to diffuse inflation. Ultimately inflation is a financial phenomenon. It is not the economy or the level of real growth that must be slowed down but the growth of liquidity, the growth of Government deficits, the growth in money supply and in those elements which contribute to excesses in the financial area initially, and which ultimately create the inflation. We also have the example of the Japanese who have grown at very substantial rates without inflation.

Senator PROXMIRE. Not without inflation. The Japanese have had much worse inflation than we have.

Mr. GREENSPAN. Well, I'm talking about the earlier period when one can look at the degree of inflation in the context of huge rates of growth in output, even adjusting for that. One does not necessarily conclude that, but I certainly believe the issue is not to restrict and restrain the economy but the financial characteristics of it if we are to explain——

Senator PROXMIRE. Well, let me get at the anatomy of this.

Are you saying that if we grow too fast we are going to have a situation where we are going to have a shortage of labor at least in some areas, and because we have that shortage of labor we are going to have to pay wages which will be inflationary?

Mr. GREENSPAN. Only if that occurs in the context of financial accommodation. By that I mean, if you had a severe labor market shortage, for instance, if we create a situation of extreme tight labor markets.

Senator PROXMIRE. We are far from that; are we not?

Mr. GREENSPAN. We certainly are, and if we don't accommodate future tightness by very large money supply increases we are not likely to experience huge, outsized wage increases.

Senator PROXMIRE. Well, what you've told me, it seems to me, is almost a certain formula for slowing down the economy. You talk

about a more responsible fiscal policy. Of course, I agree with you wholeheartedly. But if you are going to accept that, then it seems to me you have to have a somewhat easier monetary policy. If you put the brakes on in both, the only two areas where we can consciously affect economic policy overall and encourage growth, then the result must be eventually slowing the recovery down.

Mr. GREENSPAN. Well, I'm not arguing for putting the brakes on monetary policy. What we are talking about here is not allowing the relatively moderate rates increases to accelerate in the period ahead thereby setting into motion the type of inflationary excesses which can bring recovery to a halt.

Senator PROXMIRE. Are you afraid that Arthur Burns and his seven blocks of granite are going to give us such an exciting and explosive increase in the money supply that there is any possibility of this at all? Isn't there a greater danger the other way, especially in view of the fact that Mr. Burns has told us he intends to have a somewhat less expansive monetary policy in the coming year?

Mr. GREENSPAN. Well, what I would indicate is that monetary policy cannot be, and never has been independent of fiscal policy. If we allow very substantial Federal deficits to continue as the recovery lifts us onto a much higher level of economic activity, the Treasury borrowings in the capital markets will put very significant pressures on the demand for Federal funds in our short term money markets by an indirect form or set of relations. The Federal Reserve will have very great difficulty in keeping the growth of the monetary aggregates down under these conditions. Their choice would be either to allow an extremely sharp rise in short term interest rates, or to accommodate a good part of the demand for Federal funds.

Senator PROXMIRE. All right, now, let's consider the real world. In the last year the Federal Reserve Board has expanded the money supply at a slow rate, relatively, much slower than many thought was desirable.

It has worked fairly well because we have had a big increase in the velocity of money. Now the Federal Reserve Board indicates it is going to be even slower in the coming months so that when we look at what has actually happened, we don't see much stimulus there.

Let me ask you this. What is your target for growth, 5 percent, 6 percent, 7 percent in the next year?

Mr. GREENSPAN. I don't have a specific target. What I would say is that the target would be the type of growth rate which could be sustained without simultaneously creating imbalances. By that I mean if we have a growth rate which is largely the consequence of accelerated inventory accumulation, I don't care what the growth rate is, it is unstable and will create its own demise ultimately.

On the other hand, if we have a very solid recovery in consumer purchasing in plant and equipment, largely in the modernization and productivity improvement area, and we are doing that in the context in which the Federal deficit is continuously declining and monetary growth is moderate, I wouldn't care what the growth rate was. I would say that is a sustainable growth rate, whether it is 5, 6, 8 or even 10 percent.

I might add in context of the previous point that you made. Senator, that the savings rate is still high, and that if the savings rate falls to

normal levels, we should expect consumer expenditures to be quite strong. It is certainly true that the events of last year did have an effect on the upsurge in consumer buying, it is also true that the savings rate has remained high and that, in that respect, the full impact of the tax cut has never really been spent.

Senator PROXMIRE. Well, frankly, I do think we ought to have some kind of a target, but I can understand your disagreement.

Let me ask you just two more questions that you can answer very briefly because my time is just about up.

The growth rate of final sales, do you have any target for that, and your expectation, in view of the fact that the situation is now changed, that is, we have got a better improvement in unemployment than we expected, what is your expectation in unemployment for the coming year?

Mr. GREENSPAN. I would say our growth rate in final sales is likely to be close to the figure I mentioned earlier, namely, the increase in final demand of the domestic sector. The reason I use that term is that in assessing the strength of demand in this country, we are really interested in what final demand is in total and to a lesser extent in whether this demand is being filled by foreign or by domestic suppliers.

When we talk about final demand in the GNP sense, it is final demand for domestic production only.

Senator PROXMIRE. What is your numerical figure?

Mr. GREENSPAN. Well, excluding the export component, the numerical figure I would use, would be roughly in the area of 6 percent.

Senator PROXMIRE. All right. What about unemployment? What do you expect that to do in the next year?

Mr. GREENSPAN. We expect unemployment to continue to recede. There is a possibility, Senator, of a slight uplift in the June unemployment rate, if our seasonal adjustment factors are deficient. This possibility has been widely discussed and if there is something to it, we will spot that in the June figure.

Senator PROXMIRE. What do you expect it to do by the end of the year?

Mr. GREENSPAN. By the end of the year I expect it to be under 7 percent.

Senator PROXMIRE. Under 7 percent.

My time is up.

Senator Percy.

Senator PERCY. Thank you.

Mr. Greenspan, I think you certainly have a good product to work within the economy at this time. Your statement has been extraordinarily incisive and helpful. Any time you want to turn to Paul MacAvoy or John Davis for amplification, we would be happy to have you do so. We certainly welcome both of you.

How do the actual figures on unemployment now compare with the estimates that were made earlier by the Council? Are they somewhat below, on target or——

Mr. GREENSPAN. Unemployment, at this point, is quite considerably below the levels we estimated in mid-December 1975, which was the cutoff point for our budget estimate analysis.

Senator PERCY. I recall that during one meeting we had here there was a heated discussion about the forecasts concerning unemployment.

And your forecasts were interpreted to be what the administration was planning on having.

Certainly you were not planning on having that high of a rate, but you forecast on a conservative basis while trying to bring it down as rapidly as possible.

Mr. GREENSPAN. Yes.

Senator PERCY. I would like to ask about productivity and what your own feeling is about the Productivity Center, and what role it can play.

I tend to think that the productivity increases are being made by decisions in board rooms all over the country and by labor-management councils and so forth, but to the extent that Government can help—and be a catalyst—do you look upon the Productivity Center as a useful thing? And does the administration continue to keep it as a high priority item and a mechanism for constantly focusing attention on the necessity of improving productivity?

Mr. GREENSPAN. There is no question about the necessity of maintaining and improving the rise in productivity in the years ahead. This is one of the main priorities of this adminstraton. There has been some evidence of a long-term slowing down in the rate of the increase in productivity, and that since our standards of living are so closely tied to this, anything we can do to enhance productivity is something to which I think we ough to direct specific attention.

Senator PERCY. Mr. MacAvoy.

Mr. MACAVOY. Perhaps I might add that in the last few weeks, the Productivity Center has turned its attention to the problems of productivity growth in the regulated industries in particular. The conference held here 2 weeks ago brought together analysts, executives, and union members from across the country to begin to deal with the long-term problem of the slowdown of technical progress, invention, innovation, entry, expansion in the transportation, energy, and communications industries and the extent to which the slowdown relates directly to the growth of regulation in this country.

My experience at that conference indicated that this is one of those initiatives that has had some impact, and my hope is that the Center will do a great deal more in the next few years.

Senator PERCY. I constantly bring it up because I know that Senator Javits, if he were here, would talk about it, and Senator Proxmire, and Senator Humphrey have certainly supported it, as I have. I just feel that it has been somehow lost in the shuffle in the past. I think it can be helpful, although I don't want to overestimate what it can accomplish. Certainly we can increase productivity in the Government, indeed, right here in the Senate.

We have been struggling for a long time with an antitrust improvement bill. Would you care to comment on the effects of price fixing? I don't want to overemphasize the extent of price fixing, as a factor in our overall pricing system. I tend to think it is a miniscule factor in our pricing system. But if we can effectively eliminate price fixing do you have any estimate as to what amount that might save the consumer per year?

Mr. MACAVOY. Senator Percy, the problems raised by making such an estimate are probably greater than in any other area of microeconomics. Horizontal price fixing is a conspiracy, a conspiratorial

activity in violation of the criminal code. Analysts and economists attempting to assess the impact of this kind of activity are essentially looking for a criminal activity. It is difficult enough to obtain worthwhile data to study the effects of regulation or the effects of taxes or tariffs on productivity, and the decline as a whole. To look at the effects of criminal activity is almost impossible.

I have not found useful estimates of the extent of price conspiracies in this economy in the last few years. That doesn't mean that an attempt shouldn't be made.

Senator PERCY. But those who believe deeply in the market system have an obligation to do as much as they can to see that the market system works, and I presume that the Justice Department has your full support and backing for doing what they can to eliminate this abuse.

Mr. MACAVOY. The Council has cooperated, and as long as I am here, will continue to cooperate vigorously on the enforcement of laws related to horizontal price fixing. We cooperate in attempting to help Mr. Kauper and his associates with economic analysis of various kinds of pricing activities, because this indeed is a serious economic defect in our system, and we should do our best to minimize it.

Senator PERCY. Mr. Greenspan, we've had recent reports of further shortfalls in the Russian grain harvest, and indications that they will be coming in to buy more American farm products.

First of all, can you give us an assurance that the administration will not entertain another embargo. I think the President has said that a grain embargo would not be necessary in the foreseeable future.

Can you give us any assurance on that?

And second, if there is another large purchase, will you be making any recommendations about food prices to the President?

Would a large purchase have any significant impact on food pricing?

Mr. GREENSPAN. Well, as Mr. MacAvoy said, the President has no intention of putting another embargo on with the specific estimates of Soviet grain crop. As you know, we have some evidence of a Soviet winter wheat crop that is still difficult to interpret. The substantial part of the Soviet crop is the spring crop. our estimates must be very tentative, but since my colleague has had a chance to address this, let him comment further on the worldwide agricultural availability and potential exports.

Mr. MACAVOY. At this point, as Alan Greenspan says, the estimates on this coming year's supply and demand depend on yield estimates or acreage estimates. The Department of Agriculture recently released, and we have gone over these releases, estimates of the Soviet crop for this year. It appears to us as if there is no basis for expectation of as low a crop level as last year. They lost somewhat more than normal in freeze conditions, but the acreage and the plantings and the yield forecast are not being revised at this time, and it appears as if they will end out in the range of 180 to 200 million metric tons.

Senator PERCY. You do not expect it to have a significant impact on pricing then?

Mr. MACAVOY. Insofar as the Soviet purchases are concerned, they are in many markets a marginal additional source. We do not forecast at this time that they will have a significant additional impact on world grain prices as a consequence of the loss that they have just incurred in the winter crop.

Senator PERCY. We have been holding hearings on capital formation and the sufficiency of capital to sustain economic growth.

Mr. Greenspan, looking at the longer range picture, for economic growth and stability over say a 10-year period, do you foresee any problems in raising sufficient capital to sustain economic growth and to employ our increasing labor force, and if you do see some problems, do you have any recommendations that you would like to make at this time as to what we should be doing?

Mr. GREENSPAN. Yes, Senator, I do have concerns about that. One of the critical factors which would be involved in employing our increasing labor force at productive jobs, that is, high-paying jobs which are associated with high productivity is capital investment. It is one of the major long-term problems which confronts this country.

Solutions are not easy, but it would help immeasurably to reduce the drain that the Federal Government has on our financial capital markets. This would free a considerable amount of private savings to finance the physical volume of capital investment which we will need.

I would say that we have the capacity to get the Federal budget into balance, as the President has requested, by fiscal year 1979. If we do so, then I would be much less concerned with respect to the availability of savings and financial types of capital.

Senator PERCY. In other words, the lessening of demand by Government to finance a deficit, and a balanced budget would release enough capital to create jobs, and to create and sustain our economic growth. So everyone has a stake in reaching that balanced budget stage if we can.

Mr. GREENSPAN. Yes, sir.

Senator PERCY. I thank you very much.

Chairman HUMPHREY [presiding]. Mr. Greenspan, first let me say I regret that I didn't compliment you on your statement. I think it is a reassuring statement that we have had this morning. I want to join my colleague, Senator Proxmire, in commending you on it.

There are one or two features that raise some questions in my mind.

You said that the substantial income and employment gains now being registered and the strong underlying demand for capital goods which are expected to emerge by late this year would increasingly suggest a sustained and durable recovery. And then later on in your statement you say, so far the evidence clearly supports the idea that the recovery will continue to be strong.

Now, everyone has a stake in that picture. Indeed, a sustained recovery is what the Nation needs because even though we have had a modest recovery in a very real sense in the first quarter and growth in real GNP was excellent, we were suffering from such a recession, such high rates of inflation and unemployment that we definitely needed some kind of recovery just to get our thinking straightened out, so to speak, and our spirits raised a little.

Many economists tell us that we should look forward to 1977 as not a year of substantial recovery.

Am I correct in that? From what I have read and I have seen in the journals, there is deep concern over 1977.

Mr. GREENSPAN. I think that that concern has been significantly lessened in the last couple of months, Mr. Chairman. Most forecasters

are indicating less of an increase in production next year, just as we are. But let me say that our capacity to forecast that far in advance is rather limited, and all I would indicate is that there has been a tendency for the forecasts for the year 1977 to be revised upwards. And I suspect that is going to continue to be the case.

Chairman HUMPHREY. Well, I hope you're right, and some of the factors that go into that I want to just comment on at this time.

I want to look at the investment forecast, because in your statement you have indicated that investments—capital investments are improving. You continue to project higher investment spending, even for this year, which is nearly 50 percent more than business itself foresees.

I just want to lay out a statement and get your comment on it. While the Commerce Department's latest surveys of business investment plans shows a very miniscule increase of 0.8 percent for 1976 over the March survey, and a small increase of less than 2 percent over the December survey, even the current survey shows virtually no change of real investment over last year, which was a recession year.

The Conference Board survey shows a drop in business investment which must be made before construction can begin. Even the McGraw-Hill survey, the only survey showing a significant increase in real investment spending plans for 1976, indicates what would seem to be a decline in real investment for 1977.

Now, I know that these spending plans can be revised, and they are being revised regularly, but there is an ominous unanimity among those who talk to business about their plans that no major upswing in investment is in the offing, and you and I know that it takes considerable time after investment decisions are made for construction to actually begin.

Isn't it therefore rather risky to assume that business investment will come to the rescue if the fiscal restraint that you advise were to be applied in the face of this evidence to the contrary?

Mr. GREENSPAN. No I don't, Mr. Chairman, for a number of reasons. First of all, it is true that Commerce does imply no change in year-to-year real investment. We believe, however, in looking at past experience with the surveys taken in the spring in the period of rising recovery that they suggest less of an increase than actually occurs.

Second, even were it the fact that the levels of fiscal investment in constant dollars in 1976 were the same as in 1975, since a good deal of 1975 was characterized by declining investment, then a rise in investment throughout this year would still not be inconsistent with very little change in the year-to-year totals.

Now, with respect to the Conference Board's capital appropriations series, that is a manufacturing series, and the decline that occurred in the first quarter was wholly attributable to a decline in appropriations by the petroleum companies which are heavily weighted in that particular sample.

The method used for projecting actual outlays is not as good as the Commerce Department's specific requests for plans and outlays. So there has been nothing in the recent data which I believe to be greatly inconsistent with the statement that we expect capital investment markets to become quite strong late this year. That's still a good 6 months or more away.

Chairman HUMPHREY. Yes.

Mr. GREENSPAN. And carry through 1977. And that view I might say also, Mr. Chairman, is held by a number of economists, perhaps the majority, today.

Chairman HUMPHREY. The McGraw-Hill survey of May 7, which I have here, says preliminary investment plans for 1977 are relatively weak. Don't misunderstand me. I don't want them to be weak. I think that you may very well be correct, but there has been so much commentary that the capital investment plans have not been what have been anticipated that it has added some credibility to the charge that in 1977 we would have a substantially weaker recovery.

Now, again I want to say in all fairness that the recovery rate in the first quarter of 1976 was so fast that you couldn't expect to maintain an 8.4 recovery rate in GNP for 1977. I wouldn't expect that at all. In fact, it is leveling off even somewhat now.

But I notice that the investment plans in all of the surveys are about 10 percent below 1973, so that we still have some problem here.

I will turn the meeting over to Senator Proxmire. The shuttle system is working, Mr. Greenspan.

Mr. GREENSPAN. Well, I was wondering, Mr. Chairman, if I might just quickly comment on the 1977 data. The McGraw-Hill survey shows, as I recall it, a 13-percent increase in 1976.

Chairman HUMPHREY. That is correct, a 13-percent increase over 1975.

Mr. GREENSPAN. That's correct.

The typical behavior of that survey is that the second year of the projection rarely, if ever, shows a significant change, because a significant amount of the following year's capital investment is not decided upon until the October appropriations meetings of companies. So that is a basic bias in the statistics themselves.

Chairman HUMPHREY. Thank you.

Senator Proxmire.

Senator PROXMIRE. I want to follow up on that, but before I do that, you are noted for being able to keep your elegant cool and to respond to questions with great aplomb and without any concerns. Let me tell you that I want to ask a couple that might be a little disturbing, but I ask them seriously. I realize you want to do your best, and you are doing a fine job of keeping your office out of politics.

Nevertheless, I would like to ask you as the chief economist of the administration now if you would give us as dispassionate and objective opinion as you can of the effect of the election of Jimmy Carter as President in 1977. [General laughter.]

Mr. GREENSPAN. I think you have succeeded in breaking my cool, Senator.

I don't think that is something I could appropriately address myself to. While I as Chairman of the Council of Economic Advisers am hopefully in a nonpolitical area, personally, I clearly expect and hope to see that the next President of the United States would be the current one. This would make the question you raise an academic one.

Senator PROXMIRE. Well, what effect might it have on the economy if we elect a President of the United States who favors Humphrey-Hawkins, and favors a more expansive fiscal and monetary policy?

Do you want to give us any judgment on that?

Mr. GREENSPAN. Senator Proxmire, I will not comment on what particular individuals are projecting. If you ask me for my views of the impact on the economy of the Humphrey-Hawkins bill as it now exists, either in the House version or S. 50, I have not changed my view from that communicated to you in a previous hearing The programs and the approach laid out in that bill would be most detrimental to the state of the recovery in the United States.

If you asked me what I think about a policy of excessive fiscal stimulation, irrespective of who is in office, at this particular point in the business cycle it would not contribute to the well-being of the Nation.

Senator PROXMIRE. All right.

Let me ask you another question. What effect, if any, psychological effect, does it have on labor when you have very, very large increases in pay for people in top positions?

Suppose you have a TV anchorperson, for instance, who is paid $1 million a year and this is twice as much as has been paid before, do you think this could have a psychologically adverse effect on trying to keep wage increases within reason?

Mr. GREENSPAN. Senator, I believe in the market system, and if somebody is paid $1 million a year, especially in competition from two networks, I would suspect that the market is saying that she is worth it.

Senator PROXMIRE. Well, I didn't want to make that personal. I said any person, but I know what you mean.

A little more seriously, I was very disturbed, Mr. Greenspan, in your discussion of final sales. You indicated to me that you expect they might be 6 percent in the coming year. That was an expectation or perhaps a goal.

Mr. GREENSPAN. No, I was merely indicating that in the last three quarters, final sales from domestic sectors had been raising at a rate of 5.8 percent, at an annual rate. I would expect that to be a trend that would be probably likely to occur in the period immediately ahead.

Let me pause by saying we are in the process of making a revised set of forecasts, and as a consequence of that I cannot say what our numbers will be until we have gone through a thorough review of them, but it does indicate that our aggregate GNP forecast will be revised somewhat, as I indicate, in the area of 7-percent overall for this year.

But in either instance I am not indicating that that is a goal. Our goal is to get the fastest rate of growth consistent with balance, and that is the reason why we are so forcefully arguing against policies which we believe would be inflationary forces.

Senator PROXMIRE. Well, you first statement seemed to contradict what you said in your statement, because when I asked you a question about final sales, you gave me something like 6 percent. Now I read your statement. It says that real final demand increased at a 4.5-percent rate over the past three quarters, and then you say we should not expect the rise over the next several quarters to match the pace of the past 9 months.

Mr. GREENSPAN. First of all, the final demand figures that are shown in the regular national income accounts are calculated by removing inventory changes from the production or the GNP figures. That is the 4.7 percent figure which I referred to in my prepared statement.

It indicates that real final sales in the U.S. economy from domestic sources rose at that annual rate during the past three quarters. I find it more useful in assessing the underlying total demand situation to also exclude net trade portions of the GNP accounts. Excluding the effect of changes in the net export-import balance allows us to guage directly the strength of total final demand in the economy, irrespective of the source of the supply of those goods and services. That figure is calculated as real GNP, minus both inventory investment and minus net exports, and as I indicated real final demand viewed in this manner has been increasing at a 5.8 percent annual rate during the past three quarters.

The concept that we are talking about—about output referred to the 8——

Senator PROXMIRE. Why do you take exports out? It is part of the production, it is part of the jobs.

Mr. GREENSPAN. We are taking out changes in both exports and imports.

Senator PROXMIRE. Exports and what?

Mr. GREENSPAN. And imports.

What we are trying to do is to determine the strength of demand within the U.S. economy; in effect adding up personal consumption expenditures, gross fixed investment, government expenditures regardless of whether these outlays were for goods and services produced in the United States or abroad.

Senator PROXMIRE. Well, I still don't understand the technical reason for that. For one, if you have a favorable balance of trade, taking your exports and imports out tends to distort what the effect would be on the overall on the production in this country.

Mr. GREENSPAN. It depends very much on what question you are trying to answer. For example, let me give you a very clear case of why that distorts an assessment of the overall demand situation in the United States. The first quarter figures I think are very instructive. During the first quarter real final demand—that is GNP less inventory change—rose at a 4.2 percent annual rate. What happened is we had an 8.5-percent increase in real GNP in the first quarter. A very big part of that increase occurred because of large inventory accumulation in the first quarter. Now we also had a very substantial rise in imports.

What we observe is that when inventories are rising sharply, some part of these inventories are coming from abroad in the form of raw materials and so forth. Now unless we make some allowance for this we will have distorted the growth of real final demand in the United States. The increase in imports will reduce the net trade compenent of the GNP figures and indicate a less rapid rise in overall final demand in the United States than actually occurred.

Now, if we took the imports which went into inventories out, in other words removed the change in the net trade sector of the national income accounts from the final demand calculation, we, in effect, would get a figure of final sales which went up a good deal more quickly than the number as it is conventionally calculated. Indeed unless we do this, our calculation is deficient as an indicator of final demand trends in the economy irrespective of whether this demand is supplied by domestic or by foreign sources. The very substantial increase in imports, much of which went directly into inventory had no effect

on production, no effect on real GNP, but we would be treating it in a way which would have a very dramatic effect upon our assessment of the strength of final demand in the economy.

Senator PROXMIRE. Let me ask you about residential construction. In your annual report you forecast that housing starts would reach a level of about 1¾ million by the end of this year, and you also stated, and I quote, "The recovery of multifamily starts from the extremely depressed level of 1975 should begin to accelerate in 1976.

Now, we did get a good recovery in single family starts, although that has tailed off a little in the past month or two, but multi-family starts were actually lower in the first quarter than in the second half of the year.

How confident are you now that your forecast at the end of the year with respect to multifamily starts would increased, and how do you explain the weakness in multifamily starts, contrary to your expectations?

Mr. GREENSPAN. Well, first let say, that a good part of the rise in February and then the slippage in March and April was probably caused by unusual weather conditions. As you know, Senator, in the winter months, the starts figures in some parts of the country are very critically affected by weather conditions.

Multifamily starts have been less than we expected, even though the market conditions in this part of the housing market have been fairly close to our earlier expectations.

As you know multifamily residential building has undergone a fairly marked contraction in availability. Vacancy rates have fallen quite precipitously, and as a consequence the market has tightened up to a very substantial extent in a number of areas throughout the country.

This is an indication that the market for multifamily construction will soon emerge in a fairly extensive way. I am a bit surprised that the starts levels and the permit levels are not rising faster and sooner than they have.

Senator PROXMIRE. Why is it? Do you have any explanation for it?

Mr. GREENSPAN. No; I do not, Senator. Partly our problem is that a number of the builders involved in this field have been confronted by very severe financial problems in recent years, partly as a consequence of overbuilding prior to the recession. As you may recall, Senator, for a long period of time a very large number of uncompleted multifamily units were under construction, and this must be financed. As I understand it a substantial number of these builders were under very serious financial pressure and a lot of them have had difficulty getting back quickly enough to initiate the type of risk projects which are implicit in this area.

I would be surprised, I might add, if we don't see a fairly significant reemergence of multifamily starts. But as to why it hasn't started as yet, I cannot give you a conclusive answer or one with which I feel entirely comfortable.

Senator PROXMIRE. I just have one more question before I yield to Senator Javits.

As you point out, we have had somewhat of a slowdown in the economy, in the growth of economy, I should say. It is still growing. And I am encouraged by that. But we had an 8.5-percent first quarter growth rate.

What do you expect for this quarter now? We are near the end of it.

Are you in a position where you can tell us with some degree of accuracy what we will probably have for the second quarter?

Mr. GREENSPAN. No, Senator and we won't be for several days yet. The data are just beginning to come in and we are still missing some of the fairly important pieces of information that are required to form a good judgment. The data which is available suggests a fairly good increase, although obviously far short of——

Senator PROXMIRE. Might it be approximately half of the 8.5 percent?

Mr. GREENSPAN. I would assume it would be more than that.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Thank you.

Mr. Greenspan, I was going to ask you primarily about surprises, and how they will affect the economic outlook. Suppose, for example, that OPEC does raise its prices, let's say just for the sake of argument, 10 percent? What happens then?

Mr. GREENSPAN. You're talking about the economic outlook for the United States in general?

Senator JAVITS. Yes, in that sense.

Mr. GREENSPAN. Obviously, since inflation per se, irrespective of the source, is detrimental to real growth, that an increase of that dimension would, other things equal, have an effect on real growth. Obviously, however, that sort of an increase falls short of what past increases have been and I would expect that the actual impact on real growth would not be very significant.

Senator JAVITS. Suppose that we had a broad program of conservation in the United States which unhappily, I think, is unlikely, but suppose we suddenly undertook an Operation Independence of Vice President Rockefeller's that is before us, and brought down the OPEC price materially, say 10 to 20 percent, what difference would that make?

Mr. GREENSPAN. That is extremely hypothetical at this stage, but an analysis of both short term and long term effect on energy prices generally would be required.

Other things being equal, I would prefer low energy prices to high energy prices, of course. But I must say I would have to express some degree of skepticism as to whether it is possible at this stage to get energy prices down that much that quickly and in a way in which they would stay down. I would not like to see prices falling, holding for a while and then going back up. One of the major damages which the very sharp increases in oil prices did to our economy, and for that matter, for the rest of the industrial world, was that it occurred so rapidly that it distorted the whole capital structure of industry, both in the United States and in Western Europe and in Japan. If prices came down sharply, but only temporarily, the considerable move toward attempting to conserve energy through capital investment which is now underway would come to a halt. Then as the price went back up again we would be in a worse state than if in fact the prices had not changed at all.

Senator JAVITS. I can understand that perfectly.

What I was hitting at is two questions. One, what is it worth to us to bring down oil prices by conservation, by material expansion of our domestic production, by seeking new sources which it is agreed would take vast amounts of money?

Now, that is the major thing. Is it worthwhile, is it worth it to us to invest enormous capital in bringing down oil prices or substituting domestic for foreign supply, leaving out the political?

Mr. GREENSPAN. The investment is not going to bring down oil prices, per se, because the costs of alternate forms of energy are quite high. However, the advantages to this country of a marked reduction in reliance on unreliable sources of crude oil imports would be very considerable. Our industry functions on energy, and at this stage the marginal source of our supply of energy is imports of crude oil.

To the extent that supply is essentially unreliable then the levels of economic activity and the security of our jobs are vulnerable to interruptions in supplies. This is one of the reasons why the President has so strongly urged that we move as quickly as is feasible toward energy independence, recognizing that it is neither a cheap nor an easy path to follow. But the value of achieving it is very significant because it makes the level of production and jobs in this country more secure.

Senator JAVITS. And is that in any way cranked into your estimates?

Mr. GREENSPAN. Into our short-term estimates?

Senator JAVITS. Well, you generally make what, a 1-year estimate generally?

Mr. GREENSPAN. We basically make a 1-year estimate, and we have not in these forecasts made any significant assumptions with respect to the change in either the price or the availability of crude oil.

Senator JAVITS. So that if there was a radical change one way or the other, this would materially change our outlook.

Mr. GREENSPAN. Yes, Senator.

Excuse me, Senator. My colleague would like to make a few comments.

Mr. MACAVOY. Mr. Javits, before, the OPEC meeting in Bali in early June, we did go through a series of exercises in which we attempted to forecast the impact of a 10-percent or 5-percent price increase on our short-term forecasts. These are all now hypothetical because OPEC did not come forth with a price increase. Even if prices had been increased, the lag structure in imports, the inventory of preprice increase oil, available in Western Europe and other places, would have dampening greatly the expected impact on wholesale and consumer prices for petroleum products this year. However, we are forecasting substantial energy price increases in the regulated prices of electricity, natural gas and in domestically produced petroleum products.

Price increases are scheduled under the Energy Policy Act of last year and under electricity and gas regulation. These increases will probably exceed the average rate of price increase in the economy as a whole, which we have forecast for the rest of this year.

Senator JAVITS. Mr. Greenspan, you plan ahead for 1 year. Now, Senator Humphrey and I have joined together and are planning a bill which would call upon us to plan ahead for 6 years, with 2 year interim adjustments, and any other adjustments Congress may wish to make, but 2-year schedules.

Now, that is something we have put forward jointly. Then you've got the Humphrey-Hawkins bill, which I also cosponsored, which zeroes in that planning concept particularly to the level of unemployment. In other words, it gives an objective to the planning other than what I call the indicative objective, or the indicated objective of stabilizing the economy, and ensuring the highest optimum level of operation, etc.

In your work, do you perceive the need for some kind of projection by our country over and above and beyond yours, that is, of the three Economic Advisers, which is a built-in function tied in to the Joint Economic Committee, bearing in mind that it is the Joint Economic Committee which will also be the central factors insofar as Congress is concerned, and the National Planning Conference?

Whether or not you agree with our bill, I would not wish to press you on that, because that is administration policy but I would like to know whether in your work you feel the need for a longer term projection than the 1 year projection which is the work of the Council?

Mr. Greenspan. Senator, we construct forecasts for a number of years out. The 1-year span is the official published forecast that we make, and it has been the convention of the CEA.

We make internal forecasts and analyses for longer periods than a year because there is no way to really understand the forces working in the short term unless you have some view of the way in which these types of forces might be working through a time frame well beyond a year. So we do have a series of more extended forecasts, and we do use them for a number of different purposes. The usefulness, in a forecasting sense, however, of these passive and generic forecasts is quite limited for periods much beyond a year to 18 months out.

Our tools are not that refined. They are extremely elaborate, but nonetheless, they are still too simple to abstract the many interrelationships that exist in our economic system and which will be operating over that period. As a consequence, we have far less confidence in the degree of accuracy in our longer term forecasts. Nonetheless, to the extent that we find it to be useful to try to understand trends, we do that and must do that. And this is an activity which occurs in the Council of Economic Advisers, in other agencies of government, and to a very substantial extent in the private sector as well.

Senator Javits. Well, my time is up, but if I may, Mr. Greenspan, I have another question that would only take another minute.

But that is not shared with us, as is the economic report of the President, and hence, it does not have the impact of public discussion or consideration.

That's true, is it not; that is, these other forecasts that you make.

Mr. Greenspan. The reason we don't publish these in any detail is that to do so would presuppose a degree of accuracy that does not exist. We are more than willing to discuss the qualitative characteristics that we see in the long-term outlook, and individual statistics in that light. We discuss our evaluation of the technical problems. But I do not think it would serve our economic policy purposes terribly well if we came up here with a whole set of very elaborate computer printouts projecting the U.S. economy into 1985, and then started to tell you why the figures are extremely weak.

Unfortunately, there is a tendency to believe that very elaborate and very complex econometric models have the capacity to tell us something extra about the future which somehow is unavailable from normal thinking processes.

Senator JAVITS. Yes; you see, but what it bears on is my own view and Senator Humphrey's view as to what kind of machinery we need. That is why I am asking you these questions.

The fact is that you cannot plan even for 1 year without doing exactly what you are doing, except that that is not available for public consideration or public debate—for the Congress and the public to draw its own conclusions. You have to have it, and that is what we are saying, we have to have it. We have to have it within the same frame of reference, and with the same effect that we subject your ideas to examination, and we want, because it is so critical, also a public participation in building it up, because that brings me to the last point, if you would allow me just 1 other minute, and that is that I rarely see in your 1-year analyses any recommendations of any consequence or size.

For example, should we or should we not undertake this Operation Independence, because it is smart, able, productive, prosperity-breeding idea, or as another thing, should we undertake to rehabilitate the railroad systems of the country in the coming fiscal year because it is good for unemployment? What should we do about these millions of unemployed—the most constructive?

I am the ranking member of the Labor Committee. The best I can come up with is training and public service employment. I am sure that is inadequate.

Now, question, what can be the function of the Council of Economic Advisers in counseling this country as to where to go, or must we depend on others to do that?

After all, it is essential to your forecast. You can turn your forecast on your head if you have a few million more unemployed or if OPEC jacks up the price 50 percent, what do we do about it?

Should that be a part of your work?

Mr. GREENSPAN. Well, first of all, Senator, it is a part of our problem. We did, as I recall, make rather extensive analyses, for example, of the OPEC situation and its implications and they came out pretty much as I have already indicated in answer to your previous question.

If you are asking us how policy should focus on achieving the most rapid growth and the restoration of full employment in this country, I believe we can address that question. The major thrust of our policy has been to restore a stable economic environment, one in which the levels of confidence, both on the part of consumers and on the part of business is restored to a point where they are willing to invest in a very substantial way. In the last year we have seen precisely that occur; namely, a remarkable improvement in consumer confidence and the first significant stirrings of business confidence with respect to the long-term future that I have seen in a number of years.

Now, one can readily calculate that to the extent one achieves that, that is by far the best job-creating program that any of us can possibly put together. The numbers just absolutely swamp the calculations of any other programs which we are talking about.

So that if you are asking do we, as a council, make recommendations with respect to policy in this country. I would say the answer is yes, we have. It does not follow, however, that policy necessarily means what series or shopping list of particular governmental proposals are needed to achieve a specific policy end. In many instances it requires the restoration of certain fundamental things such as the resolutions of conflicts and uncertainties at the grassroots of our economy, so to speak. I do agree that we must confront all of these questions and come to the best judgment that we can but if we think that we are somehow going to put together a list of particular governmental actions which will solve those problems I would say that historical evidence, and more particularly recent evidence suggests that that is not so.

And I would certainly say that is the job of the Council of Economic Advisers, and we hope that we have been doing it as best as we know how.

Senator JAVITS. Well. Mr. Greenspan, might I say to you that without any regard to how you stand on these planning bills, we lawyers know that the best evidence comes out of what we call the res justa, that is, the heat of the battle, or, you know, the event.

I have rarely heard better testimony convincing me of the need for the planning bill than that you have just given.

Thank you.

Chairman HUMPHREY. Thank you, Senator Javits.

Mr. Greenspan, I just want to have a word or two on budget policy and monetary policy because there hasn't been too much emphasis in the testimony on that, and I hope that you would just give us as abbreviated an answer as you can, because we have to go down to the Senate.

It is the Congress, of course, that is really setting budget policy. Now, we receive recommendations from the President, we consider them influential, but he doesn't really call the shots. There is a new ball game in town, and I think this needs to be better understood.

For example, the Congress enacted a considerably larger tax cut than the President recommended. It certainly seems to me that the tax cut was good medicine for the economy. For the new 1977 budget year, the President has recommended spending a total of $395 billion, and a tax cut going beyond extension of existing tax rates. Congress, however, has set a spending target of $413 billion, and appears to be rejecting the President's recommendation for a further tax cut.

Does your present forecast for the economy assume the President's budget or the congressional budget targets, or don't you think it makes any difference?

Mr. GREENSPAN. I think it does make a difference. The forecast we are basing it upon is the President's budget, and we think that that is the right policy at this stage.

Chairman HUMPHREY. Don't you think it is wrong to make it on the President's budget when that is as dead as McNamara's goat?

Mr. GREENSPAN. I trust it is not, Senator.

Chairman HUMPHREY. Well, it is though.

First of all, the President's budget is always being modified. We have a few things coming up here every so often that we have had a little trouble getting the OMB, for example, to send up some modifica-

tions on some of the Spanish treaty, on the money for the missile heads and so on. But those are items that they say in Washington parlance are of lesser significance, you know, are under $1 billion or so. But you know it is going to be the congressional budget. The Congress of the United States in its collective wisdom or whatever you wish to call it, rejects the $395 billion figure of the President's budget as being primarily a political figure and not an economic figure, and we have maintained a budget level of about $412 billion or $413 billion is necessary. That may have to be revised.

Now, you say you are making your forecasts on the President's budget. Why don't you make it on the one that is going to happen?

Mr. GREENSPAN. Mr. Chairman, we make a large number of judgments and assumptions. My general conclusion, if that is what you are looking for, of the difference between how we evaluate the fiscal stance implicit in the President's budget, and that which is developing in the current resolution, not only the outlay levels but the budgetary is that the congressional approach increases the risk of inflation, not necessarily immediately, but in 1977 and beyond, a level which I do not believe to be prudent.

Chairman HUMPHREY. Oh, now, don't misunderstand me. I know that is a point of view, and I am trying to hurry this along a little bit.

My point is that your value to the committee is to have you discuss what is practicable. Let's talk about what is really going to happen. Therefore, the analysis that you give of the economy should be based upon the kind of budget policy that appears to be what is going to happen, because the budget is set by the Congress of the United States.

Mr. GREENSPAN. Well, I would certainly think that one would want to know both.

Chairman HUMPHREY. Well, it is nice to know the other one and maybe you should give us the second forecast.

Mr. GREENSPAN. Mr. Chairman, I think we are required by the Budget Control and Impoundment Act of 1974 to give the economic assumptions which underlie the President's proposals, and that is what we do, and that is what we should do, and that is what we put out in January and that is what we will again put out in mid-July.

Chairman HUMPHREY. But my dear friend, let me say you constantly revise your forecast on the basis of what happens in the private economy.

Mr. GREENSPAN. That's right.

Chairman HUMPHREY. And I think you ought to revise your assumptions in your forecasts on the basis of what develops in the public economy, namely, what Congress is going to do on its budget. We would like to have you take a look at that, with the assumption that it is going to have a budget around $412 billion to $413 billion, and what you see would be its impact.

You haven't said much about monetary policy. Now, I know that that is supposed to be a separate item for the Federal Reserve, but might I ask that since the money supply grew rather slowly for a considerable period, well below the Fed target range, is it not now appropriate for the money supply to catch up, that is, to grow faster than the target range for a similar period?

Would it make you nervous if the money supply grew at an 8- or 9-percent rate for 3 or 4 months?

Mr. GREENSPAN. Maybe if you extend that to 6 months, at this rate—you're talking about M-1?

Chairman HUMPHREY. That's right.

Mr. GREENSPAN. I am more inclined to think that the M-2 money supply is the more relevant one. Yes, I would become somewhat concerned that a comparably rapid growth in excess of the target range for M-2 for a protracted period of time would increase the risks of inflation.

Chairman HUMPHREY. Despite the fact that for a long period of time the money growth rate was around 3 and 4 and 5 below the target levels, and now the Fed has tightened up?

Mr. GREENSPAN. Well, I think, Mr. Chairman, it is also important to recognize that those target levels come from or are based upon a theory which relates to the way in which monetary variables affect or interact with the economy.

One of the things that came out of the late 1975 and early 1976 period is that the notions of the way we thought that money affected the economy did not fully explain what was going on.

Chairman HUMPHREY. Mr. Greenspan, I'm sorry, I've just been informed that I have to leave, and I apologize. I know you have to go and we all have to go, but thank you very much for coming.

[Whereupon, at 12:27 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, June 17, 1976.]

MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

THURSDAY, JUNE 17, 1976

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

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

Present: Senators Humphrey, Javits, and Percy.

Also present: John R. Stark, executive director; William A. Cox, Lucy A. Falcone, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Charles H. Bradford and M. Catherine Miller, minority economists.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. I would like to thank you three distinguished gentlemen for taking your time to come here and share some of your thoughts with us and assist the Joint Economic Committee in making its midyear review of the economic outlook.

We are now having hearings on that subject. Last week we heard from Mr. Greenspan of the Council of Economic Advisers. Mr. Greenspan presented us with a relatively optimistic picture for the rest of this year and the beginning of 1977.

I am sure you have read the general synopsis of his statement. He expects real output to grow at about 7 percent this year, the inflation rate to average about 6 percent, and the unemployment rate to drop below 7 percent by the end of this year.

In announcing these hearings several weeks ago I stated on behalf of the committee that economic developments in the early months of 1976 had been gratifying. Production is up, inflation and unemployment have declined and the private economy is exhibiting great vitality.

In a recent article in Business Week, it is claimed that this marks a major turn in democratic campaign strategy. I wasn't trying to map out the strategy because I do not have much to say about what the strategy is going to be. While I am flattered, I hasten to point out that back in January, if you will examine the record, I was saying the same thing and was telling the witnesses that came here that they were too pessimistic.

I said I expected the real growth in GNP to be around 7 percent. I was more optimistic then about our growth prospects than the administration or most of the private economists who testified before the JEC during our hearings on the President's economic report.

The reason for my optimism is that I get around the country and don't sit around Washington and breathe this smoggy air. When I got around the country, I found out that people were alive, they were willing to work, they were willing to invest, they don't have this doomsday philosophy which grips the Washington officialdom most of the time.

For the sake of our economy, our businessmen, our wage and salary earners, and the Federal Government, I am happy to say and to see that I was correct in expecting a strong growth path in 1976. Let me hasten to add that my expectations of strong gains in real output was based on the assumption of a supportive Federal budget such as was subsequently adopted by the Congress in the first concurrent resolution.

The administration did not present a budget. It presented a political platform. I said in January or February that we should get a budget, I said we could get around to the political platform a little later. Anybody that had the brains of a March hare knew that we had to have a budget of over $400 billion.

I have to lay it on the line. There was not any reason to assume we could get by with a $394 billion budget. So the Congress has adopted a budget concurrent resolution of approximately $412 billion. I believe the House's budget proposed is slightly higher.

We also assumed certain matters relating to the tax structure. Mr. Greenspan insists that his forecast of real growth in GNP during 1976 and 1977 is based on the President's budget of $395 billion in expenditures. There won't be anything like that.

That is whistling in the dark and blowing smoke and he knows it. I like Mr. Greenspan except I wish he would not tell us fairy tales when he comes up here. Most economists would agree that the stimulus to the economy in 1975 and 1976 is at least partly responsible for the recovery. While the recovery appears to be on track, there are several areas of concern.

These areas include the expectation of a continued historically high unemployment rate through the end of 1977. I want to say again here, so I can get it in the record, that I am fed up with the editorial journalism of this country trying to indoctrinate the American people into acceptance of high rates of unemployment.

A few months of unemployment to a few of these editorialists would convince them that there was a problem and it won't hurt the public a bit either because then they would not have to read some of the misleading articles they are reading now. I had a great breakfast this morning so I feel in good spirits.

It is just outrageous. Day after day we have editorials telling us that we can't get this unemployment rate down without inflation which is a way of simply telling about 7 million or 8 million people in this country, you starve. You be the sacrificial lambs for price stability for the rest of the Nation.

I consider that to be immoral. Since the city is filled up now with a new moral consciousness, let's have something about real morality. When you punish people by pushing them into the cesspool of poverty and unemployment and street life, which is what a rate of 7 percent unemployment does, I say it is officially enacted or proclaimed immorality.

The threat of renewed inflationary pressures, the rate of growth needed to sustain this recovery and the growth for business investment in plant and equipment or other subjects continually being discussed.

This morning we have three distinguished economists, Mr. Thomas F. Dernburg, professor of economics at American University; Mr. Arthur M. Okun, senior fellow of the Brookings Institution; and Mr. James J. O'Leary, vice chairman of the United States Trust Co. of New York. As we go along, I want to get your counsel on the problems of unemployment, whether we are going to be saddled with the acceptance of incredibly high rates of unemployment.

I want you to talk to us about the threat of renewed unemployment and the problems of business and plant investment. With that, that little outburst on my part which will be continued, I might say—I have not given up the good fight.

I do not intend to sit around and let people propagandize this country into a three-class society: Those doing very well, those running behind a little, and those flushed down the economic sewer.

Go out to my State. I go out there every weekend. I meet with people that are doing hard work. They will tell you right now what their problems are. If you think the unemployment is not there, you go home. You have a headline that says numbers of unemployed dropped.

That is the number of people getting unemployment compensation. In the fine print in order to have some degree of integrity in the newspaper, they say welfare rolls expand. Of course the unemployment is dropping. They run out of their benefits.

They are off the unemployment rolls. They have gone back to the welfare. I went into one of the top growing counties of my State, one of the fastest growing counties in the midwest. What do I find? High rates of unemployment. Blacks? We don't have any.

Puerto Ricans? No. We don't have Chicanos, even. We have Swedes and Norwegians. Then I read this drivel every day around this time, that tells me somehow or another it is just jolly. Well, these articles are dead wrong. I am going to go home this weekend and verify it again.

We are a hard working people but the official rate is 5.5 unemployment which is a load of nonsense. If you don't believe it, go down to Rochester and ask just what is going on.

I don't know who these people are that are making these surveys. Would you like to comment on that? [Laughter.]

We didn't have public radio here today so I wasn't doing that for the general public. I just need to explode once in awhile, clean out my mental processes here because I am sick to the *n*th degree with what I read which has no relationship to the facts of life unless I am blind, deaf, dumb, and stupid.

I will claim at least two of those liabilities but not all of them. Mr. Dernburg.

STATEMENT OF THOMAS F. DERNBURG, PROFESSOR OF ECONOMICS, AMERICAN UNIVERSITY

Mr. DERNBURG. I fully share your low opinion of the local press.

Chairman HUMPHREY. I don't mean just the press. It is the emphasis that is put into this stuff. The official reports indicate things that are just not happening.

Mr. DERNBURG. I am reminded by your remarks about the television commercial which shows Mr. George Gallup using his BankAmericard. It is one of those do you know me kind of things. I wondered whether he had ever used that card in Harlem because I have never really believed what the survey said, that the American people are not concerned exclusively with unemployment. But let me get on with my statement. I have been reading an excellent report on the 1976 Economic Report of the President.

I do not find very much to quarrel with. I am concerned with the fiscal conservatism that seems to have invaded the Hill and that is what I would like to discuss today.

I think we are agreed that the President's budget is excessively restrictive and that this is inappropriate at the present time because the economy is still a long way from full employment. Indeed it seems entirely possible that the President's budget—with revenue growth projected at 18 percent while expenditure growth is limited to 5.5 percent—could well abort recovery and prevent unemployment from falling much below 7 percent in 1977.

The President himself estimated that his budget would produce a swing into surplus of $19 billion in the full employment budget, and this comes very close to your own estimate of about $22 billion between the third quarters of 1976 and 1977.

We agree, then that the President's budget is too restrictive. I am not convinced, however, that Congress has done much better with its first concurrent resolution nor am I certain that the JEC's recommended alternatives represent any substantial improvement.

The figures shown in the accompanying table permit comparison of the several budgets. The table begins with the fiscal year 1976 budget as a point of reference. It then shows the President's updated budget for 1977 in line 2. The third line shows Congress first concurrent resolution. As you have noted in your report, the economy would be quite weak in 1977 had the President's budget been adopted, and his economic assumptions are therefore inconsistent with his budget.

The result of this is that revenues would be lower and expenditures higher than stated by the President. Your revision of the President's budget is shown in line 4, and the JEC's own budgetary program is in line 5.

	Revenues	Outlays	Deficit
1. 1976	297.5	374.4	76.9
1977.			
2. President updata	351.3	395.8	44.6
3. Congress 1st resolution	362.5	413.3	50.8
4. President-JEC adjusted	341.2	400.8	59.6
5. JEC	352–357	412–418	60.0

I am somewhat puzzled by some of these figures, and the JEC and the budget committees both have roughly the same outlays. The JEC assumes real growth at a rate of 7 percent whereas the budget committee assumes 6 percent.

You both operate with similar inflation assumptions and with the same tax laws. The JEC ought therefore to be showing more revenue and a lower deficit, but instead you show less revenue and a larger deficit. I would guess that if these different revenue estimates were reconciled, the JEC and the budget committees would come out with about the same budgets.

These remarks are, I think, a necessary prelude to the main point that I wish to stress. And that is that all the budgets are inadequate in the light of current economic circumstances. Some say that compositional differences make the President's budget less stimulative than the others, but that argument is unimpressive since none of the budgets seem to be at all stimulative.

Instead they are all restrictive relative to the budget of 1976. They all imply a significantly higher surplus in the full employment budget for 1977 than is being registered in 1976. Your own report acknowledges this. You say:

> When taken in conjunction with an outlay level of $418 billion, an additional tax cut oft approximately $10 billion will be necessary in 1977 simply to prevent fiscal policy from moving in a restrictive direction.

I think this conservative trend in budgeting is extremely unfortunate. I think that your assumption that your fiscal policy will yield 7 percent real growth in 1977 is highly optimistic.

And I am afraid the natural forces of revival—such as inventory rebuilding—may begin to weaken soon and that the recovery may peter out, as it often has, after 2 years. If that happens this time it will leave us with millions of workers still to be employed, and with an enormous waste of potential output.

I think, in short, that the economy needs more fiscal stimulus. Moreover, I think we should have that stimulus now rather than wait until the economy falters. It will be difficult to introduce new expenditure programs in the coming months, but it should not be difficult to introduce tax reduction prior to the second concurrent resolution.

There is always fear that tax reduction will jeopardize the revenue base. However, in the case of the personal income tax we have the factor of progressivity working for us. In fiscal year 1976 Federal revenues came to 18.8 percent of GNP. This proportion will grow to 21 percent by 1980 because of the progressivity of the individual income tax.

The 20-percent mark has generally been an implicit upper limit beyond which Congress has not permitted taxes to rise. The relief, in other words, has been granted when the 20 percent range has been approached.

If therefore we believe that tax reduction is inevitable some time before 1980, the question is when such tax reduction should take place and what its magnitude should be.

The question of timing is easy to answer. If taxes are to be reduced between now and 1980, the obvious time to do this is not at a time when the economy is well below its potential and when additional stimulus has the least chance of rekindling inflation.

As for the magnitude of the reduction, I think a reduction of from $15 billion to $20 billion in the personal income tax would be appropriate.

A $15 billion cut, if enacted now, would reduce the full employment revenue of 1980 by only about $23 billion and this would leave plenty of revenue since the ratio of full employment revenue to potential GNP would remain above 20 percent in 1980.

As I said at the beginning, I am very troubled by what appears to me to be a wave of fiscal conservatism and I would like, therefore, to conclude with a few remarks that anticipate some of the objections that might be raised against an income tax reduction.

The first objection will be that the tax reduction will widen the deficit. That will be true in the short run, but it may not be true in future years. We should bear in mind that the only ultimate hope of eliminating the deficit is to generate faster economic growth. That fact is brought out very clearly in the CBO's report of last January entitled "Five Year Budget Projections."

There CBO compared the impact on the budget of different growth paths, and came to the startling conclusion that a growth rate of 5 percent in real GNP will leave the economy with a deficit of $33 billion in 1980, while, on the other hand, a growth rate of 6 percent would produce a surplus of $58 billion.

Thus a difference in the growth rate of only one percentage point can produce a swing in the budget of $91 billion in 1980.

Immediate tax reduction might very well produce such a rise in the growth rate, and it might therefore lower the deficits of the future.

A second, and somewhat more sophisticated objection is that tax reduction might throw the full employment budget into deficit. The worry is that recovery in the private sector might then bring the economy to full employment in conjunction with a budget defict that, under the circumstances, would be inflationary.

In the present situation, this is a purely hypothetical worry since there is virtually no hope of returning to full employment in the next 2 years. Therefore, even if a tax reduction throws the full employment budget into deficit in 1977, growth of potential output thereafter will generate additional revenues and insure a surplus in the budget by the time full employment becomes a reality.

Third, I have been hearing that fiscal policy must, of necessity, be conservative since expansionary fiscal policy would be thwarted by restrictive monetary policy. Even if monetary policy is less expansionary than we might like, I am not prepared to concede that this justifies restrictive fiscal policies.

To accept this view is to turn the overall stance of policy—both monetary and fiscal—over to the Federal Reserve. I would rather challenge the Fed and force it to bear the onus of the high interest rates and high unemployment that would result from a tight-money–easy-fiscal mix of policy.

Finally, there would inevitably be complaints that a tax reduction will add to inflation. This of course is always a risk, but I would expect the risk to be minimal. If we time the tax reduction correctly it will come when ample excess capacity and unemployed labor are still available.

Moreover, as your report notes, income tax relief may carry with it the happy byproduct of a pause in wage demands. If this

happens, cost pressures on the price level will be relieved and the inflation rate may quite possibly be slowed even as output and employment rise.

To conclude: I think Congress should move ahead with personal income tax reduction and I think this should be done as soon as possible.

Thank you very much.

Chairman HUMPHREY. You are talking about an additional income tax reduction over and beyond the current extension?

Mr. DERNBURG. Yes; I assume we will get the extention and I would like to see some additional tax reduction.

Chairman HUMPHREY. Such as was posed in the JEC report? We talked about an additional $10 billion. We have talked also about a substantially larger one.

Mr. DERNBURG. Well, I am not sure I saw that in your report.

Chairman HUMPHREY. Yes, because our JEC revenues estimates assumed an additional tax cut. When you were speaking earlier about the difference between our revenue estimates and the CBO estimates, remember the JEC assumed additional tax cuts.

Mr. DERNBURG. I don't believe I saw that.

Chairman HUMPHREY. We will look it up for you right now and we will see that you receive a copy of our report.

Mr. Okun, we welcome you, sir.

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. OKUN. This is one year in which most economic forecasters do not have to scrap their January forecasts in June. Indeed, for those of us who are on the bullish end of the range at the start of the year, updating the outlook involves relatively minor alterations and rather than the production of a brand new model.

Those minor alterations move in a favorable direction—a fractional upward revision in the rate of real growth and a fractional downward revision in the inflation rate.

As always the economy has presented some interesting puzzles.

1. The inventory turnaround proceeded with unusual rapidity, providing a bonus in the growth of real GNP during the first quarter. But again that is a one-time bonus rather than a source of sustained growth.

2. The consumer has continued to display a curious pattern of shop, stop and shop again. In the past year, there have been two shopping sprees which occurred last spring and this winter, and two pauses, taking place last fall and again this spring. I expect the present pause to be followed by another shop-again interval.

3. Plant and equipment spending and homebuilding have been rather disappointing, offsetting some of the stronger performance of consumer buying and the inventory turnaround.

4. Unemployment has fallen somewhat more sharply than seemed likely. The analysis of this puzzle is complicated by the recent inconsistency of our two sets of data on employment. Reports from households (on which unemployment statistics are based) show much larger job gains than the typically more reliable reports from employers.

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5. Interest rates have been remarkably stable and moderate, largely because private demands for money and credit have been unusually weak.

6. Wages have behaved with exceptional moderation, providing the main basis for the slightly improved inflation outlook.

These are the kinds of subtle issues that make life interesting for economists. In the broad perspective that is relevant to policymaking, the main verdict is that the expansion has remained ontrack and that the range of uncertainty about its vigor has narrowed. On the one hand, it is now much safer to discount the possibility of a jack-in-the-box rebound, such as have followed some very deep recessions in the past.

In particular, one can now dismiss as demonstrably wrong the criticisms of some people in 1975 that the Congress was excessively stimulating the economy. On the other side, the recovery has refuted the pessimistic views—which you aptly called "doomsday", Mr. Chairman—expressed by some observers that the recession had permanently damaged the vitality of the American economy.

All in all, we are experiencing a very normal and typical recovery out of a business cycle recession. The key distinguishing feature is that this standard size recovery follows a double size recession.

Consequently the level of operation of this economy—as reflected in the unemployment rate, industrial operating rates and the shortfall of output and real income below prosperity levels is now similar to that at the troughs of previous post-war recessions rather than at comparable points after 1 year of recovery. The state of the economy is improving but, having begun at such an abysmal position, we have a long, long way to go to regain prosperity.

We are getting better but we started out very sick. I guess there is nothing like a serious illness to permit a long period of recuperation. When the patient starts feeling better, I sometimes think we are forgetting how far we are from recovering our health.

FUTURE PROSPECTS

From the first quarter of 1975 to the first quarter of 1976, real GNP advanced 7.1 percent. I expect the growth rate to remain fairly brisk during the remainder of 1976—probably in the 5 to 7 percent range—but not to match the vigor of the first year of recovery.

The main reason for anticipating some slowdown is that the shift from massive inventory liquidation to more normal inventory accumulation is largely behind us. The inventory turnaround was a key factor that contributed 2½ percentage points to the 7-plus growth rate over the past year.

I do not welcome any slowdown at this point. A maintenance of the pace of last year would be a desirable, indeed a conservative goal, in my judgment. Yet to make such an encore a likelihood would require an additional stimulative fiscal and monetary program at the present time.

This is the kind that Professor Dernburg was talking about. I have a great deal of sympathy for that, but taking account of risks on all sides, I would not recommend such an initiative at this time.

For one thing I can see the possibility—although not the probability—that a sudden revival of plant and equipment spending and multi-

family homebuilding late this year could produce excessive growth if it were accompanied by additional fiscal and monetary stimulation.

Furthermore, I would agree with the judgment that Chairman Greenspan expressed to you last week: "Our capacity to brake Federal outlays or to raise taxes is exceptionally limited." There is an asymmetry—a political asymmetry in the adjustments that can be realistically implemented during the course of the fiscal year—a shift toward stimulus, if it should become desirable, is more readily accomplished than one toward additional restraint.

Hence it seems prudent to base our current policy planning on a very optimistic assessment of the forthcoming vigor of private demand, counting on our ability to reduce fiscal restraint subsequently if private demand proves to be less buoyant.

In my judgment that criterion of prudence is met by the first concurrent resolution for fiscal year 1977, which calls for $413 billion in Federal outlays, the extension of the current tax cuts, and additional revenues of $2 billion through tax reform.

As I calculate the fiscal impact of this program, it involves some $11.6 billion less of restraint than the administration's January program. Hence, it is more restrictive than the proposal I offered in testimony to the House Committee on the Budget on January 27, when I recommended adding $16 billion to $18 billion of stimulus to the administration's program.

My initial preference still stands, but I can accept the first concurrent resolution as a major improvement over the administration program. It avoids an abrupt fiscal tightening; although it shifts somewhat toward restraint, it can be reasonably characterized as a steady-as-you-go budget in sharp contrast to the administration proposal.

In particular I think it does heed your wise warning against "unwise or premature government policies that would sap * * * vitality and prevent full recovery."

If that budget program is implemented, if the strength of private demand lies in the middle of the likely range, and if the Federal Reserve finances a healthy recovery at reasonably stable interest rates I would expect a growth rate of about 6 percent continuing in 1977.

That outcome would not be ideal; but neither would it be unacceptable, particularly allowing for the possibility of further adjustment to this fiscal program late this year or early in 1977.

THE INFLATION PROBLEM

Obviously the reason for moderation in our targets for recovery lies in our serious concern about inflation. An objective professional economist must report that there is a tradeoff. Beyond a doubt, a speedy return to full employment would be followed by an acceleration of inflation. And the political backlash to intensified inflation would produce another fiscal-monetary bloodletting, an encore of 1974–75—that in turn would bring on a new recession.

There are to be sure a great many uncertainties about the quantification of the tradeoff. In my judgment the basic inflation rate today is somewhere between 5 and 6 percent for prices and close to 8 percent for wages.

Such inflation rates are uncomforting that prices are still rising at a more rapid rate than was experienced in any year between 1952 and 1969.

On the present outlook I am projecting a continued inflation rate of 5 to 6 percent through 1977. But that reflects my feeling that it is as likely to decelerate as to accelerate rather than any conviction that it will stabilize.

Most important I do not believe that the inflation outlook can be significantly improved by slowing down the recovery. Indeed whether the growth of real GNP between now and the end of 1977 is as low as 4 percent or as high as 7 percent would have negligible effects on the outlook for inflation.

A careful reading of the data on labor markets and on manufacturing capacity today confirms emphatically that this economy has plenty of room for brisk expansion through the 1977 fiscal year. This country is miles away from excess demand.

In addition to the campaign to talk down the unemployment rate, there is also a campaign to talk down the presence of excess capacity in industry as well.

If wages should accelerate sharply, if industrial prices should be marked up at an accelerating rate, the source must be found in the nature of our wage- and price-making institutions rather than in an overheated economy, because we don't have an overheated economy.

Indeed, if those institutions have such a strong inflationary bias that they intensify inflation even with the pervasive slack in today's economy, we ought to determine that fact, face up to it, and deal with it fundamentally.

It is hard to say how much the bumpy economic ride of the seventies should be blamed on erratic fiscal-monetary driving and how much on potholes in the road caused by inflationary bias in wages and prices.

If potholes are the problem, then going slow is no solution. In that event, we will simply have to repair the road.

Meanwhile I would urge you to maintain a steady speed and a steady course and to test the viability of the road.

Chairman HUMPHRY. Thank you very much, Mr. Okun. I appreciate your analogies and your analysis. It is very fine. Our next witness is Mr. O'Leary and we welcome your contribution this morning.

STATEMENT OF JAMES J. O'LEARY, VICE CHAIRMAN, UNITED STATES TRUST CO., NEW YORK, N.Y.

Mr. O'LEARY. Mr. Chairman, I hope you never lose your ability to speak out as you did. I think it is great. I also want to say that I am very pleased to have a chance to take part in this discussion today.

My statement is too long to read and I am going to summarize it.

Chairman HUMPHREY. You feel free to summarize it and the whole text will be printed in the record.

Please proceed.

Mr. O'LEARY. Thank you.

We have all been impressed with the fact that this recovery of the past year has been reasonably strong, healthy, broad based, but not fully satisfactory from the point of view of the unemployment rate.

There has been a good growth of employment and some reduction in the unemployment rate. In retrospect, it might have been better if we had a little more strength in that recovery but I am encouraged by what I see compared with the gloom of a year ago. I thought it was unjustified at that time and I am glad to see that a lot of that gloom has lifted. I am very much encouraged by the fact that we have got the inflation rate down as well as we have.

I think it is useful to look at the forces behind the recovery. One has to start with public policy. I think our fiscal policy has been very helpful—the tax rebate, the investment tax credit, the income tax cut.

There is not any doubt that the $76.9 million deficit was an important force toward putting the economy back on the recovery path. We would have to say that the unemployment insurance system has contributed a great deal in terms of maintaining income. Monetary policy has also made an important contribution. There have been times in which I have been somewhat critical of monetary policy as being too cautious, but generally speaking I would have to say that the Federal Reserve has had quite a good record in the past year. I think they have contributed in terms of increasing the liquidity of the economy. We have had a substantial decline in short-term interest rates, not as much as I would like to have seen and not as much as I think could have occurred, but there was a significant decline.

But having said what I have said about public policy, it is important to recognize that the private side of the economy has responded well to these stimuli and in a sense carried this recovery well itself.

We have had associated with public policy and with other forces a remarkably strong recovery of consumer confidence and business confidence. This has not been entirely a matter of public policy. It has had some inner workings. We have had—and again associated with public policy, particularly the fiscal policy—a large rise in disposable personal income.

This has contributed to strength in consumer spending.

We have had, as everyone recognizes, some very important developments in the productivity area—good increases in productivity. Along with this, the rate of increase in labor compensation has fallen so that the rate of increase of unit labor costs has fallen, helping to bring down the inflation rate.

All of this is very healthy. Still another force that I see probably a little more than Tom Dernburg or Art Okun is the way the economy has become reliquefied.

In 1974, the steep rise of short-term interest rates disintermediated the savings institutions and dried up the long-term capital market. In 1975 and so far this year, there has been a massive funding of debt by business firms out of the banks. The long-term capital market has been opened up again. This plus the better cash flow, has made the whole corporate sytem a lot healthier than one would have expected in such a short period of time.

Chairman HUMPHREY. I think that is a very useful observation. It is one that is not always made. I think that relates a great deal to the growing health of the economic system.

Mr. O'LEARY. This is a function of short-term interest rates which opened up that capital market. What about the rest of this year and next year?

We are assuming that in the coming fiscal year the deficit will run somewhat larger than $50.8 billion that is in the conference report and will probably run as high as $55 billion. We are assuming that monetary policy will in general be directed toward a sustained growth and a lower unemployment rate of the economy.

I think the pace of the economy during the rest of this year is going to be pretty well maintained. This year we have a figure of an increase in real GNP of 6½ percent, below the Greenspan figure. We have a deflator increase of 5½ percent. We see a particularly strong increase this year—for the rest of the year—in expenditures for durable consumer goods and we see a pickup in residential construction.

We are beginning to get fainthearted about a further pickup in housing but that is part of our thinking. And we see some pickup in the second half of the year in capital spending. We think that in the last quarter of this year the unemployment rate will remain as high as 7 percent.

We would see corporate profits up this year about 26½ percent.

Chairman HUMPHREY. That is over last year?

Mr. O'LEARY. Yes; year to year. Of course you start from the low base.

Chairman HUMPHREY. I asked that question because I think it is terribly important to have a point of reference in this matter.

Mr. O'LEARY. It is a big percentage increase but corporate profits were severely depressed. On interest rates, my feeling is that ahead of us for the next several weeks maybe a moderate decline in short-term interest rates and a rallying in the bond market.

By the end of the year, rates will probably be moderately higher than they are at the present time. Bank loan demand continues to be very weak. Demand in certain sections of the long-term market, capital market are very—commercial mortgages for example—very weak. The only way we can get a sharp rise in long-term rates is if inflation gets out of hand.

We see real GNP increasing next year a little over 5 percent. We see the inflation rate up 6 percent. We see continued strength in the durable consumer goods area. We see a better rate of increase in capital spending. We see some further pickup in housing but we still see the unemployment rate again as high as 6½ percent in the last quarter.

Chairman HUMPHREY. Might I just interject here? I know I am interrupting your continuity but last evening I was with the Vice President, and members of the building trades, and the financial community at a dinner here to honor Bob Georgine, of the AFL–CIO. The general observation was to really get at the problem of unemployment. We must have a revitalized construction industry.

It employs so many people particularly in the housing area that has this ripple effect all the way through the economy. I am of the opinion as I hear witnesses today and day after day that when that construction rate stays down as low as it has for whatever reasons—and there are many—that you are really almost fighting a losing battle on any major breakthrough with unemployment.

Now we have had a sharp decline in unemployment because of the nature of our recovery but it gets sticky once it gets to the 7-percent area.

It is hard to break it out of there. When you look back over our previous years, when you have had a decline in the unemployment rate

that was significant, you had it because you had a large number of housing starts. There was much commercial construction. This construction provided jobs for an awfully lot of people that are unskilled as well as skilled.

Mr. O'LEARY. You are perfectly right in my view. I see the construction, from the financial market standpoint. The life insurance companies are large investors in what they call income mortgages. These are mortgages on shopping centers, office buildings and other income properties including apartments. The thing that is true practically all over the country is a complete flatness in that particular market.

We are not seeing the volume of mortgages in this particular area because the construction is not being undertaken. This is one of the reasons why potentially, on a demand/supply basis, long-term interest rates could be down. A lot of people feel that way.

That particular sector normally takes a very large chunk of money and activity is not strong in that particular area. Frankly my own feeling is that as we look to the future, one of the things that has to be done is to construct a program to deal with the problem. Government policy would be helpful in stimulating at least the multifamily residential part. That is where the greatest softness is.

Senator JAVITS. Would you yield at that point? That is very pertinent to the current tax bill because the current tax bill will involve incentive for nonprincipal business oriented investments in these ancillary facilities, to wit: shopping centers, and so forth.

The liberal group with which I am not yet joined but with which Senator Humphrey is—is proposing that we exclude from favorable tax treatment which it receives today commercial building of any kind, even that is ancillary.

Chairman HUMPHREY. I am not going to vote for that.

Senator JAVITS. I am delighted to hear that, Mr. Chairman. I did not think you would when they proposed it. But I think your expert opinion, perhaps with the Chair's permission, could be very important.

I think you ought to tell us whether under LAL which subsumes this particular kind of tax advantage, whether we would be wise or unwise at this time to eliminate the favorable tax treatment which is received for this kind of investment which is not nonprincipal business investment.

I say that only because of what you have just stated.

Mr. O'LEARY. I have no ax to grind at all but I think it would be unwise to eliminate a favorable tax treatment in that area. But I would add this and say that the weakness of construction in that area is fundamentally a problem of the fact that we went through a period of overbuilding many of these facilities.

There is a digestion period. Also this area was particularly hard hit by high inflation and high financing costs. A lot of the construction projects are being held back fundamentally because of the need to digest excess capacity.

Take New York, for example. New York City is just bulging with excess office space. So I doubt if tax incentives are the fundamental thing that is going to correct this. I think the general overall growth of the economy for 2 or 3 years will bring us back to the point where we shall work that inventory into the system and where we will have an opportunity to digest the inflationary forces that are there.

It is a complex problem. There isn't any doubt that this is a vital part of the economy, and that it is lagging. If you were to take 2 years ago, net increase in money for investment in commercial and industrial mortgages was something on the order of $17 billion.

Today it probably isn't $4 or $5 billion. It is a very depressed area. From the point of view of long-term interest rates, it is helpful in terms of getting rates down. It is surprising that rates have not been falling more than they have in the face of this.

But that is another story.

Senator JAVITS. May I ask as a supplement to that to enable the other witnesses to give their opinion, I am open minded on that though I did not join the pack. I probably will vote with them most of the way, which is my normal pattern. I was concerned about some of the questions that were being decided too precipituously for me. The question is this: Is there any way we could attack the tax situation to meet the economic situation you have described? In other words, it seems to me that in our economics, such building is not desirable because of market surplus and it would not take place anyhow.

Whereas if we eliminated the tax advantage we may not be able to restore it soon enough because people may not go into it because the tax advantage is not there, even when it becomes needed.

If we could have the benefit of the professional advice of you gentlemen, we would appreciate it.

Chairman HUMPHREY. Mr. Okun.

Mr. OKUN. I would share the view that you just expressed, Senator Javits, that in the near term we probably should be digesting the oversupply of commercial building and apartment building.

For the longer term, I would like to see some thinking about appropriate tax policy. I can't believe that the present law represents an appropriate way to stimulate that sector even if we decide that some particular stimulus to that sector through the tax code is desirable. The present law leads to things that I, in all candor, regard as outrageous.

It is a scandal that people can buy themselves more than $1 worth of tax saving for $1 worth of investment. It creates a situation where they don't care about their investment.

Senator JAVITS. You can be sure that they will not be able to buy $1.10 for $1.

Mr. OKUN. At the present time there are cases where they can buy $3 for $1. People are not investing in any sense of looking at the economics. They are buying tax deductions, pure and simple. That leads to misconceived investment because it leads to a structuring of incentives to package investments in order to maximize tax deductions. I think Pat Moynihan once said that he couldn't believe that the right way to feed the birds is to feed the horses.

That is exactly the issue in the present form of the construction tax subsidy.

Chairman HUMPHREY. Mr. Dernburg.

Mr. DERNBURG. Senator, I have no comment on that.

Chairman HUMPHREY. It is my understanding that we made some modification. We did not have a full repeal.

Senator JAVITS. For housing. You left in the commercial.

Chairman HUMPHREY. We did not want to repeal the tax benefits for housing. We had quite an argument in our group. At first there

was some desire to repeal all the tax benefits and I said I could not vote for anything like that.

We of course reserved for ourselves as sponsors, the right to pick and choose. You don't always get everything you like. It is like going to the cafeteria. You believe everyone ought to have a right to eat but you don't have to eat broccoli.

Mr. O'LEARY. My own feeling is that what we need is some ingenuity in devising a program to stimulate multifamily residences in the central cities where there is a real need and where you don't have excess supply.

I am not sure how that program could be devised but that is where I can see we need resources. May I conclude with a few comments on public policy? I won't take very much more time.

I would like first to say what my emphasis on public policy would be. Let me start out by saying that I feel—I have the same feeling that you do about the high unemployment rate.

I think it is true particularly if you take the high unemployment rate for young people and for minority groups, I think it is an intolerable situation to live a long time with that sort of situation. I don't see how we can. So I am all for moving this economy to full employment, however it is defined, as soon as we can.

But one thing—a word of caution that I would put here to balance that, is that we learned in 1974 and have learned in the last few years that inflation is a very destructive force in our economy—for our political and social institutions.

I think it is right for us to still be very careful that we deal effectively with inflation. That is the basic issue.

How do you get back to full employment consistently with keeping the inflation rate down in a reasonable range? All I would say is—let's not at this point in time overlook the fact that inflation itself is a very destructive process. I saw with life insurance companies, savings banks and other institutions, a situation where all it would have taken would have been another 6 or 7 months of the sort of inflation we had in 1974 and some of those institutions would have been pretty badly shattered.

Inflation is a very destructive force. Look at our private educational system. It has been hurt badly by inflation. We can't ignore the fact that getting the inflation rate down and keeping it down has got to be a very, very important part of our public policy. But our job is to get the unemployment rate down consistent with maintaining price stability.

On fiscal policy, the budget that came out of the Senate-House conference is one that from an inflation standpoint I can buy. I have no problem. You can see from my GNP estimates that it would not bother me if it were a little higher, if the deficit were a little higher than that.

The longer we go with large deficit financing and with the amount of Treasury borrowing that has to be done, the greater the danger that at some point in time we are going to come into a financial crisis.

I am one of the people who said last year there would be no crowding out. I think if you go through next year with a large deficit you run the danger of a competition between the rise in private loan demand

and public financing demand—you run dangers that interest rates will short up and that this will have an extremely adverse effect on the stock market, and will hurt public confidence.

The deficit just as an instrument of stimulating the economy needs to be thought of in terms of other financing in an economy where private loan demands are rising. Generally speaking, I like the idea of tax cuts rather than increasing Federal spending.

I think also we need to keep in mind that the deficit is a very important factor in public confidence, whether rightly or wrongly. The public has associated inflation with large Federal deficits and uncontrolled Federal spending. There is a psychological force there that needs to be kept in mind.

Even though I think the Federal Reserve has done a very good job in the last year, I think the danger is that too much attention is being paid to the monetary aggregates.

There have been important changes in the technology of money and I think that too slavish attention to M_1, M_2, M_3 on up to M_{12} is going to get us in trouble.

I see a problem in the House and Senate Banking and Currency Committees. They have gotten sold on the idea that the only thing that counts is what is happening to the money supply. I think the Fed has got to strike a balance between interest rates, the unemployment rate, the growth rate in the economy, the M's, and other factors. It cannot slavishly just look at the M's.

Chairman HUMPHREY. I want to say hallelujah to you, sir. I really think that is a most responsible and sensible comment. We get fixed on some kind of litany around here or standard and we don't see the whole picture.

Mr. O'LEARY. We have to look at everything. I felt a year ago when short-term rates went up that that was a mistake, that that was too quick a reaction on the side of restraint. I feel it this time. Yet the M's got up into a range that appeared to be excessive.

By the ground rules that got established between the Fed and the congressional committees, we have gotten ourselves into a little bit of a trap in which we are paying too much attention to the M's and not enough attention to interest rates.

If we had not paid so much attention to the M's, rates would be lower than they are today. I think that would be a better base to start from and next time we move up.

But the Federal Reserve is a dilemma. If it had not reacted to the high rate of expansion of money, after having told the Congress it was going to keep within certain ranges, it would have been criticized.

Chairman HUMPHREY. But I think at a point like that, we just need to have some consultation. Things do change and we need to learn as we go along. We get fixed on a resolution and say well, we are going to live by it even if we die by it.

That has to be stopped. What is needed is a continuing dialog.

Mr. O'LEARY. What has been happening as the Federal Reserve reacts? As short rates moved up, it caused long-term lending institutions to say to themselves; this is the beginning of a significant rise in short rates.

This means the flow of funds into us is going to diminish. It means maybe a year from now we will have "disintumentation." Their whole

attitude changed. Also the whole psychology of the loan market on expectations changed and you got a bulge in long rates.

FNMA, for example, in its auction for commitments to buy mortgages was running about a level of $25 million before the Fed took its action. The auction volume jumped up to $650 million after the markets anticipated that the Fed was moving to raise short-term rates. The mortgage market was running scared.

Frankly I feel there has been too much emphasis on money supply and more emphasis ought to be put on interest rates.

One other principle is important. Yes, we have got to deal with the unemployment problem but it seems to me a very strong case can be made against massive Federal deficits and excessive fiscal ease and more toward going at that problem in a rifle shot approach.

A lot of our unemployment is in pockets and in specific areas and there is a lot to be said for many of the things such as the public service job program, special tax incentives to private employers to provide jobs in a given area, as well as other rifle-shot measures. I think we need to approach the unemployment problem at least partly in that way and not go all the way in terms of overall stimulating effective demand. Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you very much.

Without objection, your prepared statement will be printed in the hearing record at this point.

[The prepared statement of Mr. O'Leary follows:]

PREPARED STATEMENT OF JAMES J. O'LEARY

I am James J. O'Leary, Vice Chairman of the United States Trust Company of New York. It is a privilege to testify before the Joint Economic Committee at its midyear review of the economy. My comments will cover the following: (1) An outline of the economic recovery during the past year and the main forces behind it; (2) A discussion of the economic outlook for the balance of 1976 and for 1977; and (3) Some observations on public policy needs.

THE ECONOMIC RECOVERY AND THE MAIN FORCES BEHIND IT

Before we look to the future, it will be helpful to review the economic recovery of the past year and the main forces behind it. The recovery has been vigorous and broad-based. Real GNP, at annual rates, has risen nearly 7 percent from the first quarter of 1975. The unemployment rate has fallen from 8.9 percent in May, 1975 to 7.3 percent in May of this year, and total civilian employment has increased by 3.1 million persons or by 3.7 percent. At the same time the GNP deflator has dropped from an annual rate of 13.4 percent in the fourth quarter of 1974 to 3.5 percent in the first quarter of 1976, and in the same period the the consumers price index has fallen from 12.3 percent to 4.6 percent.

Public policy has, of course, played a very important part in the recovery. The personal income tax rebate of $8.1 billion last year, as well as the personal income tax reduction of $10.0 billion, and the $76.9 billion Federal deficit which resulted from these tax measures and the decline in Federal revenues, contributed a great deal to the economic recovery. Beyond this, the unemployment insurance helped to maintain the flow of personal income. Nearly 6 million persons were receiving unemployment insurance in April. In addition, the Federal Reserve authorities have pursued a cautiously accommodative monetary policy which has succeeded in reliquifying the economy and bringing down short-term interest rates to half of what they were at the peaks in 1974. Long-term rates have also come down, but they still remain quite high.

In spite of the important contribution to the recovery made by the public policy, I believe that the main forces for the recovery have come from the private sectors of the economy—from the market system working to strengthen business activity. Public policy has, of course, facilitated and encouraged the market system. Perhaps the basic force has been the rise of consumer and business con-

fidence. As a result of the double-digit inflation and then the sharp recession, as well as the impact of Watergate, the index of consumer sentiment dropped to a very low 57 in the first quarter of 1975 (1966=100). By the first quarter of 1976 it has risen to 85 and it is probably at around this level today. During the same period there has been a pronounced increase in business confidence.

The flow of disposable personal income has increased 11.3 percent at a seasonally adjusted annual rate from the first quarter of 1975 to the first quarter of 1976. This has been the result of the increase in employment, the increase in labor compensation, the personal income tax rebate and reduction, and unemployment insurance. With the inflation rate cut in half, there has been a significant expansion of *real* disposable personal income. This has been a powerful factor toward stronger consumer confidence and increased consumer spending.

As the recovery has proceeded there has been a significant improvement in productivity. Output per man hour, which had *declined* at a 3.5 percent annual rate in the fourth quarter of 1974, has shown good gains since the first quarter of 1975. At the same time, total labor compensation per hour, which was rising at a 12.6 percent annual rate in the third quarter of 1974, has dropped to an 8.5 percent annual rate in the first quarter of this year. As a result of these forces, unit labor costs were rising at only a 3.7 percent annual rate in the first quarter of this year, compared with a 14.8 percent rate of increase in the third quarter of 1974. Given this change in productivity and in labor costs, it is not surprising that the basic inflation rate has been cut in half during the past year.

One other force which has contributed to the recovery has been the reliquification of the economy. As short-term interest rates declined from the peaks of mid-1974, funds flowed strongly into the long-term lending institutions. With long-term financing again readily available, corporations increased their outstanding long-term debt by a record $28 billion in 1975 and were thus able to fund a large part of their short-term borrowings with the commercial banks. This process is continuing in 1976. With the marked increase in corporate profits, the cash flow of business has improved a great deal, encouraging capital spending. Moreover, during the past year the total outstanding liquid assets of non-financial investors has increased by $125 billion, or 10.4 percent. Much of this buildup is in the hands of consumers, a development which has encouraged the demand for housing and durable consumer goods.

THE ECONOMIC OUTLOOK FOR THE BALANCE OF 1976

Turning to the outlook for business activity, despite the slowing in retail sales which seems to be occurring in the current quarter, I expect the recovery to be well-sustained through the balance of this year and to extend through 1977. This is grounded on the following assumptions about public policy. Based on total Federal expenditures of $418 billion in fiscal 1977 and receipts of $363 billion, I am estimating a deficit of $55 billion. This is $4.2 billion higher than the deficit estimated in the budget arrived at by the House-Senate Conference. The difference is accounted for by a higher estimated amount of Federal expenditures. I am assuming about a $16.5 billion deficit for the transition quarter. So far as the Federal Reserve authorities are concerned, I expect them to be careful not to permit an excessive increase in money supply but at the same time to continue to encourage the business recovery and a further reduction in the unemployment rate. I expect that the recent "less accommodative" credit policy of the Fed will bring the rate of monetary expansion down to an acceptable level and that the authorities will then place greater emphasis on encouraging a further sustained business expansion.

As will be seen in the quarterly estimates for real and current dollar GNP in Tables 1 and 2, I expect the business expansion to be well sustained through the balance of this year. The pace of the advance has slowed in the current quarter, but I think this is healthy and not a sign that the year-long recovery is faltering. Table 3 shows that we are estimating that, for 1976 as a whole, real GNP will increase by 6.5 percent. As will be noted, we estimate that total personal consumption expenditures (after correcting for inflation) will expand this year by 5.5 percent, with the rate of increase of expenditures for durable goods being an especially strong 13.4 percent. There is no reason to expect any decline of consumer confidence since real disposable consumer income is apt to continue to rise. We expect non-residential fixed investment to improve somewhat in the second half and for the year as a whole to increase 6.5 percent in real terms. Moreover, we anticipate a 24.3 percent expansion this year in real

expenditures for residential construction, with total private housing starts for the year rising to 1.6 million units. Home mortgage credit is apt to remain readily available, giving a lift to housing. We further estimate that there will be a $12.7 billion increase in business inventories this year, compared with a net liquidation of $10.5 billion last year. We are estimating that total real Federal purchases of goods and services will increase by 2.8 percent this year and state and local government purchases by 2.0 percent. Finally, we expect real net exports to total $13.5 billion this year, compared with $23.4 billion last year. With the expansion of our domestic economy our imports will rise more strongly than our exports, thus reducing the net exports quite markedly.

Table 4 presents estimates of GNP in current dollars. As will be noted, we expect total current dollar GNP to increase 12 percent, 6.5 percent of which will be real and 5.5 percent of which will be inflation. Table 4 presents the component parts of current dollar GNP. Given these estimates, we expect that total corporate profits after taxes will expand about 26.5 percent this year. We anticipate a further gradual whittling down of the unemployment rate which we expect to average about 7 percent in the fourth quarter.

During the past several weeks both short-term and long-term interest rates have risen, primarily due to a move by the Federal Reserve authorities to a less "accommodative" credit policy which has been aimed at curbing an excessive rate of expansion of the money supply. It appears that the authorities are being successful in bringing the rate of monetary expansion back into the desired range. In view of the slowing of the business expansion in the current quarter, as well as the comparatively favorable inflation trend, it would not be surprising to see the Fed relax credit a bit in the next several weeks. In this period short-term rates and long-term rates are apt to come down somewhat. However, if the business recovery moves ahead in the second half of the year as I expect, there will be a significant increase of private loan demand on top of a very heavy schedule of Federal financing. I would also expect the monetary authorities to be leaning against too fast a rate of monetary expansion. Taking all of these forces into consideration, I expect both short-term and long-term interest rates to be higher by year-end than they are today, but not a great deal higher.

THE OUTLOOK FOR 1977

Given the uncertainty about public policy after the election this fall, it is difficult to have great confidence in a forecast for 1977. It should be noted, however, that the Federal budget for fiscal 1977 will be set before the election and will exert its effect well through calendar 1977. As noted earlier, we are estimating the deficit at $55 billion in fiscal 1977, with outlays placed at $418 billion and receipts at $363 billion. I would expect Federal Reserve policy to continue to be careful not to permit too high a rate of monetary expansion for fear of rekindling a new round of double-digit inflation as our economy moves closer to full utilization of resources.

On a very preliminary basis, as will be seen in Table 3, we are estimating that real GNP will expand 5.2 percent in 1977 and that the GNP deflator will rise 6 percent. Looking at the components of real GNP in Table 3, we expect total personal consumer expenditures to realize another good gain—4.8 percent. Durable good expenditures are estimated to increase 8.4 percent. We expect a higher increase in 1977 of non-residential fixed investment—9.3 percent compared with 6.5 percent this year. Total private housing starts are estimated to increase to 1.8 million units in 1977 and total real expenditures for housing are estimated to increase 14.3 percent. We are further estimating that total real business inventories will be increased $16.3 billion in 1977, somewhat higher than the $12.7 billion estimated for this year. Total real Federal and state and local government purchases of goods and services are expected to rise 2.3 percent. Finally, real net exports in 1977 are estimated at $12.7 billion.

Table 4 presents our current dollar GNP estimates for 1977. We are estimating that total current dollar GNP will rise by 11.2 percent in 1977, with 5.2 percent real and 6 percent inflation. Given this rate of expansion, we would expect the unemployment rate to average about 6.5 percent in the fourth quarter of 1977. Moreover, we estimate that total corporate profits after taxes will increase about 10 percent next year.

So far as interest rates are concerned, I would expect both demand and supply conditions in the money and capital markets, as well as Federal Reserve policy, to push rates gradually higher by the end of 1977. This forecast is based

primarily on the estimate that the inflation rate can be held to 6 percent next year. Should the inflation rate turn out to be appreciably higher we would have to expect a more pronounced rise of interest rates.

SOME COMMENTS ON PUBLIC POLICY

We are all distressed to see such a high unemployment rate for our young people and for minority groups. As a matter of equity, public policy must be directed toward providing meaningful job opportunities for all who are able and willing to work. At the same time, however, we must be very careful not to put in place fiscal and monetary policies which will be so expansionary as to generate another round of double-digit inflation. Instead, our policies must be consistent with the objective of bringing the basic inflation rate down somewhat further and keeping it stable at a low level. I am firmly convinced that the double-digit inflation rate of 1974 was terribly injurious to our economic, political, and social system. If it had been prolonged for many more months it would have been devastating to many of our institutions. As much as we desire to return to full employment, we must be certain to avoid like the plague a marked escalation of the inflation rate. Much of our unemployment is in pockets geographically and in particular sectors of the labor market. It appears to me that the use of highly expansionary fiscal and monetary policies to deal with this type of unemployment problem can only do so at the great cost of another round of double-digit inflation. This suggests that our employment policies must be much more selective than we have employed in the past—namely, they must take the form of manpower training, public service jobs, tax incentives to private employment, and the like.

Given the general principles outlined above, I would support the Federal budget goals which came out of the conference between the House and Senate Committees—which placed total Federal outlays at $413.3 billion, receipts at $362.5 billion, and the deficit at $50.8 billion. From the standpoint of the rate of business expansion in fiscal 1977 and inflationary pressures, we shall be running a greater risk the more the deficit exceeds the $50.8 billion figure. Perhaps more important, I would fear that in fiscal 1977 it will be much more difficult to finance a Federal deficit of nearly $51 billion in competition with rising private loan demands, especially if the Federal Reserve is to be expected to avoid an excessive rate of monetary expansion. "Crowding out" was avoided in 1975 and so far this year, but there is a very serious danger that it will occur in 1977 unless the deficit is kept at least at the Senate-House Conference level.

Further with respect to the Federal budget, it seems clear that seemingly uncontrolled Federal spending increases cause the general public and business to fear another round of inflation and are thus harmful to consumer and business confidence. My guess is that a comparatively conservative budget picture in fiscal 1977 will help to increase the confidence factor and will thus lay the groundwork for a further healthy recovery.

So far as monetary policy in the months ahead is concerned, I believe that we should recognize that generally speaking the Federal Reserve authorities have done an excellent job of increasing the liquidity of the economy and encouraging a healthy recovery, along with a marked reduction in the inflation rate. The authorities have struck a good balance between encouraging a strong but sustainable rate of economic expansion and at the same time contributing to a significant improvement in the inflation picture.

During the year ahead the monetary authorities must continue to strike a balance between encouraging a further healthy economic expansion, but one consistent with at least holding the lower inflation rate and hopefully bringing it down further. Their task will be more and more difficult as the economy moves closer to full employment. The authorities must continue to guard against too fast an expansion of money. At the same time, however, they should not be "slavish" in their adherence to money supply goals. As Chairman Burns has noted on many occasions, there have been a number of "technological changes" in the field of money so that it is difficult in today's economy to determine a fully meaningful concept of money. The authorities have demonstrated the ability to employ many factors in the determination of monetary policy—not only the rate of increase of money but the behavior of interest rates, the slack in employment of resources, Treasury financing needs, international monetary considerations, and others. I would expect the Fed to continue to approach monetary policy from a broad base and to do everything it can to encourage a reduction in the unemployment rate that is consistent with the goal of bringing inflation under control.

As I noted earlier, the healthy recovery which we have enjoyed during the past year has stemmed in large measure from the working of market forces in our enterprise system. In shaping public policy it is highly important that these market forces be permitted to work toward a further sustained and fuller recovery. A very important role of both fiscal and monetary policy is to encourage the conviction on the part of the consumer and business that inflation can be brought under control and held under control and that the economy can continue a healthy expansion. Or to put it another way, fiscal and monetary policy must avoid encouraging the expectation that we are headed inevitably for another round of double-digit inflation.

Finally, although I think it would be disastrous to pursue highly expansionary fiscal and monetary policies to restore full employment, I think there is a pressing need for special programs designed to deal with the hard core of chronic unemployment in many areas of the country. It is for this reason that I am open-minded about a public service job program, as well as other suggestions such as tax incentives to business to encourage private employment.

TABLE 1.—REAL DOLLAR GNP ESTIMATES

	1976				1977							Percent change		
	I	II	III	IV	I	II	III	IV	1975	1976	1977	1975/74	1976/75	1977/76
Personal consumption expenditures	794.5	804.0	813.0	824.0	833.0	843.0	853.0	862.0	766.9	809.0	848.0	0.9	5.5	4.8
Nonresidential fixed investment	115.5	118.0	120.5	124.0	127.0	129.5	132.0	134.0	112.2	119.6	130.6	−12.0	6.5	9.3
Residential investment	42.0	44.0	46.0	50.0	52.0	52.0	52.0	52.0	36.6	45.5	52.0	−18.1	24.3	14.3
Federal Government purchases	95.8	96.4	97.0	98.4	98.8	99.2	99.8	101.4	94.3	96.9	99.8	−.7	2.8	3.0
State and local government purchases	165.7	166.6	166.8	167.0	167.8	168.6	170.0	172.0	163.3	166.5	169.6	2.5	2.0	1.9
Change in business inventories	10.7	12.0	14.5	14.0	16.4	17.7	16.2	14.2	−10.5	12.7	16.3			
Net exports	16.8	14.0	12.0	11.0	11.0	12.0	13.0	15.0	23.4	13.5	12.7			
Gross national product	1,241.0	1,255.0	1,270.0	1,288.0	1,306.0	1,322.0	1,336.0	1,351.0	1,186.1	1,263.5	1,329.0	−2.0	6.5	5.2

TABLE 2.—CURRENT DOLLAR GNP ESTIMATES

	1976				1977							Percent change		
	I	II	III	IV	I	II	III	IV	1975	1976	1977	1975/74	1976/75	1977/76
Personal consumption expenditures	1,029.8	1,054.0	1,082.0	1,110.0	1,136.0	1,166.0	1,196.0	1,225.0	963.8	1,069.0	1,181.0	9.5	10.9	10.5
Nonresidential fixed investment	158.1	163.5	169.5	177.0	183.5	190.0	196.5	202.0	148.5	167.0	193.0	.4	12.5	15.6
Residential investment	58.3	62.0	66.0	72.7	76.8	77.9	79.0	80.3	48.7	64.8	78.5	−10.8	33.1	21.1
Federal Government purchases	131.1	133.1	135.5	138.3	141.5	144.3	146.6	151.1	123.2	134.5	145.9	10.3	9.2	8.5
State and local government purchases	218.1	222.1	225.1	228.1	232.0	236.0	241.0	246.0	208.0	223.4	238.9	9.8	7.4	9.3
Change in business inventories	15.5	15.3	16.9	17.9	22.2	25 8	24.9	25.6	−14.6	16.0	24.7			
Net exports	8.2	5.0	2.0	−1.0	1.0	3.0	6.0	10.0	21.3	4.0	5.0			
Gross national product	1,619.2	1,655.0	1,697.0	1,743.0	1,793.0	1,843.0	1,890.0	1,940.0	1,498.9	1,679.0	1,867.0	6.5	12.0	11.2
Deflator	130.5	131.9	133.6	135.3	137.3	139.4	141.5	143.6	126.4	132.9	140.5	8.7	5.1	5.7

TABLE 3.—COMPONENTS OF REAL GROWTH

	1974	1975	1976 estimate	1977 estimate	Percent change 1975-74	Percent change 1976-75 estimate	Percent change 1977-76 estimate
Gross national product	1,210.7	1,186.1	1,263.5	1,329.0	-2.0	6.5	5.2
Personal consumption expenditures	759.8	766.9	809.0	848.0	.9	5.5	4.8
Durables	112.5	109.5	124.2	134.6	-2.7	13.4	8.4
Nondurables	303.0	306.6	320.2	333.6	1.2	4.4	4.2
Services	344.4	350.7	364.5	379.5	1.8	3.9	4.1
Gross private domestic investment	180.0	138.3	177.7	198.9	-23.2	28.5	11.9
Nonresidential total	127.5	112.2	119.5	130.6	-12.0	6.5	9.3
Nonresidential structure	42.7	37.2	39.7	43.2	-12.9	6.7	8.8
Producers' durable equipment	84.9	75.1	79.8	87.4	-11.5	6.3	9.5
Residential structure	44.7	36.6	45.5	52.0	-18.1	24.3	14.3
Change in inventories	7.7	-10.5	12.7	16.3			
Government purchases	254.3	257.6	263.4	269.4	1.3	2.3	2.3
Federal Government	95.0	94.3	96.9	99.8	-.7	2.8	3.0
State and local government	159.3	163.3	166.5	169.6	2.5	2.0	1.9
Net exports	16.6	23.4	13.5	12.7			

TABLE 4.—NATIONAL OUTPUT

[Dollar amounts in billions]

	1974	1975	1976 estimate	1977 estimate	Percent change 1975-74	Percent change 1976-75 estimate	Percent change 1977-76 estimate
Gross national product	$1,406.9	$1,498.9	$1,679.0	$1,867.0	6.5	12.0	11.2
Personal consumption expenditures	885.9	963.8	1,069.0	1,181.0	9.5	10.9	10.5
Durables	121.9	128.1	152.5	174.5	5.1	19.0	14.4
Nondurables	375.7	409.8	445.5	485.8	9.1	8.7	9.0
Services	388.3	426.0	471.0	520.5	9.7	10.6	10.5
Gross private domestic investment	212.2	182.6	247.8	296.2	-13.9	35.7	19.5
Nonresidential total	147.9	148.5	167.0	193.0	0.4	12.5	15.6
Nonresidential structure	54.4	52.7	58.5	67.0	-3.1	11.0	14.5
Producers' durable equipment	93.5	95.8	108.5	126.0	2.5	13.3	16.1
Residential structure	54.6	48.7	64.8	78.5	-10.8	33.1	21.1
Change in inventories	9.7	-14.6	16.0	24.0			
Government purchases	301.1	331.2	357.9	384.8	10.0	8.1	7.5
Federal Government	111.7	123.2	134.5	145.9	10.3	9.2	8.5
National defense	77.4	84.0	88.9	96.0	8.5	5.8	8.0
Other	34.3	39.2	45.6	49.9	14.3	16.3	9.4
State and local government	189.4	208.0	223.4	238.9	9.8	7.4	6.9
Net exports [1]	7.7	21.3	4.0	5.0			

[1] Includes Military Expenditures.

Chairman HUMPHREY. Senator Javits, I want you to start the questioning. I am going to step out for a minute. I will be right back.

Senator JAVITS. Mr. Chairman, I think that you gentlemen have come to a remarkable degree of agreement as I read these statements regarding your findings. You have given us some very excellent guidelines.

I am interested in two things. Professor Dernburg, this tax cut that you have in mind, I assume you testified to it when you read your statement or summarized it. How does that relate to the bill before us? For example, Mr. Okun was very helpful to me by pointing out that he thought the tax treatment of commercial property in the House bill looked like a fair resolution of the problem to him.

What do you think about this present controversy as to some additional tax stimulus, like the $35 tax credit, assuming that we are going to extend the existing tax cut?

What else do you want us to do?

Mr. DERNBURG. I certainly would want to see the present law extended. I am not familiar with exactly what the Finance Committee

is doing. From what I hear about what it is doing, I don't like it very much.

I don't like—my impressions may already be totally obsolete, and may involve things that went on 3 or 4 days ago. But from what I heard there will be provisions that will not go into affect until fiscal year 1978 and that seemed to me a very bad way to make tax law.

We should make our tax laws based on our current economic condition not on the basis of what might happen in some future fiscal year. It seems to me that the budget process is being circumvented and I am not in favor of that.

I really would prefer to have a nice, clean tax reduction in personal income tax without adding various loopholes and that sort of thing.

I would not be opposed to an increase in the individual exemption. I would not be opposed to widening the brackets. The inflation that we have had in the last several years has had the effect of shoving the real value of the income tax brackets closer, making them smaller. It has driven taxpayers into higher brackets even though those taxpayers do not have higher pre-tax real incomes.

That might be a useful way to conduct the tax reduction.

Senator JAVITS. The thing I am trying to ascertain is is the continuance of the existing reduction meeting your view, to wit to give tax payers a $15 billion to $20 billion additional tax reduction?

Mr. DERNBURG. Which reduction?

Senator JAVITS. The present law which is temporary and which we intend in the Senate bill to install permanently. This relates to the general income tax rates and the withholding rates.

We do have a $15 billion tax cut which is temporary. The question is shall we continue? Does that meet your view? If we continue that, then we have met your view.

Mr. DERNBURG. No. I am asking for an additional reduction on top of that. Could I take this opportunity to apologize to Senator Humphrey? I now notice that the Joint Economic Committee has in fact recommended a $10 billion tax reduction.

Senator JAVITS. In addition?

Mr. DERNBURG. Yes.

Senator JAVITS. And you concur in that?

Mr. DERNBURG. Yes. I must absolve the Joint Economic Committee from what I said about the generally fiscally conservative climate. What threw me off was the statement where you say:

> The strength of the economy should be carefully monitored for the next few months. Should growth appear to be dropping below 7 percent and it starts to bring the unemployment rate up, then additional tax reductions should be made in 1977.

I think that wait and see is a mistake because the longer we wait the more we drag out unemployment, and the more likely it will be that a chunk of the tax reduction will be frittered away in inflation.

That is what I would like to avoid. Now is the time to attack.

Senator JAVITS. Mr. O'Leary, in your statement there appears the following sentence:

> This suggests that our employment policies must be more selective than we have provided in the past, namely that they must take the form of manpower training, public service jobs, tax incentive, to private employment, and the like.

Now we have had a policy of manpower training and public service jobs. We have not had very much of tax incentive to private employment. To what extent do you wish us to change existing law in that regard? We have about 330,000 public service jobs. We would like to increase that. We have reported out of the Senate Labor Committee, where I am the ranking member, authorization for some 630,000 jobs. I would increase it to 1 million.

In manpower training, I think we have 1 million under training, give or take a certain percentage. We have no real tax incentive to private employment. I think that is very likely to come into being.

What precisely do you have in mind?

Mr. O'LEARY. Well, my initial reaction is to support the numbers you are talking about. I think we need a bigger program. I think we need a more effective program. I feel that in a city like New York or in a State where I live like Connecticut, we are not going to deal with a lot of that employment through what would be manageable, price stable fiscal policies.

We have got to get at it in a direct sort of way. I was Chairman of the Council of Economic Advisers in New York State for a short period of time. I had some—this was back in the days of Nelson Rockefeller. I got some idea as to what the problem is in the State of New York and the city from the point of view of the fact that overall, even if we get a very strong recovery in the national economy, as a result, let's say, of a highly expansionary fiscal policy, you are still going to have a lot of unemployment in New York City and New York State.

I think we have got to find ways to start public service jobs to deal with it. I come to that reluctantly but I see no other way to deal with it.

Senator JAVITS. That is very impressive coming from you as a bank official. Can I press you one step further and ask what you think about the Federal Government as the employer of last resort concept at a wage rate less than even the public service job rate?

Arthur Burns, for example, talks about something between $6,000 and $8,000 a year.

Mr. O'LEARY. I would never be afraid to associate myself with a public policy suggestion of Arthur Burns. I have often.

Senator JAVITS. Thank you.

Chairman HUMPHREY. Gentlemen, first let me say that there is a good deal of complementary relationships among your statements. Mr. Dernburg, you feel that the early extra tax deduction is a more productive economic stimulus than tax reduction later on. I should say to you that in the JEC report that while we did recommend an additional tax reduction we did it on the basis in all honesty on a wait-and-see basis.

I think that is true. I have to confess that I weighed in on that side. I also have to be careful of what the public attitude is on these matters as well as what the economic facts are.

How people perceive things is sometimes almost more important than what the facts really are. Perception as Mr. O'Leary was saying here is very important. But it is my judgment that we need a rate of growth in GNP, a real rate of growth around 7 percent to really attack the income distribution, unemployment, and productive capacity problems we face.

Mr. O'Leary, I want to say to you that I am not unmindful of the long-term dangers of deficit spending to the degree that we have been compelled to employ it. I am not as worried about crowding out as I was not, by the way, a year ago.

I felt that the danger of crowding out was overestimated as I think that you have indicated.

Mr. O'Leary. I definitely felt that way.

Chairman Humphrey. But I do feel that there is a psychological factor involved and therefore it has to be taken into consideration. I would like to have you elaborate a little more on what measures if any you would recommend to get these long-term interest rates down.

Mr. O'Leary. To get long-term interest rates down?

Chairman Humphrey. Yes.

Mr. O'Leary. First of all, let me say that in the long-term market, one cannot see strong pressures of demand against supply. The characteristic of the long-term market is essentially one in which the suppliers of funds see themselves awash with funds relative to the places to put money. This would suggest and has suggested for quite some period of time a considerable decline in long-term rates.

There continues to be large demand for corporate long-term financing. We are beginning to see more by financial institutions aside from industrial firms, and we are seeing a lot of long-term financing by foreigners in our markets because our rates are more attractive. So one should not overemphasize the fact that demand is weak. But nonetheless, it is not excessive relative to the supplies of funds.

The area of demand that is weak is the area of financing for income-producing properties—multifamily residential and commercial properties. That is probably $15 billion below what it normally would be in terms of net new money financing. So we have a situation in the demand-supply situation which would suggest lower long-term rates.

Senator Humphrey, if you consider the life insurance companies, which I think are key this year—the life insurance companies are doing much better as a recipient of funds.

They are doing much better in the pension fund field. The whole pension fund investment has moved away from the equity market because of the way the equity market has performed. I would say this year the life insurance companies may get net new money of $20 billion. They probably will have gross funds—mortgage repayments, and sinking fund payments on bonds double that, maybe $40 billion.

Many life insurance companies don't have large forward commitment positions. When interest rates were high in 1974 and early 1975, many life insurance companies did not have new money. Their cash flow was drained away by policy loans.

Now their policy loans are down and they have all sorts of money coming into them. Normally about half their money would go into commercial mortgages—office buildings, shopping centers, warehouses, as well as into mortgages on apartments. You are not getting the volume there. They are putting money into corporate bonds.

If you look at that situation, you would say to yourself, long-term rates ought to be falling markedly. And yet in the public market there continue to be large demands for corporate bond financing, which is absorbing some of the life insurance funds. Also there is a considerable volume of financing in the direct placement market.

Other long-term lending institutions such as the savings and loan associations and the mutual savings banks also have a strong cash flow relative to the demand for financing. But what they are all concerned about is their expectation that the decline in the inflation rate is not going to last and that inflation is going to heat up again. They expect short-term rates to rise again and their cash flow to weaken.

Chairman HUMPHREY. Isn't that partly due to the rather precipitous action of the Fed of late. When the Fed looked at those targets that Congress set and looked at the money supply it started to crack down again. Didn't this send signals through the financial community saying: Look, prospects of high inflation are here?

Didn't it signal that financial community to buckle in and be a little more conservative?

Mr. O'LEARY. It is partly the M's because the financial institutions have bought the idea that if you have high rates of money expansion you will have inflation. But it goes deeper than that and that is why I feel we ought to be reasonably conservative in the fiscal area.

Most of these people would say that if you took Tom's prescription of another $'5 billion or $20 billion tax cut, they would regard that as an indication of proof that the rate of inflation now is low relative to what it is going to be in the future.

They have associated inflation with large Federal deficits. In the near term it is the Fed action because they are saying the M's are increasing. The Fed sees something here that we don't see. They must see inflation heating up. The way it impacts them is that although they have rebuilt their liquidity and increased their holdings of government securities the fear of an escalation of inflation makes the institutions cautious about commiting funds into long-term investments. If you followed Tom's prescription of a $20 billion tax cut, you would encourage the idea that a year from now, we are going to have a much higher inflation rate.

Under these conditions, it is reasoned the Fed would have to be much more restrictive, short rates would be up. It scares the insurance companies. What it does it makes them much more liquidity conscious. They build up their short-term assets rather than putting the money into the long-term market. That is the psychology. They have been through this three times now in the last 10 years and they are conditioned to think that way.

Chairman HUMPHREY. Yes, indeed. It seems to me that the Congress by establishing budget control, setting budget ceilings with the concurrent resolutions and staying within them has helped to ameliorate it.

Mr. O'LEARY. That is one of the most constructive things that has happened in this country in years.

Chairman HUMPHREY. We have disciplined ourselves to it. For example, I have to handle foreign-aid legislation in the Congress. It is a tough assignment because we have to cut below what the administration asks for to be able to stay within our own budget estimates.

The pressures on us are terrific.

Mr. O'LEARY. What we need is the very thing we are talking about. What is needed is to try to assure decisionmakers all through the system that we are going to keep the inflation rate down at least as low as it is.

Why has the stock market recently been stronger? The stock market has been stronger because it smells out the idea that the second quarter has been weaker and it is beginning to smell out the idea that maybe the Fed will relax a little bit at this point.

If that happens, the bond market will rally further and the stock market is anticipating that sort of thing. That is why the stock market has come up. The sensitivity to Fed policy, the sensitivity—this whole process is so important. That is the only reason I feel you have to be cautious in the fiscal area because whether it is right or wrong, the decisionmakers associate a larger Fed deficit with a greater likelihood that we are going to come back to a higher rate of inflation.

You would have then the consequences of interest rates higher than they ought to have been, the stock market bleaker. Not that the stock market is that important but it is an important ingredient in the confidence factor.

Chairman HUMPHREY. This is why every one of us has our prejudices in this area and that is why I have felt that the economic policymaking mechanisms of the Government need to be better coordinated.

You have the Council of Economic Advisers made of competent people. You have the Office of Management and Budget that works with the President and his cabinet. You have the Federal Reserve Board. As you said some moments ago, it is not enough for us to be concerned about money aggregates. We have to have a coordinated economic policy.

Surely one of the factors involved is economic policy. How you relate all of these policies, monetary policy, tax policy, and budget policy, to a sustained growth level, to targeting in on unemployment problems is very important.

I do not think there is any way that just fiscal stimulus alone can resolve all of these unemployment problems. We can resolve some of them but we have to correct certain structural problems in the economy before we resolve all of them.

I appreciated the breadth of your vision here this morning and the manner in which you have dealt with what I think are both facts and perceptions.

I have difficulty at times with myself in these matters. The facts tell me one thing and yet as a public man, I know what perceptions mean. It is how people perceive it. I sat this morning with a group of agriculturists. They are a fine group of people.

The average citizen believes that farm prices are pretty high because they go to their supermarket and they equate inflation with the prices in the meat market, they equate inflation with the prices of fruits and vegetables and a loaf of bread.

To Mr. and Mrs. America, who do not deal in bonds and securities and capital investment, that is inflation. That is the measure of the economy to them. I told these people that the average American perceives that you are getting a big price.

But they don't understand what your cost of production is. They don't understand the cost of land. They don't understand any of these things. I said our job is to change the perception of the average American. It is not a matter of just changing the loan rates. We have got to change the perception of what is going on here.

It is a bearcat of a job, I will tell you because people grab the first straw that they see and say well, that is the final truth. I just appre-

ciate the fact that a man that comes from the banking industry as you do can come to us and give us some of this counsel and guidance most of which I fully find myself in agreement with.

Mr. Okun——

Mr. OKUN. Mr. Chairman, may I add to that?

Chairman HUMPHREY. Yes, please.

Mr. OKUN. You asked for a proposal to bring down long-term interest rates. If you could persuade Chairman Burns of the wisdom of what Jim O'Leary said on monetary policy, I guarantee you that we would have a real go of the bond market.

Chairman HUMPHREY. I think so, too. Yet you see Mr. Burns has said in testimony some of the things you have indicated. The problem is that the system does not produce the full result. One of our problems also, gentlemen, is that we don't get the data on which the Federal Reserve makes these decisions.

We are not privy to the data on which the Federal Reserve is making these monetary policy decisions? Every time I read in the press that the Fed is tightening up, for example—I don't know what that means.

It always seems to me that the Fed almost has antipathy toward expansion and prosperity. I can understand some of that. It reminds me of when I came to Congress.

I had drilled into my mind that one of the great mistakes of the thirties was the fact that when the President asked for an appropriation to fortify Guam, the Congress would not give it to him.

In the period when I came to the Congress, anybody that asked for anything for defense they got it. There was one thing we wanted to be sure of, that we were never caught short again.

Now we have a turn around the other way because we have had some other lessons. The Fed has been criticized a great deal for 1972 when monetary expansion just blossomed in the summer of 1972.

Now they think that some of us are watching them pretty carefully to make sure there is no hanky panky politics here and there and they are oversensitive to what appears to be a rate of expansion that is excessive to them. That is just Hubert Humphrey's point of view.

Mr. O'LEARY. What you say makes a lot of sense. Over the last few years, the Federal Reserve has been criticized for not paying enough attention to the interest rates and to the rate of unemployment and to the international monetary situation. In effect the criticism has been—all you have to do is watch the rate of monetary expansion and if you keep that within a reasonable range, it is going to solve all the problems in the world.

The difficulty is that the Congress accepted that and the Federal Reserve in response to it has set itself these monetary targets so it was caught in a situation where if the rate of expansion gets out of those monetary targets, it has to act regardless of what the stage of the business cycle is.

Chairman HUMPHREY. Yes.

Mr. O'LEARY. It just does not make any sense to me.

I can sympathize with the fact that they have got to pay attention to it. They go to the House Banking and Currency Committee and the Senate Banking and Currency Committee and they have made a commitment to stay within these ranges.

What does a range mean if you have an 8-percent unemployment rate and you are just coming out of a recession in 1975? Why exercise any sharp turn around if you don't know if you are out of the recession?

All I can say is that Mr. Burns' testimony always makes it clear they are looking at a lot of other things.

Chairman HUMPHREY. I have never been able to find out what they have been looking at.

Mr. O'LEARY. I have a commitment that I did not expect to have and I have to leave.

Senator PERCY. Mr. O'Leary, can I ask you one question as you leave? This will be a quick one. Do you see inflationary dangers in a more stimulative Federal budget than that proposed in the current resolution?

Mr. O'LEARY. If the deficit is larger than that proposed in the current resolution that would be unfortunate because I think it would create bad psychological reactions on the part of consumers, business and financial markets. I think at this particular point of time, let's see how things go. I am not worried that we could not at some later point have a more stimulative action if we see the economy is slowing down.

I am happy with what we have got in this concurrent resolution.

Senator PERCY. A one word reply will do to this one. If you were sitting in our seats, would you be more concerned about unemployment or inflation in the year ahead?

Mr. O'LEARY. I would balance the two. I am concerned about unemployment. At the same time I think it would be a tragedy if we get into an escalation of inflation again. I think that is the public policy job we face.

Senator PERCY. Inflation would be your answer, then.

Mr. O'LEARY. I am a little more fearful of inflation because I think the consequences of another round of inflation would be very, very damaging to our whole system. Maybe I would lean a little on the side of the inflation. But at the same time, I don't think we ought to give up the hope that we can do both, get the unemployment rate down consistent with controlling inflation.

Chairman HUMPHREY. Thank you.

We have two good witnesses here, Senator Percy.

Senator PERCY. I would be very happy to hear them. Professor Dernburg. do you believe that the 1973–74 inflation was a major contributory factor of the 1975 recession?

Mr. DERNBURG. Absolutely. There is no question about it. There are two clear examples that I can so cite for you. One is what happened to the real quantity of money in 1974. It grew at a negative rate. The actual stock of money increased during 1974. But because of the fact that the inflation rate was so rapid, the money in real terms declined. From the fourth quarter of 1973 when the downturn began to the third quarter of 1974, we had the following monetary growth rates.

In the first quarter of 1974, minus 6 percent. That is at an annual rate and that is figuring in real terms. In 1973 the second quarter it was minus 2 percent and the third quarter it was minus 9.7 percent. This was brought about by a combination of slowly growing money with a rapid rate of inflation.

Senator PERCY. Assuming inflation does heat up again, would you be concerned about another recession following it?

Mr. DERNBURG. Well, certainly the rapid inflation has a very restrictive effect. That is really the worst part of our present dilemma. When prices rise, this impinges on the real quality of money. It raises the real value of taxes.

This was something else that hurt us a great deal in 1974. My recollection is that even though real GNP fell at a rate of about 3 percent in 1974, the nominal GNP was rising very rapidly because of the rapid rate of inflation.

Personal income was rising very rapidly. Therefore personal tax collections were rising very rapidly, so much so that I think if you took the ratio of total personal taxes, both Federal, State, and local to personal income, that grew from 14 to 14.5 percent in the space of only three quarters.

That happened at the time when the economy was falling into recession. It meant that what we had always thought of as an automatic stabilizer worked just the opposite way. We had tax ratios rising at a time when gross national product was falling.

It was disastrous for the economy and it was hardly surprising that by the fourth quarter of 1974 we were in a hopeless situation. Consumers were just exhausted. This may happen again albeit slowly. Some of the effect of last year's tax reduction seems to have already been dissipated by the fact that the inflation causes taxpayers to move into higher brackets.

Senator PERCY. Would your major concern be for unemployment or inflation if at this particular time and looking ahead to the next year——

Mr. DERNBURG. I find it hard to discuss that because they are different animals. Unemployment is a horrible thing and I am very concerned about it. The fact that prices are rising is it itself nothing to get terribly concerned about. It is the consequence of those price increases that concern me. The consequences are that policy automatically becomes restrictive and that we get a conservative bias in our policymaking because we are confused, we want to get rid of the inflation and we pursue one set of policies. If we want to get rid of unemployment, we pursue another set of policies. It is a dilemma.

Senator PERCY. I would like to turn to Mr. Okun for comments on the same set of questions. I would be most anxious to have your judgments on the Humphrey-Hawkins bill. I have long believed in the Government as an employer of last resort. I think Senator Humphrey, you have had a lifetime of personal experiences.

I will just never forget when my family was on relief and my mother who was a concert violinist got a job and got $90 a month but for working 7 to 8 hours a day playing concerts for high school children. It gave us a sense of dignity at home I can still remember this day. She voted for Franklin D. Roosevelt.

Chairman HUMPHREY. You should have followed in your mother's footsteps. [Laughter.]

Mr. DERNBURG. By the time I reached voting age—but anyway I am intuitively inclined toward that, but I am also worried about a 3-percent level. Is that a realistic level? I also realize the harsh, cruel nature of inflation. There is no social program where you can reach out and

catch everyone that a 5-cent increase in the price of milk or bread or things like that affects.

How do you affect people who are paying 50 percent of their income on food? These are tough questions. Is a 3-percent level of unemployment really realistic?

Chairman HUMPHREY. Adult unemployment.

Senator PERCY. Yes, adult unemployment. We are looking for guidance and help on this.

Mr. OKUN. Let me go back to your initial question on the unemployment and inflation issue. My major concern about policy in the last several years and my major personal appeal has been to try to find ways to deal with inflation without making the technique for limiting inflation one of increasing unemployment. There are a lot of opportunities and I think these oportunities are being sadly ignored.

That is the basic difficulty we face today. I do believe we should have been doing more in recent years. Senator Humphrey tried to do this by looking to food stocks for insurance against the kinds of prices we had with the food price explosion in 1973.

I happen to believe that the only way we will ever solve our agonizing dilemma of unemployment and inflation is with the aid of some kind of a social compact or incomes policy—some way in which we get business, labor and government to agree that there has to be some self-restraint on prices and wages in order to make it possible for this economy to have reasonable performance of real growth and high employment without inflation.

The American people's antipathy to inflation has good reason. People do live by the dollar as a yardstick and as a measuring rod. They can't live comfortably in a world in which the price level is highly uncertain and highly erratic.

I think we have to meet that concern. There are ways of dealing with it that don't require us to raise unemployment. We do have some illustrations abroad of countries who have for years tried to deal with the problem by going from high unemployment rates at one point to a booming economy and high inflation rates at another point—a continuation of stop and go. They are realizing that they to have to face up to this wage and price restraint problem.

The British are beginning to face up to it and they have fashioned a tax cut that will induce more workers to accept greater restraint. Missing from the Humphrey-Hawkins bill is an incomes policy formulation or even a procedure for the development of wage and price targets along with unemployment targets and I would feel much more comfortable with the bill if that additional language were supplied.

Chairman HUMPHREY. It does call upon the President of the United States in the presentation of his targets for employment, for production and income to also present an incomes policy program. In other words, an anti-inflation program. We just did not spell it out.

The minute you spell it out you have more controversy about the details than you have about the substantive measures of the bill. I recognize the legitimacy of the concern which people have expressed because I too am concerned about inflation.

Some people think that the only way to control inflation is wage and price controls. Therefore it you put that in the bill, you are off on a big old struggle on that issue which clouds all the others. I therefore felt

that what we should do is to recognize the problem, to know that the problem of inflation is there. The bill calls upon the executive branch of the Government in cooperation with the Congress to present and to develop the kind of a policy which exercises any inflation restraint.

I think the weakness that we have had insofar as the way the bill is written is that we did not spell out what certain people want. A lot of editors want us to put in wage control. The labor movement would like to have you put in price control. Some of us feel there ought to be selected areas in the economy in which there are wage and price restraints over a period of time.

I am not averse to an incomes policy. In fact my whole life in public life has been directed toward that. Every time we have been ready to write one, we had more people with rifles and shotguns shooting this down than we had anybody with building blocks to hold us up.

Senator PERCY. I think you have few peoples for wage and price controls. They have been burned and burned badly. Probably the experience we had was a good experience because we don't know how to regulate our economy that way.

Chairman HUMPHREY. You see what it really boils down to, then, Senator, is that what people are concerned about is there perception that if you have full employment, you automatically have inflation, automatically. This is what the controversy surrounding the Humphrey-Hawkins bill boils down to.

All we did was put a target of a rate of 3 percent unemployment in the bill. It really boils down to about 3.6 with the youth unemployment but if you put it in there—the answer that comes back is if you are going to get rid of unemployment, you are automatically going to have inflation.

This is like saying that if you get rid of pernicious anemia you are going to have high blood pressure or if you get rid of high blood pressure, you are going to have pernicious anemia.

People won't recognize that there might be a way to come closer to full employment and have restraints on inflation. I think it takes an incomes policy. I am just not sure what the segments ought to be in that policy.

Senator PERCY. I would like to ask you about the Federal budget. Do you see inflationary dangers in a more stimulative Federal budget than that proposed in the concurrent resolution?

Mr. OKUN. My ideal Federal budget is more stimulative than that. I am indicating a willingness to wait and see and I accept the first concurrent resolution as being in the ballpark. I am absolutely convinced that market forces today cannot generate an acceleration of inflation.

Let me add that that does not guarantee that there won't be an acceleration of inflation. If there is an acceleration of inflation over the next year with anything like the current output, you will not be able to find the source in terms of market force and excess demand.

You will have to look at what creates our inflationary bias.

Senator PERCY. I rather interpreted your statement as implying that if the concurrent resolution prevails, then you would be somewhat satisfied that we are on a steady-as-you-go path and we would need no further additional fiscal and monetary stimulus.

Am I wrong in that assumption?

Mr. OKUN. The question is how satisfied. I guess I find the concurrent resolution acceptable and I would be reasonably optimistic about the outcome.

We could do better by doing more. My guess is that if we have occasion to take a look late this year or early next year, we are much more likely to want to add more stimulus than to subtract it. But this looks like a reasonable basis for planning at this time on the assumption that we have the cooperation of the Federal Reserve in financing that kind of a recovery.

Senator PERCY. Mr. Dernburg, you are quite concerned about lack of necessary fiscal stimulation. Do you believe that the present budgetary process followed by the Congress has a downward bias with regard to stimulative policies because expenditures are so tightly controlled?

Mr. DERNBURG. Well, since I still work for the budget committee now and then, I am reluctant to get into this one. I think the bias has been a conservative one. I think the real problem has been that the President and Congress have not seen eye to eye. As Senator Humphrey says, the President's budget was not a budget—what was it you called it?

Chairman HUMPHREY. I don't remember.

Mr. DERNBURG. Anyway I think this year is an example. The President sent the budget up. It was unrealistic. It would have tried to get the deficit down by something like $33 billion. I could not believe when I first saw it that anybody would take it very seriously, the idea of holding expenditures growth down to less than 6 percent, for instance, does not make sense to me.

I assumed that when it came up here to the Hill that the budget committees would take it over and would make it look more realistic. They did but they did not make it much more stimulative. What they did was to increase the expenditures but they rejected his proposed income tax reduction so the deficit came out about the same way.

The budget committees' deficit was $50.6 billion and the President's was about $45 billion. That is not an enormous difference. It appeared to me that the President was sort of saying, well, here is my deficit, and I dare you to raise it. Congress, dealing with election year problems, was unwilling to take the dare.

Senator PERCY. My last question deals with an area that Senator Humphrey has alluded to here. Mr. O'Leary said in his statement that we—he suggested a need for a selective employment policy. Would the two of you care to comment on what you think we can do about this very special problem of solving the problem of youth and minority unemployment which is always highest and a very tragic part of our unemployment picture here?

Mr. OKUN. May I make one remark on your last dialog? I would give the Congress a somewhat higher grade for its performance in response to the recession. As I read the fiscal 1976 budget, it is the most stimulative program we have ever had during peacetime. It is appropriate because it is the most severe recession experience we have had in the whole period since we began using fiscal policy as a recessionary tool.

At some point we have to start moving back to a reduction in restraint of the policies. My general feeling now on the employment outlook is that the main source of cure is going to be in the creation

of private jobs and, that stimulus to the overall private economy is the way to keep supporting recovery.

We have played a constructive role by having the public service employment program. It proved to be a quick-starting, quick-acting program. The problem of teenagers and minority workers is more of a structural problem which will exist even when we get to prospertity and the solution to that is likely to be complementary with general economic policies.

I don't know how you find jobs for people who have trouble finding jobs when you don't have jobs for people who have long continuous work records, well-established skills and so forth. I would worry about gearing up things like training programs in a recession when these programs are just going to have an output of highly trained workers which will produce a much higher quality of labor on the unemployment line.

If there are no jobs for anybody, they are not going to find jobs either and we are just going to increase frustration and divisiveness.

I would like to see some efforts made in the context of a move to prosperity to provide additional incentives for the private creation of jobs for teenagers and minority workers. There are a number of proposals floating around in academia for various types of incentives, voucher plans, for example, that look very attractive to me. I do think that, in the context of a recovering economy, training programs have a lot more promise.

I don't think we have given the whole area of manpower training a fair chance. We have dabbled in it at the wrong times and concluded that it does not do very much and that is not fair.

Senator PERCY. Thank you very much, Mr. Chairman. Mr. Chairman, I wish to express appreciation to our distinguished panel for being here this morning.

Chairman HUMPHREY. Thank you for joining us, Senator Percy. I have just a couple of very brief questions and would like brief answers. I understand, Mr. Okun, that you said that wages have behaved with exceptional moderation; is that correct?

Mr. OKUN. That is correct.

Chairman HUMPHREY. And therefore it has been a moderating factor in the inflation picture?

Mr. OKUN. Yes.

Chairman HUMPHREY. Do you expect this moderation to continue?

Mr. OKUN. I wish I had more confidence. Our ability to predict wages has been very poor. Lots of people were sure that the first sign of recovery would trigger off large catch up demands. That has not happened. Maybe we will continue this way. Every foreigner that comes to my office just cannot understand how the United States can have such a different kind of wage behavior.

They always ask about when we are going to have our wage explosion. It is not even whether. It is when. They feel that our workers and our industries can't be different from theirs to that extent. It is an area we have to be nervous about.

Chairman HUMPHREY. Therefore do I interpret you correctly that you feel that we need an active incomes policy more or less on a voluntary basis but one that could make a valuable contribution to responsible price and wage increases?

Mr. OKUN. That is correct. It is an insurance policy in part. We could have done even better. If we had set targets like 6 percent on wages and 3 percent on prices this year. If they were established by the Congress and the President, I think it would have had a great influence on what in fact happened to wages and prices.

People would have paid attention. As I see it, what keeps wages turning is a spiral effect which is very hard to break.

Chairman HUMPHREY. I have noticed a number of price increases, for example in the steel industry of late and the automobile industry is projecting some more. One of the things that people seem to forget and is a reason the Consumer Price Index has held as well as it has is that there has been a drop in food prices and some drop in interest rates, short term, which will—those adjustments come from time to time.

Mr. OKUN. During the first quarter we had some drop in gasoline prices that came from Congress insisting that the tariff be removed.

Chairman HUMPHREY. Yes.

Mr. Dernburg, do you favor incomes policy?

Mr. DERNBURG. Yes; I do. I think that it is going to be so important to raise employment and to prevent inflation that I think we must have some supplementary policy instrument. I agree with Mr. Okun that the economic conditions we are experiencing this year are those that are conducive to proper functioning of an incomes policy because there is no excess demand in the economy. Therefore it is quite possible to maintain—to keep the income policy from breaking down.

Chairman HUMPHREY. I would settle for inflation rates now of what we had even then. I think the point that I see here is that in our arguments with the Fed on tightening up and so on because of the worry of inflation is that if you had an income policy along the lines that you are saying, Mr. Okun, where we would have some guidelines, we would be in a better position of economic integrity to really crack down at the Fed and in the other branches of the Government because we would be exercising some self-discipline in the private sector.

Gentlemen, I know you have to go and I have a luncheon. I can't adequately express to you my thanks for your helpful testimony. It has given us information that is very valuable. Thank you very much, Mr. Okun and Mr. Dernburg.

I am glad to see you again. Thank you very much.

We stand in recess.

[Whereupon, at 12:11 p.m., the committee adjourned, subject to the call of the Chair.]

MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

WEDNESDAY, JUNE 23, 1976

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

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

Present: Senators Humhprey and Javits; and Representatives Brown of Ohio and Brown of Michigan.

Also present: William A. Cox, Lucy A. Falcone, Louis C. Krauthoff, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Charles H. Bradford and M. Catherine Miller, minority economists.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. Gentlemen, we thank you for joining us this morning. We start our sessions in Congress now in the rural spirit, very early in the morning, get up to do the chores and get set for the day; we now have the sessions open at 9 o'clock.

The session this morning of the Joint Economic Committee is designed to continue the midyear review of the economic situation and outlook. We are very fortunate to have a panel of three distinguished economists, who have been invited here to discuss the overall economic outlook and with some special emphasis on monetary policy. Next Wednesday we will conclude this series of hearings on the Midyear Economic Report with testimony from the Chairman of the Federal Reserve Board, Mr. Arthur Burns.

In opening this hearing, I want to raise a rather fundamental question relating to our economic objectives. To put it as simply and directly as I can, where are we trying to go, and do we really want to get there?

With unemployment as high as it is and with recent progress against inflation really quite encouraging, one might have thought it was fairly obvious that a continuation of vigorous economic recovery was desirable. But let me read you two recent newspaper headlines:

The Wall Street Journal on Monday, June 21: "Go-Slow Recoveries To Be Stressed by U.S. at Summit Next Week."

And the Washington Post of the same day: "OECD To Propose Growth Slowdown in New Policy Plan."

The Wall Street Journal article notes that at the Rambouillet summit meeting last November, foreigners were skeptical of U.S. predictions that our economy had entered a period of fairly strong recovery. It then goes on to quote an unidentified U.S. diplomat as saying:

To our surprise, events have substantiated our claims at Rambouillet of U.S. economic recovery, and it's starting to scare hell out of us.

I'm glad that fellow is unidentified, or I would have him up here by the nape of the neck. What kind of "Alice in Wonderland" world is this, gentlemen? We project economic recovery for this year, and our projections turn out reasonably accurate, and then "it scares the hell out of us" to find out that we were right.

I want to tell you, it doesn't scare me to have an economic recovery. Frankly, I would like to go on record with a very courageous statement—I welcome it. I want to see it continue. The folks that I represent out in the State of Minnesota would like to see it continue. It would scare me if we did not have some recovery. Recovery does not necessarily mean inflation, and that "bogy-man" should be put to rest.

I am pleased to note that, in their prepared statements for this morning, two of our witnesses place considerable stress on the need to sustain rapid rates of real economic growth throughout this coming year. In the question period I want to hopefully pursue this issue in some detail and develop as much precision as we can.

I think it can be said that nobody wants to see a repetition of the world commodity boom of 1973–74 and the speculation and inflation that followed. Certainly, I support efforts to coordinate our policies with those of other countries to avoid any such recurrence. Certainly, achieving and sustaining reasonable price stability is an essential precondition of restoring full employment. That is true in the United States, and it is true in Europe, where the inflationary problem is more intractable. All the same, at this early stage in the recovery from the deepest worldwide recession since the 1930's, it is too early to talk about going slow in terms of growth of real output and employment. I just toss out something I hope you gentlemen will nibble at a little bit in your discussion, and maybe you can help us with some factual information.

I have always had a feeling that the international banking system went on a binge in 1973–74, sort of a lost weekend that extended over 1½ years. They were loaning money out at a most incredible rate, very rapidly, large amounts, for all kinds of speculations. We saw that domestically in the real estate boom. No one has checked up on those fellows.

Everybody gets scolded. The poor get scolded for cheating on welfare; the labor people get scolded for wanting too much wages; the farmers get scolded because the prices of food go up; the retail grocer gets scolded because the consumer is unhappy about what he pays at the supermarket; electrical utilities get scolded because their rates go up; and even the oil companies get scolded because they've got too high a price on oil.

But for some reason or other this crowd that is loaning all this money out, that is supposed to have fiduciary responsibility, and that is supposed to know what it's all about, they are above the battle. I think we ought to bring them in the battlefield and take a look to see what they are up to.

This committee has done an inadequate job on that, including the members and the staff. We have not really looked into this at all. The speculation didn't take place with people playing with Easy Money, Monopoly games, or dominoes; it had to take place with credits, and bonds, and stocks, and money that was handled by the largest international banking houses.

I wonder why the economists haven't put their finger on this. Why we are going around looking for street crime when something else is going on. That really bothers me. I haven't gotten that out of my statement this morning, it just dawned on me as I was thinking about the international situation. I really believe there is something here that needs to be looked at. I would like to know how the speculation in commodities, and how this constant speculation in currencies was financed. Why is it that the bankers have the right to play games with our money in speculating activities—and I am not talking about the banker out in Minnesota, or in Alexandria, they haven't had any more to say about it than I have had to say about it.

Each country has unique elements in its own economic situation. Not all countries have a rapidly growing labor force which characterizes the United States. Not each country needs to grow in the same way, or is capable of doing so. What distresses me is that the officials of this administration seem to regard slow growth as a tremendous virtue. They want to be careful to grow slowly and to hold that up as an example which they are urging other countries to follow.

However, policy is not made exclusively by the executive branch in this country, it is the Congress which has ultimate responsibility for determining our economic policies and for assessing their impact.

I just thought I should let people know this morning that there is one Senator who is not afraid of a policy of economic recovery. One Senator who will vigorously oppose any effort by the United States to set an example for the world of stagnation and continued high unemployment. I think I am far from alone in this feeling, and this too is a question I want to explore with our witnesses this morning.

We have as our witnesses Mr. Sherman Maisel, former member of the Board of Governors of the Federal Reserve and now a professor at the University of California at Berkeley and also codirector of the west coast branch of the National Bureau of Economic Research.

We have Mr. James Tobin, professor of economics at Yale University and former member of the Council of Economic Advisers.

We have Mr. Charls Walker, president of Charls E. Walker Associates and former Under Secretary of the Treasury.

All of these men are extraordinarily able and have a very fine background. We want to thank you for your long record of service to our country, both at the academic level and also in the public service.

We will start out with you, Mr. Maisel, this morning.

STATEMENT OF SHERMAN J. MAISEL, PROFESSOR, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. MAISEL. Thank you, Mr. Chairman.

I would like to present my statement for the record and to comment on it briefly, if I may.

76-478—76——6

Chairman HUMPHREY. It will be included in full.

Mr. MAISEL. We are recovering this year at an average rate, based upon the natural strength of the economy and proper policies of the past year.

As the Chairman pointed out, those who feared greater inflation and a halt to the recovery, if we started out on a 7- to 9-percent real growth path, turned out to be wrong.

Those who held last year that monetary and fiscal policy ought to be somewhat more expansionary than the administration proposed seemed to be right. We had the extra policy stimulus. It has meant expansion of real output closer to the optimum with prices lower than anticipated, and unemployment also lower than anticipated by either the optimists or the pessimists.

This reminds us that our forecasts and projections will contain a good deal of error, particularly in the price and job spheres.

On the monetary policy, Chairman Burns and the Fed were correct: We could get along without much money as a result of a very sharp increase in the velocity of money.

On the other hand, it appears that interest rates were raised early last summer and at other times primarily because of poor statistical seasonal adjustments and overreaction to temporary movements in the money supply.

Investments in both plant and equipment, and in housing, are lagging behind normal. High interest rates are almost certainly the cause of these lags.

In my view monetary policy has put far too much stress on money supplies. The Fed periodically notes what a poor index money supply is, but it follows it anyhow. We would probably have fewer short-term interest rate movements and lower long-term rates if more attention were given to interest rates in quarterly monetary operations and targets.

There is also some indication that "expectations" have been reintroduced as a target of Fed policy. This would be fine if we knew what expectations were, what affected them, and whether they were helping or hindering us in achieving national goals. When the Fed used expectations as a target in the past, many analysts felt it turned out to be mainly a method of following value judgments or prejudices of the Board. A return to such a target by selecting monetary growth rates, primarily to affect expectations rather than to influence spending, output, and prices, would be unfortunate.

Because of high interest rates, housing remains a critical problem. We need 2.2 to 2.6 million conventional starts annually; this year we are 30 to 40 percent below our needs. Continuation of this situation is dangerously inflationary. Unless housing production moves up to cover needs, we will experience still more rapid increases in rents, housing prices, and building costs.

For this coming year we should again seek growth in the 7- to 9-percent range. Anything less would lead to a loss of both output and jobs, and price levels——

Chairman HUMPHREY. What was that figure again?

Mr. MAISEL. 7 to 9 percent.

Chairman HUMPHREY. You are talking now of 1976, or 1977?

Mr. MAISEL. That will be for the fiscal year starting next week.

Chairman HUMPHREY. Yes.

Mr. MAISEL. Anything less would lead to both a loss of both output and jobs, and price levels rising as fast or faster than at present.

To halt inflation we need a more rapid growth in investment and more attention to the forces raising particular costs and prices.

If I might in addition, Mr. Chairman, comment briefly on several of the questions you raised. This morning's paper went beyond the statement of yesterday that said the OECD had come out at the urging of the United States for a 5-percent real growth rate.

Chairman HUMPHREY. Yes.

Mr. MAISEL. And obviously, from my statement, I feel that would be unfortunately low. I don't know about the rest of the countries of the OECD, but in the United States we would only get down to that rate if we had quite restrictive and contractionary policies. At this point, the economy by itself would not stay at that level. So, that would mean, as opposed to taking a somewhat neutral or slightly stimulating policy in order to hold the economy to a 5-percent growth rate, we would have to raise interest rates higher, and we would have to have a tighter monetary policy and tighter fiscal policy also. It seems to me that would be a dangerous policy.

With respect to the banking problem that you raised, I think it was clear to anybody watching banking over the last 10 years that there was a transformation in the larger banks' ideas as to what a bank should do; the concept of "go-go" banking came in. This led to additional credit and to less careful control of credit. It was just a very different picture of what banks should do. I think that changed rapidly——

Chairman HUMPHREY. Oh, yes.

Mr. MAISEL [continuing]. About a year ago so that up to the moment banks have not been extending credit as rapidly as they should. It certainly changed completely over the last year.

With respect to the more general question, I think two things happened in the international field, One was the OPEC earnings and the availability of OPEC earnings to the international banking system to lend around the world; that is one source of additional credit.

The second was the ability of the Eurodollar market to create credit and money. I think all of us who have been students of the banking system are very clear that a system that builds multiple deposits on a small reserve base can create credit. There are lots of arguments, but no good indication about what exactly the multiple expansion of the Eurodollar market is; but clearly it is considerable. During this period there was a multiple expansion based on a much smaller amount of reserves. The availability of credit you spoke of came from that. In fact, we have had a completely new international banking system—a system that of its own accord was able to create credit. That was part of the problem.

Chairman HUMPHREY. My description was designed to point out that the additional description of the causes of inflation had somehow or other left out the proper emphasis upon what I call international banking speculation and finance. I just had a feeling about it. I used to read about international financers playing the currency market like an international crap game, and it used to bother me. Maybe that is

because I am a midwesterner—I'm all for banks loaning money to build things; but playing games with each other's money never made much sense to me.

Maybe it's a midwestern work attitude that I have, but I never saw any reason why some international bank should take other people's money and start playing the lira, the deutsch mark, or any other currency. It seems to me that violates their fiduciary responsibility.

Mr. MAISEL. I think we are all aware that the whole history of our country has been one of cyclical movements in banks, where, at one time, they create too much money, and at another time, not enough. I think what we saw was simply a movement of that type of reaction into the international scene.

Chairman HUMPHREY. How did they ever get the right to create money? The way I read the Constitution, some place along it says the Government of the United States is supposed to do that, that is what bothers me. I won't take you back over that line because that will get me into arguments.

I remember no place in the Declaration of Independence or the Constitution where banks have the right to create money; they have the right to gather it and extend credit on the basis of that money.

Mr. MAISEL. Well, we have known for over 400 years that banks have the ability to create money, the Constitution didn't stop what was there.

Chairman HUMPHREY. That was the first big argument they had in this country, and I was on the side of Jefferson and still am. [Laughter.]

Thank you, Mr. Maisel, with no objection, your prepared statement will be printed in the hearing record.

[The prepared statement of Mr. Maisel follows:]

PREPARED STATEMENT OF SHERMAN J. MAISEL

I would like to discuss several points, each significant if we are to have increasing output and jobs free of inflation.

1. We are in the midst of an average recovery. The prospects that it will continue this next year are good providing governmental policies remain accommodative.
2. This past year, proper policy decisions were made. They sought faster growth rather than restricting output through contractionary policies.
3. Just as at this time last year, recent Federal Reserve actions lead to some concern that adequate reserves to meet proper national goals may not be furnished. Congress and the public must continue to examine monetary actions carefully. A lack of public debate and a failure to arrive at a consensus on national goals can lead to improper policies.
4. Our failure to build enough houses for our growing population is potentially inflationary. Housing is a logical sphere for additional government action. More housing construction can lead to additional jobs and a lower inflation rate.
5. Policies this coming year should seek a growth in output as large or larger than in this past year. Real growth of 7 to 8 percent will have an anti-inflationary influence while increasing jobs and general prosperity and decreasing the Federal deficit.

THE PAST YEAR

Growth in output (but not final sales) has been about average for the first year of a recovery. While somewhat less than optimum, the path of expansion seems adequate and within the margins of our policy capabilities. Does this mean that the debate of a year ago over proper policies was futile or wasted? I think not. That discussion led to the adoption of a goal of rapid expansion in place of the inadequate monetary and fiscal policies which many advocated because they feared that even a normal recovery would be inflationary.

At the time of the Midyear Review in 1975, discussions revolved around four items: (1) Would a growth rate of 7 to 9 percent be inflationary? (2) Was it necessary to cut back on federal expenditures and tax relief because of the extremely high projected budget deficit? (3) Would the Administration's proposed immediate decontrol of oil act to impede the recovery? (4) Had the Federal Reserve erred in sharply raising short-term interest rates, and would recovery be enhanced if interest rates fell?

Whether as a result of that debate or for other reasons, policy decisions were expansionary. Expenditures and tax relief were increased over the Administration's proposals. Immediate decontrol of oil was postponed. Monetary policy led to a decrease of 25 percent (160 basis points) in the Treasury bill rate and 7 percent (60 basis points) in the long-term corporate bond rate. The higher growth rate was picked as a proper goal.

Yet even with all of these actions, increases in output remained at the lower end of a desirable range. Furthermore, these reflationary policies not only did not worsen the rate of inflation, price increases actually fell well below anticipations.

We should note, however, that typical of the past ten years, while the spending projections forecast with the expansionary policies turned out to be accurate, estimates of prices, output, and unemployment were off. Happily, however, in contrast to previous years, events were more favorable than had been projected. Price and real output performance improved more than expected and unemployment was 0.6 percent less than anticipated.

We should also note that those who criticized Chairman Burns and the Federal Reserve so strongly for the Fed's projection of a sharp increase in money velocity turned out to be wrong. Actually velocity rose even more than the Fed had projected. In my last year's testimony, I pointed out that such an increase in velocity was possible and had been experienced in the past, but I was skeptical as to whether it would occur. Because of this uncertainty over the demand for money, I urged that more attention be paid to interest rates while decreasing attention to movements in money (M_1). In contrast to most recovery periods, interest rates did fall, although they remained exceedingly high by historical standards.

MONETARY POLICY

This year, as last, many believe that if we are to achieve a desirable growth in output, the Federal Reserve's monetary targets for this coming year are too low. For spending to rise sufficiently with current monetary targets, the velocity of money will again have to rise rapidly. While less than last year, the increase would be high compared to history. Critics of the Fed feel that we are unlikely to have two large increases in velocity in a row.

My concerns are somewhat different. The debate and the sharp movements in monetary velocity indicate how uncertain we are as to the relationships between money and spending. Furthermore, much analysis is oversimplified since it disregards the lags between changes in the monetary sphere and those in the economy. Those who note that this year investment growth is lagging believe that this shortfall results directly from an inadequate increase in money last year. Higher money velocity led to historically high interest rates and investment at this time lower than desirable. They fear that the results of current policy may be even more unsatisfactory in the future.

It seems to me that given our existing degree of uncertainty, more emphasis should be placed on using as much information as is available. Reading recent Federal Reserve statements and speeches is disturbing because it shows far too great a concentration on changes in money with too little attention paid to interest rates.

The reasons for avoiding such undue concentration were well stated in a speech by Governor Wallich last month when he said:

"A well known rule of thumb of monetary policy says that when there are disturbances on the side of the real sector, monetary policy should focus on the aggregates and allow interest rates to move up or down in order to counter the disturbance. Conversely, when there are disturbances on the monetary side, monetary policy should focus on interest rates in order to avoid transmitting these disturbances to the real sector. What we have seen of late clearly has been a disturbance on the monetary side—the less predictable demand for M_1."

I have followed this rule of thumb to advocate what I call the Golden Mean of Monetary Policy. This says that calculations should be made of the desired changes in both the monetary aggregates and the interest rates needed to meet

national goals. Initially the money targets should be followed. However, for the reasons stated by Governor Wallich, plus others well recognized, if relationships between money, interest rates, and output seem to be developing in an unexpected manner, the target should shift to interest rates.

Somewhat related to the Fed's concentration on changes in money, a shift seems to have occurred in the analysis as to what should determine monetary policy. While hard to pin down, less emphasis appears to be placed on considerations of monetary policy's effect on the economy through money, liquidity, credit or interest rates. Instead more stress appears to be given to attempts to influence expectations directly, particularly those of price setters in contrast to investors or spenders. The analysis and targets of 15 years ago seem to have reappeared, although justified now by "rational expectations" rather than "leaning against the wind." Most analysts believe that "expectations" were an unsuccessful target for monetary policy in the past. For related reasons, they are likely to be an unsatisfactory basis for current operations.

HOUSING

Potentially one of the most dangerous inflationary pressures arising from high interest rates is their tendency to reduce investment below that required for noninflationary growth. Housing is a prime example of this problem. Since 1973, we have failed to build enough housing units to meet our normal demand. If the deficit in available units continues to expand, it is bound to lead to still more inflationary increases in the amounts consumers pay for shelter. Increases in homeownership costs have been unusually sharp in the past few years. Without a higher level of production, pressures on rents, which until recently were moderate, will jump.

I have reexamined recent data on housing requirements. Through the end of this decade, even under the most conservative calculations, it appears that a minimum demand of 2.4 million units a year exists to be met from conventional starts and new mobile homes. To this many would add production necessary to do away with an existing shortfall of anywhere from 500,000 to 2,500,000 units below current needs. Most of this shortage has developed since 1973. Assuming this shortfall should be erased over four years, we have a minimum need of 2.2 million conventional starts a year, while estimates of requirements as high as 2.6 million such starts a year are not extreme.

Much of current needs appear to be for rental units. Although inadequate in recent years, national policies could do a great deal in this sphere. If the level of housing starts fails to move up steadily in this next year, not only will current rents rise, but industry bottlenecks will probably once again lead to very sharp cost increases when demand finally does become effective.

THE NEXT YEAR

Our total rate of real output has finally regained the level previously reached in 1973, and industrial output should also surpass its previous peak this year. Employment is higher, but unemployment remains high, prices are still rising rapidly, and losses from potential output are great. Because our full output potential will still be underutilized, another downturn should be unlikely. Basic investment demands, including normal inventory expansion, will not yet have been met. Still history warns against too easy optimism. In just such periods have poor policies led to unfortunate results.

The question is how fast should we encourage demand to grow. Price movements are still unsatisfactory. Would the inflation rate improve significantly if contractionary monetary and fiscal policies held back growth in real output? I do not think so. In fact, in sectors such as housing, greater expansion will be anti-inflationary. Other examples exist in transportation, plant and equipment, and some types of urban improvements.

Last year, rather than accepting the pessimists' views, we correctly opted for faster growth. This year, again, policy should seek real growth in the 7 to 9 percent range. Inflation should be attacked by specific and sectoral policies rather than through restraining overall demand. Because price and cost problems are difficult, we have not accomplished much in these spheres. This is unfortunate. To halt inflation while maintaining a desirable growth in output and jobs, more attention must be paid to the forces raising particular costs and prices. Otherwise, as we approach fuller utilization of our output potential, demand will be curtailed for anti-inflationary reasons before we achieve full employment.

Chairman HUMPHREY. Now, Mr. Tobin, please proceed.

STATEMENT OF JAMES TOBIN, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. TOBIN. Thank you, Mr. Chairman. I have also submitted a statement.

Chairman HUMPHREY. We have your statement.

Mr. TOBIN. I will read some of it, and summarize other parts.

Chairman HUMPHREY. We will have it all inserted in the record.

Mr. TOBIN. Since April the Federal Reserve put the Federal fund rate, which is their intervention rate in the cerdit and money markets, up by about three-quarters of a point. Now it seems they have reached, at least temporarily, a plateau, a Federal funds rate of 5.5 percent.

I thought and think now that the jump up by the Federal Reserve in the short-term interest rate was premature and unnecessarily threatened to slow down recovery. I cannot find justification for that move either in the present status of the economy, or in prospects for the rest of this year and next year.

Now that we seem to be at a new plateau and the credit markets have settled down—at least temporarily—I express the hope that the Fed will keep things there and not raise rates again this year.

The economy has improved substantially from the recession trough of the early part of 1975, but we still have a long way to go. One way to look at it now is to note that we are at levels of unemployment and general economic activity that are comparable to troughs of previous postwar recessions, even though we have had a year of recovery. We have ample productive resources to respond with added production and employment, rather than accelerating inflation, to expanding monetary demand. We are running 7.5 percent, about $120 billion, short of the GNP the economy is capable of producing with 5-percent unemployment, a figure we had as recently as the last quarter of 1973.

An important point to remember, as it relates to some of your questions earlier, Senator Humphrey, is that even if real gross national product were steadily growing at 7 percent a year—which the administration and many other people think is on the high side—it would take 2½ years, until the beginning of 1980, to close the gap between where we are and what we could do with a reasonable rate of unemployment.

Chairman HUMPHREY. In other words, drop it down to 5 percent.

Mr. TOBIN. To drop it down to 5 percent, to use some of the ample excess capacity in the American industry.

So far the recovery has been fueled by consumer demand and by business inventory accumulation. Between the second quarter of last year and the first quarter of this year the real GNP rose at a little more than 8-percent annual rate, above $70 billion in 1972 dollars. But if we take the inventory accumulation out of that, the increase in final sales, GNP minus inventory accumulation, is only a rate of 4.6 percent; and of that about three-quarters was private consumption expediture. That compares with a normal ratio of consumption, of consumption to final sales of about 61 percent.

The main reason for the spurt of consumption and indeed for the turnaround of the economy in 1975 was largely the tax rebate and tax reduction which the Congress wisely enacted.

Private expenditures other than inventory accumulation and consumption remain relatively weak. Housing construction has revived

from the dismal slump of 1974–75, but it is still a third below 1973. Housing starts are running at 1.4 million annual rate, well below the 1973 level of 2 million, well below the 1972 level and below the requirement that Sherman Maisel mentioned a few minutes ago. The revival of housing has stalled, in recent months.

Business fixed investment remains 13 percent below 1973 in real volume, and surveys of investment intentions indicate little or no improvement in 1976. Indeed, so far this year realizations are falling short of intentions expressed in previous surveys.

Now, those things are important because continued recovery into and through 1977 depends on a substantial revival of residential and business investment. We cannot go on for very long with recovery powered just by inventory accumulation, or by consumption. There is nothing in the Federal budget resolution and tax plans which would give a new impetus to consumption. We could expect consumption to follow along, although perhaps savings rates may even rise; but consumption is not going to be a reliable, dependent source of income expansion.

We are not going to get much stimulus either, from Government purchases, judging from the Federal budget and the fiscal difficulties of the State and local governments.

So, that is why I think it is important to foster a financial climate that is favorable to private investment later this year and next year.

We need to have a sustained recovery. We have never had a reasonably strong recovery without a substantial recovery of private nonconsumption expenditure.

The stability of interest rates from January until the end of April of this year greatly contributed to a favorable climate for later recovery of investment. One gauge of that—the valuation of American companies in the bond and stock markets this year, until recently, increased faster than the costs of capital goods that corporations buy.

We had a precipitous decline in that ratio in 1974. It got down to about 72 percent. That is, the security markets were valuing the productive assets of American companies at less than three-quarters of new replacement costs in capital goods markets. Thanks to the beginnings of recovery, improved profit prospects, and to declining or stable interest rates, the ratio of market valuation to replacement cost rose to 95 percent in the first quarters of this year, and that is where it is now.

It still does not compare, however, with the figures well above 130 and up to 170 percent that helped us to sustain investment during the 1961 through 1965 recovery. So, I think that the turning of the screw by the Federal Reserve in May was an unfortunate blow to the improvement of the stock and bond values.

The stable interest rate policy of the Federal Reserve had also been good for the financial institutions, savings and loans, and savings banks that are so important in the mortgage market. We have had a reflow of funds into these institutions. They were rather conservative in building back liquidity, so mortgage lending has not improved commensurately; but we could expect that with improved liquidity they would go more aggressively into the mortgage market. The last thing we need at this point in the housing sector of the economy are rising interest rates on open market instruments, causing another wave of "disintermediation."

So, I am giving credit to the Federal Open Market Committee for the improved financial health which its policy of stable low-interest rates brought about. But we must also observe that luck played an important role, also. Recently the Federal Reserve was able to support a Federal funds rate as low as 4.5 percent without exceeding its targets for growth of monetary aggregates. The reason was that we had a timely increase in the velocity of money in the fourth quarter of 1975. That made it possible to handle the 15-percent recovery in the nominal value of the gross national product with only a 3-percent growth in M–1.

Chairman Burns has pointed out quite often that a cyclical rise in velocity was normal in recovery, but the surprise this time was that we had such a big increase, and that it occurred while interest rates were declining or stable. Usually interest rates and velocity move together, because the rise in interest rates is what induces people to economize their use of the cash balance.

Unfortunately I don't think anyone really understands how we lucked out on this point, what happened that caused the rise in velocity and the decline in money demand during this period. We don't know therefore whether it will reverse itself pretty soon; or whether it is a one-shot improvement in velocity and we go on from where we stand now, or whether it is a trend which will continue. So, it is rather difficult to know at the moment what the relationship between future interest rates and monetary aggregate will be. That is why I think the Federal Reserve should not pay so much attention to the monetary aggregate for the remainder of the year 1976, but do what it did last year. That is, when the monetary aggregates start behaving in ways that are not expected or explainable, use common sense and provide interest rates which are appropriate to the health of the economy.

Our problem right now is that the recent growth in the monetary aggregate has put them above the Reserve's most recent target ranges for the growth of M–1 and M–2. I have a table that shows where we stand with respect to those most recently expressed targets. The fact is, of course, that during 1975, as monetary aggregates were growing more slowly than anticipated, the Fed scaled down the targets to be more consistent with actual experience. They scaled them down several times.

I don't think that was bad, and I am not going to criticize them for not sticking with the targets they had earlier announced. All I am asking for is symmetrical performance. If now it turns out that the monetary aggregates are growing faster than the targets and high interest rate increases are needed to stay within the targets, I think those increases would be unfortunate for the economy.

After all, the central concern of the Federal Reserve, the Congress, the Executive, and the public is what happens to the economy, not what happens to any statistical measure of money, M–1 or M–2, whatever you want. And when you look at the economy you can see that it is in a position to absorb quite safely additional demands for goods and services.

Price inflation has receded most satisfactorily from the double-digit figures which led to restrictive monetary policy and the recession of 1974. Perhaps some of the decline in inflation is due to the recession itself, but most of it I think was due to the exceptional and transient external sources of the 1973–74 inflation.

I agree, as most observers do, that the ongoing rate of inflation in this country is now 5.5 or 6 percent a year, as can be inferred from looking at the wage increases of 8 to 8.5 percent, and subtracting the normal 2.5 percent for productivity gain. I also hope there won't be panic about any temporary fluctuations in price indexes from month to month around this trend.

I think it would be a mistake, for example, in case it turns out that food shortages in Russia or elewhere raise grain prices and food prices, if that would cause the Federal Reserve to adopt tight monetary policies.

I have an additional reason for emphasizing the importance of a monetary policy geared to a sustained and strong recovery rather than to particular numerical targets of monetary growth, and that is to avoid the necessity for any further fiscal stimulus to the economy beyond what the budget resolution contemplates. It seems to me that the Congress has been acting and is acting very responsibility in implementing the new budget procedures. One consequence of that is that indeed fiscal policy for 1977 will be less stimulative than this year. The reduction in Government deficit financing leaves both more need for and more room for private capital formation. We hear a lot about prospective capital shortages in the 1980's, and we know that the economy does have a long-range need for more productive capital. So, it is desirable to make sure that this recovery has a high component of productive investment as the major part of the expansion of demand needed to bring recovery about.

But the corollary is that the Federal Reserve has to create and maintain a healthy financial climate, which will encourage that kind of private investment and housing investment. It does not make sense to worry about capital shortages in the 1980's while following a policy that discourages private investment in 1976 and 1977.

The Congress has been doing its part toward a sensible and responsible policy mix, and they have every right to insist that the Federal Reserve do its part too.

Chairman HUMPHREY. Thank you, Mr. Tobin, your prepared statement will be included in the record at this point and we will come back to a round of questions after Mr. Walker completes his testimony.

[The prepared statement of Mr. Tobin follows:]

PREPARED STATEMENT OF JAMES TOBIN

CURRENT MONETARY POLICY

Federal Reserve credit policy has tightened since April. The Federal Funds rate, which is directly controlled by the Fed's day-to-day open market operations, has risen almost a full percentage point. Short term market rates have risen correspondingly, and banks are charging more for commercial loans. The change in Fed policy, after 3½ months of stable short term rates with the basic Funds rate between 4½ percent and 5 percent, has generated expectations of further increases. The combination of actual and expected increases in short term rates pushed up long-term bond yields and mortgage rates and caused stock prices to decline.

In my judgment, the new Federal Reserve policy was premature and unnecessarily threatened to slow down, perhaps to halt, the recovery of the United States economy. I cannot find justification for the move either in the present state of the economy or in the prospects for 1977. Recently the Federal Funds rate has been stabilized at a new plateau around 5½ percent. The bond and stock markets, encouraged by the signs that the Fed was not continuing to tighten immediately, have recovered some of the losses. I hope the Fed will not raise rates further in 1976.

The economy has improved substantially from the recession trough in the first quarter of 1975, but the recovery still has a long way to go. Unemployment, at 7.3 percent of the labor force, is even now higher than at the bottom of any previous post-war business cycle. Capacity utilization in American industry averages only 7 percent, and excess capacity is widely diffused across the economy. There are ample productive resources to respond, with added production and employment rather than accelerating inflation, to expanded monetary demand. The economy is running 7.4 percent, or $120 billion (current dollars) short of the Gross National Product it is capable of producing with 5 percent unemployment. Even if real GNP were to grow steadily at 7 percent per year, it would take two and a half years, until January 1979, to close this gap.

So far the recovery has been fueled by consumer demand and by business inventory accumulation. Although real GNP rose by 8.1 percent annual rate, 70.3 billions of 1972 dollars, between 1975–II and 1976–I, final sales—GNP less inventory accumulation—rose only at a rate of 4.6 percent, $40.2 billion. Of the increase of final sales, 74 percent, $30 billion, was consumption expenditure. The normal share of consumption in final sales of GNP is about 61 percent in a healthy economy. The reasons for the spurt in consumption, and indeed for the turnaround of the economy in 1975, were the tax rebate and reduction wisely enacted by the Congress.

Private demands for goods and services, other than inventory investment and consumption, remain relatively weak. Residential construction has, of course, revived from the abysmal slump of 1974–75. But it is still, in real volume, one third below 1973. Housing starts are running at 1.4 million anuual rate (seasonally adjusted), well below the 1973 level of 2 million. Moreover, the revival of housing construction has stalled in recent months. Business fixed investment remains 13 percent below 1973 in real volume, and surveys of investment intentions indicate little or no improvement in 1976. Indeed so far this year realizations are falling short of intentions expressed in previous surveys.

Continuation of recovery into and through 1977 depends on substantial revival of private residential and business investment. As stocks of goods are restored to normal levels relative to production and sales, inventory accumulation will cease to be the principal fuel of expansion. Likewise, consumption cannot continue to be the driving force it was in the initial stages of recovery. No new tax cuts or transfer outlays are in the budget now before the Congress; indeed continuation beyond July 1st of the old tax cuts, from which consumers are now benefiting, is still uncertain. In these circumstances, consumption can be expected to rise along with household income but not to be a reliable and important independent source of income expansion. As for government purchases of goods and services, the federal budget promises little or no increase, and state and local governments are seriously retrenching. I believe there is very little disagreement on these points among model builders, forecasters and other students of the American economic scene.

That is why it is important, now in 1976, to foster a financial climate favorable to investment later this year and next year. Stability of interest rates from January to May had greatly contributed to a favorable climate. One gauge is that the valuation of American corporations in the bond and stock markets had increased faster than the costs of the capital goods and corporations buy. In 1974–IV, it may be estimated, the bond and stock markets valued U.S. nonfinancial corporations only at 72 percent of the replacement cost of the productive assets of the businesses. The weather was not propitious for financing and undertaking new investment. Thanks to the beginnings of recovery, improved profit prospects, and to declining or stable interest rates, the ratio of market valuation to replacement cost rose to 95 percent in the first quarter of this year. This still did not compare, however, with the figures—130 percent to 170 percent which helped to sustain investment during the pre-Vietnam recovery 1961–65. As I already observed, when interest rates rose recently, both bond and stock prices fell somewhat. Since stock values may already reflect the earnings improvement which the recovery is bringing about, they fall with increases in the discount rate at which expected earnings are capitalized.

The home mortgage market also benefited from the pre-May monetary policy. The high interest rates of 1974 had been disastrous to home-building, partly because they drew money out of the thrift institutions that specialize in mortgage lending. But when open market interest rates fell below the rates on deposits and shares in thrift institutions, funds flowed back into the intermediaries. Mortgage lending has not rebounded commensurately, partly because these financial insti-

tutions—like many other firms, households, and governmental units—have given first priority to rebuilding liquidity. At this point, the last thing the housing sector of the economy needs is another wave of "disintermediation."

The Federal Open Market Committee deserves credit for the improved financial health which its policy of stable low interest rates brought about. But luck played an important role also. The FOMC was able to hold the Federal Funds rate as low as 4½ percent without exceeding the targets for growth of monetary aggregates the Committee and its Chairman had previously announced. A timely rise in the velocity of money, especially in the 4th quarter of 1975, made it possible to handle the 16.2 percent recovery in the nominal value of GNP from 1975-II to 1976-I with a 3.1 percent growth of M_1. A cyclical rise in velocity is normal in recovery, as Chairman Burns has pointed out, but the surprises this time were the extent of the increase and the fact that it occurred while interest rates were declining. Usually interest rates and velocity move together.

At the moment the reasons for these fortunate events are inadequately and diversely understood. We all have our ad hoc explanations. But it is safe to say that no one knows whether velocity will (*a*) return to previous level and trend, (*b*) resume its previous trend and behavior from its current high base, or (*c*) continue to increase more rapidly than previous trend. Other things equal, (*a*) would mean higher interest rates than (*b*), and (*b*) higher than (*c*).

In the light of the bulge in velocity—in other words the slow growth of monetary aggregates at prevailing interest rates—the Fed has repeatedly revised, mostly downward, its long-run target range for growth of monetary aggregates. The Fed's first announcements referred to growth in aggregates from March 31, 1975 to March 31, 1976, and then for quarterly averages 1975–II to 1976–II. The acceptable ranges were 5 percent to 7½ percent for M_1 and 8½ percent to 10½ percent for M_2. The actual outcomes fell short of the lower end of the range for M_1, but above the target levels for M_2. These targets were superseded successively by these subsequent announcements. Table 1 shows where M_1 and M_2 stand relative to those targets.

The problem we face is that both M_1 and M_2 are running above the Fed's most recent scaled-down target ranges. This is presumably one reason why the Fed has raised its bracket of intervention rates in the Federal Funds market, attempting to slow down the growth of aggregates. The good fortune which made the Fed's earlier targets consistent with interest rates, credit conditions, and security markets favorable to recovery may already be running out.

TABLE 1.—IMPLICATIONS OF FEDERAL RESERVE TARGETS

Target	I	II	III
	M_1 as of week ending May 26, 1976 (actual $302,800,000,000)		
Date decided	Oct. 21, 1975	Jan. 20, 1976	Apr. 1, 1976.
Date announced	Nov. 4, 1975	Feb. 3, 1976	May 3, 1976.
Acceptable growth rate (percent)	5 to 7½	4½ to 7½	4½ to 7.
Period	1975–III to 1976–III	1975–IV to 1976–IV	1976–I to 1977–I.
Acceptance range 26 (billions)	$304.5 to $310.2	$301.5 to $306	$300.4 to $302.3.
Comparison of actual	Below	Within	Above.
	M_2 average of 4 weeks ending May 26, 1976 (actual $697,500,000,000)		
Date decided	Oct. 21, 1975	Jan. 20, 1976	Apr. 1, 1976.
Date announced	Nov. 4, 1975	Feb. 3, 1976	May 3, 1976.
Acceptable growth rate (percent)	7½ to 10½	7½ to 10½	7½ to 10.
Period	1975–III to 1976–III	1975–IV to 1976–IV	1976–I to 1977–I.
Acceptable range May 26 (billions)	$686.9 to $701.5	$684 to $693.3	$687.8 to $691.6.
Comparison of actual	Within	Above	Above.

I urge the Federal Reserve not to be bound by its current targets for monetary aggregates. These may well imply a premature run-up of interest rates which would imperial the prospects for residential and business investment on which continued general recovery depends. I do not fault the Fed for allowing growth of money supply to fall below its earlier targets when it was apparent that money demand was unexpectedly low. I just enter a plea that the FOMC be equally flexible in applying and interpreting its targets when the ball bounces the other way.

The central concern of the Federal Reserve, as of the Congress, the Executive, and the public, is what happens to the economy, not what happens to M_1 or M_2

or any other M. As I have argued above, the economy needs and can safely absorb additional demand for goods and services. Rates of price inflation have receded most satisfactorily from the double-digit figures which led to restrictive monetary policy and recession in 1974. In my view the decline in inflation rates was to be expected, given the exceptional and transient external origins of the 1973–74 inflationary bulge. No doubt the recession itself, and the high rates of unemployment and excess capacity it produced, have also helped to moderate U.S. wage and price inflation. I agree with the general view that the ongoing rate of inflation in this country is now 5½ or 6 percent per year, as can be inferred from a rate of wage increase of 8 to 8½ percent per year less the trend rate of productivity growth. There will be temporary fluctuations in price indexes around this trend, due to events in particular sectors.

We should not place much weight on month-to-month changes in volatile prices, but instead keep our eyes on the rate of wage and cost inflation, which has been behaving as expected or even better. For example, I think it would be a mistake to adopt tight monetary measures, and risk another recession in the U.S. and other advanced capitalist countries, if it turns out that poor harvests in Russia raise world grain prices once again.

Monetary policy which keeps the recovery going does not sow the seeds of an accelerated inflation, even if target rates of growth of monetary aggregates are exceeded. The Federal Reserve does not "join the inflationists" by acquiescing in rates of monetary growth which lay the foundations for sustained recovery. As Chairman Burns is better equipped than anyone else to explain convincingly, rates of monetary expansion which would be highly inflationary if indefinitely continued will not have this result if they are moderated and discontinued as the economy recovers to satisfactory rates of utilization of labor and other productive resources. There is, fortunately or unfortunately, plenty of time and economic slack to allow the Fed to avoid overshooting the mark.

I have an additional reason for emphasizing the importance of a monetary policy geared to a sustained and strong recovery rather than to particular numerical targets of monetary growth. That is to avoid the necessity for further fiscal stimulus to the economy, beyond what is contemplated in the budget resolution. The Congress is acting very responsibly in implementing the new budget procedures. Indeed fiscal policy for 1977 will be less stimulative than this year. The reduction in government deficit financing leaves both more need for and more room for private capital formation. Given the slump in private invesment and the longrun needs of the economy for productive capital, as the discussion of prospective capital shortage in the 1980s has indicated, it is desirable that this recovery have a high component of productive investment. It is up to the Federal Reserve, as well as the Congress, to achieve this goal. The Congress is doing its part, and the Congress has every right to insist that the Fed does its parts.

Chairman HUMPHREY. Mr. Walker, we welcome you, and thank you for taking the time to come here.

STATEMENT OF CHARLS E. WALKER, PRESIDENT, CHARLS E. WALKER ASSOCIATES, INC.

Mr. WALKER. Thank you very much, Mr. Chairman.

I have a short statement, and as a matter of fact, if I read the statement, I think I could do that quicker than summarizing it.

Chairman HUMPHREY. Why don't you do that, do it the way you like.

Mr. WALKER. Mr. Chairman, members of the committee, history will evaluate Lord Keynes' overall contributions to political economy, but in one respect he performed—in my judgment at least—a signal disservice. This was in giving the back of his hand to the longrun equilibrium analyses of the classical school by sarcastically noting that in the long run we are all dead. That's true. But to conclude from this that only the short run counts in formulating national stabilization policy, including monetary policy, can be a prescription for disaster.

One reason is that the "long run" is a combination of "short runs." What looks good in the short run, when the time horizon is short, may be highly disruptive in the long run, when a series of shortrun policies has its ultimate impact.

Not that the answer to this problem is to judge each action in terms of its impact in 5, 10, or 20 years. It is instead to remind ourselves constantly that today's actions do deal with tomorrow's problems and can have significant impacts on down the road.

With these remarks as background, I should like now briefly to pinpoint what seems to me the most crucial factor in the longer run economic outlook, after which I'll comment on monetary policy in particular.

The short-term outlook is good. Output is rising, unemployment is declining, and inflation is waning. About the only criticism that can be leveled at recent policies is that we are not moving fast enough in achieving our multiple goals relating to output and unemployment.

The answer in my view is that we dare not, lest our shortrun eagerness to drive unemployment down create massive longer run problems. I would remind the committee that the longest sustained noninflationary boom in modern times was in the first half of the 1960's, in which Government policymakers—partly because of our international financial problems—refused to pour on the coal and move at flank speed toward full employment. Many fail to recall that the 7 percent unemployment of 1961 was not driven below 4 percent until 1966, and then partly because of war. Some also fail to recall that unit labor costs and, as a result, wholesale prices were stable during most of that period.

Let me put it another way. Some day an outstanding athlete is likely to run a 3½-minute-mile. This achievement will not occur this year, i the next decade, or perhaps in this century. But this is not to be deplored, for neither the performer nor spectators would be exhilarated if the runner, in his effort to break all records, dropped dead just beyond the finish line.

And so it is with economic policy. I personally would like to see unemployment and poverty eliminated tomorrow—check that, this afternoon. But it will not happen. And crash efforts to make it happen too soon will, in my judgment, augment the inflation that I believe to be the root cause of our major economic problems, including unemployment.

This is one dimension of the "shortrun/longrun" problem. Another relates to the pressing need for stepping up our investment in productive plant and equipment, the very basis of our economic progress.

Again, you can find many who will ask, "What's the problem?" The shortrun prospect is for some slackness in capital markets. Moreover, our percentage of GNP devoted to nonresidential fixed investment has been relatively stable for a long time.

To be sure, today's relatively quiescent capital markets, rising corporate profits and liquidity, and so on, are a dickens of a lot better than the situation in the very recent past. But to suggest that the shortrun situation portends a solution to our longrun capital formation problem would, in my view, be shortsighted indeed.

To be sure, again, productive investment relative to GNP has held up well. But more and more of this investment has had to be devoted to standing still—replacing wornout or obsolescent equipment. In addition, the simple ratio overlooks the crucial relationship of investment per worker. Few economists would dispute the view that such investment raises real wages, helps fight inflation by increasing ef-

ficiency, and provides jobs for workers in an increasingly sophisticated industrial economy.

What's been happening to investment per worker? Prof. Paul McCracken has concluded that the amount of nonresidential capital formation per person added to the labor force during the 1970's has declined by 22 percent from the levels in the 1956–66 decade. Prof. David Meiselman has calculated that in dollars of 1958 purchasing power, from 1961 to 1965 there was an increase of $55,000 in the gross stocks of business capital for each person entering the labor force. During the 1966–70 period, it had fallen to $46,000, and during 1971–74, to only $41,000.

I will not belabor the point. My conclusion is that our current and prospective rate of capital formation cannot be expected to further our economic goals with respect to growth, employment, and price stability. Consequently, I would urge that this committee continue its study of this crucial problem, with special attention to changes in the tax laws to foster capital formation, rather than inhibit it, as I now believe to be the case. Building on Professor Tobin's remarks, there are several ways in which you can promote capital formation. In my view, the most direct and effective way is directly by increasing the rate of return on investment through lower taxes on that investment.

Turning now to monetary policy. I do not have a great deal to say on this because I think Federal Reserve authorities have acquitted themselves very well over the past year. To be sure, the near doubling in the rate of monetary growth in the past few months—from an annual rate of almost 5 percent from mid-June 1975 to mid-June 1976 to close to 9 percent since mid-March—that rate of increase is disturbing.

However, the Fed appears to be moving or has moved to "snub up" the rate of monetary growth—not stop it, but reduce it—and this is especially appropriate for this stage of the economic recovery, when bank loan demand can be expected to mount rather strongly. Failure to keep monetary growth in bounds would, in my judgment, repeat the monetary policy errors of 1972, which helped fuel subsequent inflation.

There are, however, a number of observers who disagree with this view. They argue that reining in the money supply now—again I am saying to decrease the rate of growth—will force interest rates up. The recovery, although too powerful to be aborted in the near future, would in their view proceed too slowly and unemployment would remain at unacceptable levels for too long a period. In fact, they argue that in some way the Fed ought to reduce interest rates.

I would answer that if a 5-percent rate of monetary growth was good enough to support a stronger than expected recovery, it should—absent a sharp lurch toward fiscal surplus, which hardly seems likely—be sufficient to support continued recovery while minimizing the danger of a return to demand-pull inflation. Moreover, I strongly disagree with the view that the Fed can fine-tune interest rates under current market conditions. In fact, strong steps by the Fed to bring interest rates down, presumably by pumping up bank reserves, would actually have the opposite effect—interest rates would instead rise.

Now, this view is in sharp contrast to what I learned in graduate school; what I concluded in my doctoral thesis; what I taught in my own courses in money and banking; and what I believed as an official of the Federal Reserve System and as an economist for the Federal Open Market Committee. After all, bank reserves are high-powered money. They provide the base for expanding loans and investments. More loans and investments mean an increase in the supply of credit, which in turn should result in a decline in interest rates, the price of borrowed money. Or should it?

The hangup arises from the fact that the new loans and investments made possible by the increase in reserves also generate additional demand deposits in commercial banks—the principal component of the money supply. And since people usually borrow money to spend rather than hold, an excessive rate of growth in the money supply can result in a rise in spending and the classical demand inflation most simply defined as "too much money chasing too few goods."

Inflation then accelerates. And in recent years we have relearned—after about a century—an important lesson, something that people in many Latin American and other countries have known full well for many years. That lesson is that galloping inflation inevitably begets sky-high interest rates. The reason is that the so-called money illusion is partially if not almost wholly dispelled: people begin to bargin in "real terms." In labor markets the cost-of-living escalator is the prime example. In credit markets, borrowers rush in to get money to spend "today" in order to beat tomorrow's price increases. Lenders are reluctant to part with dollars that will deteriorate in value before repayment. So, lenders demand more interest and borrowers, in their eagerness to spend, pay it.

Some who agree with this analysis might nevertheless point out, and quite correctly, that today's increase in the money supply will lead to inflation only after a lag of several months and perhaps longer—there is a difference of opinion on that. But that makes no difference. As has been demonstrated repeatedly in recent years, participants in financial markets have fallen into the habit of almost immediately "discounting" the ultimate inflationary impact. In fact, their actions frequently approach the ridiculous; a drop in the money supply for the week, announced on a Thursday afternoon, can cause a sharp drop in interest rates the next morning (note: not a rise in rates, reflecting an expected shortage of money to borrow, but a drop, as inflationary fears recede).

Indeed, that happened only last week. And even though the actions of market participants may be ridiculous, since it is the trend in money supply over a period of months that is important, they are nonetheless real and have a significant impact on financial markets.

None of this means that Fed actions have no impact on financial markets—they do. But the only sure-fire way for the Fed to bring interest rates down in the months ahead would be to starve the economy for money and induce recession, thereby causing a contraction in the demand for credit. No one wants that.

I therefore conclude that the better part of wisdom is for the Fed to concentrate on maintaining a stable and reasonable rate of monetary growth, say 5 percent in M–1, accept the increases in short-term interest rates that are inevitable in a strong business recovery, and

through these actions advance the day when inflation—and therefore high interest rates—are no longer a threat to our economic wellbeing.

Thank you very much.

Chairman HUMPHREY. I will just start one question, and then we will turn the questioning over to Congressman Brown.

I am very interested in the apparent difference in views that is held on this matter of supply of money between Mr. Walker and Mr. Tobin.

First of all, Mr. Walker, I was not only impressed, but also alarmed by what you had to say in the part of your statement where you said, "None of this means that Fed actions have no impact on financial markets"—after you describe what happened in the financial market—"they do." Then you go on to say:

> But the only sure-fire way for the Fed to bring interest rates down in the months ahead would be to starve the economy for money and induce recession, thereby causing a contraction in the demand for credit.

Well, where were you in 1974–75? You were around here. That is exactly what the Fed did. It starved the economy and interest rates went out the ceiling.

Mr. WALKER. I think what is involved here is the basic impact of inflation. The increase in monetary growth, excessive monetary growth in 1972, as I noted, was one of the factors in feeding inflation, although there were a lot of other factors in the international commodities market and so on.

Chairman HUMPHREY. Yes; I know that.

Mr. WALKER. What I am saying today is, that given expectations which would make any attempt self-defeating to lower interest rates by pumping up bank reserves, the only sure-fire way—and I deplore it—for the Fed to bring interest rates down would be to throw the economy into a tailspin.

Chairman HUMPHREY. That's exactly what did happen, that is my point, the economy was in a tailspin, and the more it was tailing and spinning the more the interest rates went up.

Mr. WALKER. We see a culmination then of a situation we had not had for a long time—galloping inflation and underlying recession, which was hidden by the rate of the dollar inventory increase.

But I am talking about the here and now situation, and I would make this point. In our history we typically had really low interest rates——

Chairman HUMPHREY. In recession.

Mr. WALKER. That's my point. We had a prime rate of one-half of 1 percent in the 1930's.

Chairman HUMPHREY. I understand, I grew up in the recession.

Mr. WALKER. I did too.

Chairman HUMPHREY. My father educated me on Federal Reserve policies before I went to college or went to Congress; he told me exactly what happened in the 1920's when the Federal Reserve Board cracked down; businesses started to go bankrupt where I grew up; the banks went broke by 1926 or 1927, which was not noted back in New York because they didn't read the Times Record from our part of the country; but it was happening.

Now, my point is, it is a different world, and I sometimes think the economists and the bankers forget it because we did have the specter

of high inflation and recession—we had high inflation and unemployment; we had recession and high interest rates, all of which confounded all the conventional wisdom.

My argument with you is that you say there is a sure-fired way to bring interest rates down in the months ahead, to starve the economy for more money and induce recession. I am saying the most previous example, experience doesn't in any way uphold your thesis.

Mr. WALKER. They came down.

Chairman HUMPHREY. They came down?

Mr. WALKER. My point is, they came down in 1975.

Chairman HUMPHREY. That was when we began to get some recovery, after the unemployment rate started to decline, after inflation started to recede, the interest rates started to come down.

Now, Mr. Tobin, that comes to you, I have a question here. Mr. Walker's argument is that a more expansive monetary policy will raise interest rates, creating inflationary expectations. On the other hand, you argue to tighten up the money supply will cause interest rates to rise. Here we are trying to get advice. I would like to have you two explain the differences. And while you are doing it, by the way, I have to run down and vote, but Congressman Brown will preside here, and we will be right back. If you will give a little time to this, we will have a chance to argue it out between the three of you here.

Mr. TOBIN. All right.

Chairman HUMPHREY. You go ahead.

If you would like to question on your own basis, that's fine with me. Go ahead, open this up.

Representative BROWN of Michigan. Proceed, Mr. Tobin.

Mr. TOBIN. Well, the first point I would like to make is that the effect of any expansion of monetary demand in the economy depends on the circumstances in which it is introduced.

Now, Mr. Walker said that inflation is, sometimes, or maybe he thinks always, too much money chasing too few goods; and there are certainly occasions in which that has been the reason for inflation in the United States. But at the moment it is not, we don't have any problems with too few goods because we have a lot of excess capacity, a lot of unemployment of labor, and a lot of unemployed industrial capacity.

Representative BROWN of Michigan. Could you stop right there? You talk about underutilization; is that really a valid test compared to the utilization in the past?

Under the present circumstances, with obsolescence and a lot of the other things that are presently applicable, is that 72 percent as part of the 100 percent valid as compared with what it is historically?

Mr. TOBIN. Maybe the normal operations are not 100 but 90 percent, or in the high 80's, something like that. So, I am not saying that there is 28 percent excess capacity in the country.

What I am pointing out is that there is plenty of excess capacity in the country. After all, we are barely producing in absolute terms, what we were producing in 1973, before the recession began. The economy is capable, we know, by long experience, of increasing its output of goods and services by about 4 percent per year. We have not been doing that lately. So, we still have a lot of "slack" in the economy.

And the cliche that injecting more money into the system is bound to cause inflation—even more inflation than is already built into the momentum of the system—completely ignores the fact that there is the excess capacity of labor and equipment which can respond to increased demand. That is why we have already had such a large increase in production and employment: There have been ample resources to meet increased demand.

So, in these circumstances it seems to me quite wrong to say that any particular rate of monetary expansion above 5 percent—what Mr. Walker said—would be inflationary.

Now, the 5 percent is really very modest, on past experience. What we are talking about is an increase in GNP of, let's say 7 percent in real terms; and we have a 6-percent built-in price increase going on, that is 13 percent a year. And 5 year M–1, the conventional stock of money, leaves 8 percent increased necessary velocity to finance, a 13-percent increase in GNP.

Now, maybe we will be lucky again and that will do it because the luck is people economizing their use of demand deposits and currency, as they apparently did do in the early part of this year and the last part of 1975; but we cannot count on that.

What I was objecting to is sticking to any rule like that, independent of what is going on in the demand for money, in interest rates, and in the economy at large.

Now, it is possibly true that because Mr. Walker says what he does—and a lot of people write things like that in financial pages—that if there is a series of reports on Friday afternoon about a 10 or 12 percent rate of increase of M–1, that people will think that there is going to be more inflation soon, or that the Federal Reserve is going to think there is going to be more inflation soon, and the Federal Reserve is going to cut back.

But I think that Arthur Burns is perfectly capable, and I think he is exactly the man to explain to the American public and to the financial papers, and to Mr. Walker, that having a fast rate of growth of money stock for a while, that doesn't mean he is going to do it forever into the long run when we are all dead, but the country is still going on.

So, having 10 or 12 percent monetary growth, if that is what it takes to hold interest rates about where they are, that doesn't mean that Arthur Burns is becoming an inflationist and he is going to keep doing that through 1980, in which case it would be inflationary. He has plenty of time and plenty of slack in the economy to moderate that and discontinue it before we run into any capacity limitations in the economy.

Representative Brown of Michigan. Just one question with respect to your latter remarks. If Arthur Burns says today there is an increase of 10 percent, but in the same breath says, "Tomorrow I am going to decrease it to 3," isn't the expression with respect to the increase of 10 percent counterproductive?

Mr. Tobin. No, not tomorrow. We are not going to get back to anything like a decent rate of operation of the economy even with the more ambitious rates of growth for a year or two; that I would think. We are not going to get back until 1978 at the earliest, or 1979. He has plenty of time. The Federal Market Committee meets every week, and he

can perfectly well explain what he is up to, what he is trying to do in terms of a sustained and strong recovery, and express it in those terms; not in terms of numerical figures about the monetary growth rate.

I think if we have learned anything from the most recent experience, it is given the large amount of volatility in the use of cash balances, and velocity of money, that sticking to these growth rates is ridiculous. You don't want to have them out of bounds over long periods of time.

But sticking to them in short periods of time, they didn't do it last year and shouldn't do it this year.

Representative BROWN of Michigan. Mr. Walker.

Mr. WALKER. I would like to make a couple of very brief comments. I agree with Professor Tobin here that a lot of other factors should be considered in formulating monetary policy. Given today's uncertainties, the 5 percent figure seems to me to be pretty much in the ball park.

How much capacity is there? I don't know. There is a big argument going on between the practical men of business, and the theoretical men of economics. The theoretical men in economics say, "We have this great gap in overall GNP, so we've got a lot of slack," and the practical men of business say, "We see shortages cropping up in certain supplies, bottlenecks may be around the corner." I guess the answer is somewhere in between.

Representative BROWN of Michigan. You would agree that the 72 percent is not really valid.

Mr. WALKER. Yes, especially in view of the fact that 88 or 90 is optimal, and you can have bottleneck problems, really, for lack of a few crucial items.

Representative BROWN of Michigan. So, in determining the present utilization, if you treat all sectors of the economy alike, you come up with a figure, but it may be invalid with respect to essentiality——

Mr. WALKER. Especially your basic materials, and there is where we badly need better data than we have at the present time. When Senator Humphrey gets back we can look over the figures of money growth and interest rates 1972, 1973, 1974. I was not suggesting that we induce recession to lower interest rates, I was suggesting that that is the only sure-fire way that rates can be brought down now, which brings me to my final point, relating to what Mr. Tobin said. He said:

> Well, writing all these things in the newspapers, and the market people see it, then they go out and react, and that is the problem.

I don't think that's it at all; I think they learned from experience. That is somewhat like the Mark Twain story about the cat that sat on a hot stove; he jumped about 10 feet in the air, and that cat never again sat on a hot stove lid—as a matter of fact, he wouldn't even sit on a cold stove lid.

I think that is the situation in the domestic markets today. They are looking back at the experience of 1973 and 1974, and those monumental increases in interest rates. There was almost a paranoid fear up until last week, when interest rates eased off, that we are moving back toward the range of double-digit inflation, double-digit interest rates, that we were going to have a repetition of history.

I don't see that—if we keep this boom from getting out of hand. I think the market should rejoice that thus far Federal policymakers—

fiscal and monetary—have promoted and sustained balance, relatively, as we can expect, the best we can expect.

Representative BROWN of Michigan. Mr. Maisel.

Mr. MAISEL. I think one point is clear in terms of capacity utilization: All three of us do feel strongly that we do need more investment; we all three agreed in our statements, and I think that is vital, more investment is anti-inflationary.

The difference is that Mr. Tobin and I would put more stress on the idea that one path to more investment is lower interest rates. That is a very important part in getting more investment. So, I think that is one point.

Representative BROWN of Michigan. But you also agree you get lower interest rates by increased monetary supply.

Mr. MAISEL. Let me go to that briefly, please. In terms of Mr. Walker's last statement, I disagree. I think the stock market is reacting very rapidly and the bond market is reacting very rapidlly; but they are reacting to the fact that they believe that when the Federal Reserve reads that the money supply has gone up for the last month, the Fed is automatically going to furnish smaller reserves, and it is therefore going to raise interest rates in the short term market.

They are reacting to what they think is the way in which the Federal Reserve is going to act.

I think the point Mr. Tobin and I are making—and one that Governor Wallich, by the way, as I showed in my statement, made a month ago very properly, is that this is simply an incorrect reaction by the Federal Reserve.

I was here a year ago at these same hearings. At that time the Federal Reserve again had raised interest rates very rapidly in the short term. I think it was in July of last year—and it seemed to me obvious that they were reacting to an incorrect seasonal—if you go back over monetary history over the last 5 or 6 years, you find that these numbers get changed all the time.

So, what Mr. Walker is saying is, we now have to be dominated, our economy has to be run by incorrect statistics. I am not willing to agree that that is a logical way to make national policy, to have someone sitting at a computer at the Federal Reserve determine what monetary policy should be; we simply know that such a policy is incorrect. These figures do average out over time. I think Mr. Walker and Mr. Tobin made this point—we depended last year on the fact that the amount of money didn't have much relationship to the economy, the rate of velocity changed greatly. If we look over the last 20 years, the rate of velocity changed by 50 percent or more. If we look at it on a year-by-year basis, the rate of change in the velocity of money is much larger than the rate of change in the economy. It is one of the most unstable numbers that we know of. In terms of both the demand for money and also statistically, it is a very bad number.

Now, if anybody tells me that we ought to let our policy be dominated by what we know is a very bad number, I think that is an incorrect way to run policy. I think the proper theory is the one that Governor Wallich says, and that we basically, I think, all of us agreed upon earlier. There is a trade-off. You can run policy based on either interest rates or the amount of money. The amount of money in many periods may be a fairly decent tool to use; but when it seems to be

going wrong you ought not to pay attention to it. I think that is the point of Mr. Tobin's statement and it is the point of my statement.

We know that the velocity of money is unstable. For monetary policy to come out all right this year, velocity has to be more unstable than it traditionally has been in the past. The chance of that happening twice is not good. In the meantime, we ought to pay more attention to what is happening to interest rates than we do to the amount of money.

Representative BROWN of Michigan. Would you like to respond, Mr. Walker?

Mr. WALKER. I agree with Mr. Maisel that a policy based on bad statistics is a bad policy, just as policy made by bad policymakers can be bad. We don't have any disagreement on that particular score.

But I think we are dancing around the fundamental argument, at least the fundamental point I want to make—and I'm sorry my paragraph got the Senator off on this other thesis—we are living now in a world we have not experienced, except for a brief time after World War II, since the Civil War. It is a situation that has prevailed for many years in what people traditionally have referred to as the Banana Republics, small countries where you have side by side very high rates of inflation—20 to 30 percent—and very high interest rates—20 to 30 percent or more.

We were able to get along for a long period of time with the money illusion persisting, which is another way of saying that people thought that when they got a dollar for a certain amount of work, or a dollar in interest, that that dollar taken to the store would buy a dollar's worth of goods.

We have learned now that a dollar pay increase may be worth only 90, 80, or 70 cents at the store a little bit later, before the end of a 3-year contract. And we have now learned that if you want even 3 percent in real terms on your money, you have to ask for 10 percent in order to offset a 7-percent inflation rate.

Now, given those circumstances, which I see existing not just in sophisticated financial markets, but it is tied in with this intermediation on the part of small savers. That sort of situation gives you a different framework in which you apply monetary policy.

My basic thesis is not that we should deflate to get lower interest rates. My thesis is that if you try to lower interest rates by raising the rate of increase in the money supply to an inflationary level will get higher interest rates instead. That was not true as recently as the 1960's.

Mr. TOBIN. I don't think we have to debate whether that is true or not as a matter of principle. There is really something quite funny about a belief, which I have heard expressed not only by Mr. Walker but by others, that whatever you are doing right now is exactly right, and that if you move either way, you will do the wrong thing.

I don't believe that either Mr. Maisel or I suggested that the Federal Reserve should be trying at the moment to reduce interest rates. We regret that they have raised them. But what I am saying—and I suspect Mr. Maisel as well—is that they should not raise them again, at least for quite a while. They should stay where they are, and not drag the recovery down during the rest of the year and 1977. The Fed should try to keep the impetus going by sticking with the present intervention rates in the Federal funds market. They should do that

even though rates of growth of monetary aggregate may exceed their target numbers. They may or may not, we don't know what they are going to do. These rates have been very volable, as Mr. Maisel said.

And what seems to me the possible calamity or misfortune today would be this: If it turns out that in order to halt some preannounced and already scaled-down numerical targets for rates of M–1 and M–2, we have to have a runup in interest rates, we could suffer another wave of disintermediation to savings institutions that are financing mortgages and another collapse of stock and bond markets.

That would make a bad climate for the continuation of the recovery in 1977. And it would be done just to stick to a numerical M target. I don't think necessarily the Federal Reserve will do that. I am just hoping that they will not. But if they stick to Mr. Walker's 5 percent, I think that is what will happen.

Now, as Senator Humphrey said, Mr. Walker's prescription is that we should follow a very slow recovery policy in the interest of trying to wring some more inflation out of what is now built into the economy.

If so, we will have high rates of unemployment for the rest of this decade. We will not enjoy a good climate for the revival of private investment to meet the longrun capital needs of the American economy. It is not a good climate when you are having a slow recovery and people don't have high profits and sales to look forward to. A climate of very slow recovery and which is a tight monetary policy is not favorable to capital investment. Consequently Mr. Walker and others propose to make up for that by perhaps tax concessions for capital investment. But we have a large amount of unemployment and an economy which cannot encourage capital investment on its own.

Representative Brown of Ohio. I wonder if I can get into this and get my 10 minutes in. I have some questions I want to explore. I don't know what the procedure is.

Chairman Humphrey. Go ahead. I tell you, today is "catch-as-catch-can" day.

Representative Brown of Ohio. Well, let me press on with that point for a minute, Mr. Tobin and gentlemen, by suggesting that monetary policy is not the only way to reduce interest rates. If you gave tax benefits across the board in the economy you would do to the average individual several things, it seems to me.

First, you would stimulate private activity in terms of expenditure on consumption of goods. Second, you would stimulate savings since the average taxpayer has more money in his pocket and in the bank; there is more money in the bank's pocket, and the interest rate is likely to come down. I mean, pressure is there for interest rates to come down, and you have the opportunity for the Federal Reserve bank to tighten up on credit if it will, as long as there is this sort of developing increase of savings in the bank. That tightening up may not tighten up to the point that it forces interest rates higher.

So, my question is, how much of a generalized tax cut could we give at this time in order to stimulate the economy, without having an adverse impact on the economy through too rapid growth, or some impact that would be disadvantageous to the sort of slow and steady course that we ought to have?

Mr. Walker. I don't have any great quarrel with the budget resolution you adopted in terms of the state of the economy as I see it. Other facts aside——

Representative BROWN of Ohio. Could I interrupt you just a minute to say that one reason you can borrow the money to finance the deficit, without having a sharp impact on rates of interest and inflation, is that that tax break and the natural tendency of private individuals to save is stimulated. So, you have more savings available to finance that Federal debt.

But, you do not get, coming at the same time, the capital investment of the private sector borrowing that we perhaps should have.

Now, a further tax break might increase those savings further, might further stimulate the purchase of consumer goods, and might also at the same time stimulate the private companies to come in to private financial institutions. And if you did that, you would also have to damp down public spending, I assume.

Mr. WALKER. Well, I would prefer, Congressman, that if we now have additional individual tax cuts that they will clearly promote savings and investment. People say, "Oh, you just want to cut taxes on Fat Cats." That is not true.

I'd like to see the small saver get a break.

The technicians say it can't be worked out. Well, I don't see why it can't be worked out, something along the lines of a reasonable credit against income taxes for anybody who increases his savings in a savings bank, savings and loan, commercial bank, life insurance cash value, or stocks or bonds.

Representative BROWN of Ohio. Would you include education?

Mr. WALKER. No, tax credit would be for savings—an increase in your net worth through savings. You would get a tax credit for the increase that took place in a given year. Now the technicians say you will run into all kinds of problems—I agree there are technical problems.

But my point is that I would concentrate now on the tax cut area in the context of this longrun capital formation problem that we have, both in reducting the tax load on business investments and rewarding the savers. We don't reward savers very well in this country—we pay low interest and take it away through inflation.

Representative BROWN of Ohio. What about tax cuts in terms of raising individual exemptions that would put more money into the pockets of the consumer—whether rich or poor. He or she then could make the determination whether he wants to save it or invest it; whether he wants to invest it in some social purpose, such as higher education perhaps; for improvement of housing, or whether he wants to go out and use it up; he still has the money to make this personal determination.

Mr. MAISEL. Mr. Chairman, I think we all agree that there is a difference here between the short run and the long run. Since we need more growth this next year, less taxes would not be that inflationary in this coming year. But I am concerned, as are Mr. Walker and Mr. Tobin, about 4 or 5 years from now.

Again, I think if we are going to cut taxes, you can only do it if you cut Government expenditures, and I don't think that is very possible. I think the problem of the budget agreement is there. If you don't cut Government expenditures and you cut taxes, then you have some additional growth in this next year or two, but 3 years from now it can mean a very inflationary situation.

Representative BROWN of Ohio. Well, can I reverse the argument given earlier by my more liberal socially oriented colleague that says, if you spend the money to put somebody in a job—a government job—that he has money, and that stimulates the economy.

How about doing it the other way and say, if you give money to those people who are working and producing for the economy in the form of tax cuts, that they may produce more, and you are less likely to have—well, you produce more because he spends more; and you are less likely, therefore, to have deficits even though you are undertaking wonderful social purposes with all this Federal money that you tax away. In other words, you stimulate the tax returns because the person is using it in the private economy.

Mr. MAISEL. As I said, there is no problem on that when we want to stimulate the economy this year. This coming year a tax cut might not decrease revenues very much for exactly the reasons you are giving; it stimulates the economy; we have less than full capacity, therefore, you will have additional Government revenues and we will have more money in our pockets.

Representative BROWN of Ohio. I guess what I am saying is, You could have more growth in the private economy and you can spend—maybe we could thing of ways to spend it fast enough.

Mr. MAISEL. That is where I think we are in a problem. We have a limited amount of capacity; we have a limited labor force. Three or four years from now, when we are at that capacity, I think we are going to need a sizable Government surplus. I think if we reduce taxes now, the chances of our getting a Government surplus when we need it 2 or 3 years from now, are very small.

Again, the reason I think we need the surplus is the same reason we have been discussing here. I do think we need more investment in this economy, and one way we are going to get that investment is by running a Government surplus 3 or 4 years from now in order to have lower interest rates.

My concern, as I say, is that I think the better way to do it is to say that if we get back to a better interest rate situation, that will allow the capital markets to give us the investments we need. In order to have that, it probably is going to mean that as we approach full capacity, we have to go to a Government surplus. I think none of us are talking about very large sums, but we are in a situation where we are going to have to have a Government surplus to add to Government savings. This goes back to the whole thing of what has happened in the social security fund. We agreed not to have savings in the social security fund.

It is my opinion that as we approach full capacity we ough to be running a Government surplus if we want to fight inflation.

Chairman HUMPHREY. Go ahead, Mr. Tobin.

Mr. TOBIN. I think it is helpful to divide this problem of economic policy here into two steps. The first would be the question of how fast, how rapid a recovery you want; and the point at which you want to get back to something like the levels of utilization that we had, say, in 1973. The administration's plan for that is to get back there around 1981. Around 1981 we will have recovered, in half a decade, or 6 years, what we lost in 18 months. And Mr. Walker, by emphasizing how slowly we must go, also seems to endorse the idea that what we lost in 1½ years we can only regain in 5 years.

Representative BROWN of Ohio. Are you suggesting—would you address yourself to my tax-cut idea—are you suggesting that a tax cut would be too rapid?

Mr. TOBIN. No; I am coming to that. On the other hand, I think this committee has consistently recommended a faster recovery than the administration, one that would get to 5-percent unemployment several years ahead by 1978 or early 1979. That would require a faster rate of growth of the GNP, maybe 7 or 8 percent now, instead of 6 percent in 1976 and 1977.

So that is problem 1, issue No. 1.

The second question is, How you should get there? That involves whether you use a tax cut and fiscal policy on the one hand, or monetary policy on the other hand, as the sources of the stimulus to demand that achieves whatever speed of recovery is agreed.

You can do it either by having a big tax reduction, a big burst of Federal spending—in which case for the same path of recovery interest rates and monetary policy will be tighter—or by having a less restrictive monetary policy, less expansion in the Federal budget and a smaller deficit.

There are several the reasons for thinking you should not go further on the fiscal expansion route. It is important to maintain a large availability of savings. It is important not only to have savings available, but to translate it into investments that will best meet the capital needs of the future.

But it is not enough for the Congress just to follow a prudent fiscal policy to get that result. The other requisite is that monetary policy make up for the conservation of fiscal policy.

Chairman HUMPHREY. Mr. Tobin, that happens to be my view you just expressed. There has to be a coordinated effort between the fiscal and monetary policy. Without that effort the economy will suffer.

I want to just take a few minutes because I have to go down and vote again, and ask a basic question of all of you.

The Joint Economic Committee did recommend a policy that aimed at a 7-percent growth in real GNP throughout this year and 1977. Now, it appears that we come close to achieving our target in 1976. But all of the indicators tell us that we will be down in 1977; and indeed, when we had Mr. Greenspan here, he indicated a 5-percent growth rate.

My question is, Is a continuation of the 7-percent GNP growth an appropriate target for next year, and if it is, do you think that target could be achieved under the current policy?

So, let's just start off with Mr. Maisel.

Mr. MAISEL. Mr. Chairman, as I indicated, I think it is a feasible policy, one that would be basically noninflationary. It would be better—again answering Congressman Brown—if we got there through monetary policy instead of through fiscal policy, and that therefore is the basis of my recommendation.

But at this point the Federal Reserve has to be very careful that it doesn't allow interest rates to go up. Basically, given the buildup of liquidity in the economy, we should expect that interest rates should continue to fall for the next 6 months or year.

If, as a result of too closely following a rather small money supply target, the Federal Reserve forces up long-term interest rates, rather

than having them fall over the next year or so, I think that would be unfortunate. We still may get there, but it may require more tax action, expenditure action, and a greater Federal deficit. I would prefer to have it accomplished by interest rates not rising.

Chairman HUMPHREY. Yes. Mr. Tobin.

Mr. TOBIN. I think 7 percent through 1977 is definitely an appropriate target. It could even be on the modest side, considering the length of time it is going to take to get us to a reasonable degree of utilization and employment. So, I think we should do at least that well; that is point one.

Point two, it is not inflationary. That is to say, it would be consistent with a continuation of the present inflationary pattern in the economy, which is on the order of 5½ to 6 percent a year.

So, I would say a recovery like that could be achieved. Now, will present policies produce that? I agree with what Mr. Maisel said, they may produce it if we are lucky; but it can be that the monetary targets and growth rates for M-1 and M-2, et cetera, which have been expressed, are not consistent with that objective.

I think the whole question that we are discussing here this morning is, when that turns out to be the case, or if that appears to be the case, what gives? Does the Federal Reserve then adjust its aggregate monetary policies to achieve that kind of growth rate in GNP; or do they stick with some numbers in regard to M-1 or M-2?

I hope that is what you are going to ask them.

Chairman HUMPHREY. I wanted to get to that. I regret that all these questions have to be interrupted here, but you know the Congress sets these targets with the Federal Reserve, and it may well be that we locked ourselves into something here that wasn't too desirable.

Mr. Walker, I am not being impolite, but I must go; you can go ahead and answer those questions, it is your turn.

Mr. WALKER. I fully understand, Mr. Chairman. I have been answering all of your questions while you were gone, and it's been easier for me to do it that way. [Laughter.]

I would like nothing better than to see 7-percent real growth next year; in fact, I would like to see 8, 9 or 10 percent—if it could be achieved without reigniting the fires of demand inflation. If it requires, as I suspect it does, a big step-up now in the rate of monetary growth, I think that you would engage in a self-defeating exercise from both a short-run to a long-run standpoint.

From a short-run standpoint, I think you would hasten the day when you would be back into a recession, probably a recession accompanied by an inflation of the type we experienced in the recent past. From the long-run standpoint it would be self-defeating with respect to stepping up the rate of capital formation, which thus far is the only area of agreement we three have been able to come to today.

I would like to put it another way, I would like to see policies now, Mr. Chairman, that are very similar to those that were followed when Professor Tobin was a member of the Council of Economic Advisers, from 1961 to 1965. I could not give a better description of the policy need now than to describe what happened during that period. There again, in 1960-61 we had a very high rate of unemployment and we said we were not going to try to cure that overnight, as a matter of fact, it took 4 to 5 years to get down to the interim goal of 4 percent then set by the Council of Economic Advisers.

What happened to interest rates during that period? Well, this is very instructive and is a lesson today. Relatively speaking—I am looking at the Federal Reserve's Historical Chart Book—you had a pretty sharp increase in the prime commercial paper rate; that is a measure of the throbbing of your expansion in business activity. But your AAA corporate bond rate, which peaked in 1960, went down for the next several years. This was an indication, in part, of the buildup in savings that Professor Maisel was talking about. It is also an indication, in my judgment, of a waning of inflationary expectations.

Not everybody remembers that in the 1950's many were saying that we were going to have inflation forever. But in the early 1960's we began to realize that inflation could be contained, and that had an effect on corporate bond rates. It brought them down.

So, if you can keep out of financial market participants' minds the idea that we are going to return to what we had in the recent past, I can see a rise in short-term rates this year that is not worrisome at all because it reflects real economic expansion, and long-term rates going down because of receding anti-inflationary expectations.

That is the policy I would like to see.

Representative Brown of Michigan. Just one question, and then I will yield to Senator Javits.

The most significant event, however, during the period you are talking about, was a tax reduction, was it not?

Mr. Walker. Well, I would not say it was the most significant event, but it was a very significant event, the tax reduction for both consumption and investment.

Representative Brown of Michigan. What was it, around 27 percent?

Mr. Walker. I don't remember the percentage.

Representative Brown of Michigan. So, if that was not the most significant event, what was?

Mr. Walker. I think the way monetary policy was handled during the period. There was no concern that the increase in short-term rates that was taking place would reduce the rate of the return to full employment; it was stretched out, very similar to that 1981 target Mr. Tobin was talking about a moment ago.

Mr. Tobin. May I comment on that?

Representative Brown of Michigan. Certainly.

Mr. Tobin. My comment on that is this. There were no monetary growth aggregate targets then, so neither the Federal Reserve nor anyone else was adhering to some percentage rate of growth of M–1.

The increases in short-term interest rates that Mr. Walker referred to were very modest.

Mr. Walker. They were relatively large for those days.

Mr. Tobin. The only reasons for the increases were balance-of-payment reasons, to retain funds in the United States. It was feared that if short-term interest rates were lowered in the United States they would push funds abroad. We don't have those reasons now, because we have a floating exchange rate, not the fixed rate system we had in the 1960's.

If we had had that system in 1960, I think the monetary policy would have been one of stimulation. At any rate, there was no attention during that period for the rate of growth of M–1.

Moreover, I am not sure I want to accept all of Mr. Walker's backhand compliments. The Kennedy administration, or at leasting part of the administration, did hope to have a faster recovery than was achieved. Many people who said any recovery would be inflationary were proved to be wrong by what happened. But they held back the tax cut for almost 2 years from the time it was initially conceived and proposed.

Representative BROWN of Michigan. Without spending a lot of time on it, you are suggesting that during this period of time monetary policy was sort of an accommodator, rather than an advocate?

I would pose that question to all. Really, what is the fiscal policy versus monetary policy relationship, what should be the role of monetary policy, should it be an advocate, or an accommodator?

Mr. MAISEL. I think that basically it can be an accommodation, but that is the critical thing Mr. Tobin and I are concerned with, that it won't be an accommodator if it fixes on an incorrect target.

The critical problem is, what should the Federal Reserve target be for the next year. And my own view is, if they try to stick to the 7-percent money supply it may or may not work out well. It is costing us considerably in interest rates now because following a money supply target causes markets to fluctuate, both the interest market and the stock market. I think that is costing us investment; it is costing us housing. It is an expensive target, even in terms of the small fluctuations which occurred.

If you look at money supply over the past year or two, and what the Federal Reserve has done, it has not been a very stable thing; they move very rapidly every 2 or 3 months, as the money supply figures have changed. I think they have done that too fast. Their policy raises interest rates somewhat over what they otherwise would have been. But, that is a miner problem.

The major problem is, if we now find that velocity is not going up the way it did; if we find the 5-percent range of M–1 suddenly causes short-term interest rates to rise 1 percent, 2 percent, or 3 percent higher, and causes long-term rates to go up, then I would say that was not being accommodative. It was making an error, and the Federal Reserve ought to take a longer period to see what the real interest rate is before they continue to follow as slavishly as they have the short-term money supply figures.

Representative BROWN of Michigan. Mr. Tobin.

Mr. TOBIN. I agree with what Mr. Maisel said.

Representative BROWN of Michigan. You say it should be an accommodator for the economy.

Mr. TOBIN. It should be an accommodator in the present circumstances, it should not accommodate everything. There are a lot of things the Federal Reserve should not accommodate that could happen: it should not accommodate an expansion of the aggregate demand by fiscal or other events that would take us beyond the capacity of the economy to produce.

Representative BROWN of Michigan. But that is the basic rule, you think.

Mr. TOBIN. No; I don't think that is the basic rule. Once you have a deliberate coordinated strategy in which fiscal and monetary policy are meshed, with each playing a part in aiming at a certain agreed

real objective in terms of the unemployment, growth, production and inflation, once you have agreement on where you are trying to go in terms of those basic goals, then there is a division of responsibility between the two kinds of policies, the fiscal and the monetary. They both should play their part.

Representative BROWN of Michigan. My time is up, but if this is true, that is, monetary policy should in effect be intermeshed with the fiscal policy with respect to the direction of the economy, then why should not the role of the Federal Reserve insofar as it governs monetary policy, be granted to the executive branch?

Mr. MAISEL. I have a book, and I will send you the excerpts. Of course, that is traditional in most countries of the world, and we are one of the few countries where the division is much greater than in most other countries. The reason why you should not have the Fed tied too closely to the executive is that at this time the Chairman of the Federal Reserve has an entree to the press, an entree to the President that he would not have if the Federal Reserve were closely tied to the executive branch.

Given the men that were around President Nixon, it would have been very difficult for the Federal Reserve to have had independent policies and kept to them. The independence of the Federal Reserve, I think, is primarily important in terms of having another channel of economic thought in Washington and outside.

Now, this committee, I think, is a very useful channel, but I think the Federal Reserve serves as a very useful channel too of independent economic thought in Washington. But I still think, given that fact, when the decisions are finally made by the President and the Congress, there is no question that the Federal Reserve has to coordinate its policy with them.

Representative BROWN of Michigan. I won't ask you other two to respond because my time is up, and I yield to Senator Javits; but I would like to have your response later when we come back around.

Senator JAVITS. Gentlemen, I am very interested in the following: Here you are, three fine minds, the finest we have; and I note that so far the appraisals which you have made are in the detail of the situation.

I wonder whether you could shift your focus momentarily to the broader canvas I ask you to follow—and that is the only question I shall ask.

Here we are wrestling with tax reforms, which we are told would have major effects on the economy. For example, one of the things all of you point out—especially Professor Tobin and Professor Maisel—is the difficulty in the housing field, and the tax laws are set to turn on those sluice-gates respecting investments in housing and real estate generally, construction.

As a matter of fact, we adopted an amendment last night in the Senate and the chairman of the committee promptly rose and said. "We are all going into construction."

Second, we have just adopted a revision of the antitrust laws, which certainly on the penalty side carries very serious implications. And we have also adopted an amendment of which I have the honor of being the author to review the antitrust laws by a very high-level commission.

Third, we just adopted a new policy, announced by the Secretary of State, both here in September of 1975 and in Nairobi a few weeks ago, with respect to the Third World, calling for very large outputs of money and credit by the United States, various types of funds; we have gone away from the breadth and width concept of even the quasi-fixed parities to a floating exchange rate. We are putting another roughly $2 billion into the International Monetary Fund, and so forth.

Now, as you look at the world, what is the effect of these major changes upon the matters which have been discussed, the rate of inflation, the rate of growth, the impact on the monetary policy and operations of the Federal Reserve, either in terms of the laws we are fashioning, or in terms of how you would like to see us fashion them; what advice could you give to the Congress respecting these other broad policy questions which are being decided, and their impact upon the economies of the free world, in which you are all so expert, can you describe to us more in detail these major implications which I have described?

Mr. WALKER. I haven't had a tough one like that since my Ph. D., and I am not sure how helpful I can be. I have some thoughts on at least the first and third—I am not all that familiar with antitrust legislation.

The whole issue of tax reform—an area that I have been closely associated with now for 7 or 8 years—is very much misunderstood in the minds of the American public.

People think on the one hand that there are literally billions upon billions upon billions of so-called tax loopholes that are available for plugging. That's not true. And the typical voter believes that you double his taxes; on Mr. Moneybags, you cut his taxes in half. And that is not true either.

But aside from that, as to a tax reform measure that runs anywhere from $800 million to $2 billion in an economy the size of ours, I cannot conclude that it has a very significant macroeconomic effect. However, it can have a very large microeconomic effect if you happen to zing in on a particular industry.

If you took away all the preferences and the tax laws for the housing industry, which are very large, yes, it would have a very significant effect.

On the second point I do have one comment. Dealing as I do in my business to a considerable extent with leaders in the business community, I know the sorts of things that worry them about antitrust legislation and enforcement. I think leaders in the business community would strongly welcome the reexamination of antitrust legislation which you are sponsoring. I think they believe there are some rather fixed ideas in that part of the Justice Department, having to do with the idea that size in itself is a fundamental criteria, as contrasted with the thrust of the antitrust laws, having to do with restraint of trade, conspiracy, and things of that type.

So, the business community is apprehensive—as in the oil industry now—that the trend may be to say, "Well, let's break them up, primarily because they are big." They think that bigness in certain instances has a place.

On the final point—and you know, Senator, I used to work with you and others on the international financial organizations—there are

problems. I am not sure that economists can tell you much. My own judgment, which I have held for many years, is that with respect to raising the standard of living in poor countries, that there is simply not enough official governmental money available to go through the international institutions to solve their investment problems. And, living in the world we do, political factors are going to enter into the determination of the size of that, as well as its distribution among countries.

The answer, in my judgment, which was the message I carried to a meeting of the Inter-American Development Bank in Buenos Aires in 1971, is that those countries have got to create a climate that is conducive to a stable inflow of private investment. Officials in those countries say they have full rights to expropriate if they provide just compensation—and they're right. But even if legal, private capital will be hard to attract to those countries in the future.

To sum it up, what I am saying is, I have no objection to a much larger flow of official funds hopefully through the international institutions, to these poor countries. But, if they do not at the same time create a stable climate for private investment; if you can't get businessmen to go to work there because they may be kidnapped or killed; if you can't get investors to put money there because it may be expropriated next week or next year, they never will come out of the woods.

Senator JAVITS. Thank you very much. Professor Tobin?

Mr. TOBIN. Let me just comment on a couple of things that you asked about, Senator.

First, regarding housing and the tax incentives for housing—Mr. Maisel is a great expert on housing, so I am sure he will say something about it. The warning I would like to offer is against using the tax system as remedies for problems in the economy at large, problems which have resulted from the recession, and other events of the last few years. Housing took an awful beating in that recession. But, the beating is the result of the macroeconomic policy, the monetary and fiscal policies that have brought us recession and incomplete recovery.

I think it would be a mistake in housing, just as in relation to business investment, to try to make up sector by sector for the damage that has been done by overall economic developments and overall economic policies, by concessions in the tax laws.

I think the emphasis should be on a healthy and fairly rapid recovery to the kind of prosperity that will support high demand for housing and for business investment, without having to support them artificially through tax laws.

If you have tax reforms that are justified on their merits, that is another matter. But much of the impetus for tax concession today comes from the distress due to the business cycle. The remedy for that is stablization of the business cycle, and sense of sector-by-sector tax concessions.

The second point of yours I would like to take up is your observation that we are now in a world of floating exchange rates, rather than fixed parities. What difference does that make to monetary policy?

The difference is that it makes monetary policy a more powerful tool of domestic stabilization policy than it was under the regime of the fixed rates. More responsibility for the domestic health of the economy falls upon the central bank—in our country, the Federal Reserve—than it did when we were under a fixed rate regime.

So, for example, under the fixed exchange rate policy the Federal Reserve in our country had to worry a lot about the impact of its policies and interest rate on balance of payments, on capital movements, and on losses of reserves. Those worries are much mitigated by the floating rate system. That means that more of the burden of stabilization—in this particular case expansion—is their responsibility domestically.

Senator JAVITS. Mr. Chairman, my time is up; if you wish, I would like to get the Maisel's response.

Chairman HUMPHREY. Go right ahead.

Mr. MAISEL. The housing problem, I would not put it in the macro sense, but I think that there is a problem. I don't know whether the amounts of subsidy to housing are too large, or not—they are a good deal larger than Mr. Walker said. I think the real problem is their inefficiency. They are erratic in terms of who gets what. They depend upon how much a person's income is from other sources, and things of that sort. I think that is one of the questions of reform.

The thing that concerns me even more is that they don't really have anything to do with how well a person maintains the property he has. They put all sorts of stress on milking the property, getting your money out through depreciation. The current housing tax laws, to the best of my knowledge, are simply not related to running a property well, either for the persons themselves over the long run, or for the economy, or for a city over the long run. They are based on getting in and getting out. They are very erratic methods.

So, insofar as reform is useful, and I think it could be useful; it would be useful if the same amounts of funds went more logically toward the goal we need in the housing area.

I think there are critical problems, but I think the way in which the tax laws have grown in this area have not been aimed at a housing policy; they have been aimed at getting a certain number of units built, often in the wrong period and not necessarily when we need them.

On the other one, while I am not as great a believer as some of my friends are in how much we can get out of antitrust policy, deregulation and other things in terms of the general inflationary situation, it seems to me our problem of inflation is so great that we have to use every tool we have. Antitrust policy, deregulation, and so forth, have some advantages. They are going to give us something. I don't think they are going to solve the problem, but I don't think we can afford to waste any tools in the anti-inflationary fight. So, I think we have to look and see whether we can get more out of this type of tool for improving the structure of our production system.

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

Chairman HUMPHREY. I am very concerned about these real growth rates because I have the feeling that the argument that I posed in the beginning as to the rate of recovery is still very fundamental as to what is going to happen in the overall economic picture in terms of inflation.

I gather there is a general feeling here that the 7-percent growth rate was sustainable?

Mr. WALKER. No.

Chairman HUMPHREY. You do not feel it is, Mr. Walker?

Mr. WALKER. No.

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Chairman HUMPHREY. Mr. Maisel and Mr. Tobin, if you had a 5-percent growth rate, which is what we recommended to the OECD, and which is what seems to be more or less the policy being underscored by Mr. Greenspan, then unemployment, according to the Congressional Budget Office, would be between 6.3 and 6.5 percent for the year 1980. If you had a growth rate of 6 percent, you would get the unemployment down to 4.5 percent by 1980.

Now, I know there is a great deal of concern about the ravages of inflation, but what about the incredible waste and loss of unemployment, is that not a factor that has to be weighed? I recognize inflation affects everybody. But the unemployment rate has a way of affecting everybody too, it cuts down on our revenues: it cuts down the gross national product; it cuts down consumption; it has a way of affecting the whole economy.

Now, why do you feel that a 7-percent rate, Mr. Walker, is not defensible for the foreseeable future?

Mr. WALKER. Senator, I don't believe 7 percent is attainable without a degree of inflation that would perhaps drive us into early repetition of what we have gone through in recent years.

In this I cannot be dogmatic. But I think on the basis of experience, as well as the analyses that have been done in OECD, it would certainly run that risk. I think perhaps our discussion should revolve around not the goal—I don't think there is any disagreement on the goal whatsoever—but it is a question of how you get there.

There is no disagreement today that there have been significant changes in the structure of the labor force, especially in the last 20 years. I am a great believer in, and I would be willing to spend very large amounts of money to upgrade the skills, habits of work, and education of the unemployed. There are a lot of jobs out there for people who have the right training, right experience, right education, the right habits. I have been advocating for years that we ought to set up a new Civilian Conservation Corps.

You know, you go around the country and you talk to groups of our generation, and you mention the word "WPA," and you get scowls. If you mention the letters "CCC," you generally get smiles.

And since we have such a horrendous unemployment rate among teenagers, 16 to 19, I would set up a program which is not all work, but half work, half study. We have so much to do; for one thing, rebuilding the railroads.

Chairman HUMPHREY. I am of the same opinion.

Mr. WALKER. I agree with you on that.

Chairman HUMPHREY. I wish you had not left the administration.

Mr. WALKER. No; I left it at a good time. [Laughter.]

Chairman HUMPHREY. You left it at the right time all right, but I can't get any of them to agree with this.

Mr. WALKER. Well, I wish you could, I have constantly "bumped" in this sort of direction.

Chairman HUMPHREY. I agree with you.

Mr. WALKER. OK, there we are in agreement. If we approach it that way, we say we can go so far through general stabilization programs before we are in trouble; and I can't tell you exactly where that is.

A year and a half ago Mr. Muskie's Budget Committee said to me, "What should the deficit be," and I said, "Senator, $50 billion we can handle, and $100 billion we can't." Somewhere in there. They came down to $75 billion.

Chairman HUMPHREY. We really reduced it down to $69 billion, or $70 billion.

Mr. WALKER. Yes, because we have this very rapid rate of growth that has been taking place. We certainly can't handle 8 or 9 percent real growth, that is just going to blow us to Hades; and I am certain that 2 or 3 percent is too low. I think that 7 percent tends to be too high. And if you get the unemployment rate down to 6.5, 6.2, 6 percent, I am not sure where the demand inflation problem starts. But if you take the approach you and I—and I'm delighted you found a place to agree with me——

Chairman HUMPHREY. We are not that far off on a lot of things.

Mr. WALKER. I just refuse to believe that we cannot do a better job in a manpower training in the adult labor force, as supplementary to a modern CCC. If we could do those kinds of things, you and I might end up on exactly the same side.

Chairman HUMPHREY. But if you take a look at certain features of the so-called Humphrey-Hawkins bill—which I am sure some of you don't agree with—you will find a great deal of emphasis on just what you said, the necessity of training programs, work training programs.

I don't want to keep you here forever, but I have other questions I want to ask.

Mr. Maisel, I want to ask you about your "golden rule of monetary policy." Your rule urges that we focus on the growth of monetary aggregates unless the relationship between money and interest rates and output seems to be developing in an unexpected manner. In that case you said that we would shift our focus to interest rates.

Could you be more specific about when this shift should occur, and what we should look for?

Mr. MAISEL. Let me be specific, Mr. Chairman, in terms of the current situation. Let's assume that we do have agreement that 7 percent real output is the proper goal for this next fiscal year, and we are talking about a 5- or 6-percent price increase; so, we are talking about a 13-percent growth in current GNP.

Now, according to our models—the ones they use at the Federal Reserve and elsewhere—since the Federal Reserve says that 7 percent is the maximum amount of M–1 that they want to add, their model must say that they can get 13 percent growth in current dollar output with 7 percent growth in money. It also must say that there is some interest rate compatible with that.

Let's say the compatible interest rate is an 8.5 percent rate for the AAA corporate bonds. In other words, that says for this next year, as far as the Federal Reserve model is concerned, it doesn't matter, you either put in the 8.5 percent interest to get the 13-percent growth in GNP, or you put in the 7-percent money and get out the growth in GNP. Nobody knows which is right. As far as history is concerned, you need both this money and the interstate to reach our goals for this coming year.

The problem that worries me and worries Mr. Tobin is, what happens if suddenly interest rates go up to 9 percent, or to 9.5 percent, because we are only getting 7 percent or so growth of money. I would say that for a period that would indicate that something was wrong with the model of money, that that 7 percent money was not enough to get the growth we needed; that either the velocity figure that was put in with the 7 percent was wrong, or the 7-percent figure was wrong; in past experience both of them frequently have been wrong.

Therefore, for the next 4 to 5 months, when the Federal Reserve sees what is happening, they should look at the interest rates and say, "Well, we have to put in 9 percent money to keep those interest rates from going up over these next 3 or 4 months, that is what we should do."

Theory tells us that that is correct, at least the theory that I teach and the theory that Mr. Tobin teaches, and even the theory that Mr. Walker taught, tells us that you ought to do this.

Now, that is what I mean by the "golden rule." The model tells us you have a certain interest rate to expect to get your goal, you have a certain amount of money; if it turns out that the amount of money seems to be too low because interest rates are rising, even though you are still on the right growth path, then you should create more money.

Now, if we suddenly found that we were getting 15 percent growth in GNP, or 16 percent growth in GNP, you would not want to do that. Then you would be off your path. You would want your interest rates to rise because we were growing too rapidly and the increase in interest rates would be proper.

The question is, if you are on a GNP growth path, should you allow interest rates to go up initially more than the model says is needed—and I think the answer is, you should not.

Chairman HUMPHREY. Now, this underscores the statement which was made last week by Mr. James O'Leary, who is the vice president and chief economist of the U.S. Trust Co. in New York. He was very critical of the great emphasis being placed on money supply growth as a policy target; he was critical of talking about policy in terms of money supply. He said—I want to get your reaction to it—and I quote, "I don't think most of the monetary aggregates are worth our attention. There have been important changes in the technology of money. I think too much attention to M-1, M-2, M-3, on up to M-12, is going to get us in trouble.

I see a problem in the House and Senate Banking Committee. They have gotten sold on the idea that the only thing that counts is what is happening to the money supply. I think the Fed has got to strike a balance between the interest rates, unemployment rate, and growth rate in the economy. But the Federal Reserve is in a dilemma, if it had not reacted and had told Congress it was going to keep within certain ranges, it would have been criticized."

Now, do you think it is a proper pursuit of Congress to try to get more information from the Federal Reserve System, and the Reserve Board as a whole with regard to the direction of our money supply? Should Congress give the Fed more direction?

Mr. MAISEL. The answer to the last is, "Yes." I don't object to the Members of Congress questioning the Federal Reserve. I never felt that Congress was exerting too much pressure in terms of meeting the national goal.

The Federal Reserve has to strive to meet our national goals as determined by Congress and the Executive; so, I don't think there is any problem there. I think the problem is that there has been too slavish attention given to the monetary aggregates.

But I do also think, in terms of Mr. O'Leary's statement where he listed interest rates, output, and prices, I would include money supply in there because money supply is a proper indicator within limits.

Chairman HUMPHREY. I think he would have included that. He was saying the other factors needed to be included.

Mr. MAISEL. Therefore, I agree.

Chairman HUMPHREY. There has been, for example, growth rate in the money supply of about 9 percent. Mr. Walker, I will get back to you because you said that there has been a doubling in the rate of monetary growth in the past few months to an annual rate of close to 9 percent since mid-March. You said such a growth rate is disturbing. But over the last 12 months the money supply has grown at only a rate of 5.4. Why is 9 percent during part of that period disturbing when the average comes out to be quite modest?

Mr. WALKER. Only if it is implied that it is going to be continuing over the next 3 to 4 months. I went on to say that they seemed to be snubbing up, and I think that is appropriate, to get back somewhere in that basic target range.

I don't think the Congress should have given the Fed quite as explicit guidelines. I think there are considerable dangers in that.

But the problem I run into—you were discussing it a moment ago, Professor Maisel's golden rule—it seems to me you have to ask a question when things seem to be out of whack between the monetary growth and interest rates—why are interest rates going up? That's the problem, you see.

If they are going up because of the forces of a normal business expansion, that doesn't bother me all that much. If they are going up because the Federal Reserve, under the circumstances, is having to hold the rate of monetary growth, maybe not to 4, maybe not to 6, maybe to 7, and still the demand for money is so strong that interest rates go up, if they are trying to fight off inflation, that is another sort of situation.

But, if interest rates are going up because the money illusion has been destroyed—people quit thinking that a dollar is worth a dollar. They have to bargain in real terms, in cost-of-living escalators; they want escalators on the interest rates that they have on securities outstanding, and so on—then you have an entirely new ballgame. That is the thesis of my remarks. And trying to pump in money and keep interest rates down under those circumstances, in my judgment, is wrong.

Chairman HUMPHREY. Gentlemen, we are just going to wind up here. We have a big battle with the tax legislation in Congress, and in that light, of course, the whole argument about the relationship of our tax policy to economic recovery comes up. Much of it is also centered on the need for investment and capital formation for investment purposes.

Two of the most widely read economic forecasters, Data Resources and Chase Econometrics, are forecasting a slowdown or recession in the economy in 1978 and 1979—at least a very serious slowdown.

If firms read these scenarios—and I gusess they do because they are widely held in high esteem—and these firms place any credence in them, is it possible that these companies may very well trim their capacity expansion accordingly, and make these forecasts a so-called self-fulfilling prophecy? Do you think there is any of this in the present sluggishness of corporate investment? And I say this because the profit picture of corporations today is very, very good. Mr. Tobin?

Mr. TOBIN. I think there is a disquieting kind of change in expectations on the part of business about the longer run future of the American economy. Businessmen have certainly scaled down their expectations in regard to growth, and in regard to the utilization of resources that the economy will on the average achieve over the next 10 years or so.

The climate of opinion of business is veering toward the idea that 6-percent, 6.5-percent unemployment rates may be normal for the future. They fear we will have recovery, and then the brakes will be put on hard again and we will have another recession. This contrasts with a former climate of thinking that expected steady growth with rather small ripples and a fairly high rate of capacity use, and a low, normal unemployment rate.

I think there is some danger of that self-fulfilling prophecy. I think there is too much complacency about it. I don't understand why the business community would be content with a vision of the future of that kind, in which 6 or 7 percent of the labor force are chronically unemployed. That is too many to put in CCC camps, by the way.

Mr. WALKER. The business community is not complacent, they do not believe that that level of unemployment is viable, economically or politically; they are just as concerned about it as the rest of us.

Chairman HUMPHREY. But what are they willing to do about it?

Mr. WALKER. They are willing to hire people when the markets are there. What we have to try to do is try to prove the inaccuracy of those forecasts. I would string along with Paul McCracken and others who say that this can be a fairly long and sustained boom if we don't try to run it in a 3½-minute mile. That is how I view the situation.

I would like for the record to make some comments on your comment that corporate profits are very high.

Chairman HUMPHREY. I would say they are substantially better.

Mr. WALKER. They are better.

Chairman HUMPHREY. My old country feeling is that if you see there is a chance to make a buck, you will invest. You know, I grew up in the Midwest, and I don't think people invest because they want to invest; they invest because they think there is going to be some business.

I am having a little personal experience with the matter. I am deciding the question of whether or not to spend $50,000 to remodel a store. That is an investment for a small businessman.

Now, what is the calculation that you make in your mind when you have to make that decision? Whether or not there is going to be any trade out there that will help us liquidate that investment. In other words, if you are going to put in new fixtures, a new store front, and it is going to cost you $50,000 to $75,000, you ask one question: Not, should I invest because I want to be an investor. The question you ask is, If I invest it, will there be enough trade coming in that front door so that I can pay for it?

So, therefore the general economic situation is much more important. For example, in my little area where I live, the thing I am interested in is, What is going to be the price of soybeans, What is going to be the price of corn; that is what I am interested in. That will determine whether I am going to invest. And there are many of these small investors throughout the country.

When you are thinking about investors in this country you are thinking about a handful of big companies. As a matter of fact, most of the employees in America are in small companies, and they invest primarily on the basis of whether or not they can make a buck—that is a good rule, you know; not whether somebody in Congress says you go to M-1, or M-2, or something. They take a look whether or not they are going to make any money.

Now, don't misunderstand me, I think the rate of growth in the money supply has a great deal to do with what is going to happen in the economy, but the average man—I talk to thousands of people out my way, and they don't know what we are talking about when we talk about M-1—they think it's a rifle. [Laughter.]

They really do.

Mr. WALKER. They are right.

Chairman HUMPHREY. What they know is, No. 1, they can't afford to buy a house. And you know why? Because the average home today is a $45,000 house, and by the time you got it paid for over a 30-year mortgage, it's a $100,000 investment. You pay some $55,000 in interest charges.

The guy says, "I'm not going to buy a house." I don't know why we don't get excited about that. I picked up that Boston Globe here about 1 or 2 months ago, and it says in Boston only 2 out of every 10 people can afford to buy a home. Now, if you can't afford to buy one, you can't afford to rent one either because with the shortage of supply rents are way up, and that hits the average person that is working.

And I noticed even in a stable economy like Wisconsin, Minnesota, these Midwestern States, that the rate of homeownership is dropping every year. Now, that is a very bad sign.

I listened to you three gentlemen, and I find you said there are two things that are needed, one is more investment capital and the other one is housing. More investment and housing. You know, we have been fooling here, we have people coming in giving us these forecasts on starts and permits, and when we come right down to it, we are going to build 1.3 million homes this year; we should be building 2 million at least, or 2.2 million—we are way off the mark to meet demand.

There isn't any way you are going to get recovery with the housing depression—no way. I mean, you can play games, fool yourself and play the market, but finally it gets down to whether or not you are producing something. A home is production; iron ore is production; and automobile is production; planting and growing crops is production. I am a production man. I just happen to believe that if the housing industry is in the doldrums, we have other industries in the doldrums, and that is the reason there is a lot of unemployment.

Housing absorbs huge amounts of semiskilled and unskilled workers, huge amounts. And I think the question is, Do you want a Government employment program, or do you want a housing program.

Now, in order to have a housing program we are going to have to have some Government help for low- and moderate-income housing because you can't build it and have it available for low-income people.

I have often felt it might be better to have some interest subsidies, have a fellow own a home and build a home than have public service jobs. I would rather have somebody working on that job, digging a foundation, digging out a basement, and building up a home. Most housing is a nonunion occupation. But we have a system here that doesn't work.

I want to get back to what someone said a moment or so ago. The business community should get a little excited about it. The trouble is, I think we are listening to people that manage money and don't produce. And of course I worry about the theory of the leisure classes.

Mr. WALKER. You put your finger on a very important point in the earlier part of your remarks, talking about the small businessman investing because he thinks there is going to be a market out there. There is a lot of investment from small business, but a tremendous amount from the corporate community, also. And the paradox of the situation is—and I may be wrong—but many in the business community are convinced that if we try to move back to full employment at the speed implied by Humphrey-Hawkins, that by 1978 we will be back in that situation where we will have weak markets, and therefore you don't get investment—that is the paradox.

Chairman HUMPHREY. Well, I don't deny they think that.

Listen, I think we'd better go, you have been awfully nice to come here, you have been very helpful. One interesting thing about arguing economics, everyone is entitled to his own point of view. We are also somewhat conditioned, I guess, by our own experience, our own environs. I recognize the great concern of the public over inflation. I have often felt, though, gentlemen, that there could be some assurance on the part of the Government, not that they will bail everybody out, but that they have certain established conditions that will give the people the assurance to invest, for expansion. But the way we have gone, it's like a circus act, there is a new play going on in every ring all the time, there is no continuity; one time it's one program over here and another time another one over there. The only thing we had assured was the tax reduction, and that tax reduction did have a positive effect. It had an effect primarily in the area you talked about, consumer goods; the real problem is durables and heavy capital goods, we have not had quite enough of that.

Thank you.

[Whereupon, at 12:35 p.m., the committee adjourned, subject to the call of the Chair.]

MIDYEAR REVIEW OF THE ECONOMIC SITUATION AND OUTLOOK

WEDNESDAY, JUNE 30, 1976

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

The committee met, pursuant to notice, at 10:07 a.m., in room 318, Russell Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Proxmire, and Javits; and Representative Reuss.

Also present: John R. Stark, executive director; William R. Buechner, William A. Cox, Lucy A. Falcone, Robert D. Hamrin, John R. Karlik, Louis C. Krauthoff, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Charles H. Bradford and M. Catherine Miller, minority economists.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. Mr. Burns, as I said to you privately and will now say publicly for the record, we appreciate very much your coming before the Joint Economic Committee as we conclude our hearings on the midyear economic report.

It is the tradition of this committee acting under the Employment Act of 1946 to make a midyear review of our economy and offer observations that the committee may deem desirable.

At this time there are many encouraging signs in our economy, and of course there are also some that are not as encouraging as we would like, and are in fact somewhat discouraging.

In preparation for this morning's hearing I asked the staff to assemble some information on the behavior of the money supply in relation to the targets established by the Federal Reserve Board. I might say at this point that we have had some witnesses at the midyear review hearings who have made some critical comments about what we call the money supply targets. For example, Mr. James O'Leary, vice president and chief economist of the U.S. Trust Co. in New York, was critical of the great emphasis being placed on money supply growth as a policy target, and I might add to my colleageus in Congress that he was critical of the Congress for requiring the Fed to talk about policy mainly in terms of money supply. Today we will want to get your reaction to the statements of Mr. O'Leary and others.

Looking at the money targets, if we look at those targets established for the period from the third quarter of last year to the third quarter of this year, the narrowly defined M_1 money supply in the current quarter will fall below the target range, while the broader measure, M_2 will fall within it. However, if we look at the targets measured from the fourth quarter to the fourth quarter, M_1 falls within the range this quarter, but M_2 is above it. Looking at the latest targets, those which run from the first quarter of 1976 to the first quarter of 1977, both measures are presently above the target range, at least at this time.

I am sure, Mr. Burns, that you understand all of this; but I have to be frank with you that I sometimes find it a bit confusing and there are times that I am dubious as to its helpfulness. But I have gone through this exercise in the hope of dramatizing a basic point. That point is this: it seems to me there is too much talk about M_1 and M_2 and M this and M that, and possibly too little talk about our basic economic objectives of employment, production and purchasing power.

Now, as you know, I was one of the original sponsors of the congressional resolution which requires the Federal Reserve to appear before the Banking Committees each quarter. Senator Proxmire was the chief sponsor here in the Senate, and Congressman Reuss in the House. I thought at the time that I knew what we were doing in sponsoring that resolution: in fact, I was quite positive about it.

I had in mind a periodic explanation by the Federal Reserve of how it intended to use monetary policy to help achieve desired levels of employment, production, and purchasing power. I want to also add at this time, because you and I have had an exchange on this before which I thought was very helpful, that the Congress has been derelict itself in establishing what it thought were the goals that we needed to achieve in any formalized manner. So, it has been a little difficult for the Fed or any other agency of government to target its efforts toward goals when we ourselves are so ambiguous as to what we want.

I also had in mind an exchange of views between the Congress and the Federal Reserve as to what those levels of employment, production, and purchasing power ought to be and how they could be achieved.

To some extent the appearances before the Banking Committees, as well as your continued appearances before this committee, have had that intended result. We have discussed and at times even argued about what our goals should be. We have had useful and informative discussions. Nonethless, I think we have at times been sidetracked into excessive discussion of the "M" so to speak, of the M this and the M that at the expense of discussion of our more basic objectives.

So, I thought this morning that we would try to clear the air a little bit.

Mr. Burns, I am interested in what happens to the money supply primarily to the extent that money supply affects what happens to production, employment, and purchasing power. I do applaud the progress the Fed has made in the past year or so in formulating its policies in terms of annual targets for the monetary aggregates. But I applaud it only because formulating those targets forces you and me and everyone else to think more carefully about the relationship between the monetary aggregates and the real strength of the economy.

I do not want anyone to regard those money supply targets as sacred. If at any time inconsistency develops between meeting the money supply targets and providing for healthy economic growth, which takes into consideration both inflation and employment, it is the money supply targets which have to give way.

Mr. Burns, you have been rather fortunate over the past year. It has proved possible to support a healthy economic recovery without having the money supply exceed its target growth path. And, I may add, without having interest rates shoot up.

Unfortunately, the good fortune maybe cannot hold together forever. The day may soon arrive, perhaps it may have already arrived, when the Fed must choose between meeting its monetary targets and providing adequate credit for a continuation of a vigorous economic recovery.

Now it is at that point in my remarks where we may get some discussion. I hope and believe your choice will come down on the side of the economy rather than on the side of some sacrosanct money supply target.

I for one assure you that I don't intend to criticize the Fed for going outside its monetary targets, nor for that matter even to praise you for staying within them. What I would criticize would be restrictive policies which interfere with economic recovery or excessively expansive policies which contribute to the worsening of inflation.

It's easy to say what I've said; it's more difficult to achieve it. That I recognize.

What I will support and applaud will be a policy of cooperation with the Congress in achieving the growth of output, employment, and purchasing power which we all desire.

Mr. Burns, before I ask you to proceed, my colleagues may want to make some comment.

Congressman Reuss?

Representative REUSS. I have no comment at this time, thank you.

Chairman HUMPHREY. Senator Proxmire?

Senator PROXMIRE. I am just a little troubled, Mr. Chairman, at the feeling that we are now telling the Federal Reserve to forget about the money supply. We have fought awfully hard to get that. We have not had any opportunity to have any direction or control of the Fed. Unfortunately it tended to go its own way and it wasn't its fault. It had no guidance from the Congress.

At long last, after a very tough struggle, we did get an agreement on trying to require the Fed to come in and tell us what their money supply target was, and then to part from it but try and stay within it, and then explain why it was necessary to part from it and give us an opportunity to debate it and discuss it.

I do not think that the Chairman has ever regarded it as sacred. But it was the one way we could get a handle on monetary policy and relate it to our economic policy and have some notion of how it was affecting employment, unemployment, growth and so forth.

So we do hope that we do not now say that the one control we do have will not be taken too seriously by the Federal Reserve.

Chairman HUMPHREY. I do not want my comment to be so interpreted. I simply said that the monetary targets are but a tool, a means, that are directed toward the goals of employment, production, and

purchasing power, and I think it is a decided advantage and it is, I think, a singular accomplishment that there has been a resolution to the effect that the Fed will state its goals and give us some way to judge its performance relating to the economy.

Have you anything else, Senator Proxmire?

Senator PROXMIRE. No. That's fine, thank you.

Chairman HUMPHREY. Now, Mr. Burns, we look forward to your testimony and may I say to your guidance here this morning.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you very much, Mr. Chairman. I listened with greatest interest and pleasure to your introductory statement. I was hoping that your colloquy with Senator Proxmire might continue. You have now cut it short. Let me merely say that I agree entirely with what both of you gentlemen have said.

Chairman HUMPHREY. That's a good one for openers, Mr. Burns. [General laughter.]

Mr. BURNS. I need hardly say that I am pleased to meet once again with this committee to present the views of the Board on the condition of our national economy.

The economic expansion now underway is entering its second year. Business activity began to pick up in the spring of 1975, and has gathered momentum since then. In the quarter now ending, the physical volume of total production will be about 7½ percent higher than a year ago.

As is typical of a period of cyclical expansion, the rebound of activity has been especially vigorous in the industrial sector. New data released this Monday by the Federal Reserve Board indicate that industrial production, that is, the output of our factories, mines, and powerplants, has risen since March of last year at an annual rate of 13½ percent a stronger advance than was indicated by our earlier reports.

The expansion of economic activity in the various service trades as well as the industrial sector has led to material strengthening in the demand for labor. Total employment across the Nation has increased by more than 3½ million from its low point in March 1975. This gain has been accompanied by significant lengthening of the average workweek—especially in manufacturing, where the amount of overtime is back to the highest level since the summer of 1974. Meanwhile, long-term unemployment has sharply diminished, and the overall unemployment rate has come down from about 9 percent a year ago to 7¼ percent presently.

The rate of utilization of our industrial plant has also moved up with the expansion of business activity. In the materials-producing industries, only about 70 percent of available plant capacity was effectively used during the second quarter of 1975. At present, the rate of capacity use has reached 80 percent in these industries. Where the recovery of production has been especially rapid, as in the paper industry and some branches of the textiles industry, the utilization of capacity already exceeds 90 percent.

The intensity of the economic recovery to date has been close to the average for cyclical upswings of the period since World War II. More-

over, the pattern of the current expansion has been similar in many respects to that of its predecessors.

Consumers led the way out of recession last spring, and they have been a major source of stimulus to economic expansion since then. As confidence improved, they became more active buyers, and the rise in consumer spending outstripped by a considerable margin the increase in disposable income.

The advance of consumer buying, which began in markets for apparel and other nondurables, soon spread to durable goods. During the quarter now ending, consumers spent approximately 13 percent of their after-tax incomes on durable goods—compared with 11½ percent a year earlier. The automobile market has been especially active. In recent months, unit sales of domestic models have run about 50 percent above their depressed level in April 1975.

As purchases of big ticket items rose, consumers incurred new indebtedness. However, the rate of increase in consumer installment debt has thus far remained moderate in relation to consumer incomes.

The hesitation that developed recently in the pace of consumer spending is, in the Board's judgment, a transitory phenomenon. After a rapid advance from last December through this March, total retail sales remained unchanged in April and then declined somewhat in May. Temporary pauses of this kind are not uncommon during periods of cyclical expansion. Members of this committee may remember that the lull in consumer buying last autumn was soon followed by a renewed surge of retail sales during the winter months. There is good reason to believe that the recent slowdown will also be temporary. The basic determinants of consumer spending are clearly favorable: real incomes of families are increasing, labor market conditions are improving, and so too is the liquidity position of consumers. I would therefore expect consumer spending to continue moving upward. In fact, incoming sales data for the past 3 or 4 weeks on automobiles and most other branches of retail trade suggest that a resumption of the upward trend is already underway.

A further rise of inventory investment should also add strength to general business activity. In many nondurable goods industries, inventories have now been destored to levels that are adequate to meet current rates of sales. In the durable goods trades, on the other hand, renewed accumulation of inventories is just getting underway. New orders for durable goods are now rising vigorously, and rebuilding of stocks should be a stimulus to production in the months ahead.

A larger, and more basic, source of stimulus to economic activity can be expected from increasing business outlays for new plants, machinery, and other equipment. Business capital spending typically joins the recovery process later than other sectors of the economy. But as utilization of capacity increases and profits improve during the course of an expansion, business firms typically move ahead more aggressively with their capital investment programs. Although such a development has been somewhat delayed in the present instance, the traditional pattern is again emerging.

Thus, production of business equipment has been rising since November 1975 at an annual rate of 11 percent. Other indicators of business capital spending are also pointing strongly upward. New orders for nondefense capital goods have risen in each of the past 5 months,

and in May were 16 percent above their level at the end of 1975. Also, the most recent surveys of business anticipations indicate some further strengthening of plans for capital expenditures this year.

In the other major sector of private long-term investment—that is, homebuilding—the revival of activity has contributed to economic expansion since the spring of 1975. New housing starts last month were almost 50 percent above their trough in early 1975, and unemployment among construction workers has fallen by a third from its cyclical peak.

The rebound in residential construction has been largely confined to single-family homes. Construction of apartment houses has been held down by several factors—previous overbuilding, high construction costs, and lagging rents. In fact, inflated costs of construction, maintenance, and operation are now a major limiting factor for all branches of residential construction.

It is reasonable, nevertheless, to anticipate a gradual further advance in homebuilding activity during the second half of this year. Residential building permits have been rising rather steadily and last month reached their highest level in 2 years. Mortgage credit is in ample supply in practically all parts of the country. Furthermore, while the construction of apartment houses has remained at a depressed level, vacancy rates for rental units have declined noticeably.

Our net trade balance with other countries may also show some improvement in the months ahead. During the past year of economic recovery, our foreign trade balance declined. The physical volume of imports—which fell off sharply during the recession—began to rise again during the third quarter of last year, reflecting the enlarged demand for petroleum, industrial supplies, and other goods needed to support the rise of industrial production or to meet consumer preferences. Our merchandise exports, however, have yet to regain the upward trend that was interrupted by worldwide recession.

Imports of industrial supplies and consumer goods will probably move up further as the expansion of our economy continues to cumulate. But the outlook for our export trades is also brightening. Although economic recovery in other industrial countries began later than in our own, the pace of economic expansion in Western Europe and Japan has of late begun to gather momentum. Material strengthening of demands for American machinery and other products is therefore to be expected.

During the course of the current expansion, several milestones have already been passed on the road to restoring our Nation's economic vitality. By early this year, the number of persons holding jobs had already regained the prerecession level, and total employment has since then moved above the previous peak by nearly 1½ million. The average level of real disposable income per person rose to an alltime high in the first quarter of 1976, and the real value of the gross national product now also exceeds the previous peak level reached in the final quarter of 1973.

Our country still has some distance to go, however, to regain full prosperity. It is therefore vital to maintain conditions that will foster continuation of a good rate of economic expansion.

Fortunately, the recovery process has thus far remained balanced and orderly. There have been few signs of the speculative excesses that sometimes develop in the course of a business-cycle expansion

and inevitably cause trouble later on. Our Nation has made notable progress in reducing the rate of inflation. The rise in consumer prices came down from 12 percent in 1974 to 7 percent in 1975, and to an annual rate of 4 percent in the first 5 months of this year. This recent further moderation in the rate of inflation, however, stems in large part from special factors that for a time reduced the prices of food and fuel. When these erratic items are excluded, it appears that the underlying annual rate of inflation has not diminished since mid-1975, and that it may still be about 6 or 7 percent.

Any such rate of inflation constitutes a serious threat to the economy, and elimination of our disease of inflation must therefore remain a major objective of public policy. At the same time, it is important to recognize that we have managed during the past year to avoid a fresh outburst of inflation—a development that would have quickly eroded the purchasing power of wages and savings, created strains in financial markets, undermined confidence, and sapped the strength of the forces of economic expansion.

Let me turn now to the role of monetary policy in these developments. The Federal Reserve was urged repeatedly during the past year to pursue a more expansionist policy in order to speed the return to full employment. Concern was expressed by some economists, as well as by some Members of Congress, that the rates of monetary growth we were seeking would prove inadequate to finance a good economic expansion. Interest rates would move up sharply, it was argued, as the demand for money and credit rose with increased aggregate spending, and shortages of money and credit might soon choke off the recovery.

We at the Federal Reserve did not share this pessimistic view. We knew from experience, first, that the turnover of existing money balances is apt to increase rapidly with the return of confidence, second, that rapid expansion of money and credit is apt to intensify inflationary expectations and soon sow the seeds of another recession. Consequently, we resisted advice to open the tap and let money flow out in greater abundance.

The monetary policy pursued by the Federal Reserve fostered a moderate rate of monetary expansion. During the year ending this quarter, M_1, the narrowly defined money stock, which includes only currency and demand deposits, grew about 5¼ percent. A more broadly defined money stock, M_2, which includes also savings and time deposits other than large CD's at commercial banks, rose by 10 percent.

These increases in the stock of money were sufficient to finance a large increase in the physical volume of output even at rising prices, because they were accompanied, as we expected, by a sharp rise in the turnover of money balances. Moreover, this rise in velocity was not associated with rising interest rates or developing shortages of credit. On the contrary, conditions in financial markets have remained relatively easy.

There is a striking contrast between the movement of interest rates during the current expansion and their behavior in past cyclical upswings. Short-term interest rates normally begin to move up at about the same time as the upturn in general business activity, although the extent of rise varies from one cycle to another. Upward pressures on short-term interest rates might well have been expected during the

past year, in view of the vigorous rebound of economic activity, the continuing advance of the price level, and the record volume of Treasury borrowing. However, after some runup in the summer months of 1975, short-term rates turned down again last fall, and long-term rates also moved lower. By April of this year, interest rates on most short-term market securities had fallen to their lowest level since late 1972, while yields on high-grade new issues of corporations declined to their lowest level since early 1974. The main cause of the unusual behavior of interest rates during the past year was undoubtedly the lessening of inflationary fears, and the consequent reduction in the inflation premium that got built into interest rates—particularly, the long-term rates.

The financial climate that has prevailed during the past year of economic recovery has permitted lenders and borrowers alike to strengthen their financial condition. For example, the liquidity position of savings banks and of savings and loan associations has improved markedly over the past year. Moreover, the flow of individual savings to the thrift institutions is still ample. Deposits at savings and loan associations—the leading suppliers of home mortgage credit—rose at an annual rate of 14 percent in May, and the outstanding mortgage loan commitments of these institutions increased further—to more than $20 billion, the highest level in three years.

Commercial banks have also rebuilt their liqiudity. They have added a large quantity of short-term Treasury securities to their portfolios and they have also reduced reliance on volatile funds. The condition of the banking system has been further strengthened through widespread additions to retained earnings and some new issues of common stock. The ratio of capital to risk assets of commercial banks, which declined steadily during the ealy 1970's, has thus increased appreciably, and confidence in the banking system has been bolstered.

Our Nation's business enterprises have likewise taken advantage of the prevailing financial climate to improve their financial condition. Corporations issued a huge volume of long-term bonds during 1975, and they used much of the proceeds to repay short-term debt and to acquire liquid assets.

This year, they are still finding long-term funds readily available. Public offerings of bonds by domestic corporations will total about $3 billion this month—an extraordinary volume by historical standards. For a time, access to public markets for long-term funds was confined largely to firms with the highest credit ratings. Of late, however, some lower-rated firms have found a more receptive public market for their debt issues, as is reflected in a narrowing of the yield spread between Aaa and A-rated bond issues from 1½ percentage points last summer to about ½ percentage point this spring. Many medium-sized firms and others with lower credit ratings have met their needs for long-term funds through private placements with life insurance companies and other institutional lenders.

Besides this, an improved stock market has made it easier for corporations to raise equity funds for financing new investment programs or for restoring capital cushions. This month, corporate enterprises have sold about $1½ billion of new shares to the public. If the pace of new stock offerings during the first half of this year is maintained over the next 6 months, the year will end with the largest volume of corporate stock flotations in our history.

These accomplishments in finanical markets indicate, I believe, that the course of moderation in monetary policy pursued by the Federal Reserve over the past year has aided the process of economic recovery. Our actions during recent weeks have further served to reassure the business and financial community that we intend to stick to a course of monetary policy that will support further growth of output and employment, while avoiding excesses that would aggravate inflationary pressures and thus create trouble for the future.

As I indicated in testimony before the Senate Banking Committee, the Federal Open Market Committee recently reduced the upper limit of the projected growth range of M_1 in the year ahead from 7½ percent to 7 percent, and the upper limit of M_2 from 10½ percent to 10 percent. The changes are small, but they are a logical step in light of financial developments and the behavior of the economy.

Senator PROXMIRE. I will go and vote and then come back.

Chairman HUMPHREY. Please go on.

Senator Proxmire will just go to vote and then will be right back.

Mr. BURNS. The decision to reduce the upper limit of the ranges for M_1 and M_2 reflects the experience of the past year, when improvements in financial technology made it possible for a moderate rise in the money stock to finance a good economic recovery with declining interest rates.

However, with a full year of renewed expansion in business activity already behind us, some downward adjustment in the upper boundary of the growth ranges for M_1 and M_2 might have been called for in any event. The adjustment in the projected growth ranges for M_1 and M_2 over the year ahead was thus a very small but prudent step in the right direction. Looking to the longer future, it would be helpful if everyone recognized that the rate of monetary expansion we have recently projected is still too high to be consistent with general price stability.

Another indication of our intention to adhere to a moderate course of monetary policy may be found in the prompt actions we took some weeks ago to ward off the threat of excessive growth of the monetary aggregates. In April the pace of monetary expansion jumped very sharply—to an annual rate of 15 percent for M_1. We recognized that technical factors—such as the decline in the Treasury's cash balance—might be partly responsible, and that the bulge in the monetary growth rate might be temporary. We could not, however, risk an explosion of the monetary aggregates during a period of strongly advancing economic activity.

Over a period of several weeks, starting in late April, the Federal Reserve thus became somewhat less accommodative in meeting the demand for bank reserves. The upward movement in market rates of interest that followed reflected our actions as well as rising demands for credit. In more recent weeks the pace of monetary expansion has again moderated; short-term interest rates have stabilized or fallen back, and long-term rates may have begun declining again.

In the Board's judgment, the small but prudent steps just described have bolstered confidence and enhanced prospects for sustaining a healthy economic recovery. The Board believes that the prospects for a durable prosperity would be further enhanced by moderation in the course of fiscal policy.

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The deficit in the Federal budget has diminished very little over the past year—especially when the operations of off-budget agencies and Government-sponsored enterprises are taken into account, as they should be. During the first quarter of this year, the annual rate of deficit, as calculated in the national income and product accounts, was still close to $70 billion, and there is little evidence of a significant closing of the huge gap between receipts and expenditures during the second quarter. It is of the utmost importance that the Congress and the administration cooperate to maintain tight control over Federal expenditures. At the present stage of the business cycle, a substantial decline of the Federal deficit is essential if renewed inflationary pressures are to be avoided and savings are to become available for much needed private investment.

We can all take considerable satisfaction in the progress that has been made over the past year in restoring more prosperous conditions in our country. Both the Congress and the administration deserve credit for improving the economic climate.

Much remains to be accomplished, however. Unemployment remains much too high. Productivity has been lagging. The expansion of our industrial plant is proceeding at too slow a pace. The homebuilding industry and other branches of construction are still depressed. And the menace of inflation is still with us, though in a less virulent form than in many other countries around the world. Rampant inflation abroad—West Germany and Switzerland are outstanding exceptions—has contributed to the turbulence in foreign exchange markets this year.

Participants in the economic summit meeting just concluded in Puerto Rico have recognized the dilemma faced by economic policymakers throughout the advanced industrial world today. There is a pressing need for expansion in the economies of both the industrialized countries and the developing nations. However, traditional policies of economic stimulation may well prove counterproductive in today's environment of deeply ingrained inflationary expectations.

The declaration of the Puerto Rico conferees regarding the need to maintain an economic climate that is conducive to enterprise and investment, while working toward the complete elimination of inflation, is both welcome and appropriate. Both in this country and abroad, our main hope for achieving lasting prosperity lies in adhering to prudent fiscal, monetary, and structural policies.

Thank you.

Chairman HUMPHREY. Mr. Burns, if you would permit me just to leave for a moment. Senator Proxmire will be back right away and he will open the questioning when he is back with you. I am sorry we will have this interruption. Just relax with your pipe for a moment.

Mr. BURNS. Thank you very much.

[A brief recess was taken.]

Senator PROXMIRE [presiding]. Mr. Chairman, I understand that Chairman Humphrey wants us to continue. So, if you would like to complete your statement, please do so. He will be back shortly and I will go ahead with the questions if he does not return in time.

Mr. BURNS. I completed my statement, Senator.

Senator PROXMIRE. You completed your statement? All right, fine.

I must say, Mr. Chairman, as I have said so often in the past, in this particular economic period the developments seem to have borne out your policies. You were criticized by me as well as by others for not having a more expansionary policy; but you stuck by your guns and argued that although it might seem a moderate increase in the money supply would not permit recovery, the velocity would take care of that. You were proven to be correct.

However, I must say I still have difficulty with the outlook now, and I hope you will help me with it.

No. 1, this has been, as you know, what we had ending last May, an unusually deep recession—the deepest recession in the postwar years. So far, as some people observe, it has been only a standard-sized recovery. It has not been as rapid as one might think considering the depth of the recession.

Furthermore there has been a slowdown in the current quarter. It is hard to say how much. Maybe we had a growth in real terms of 5 percent or 4 percent, but it was not nearly as good as it was in the first quarter. Now that suggests to me that if we continue on this present pattern, we are not going to improve the rate of unemployment. It's likely to stay above 7 percent, and we are not going to be getting the kind of growth and recovery that we need.

You feel confident, however, on the basis of your statement, that this is simply a pause and that we are going to move ahead more vigorously in the rest of the year.

Now, on that point, you put quite a bit of stock in the strengthening of capital investment plans, and the reports I've seen suggest that this acceleration of the economy is likely to be only a little better than last year in real terms.

Do you agree with that?

Mr. BURNS. The judgment you have just expressed, Senator, is based, I believe, on the surveys of business plans for capital expenditures made by our Commerce Department.

The most recent survey suggested that capital expenditures in 1976 would be 7.3 percent above 1975; and one taken some 3 months earlier suggested that the increase would be 6.5 percent. If I considered these surveys by the Commerce Department as conclusive, then I think I would have to accept what you have said. But I do not take them as conclusive.

Over the years I have followed much more closely, and I think for good and objective reasons, the figures on new orders for machinery and equipment, and also those on construction contracts for industrial and commercial buildings. I have found these indicators to be more accurate over the years.

As I indicated in my statement, new orders for machinery and equipment—or, more broadly, for nondefense capital goods, have risen very sharply in the past 5 months. Contracts for commercial and industrial construction have been lagging, although they are running higher in the second quarter than they were in the first quarter, on a physical volume basis. Furthermore, surveys by some private agencies suggest a larger pickup in business capital expenditures than the Commerce Department survey.

Senator PROXMIRE. Well, I have some data here that suggest the contrary. I understand the latest McGraw-Hill survey indicates that plans

were, as they characterized, weak for 1977. The conference board's recent survey of investment appropriations, which foreshadows future investment activity, showed a marked decline.

Even the econometric models, whose forecasts take account of past patterns of investment spending, project investment to remain well below its 1973 level in 1977.

Mr. BURNS. Let's put the econometric models to one side. Otherwise, we will get into a debate in a fairyland world. I've just been to Disneyland and there isn't much difference between the two. [General laughter.]

Senator PROXMIRE. It is that Disneyland model which shows the most optimistic projection, however. But let's disregard them.

Mr. BURNS. I want to disregard them, and I am glad you are joining me, at least for the moment.

As for the National Industrial Conference Board report on capital appropriations, that showed a very sharp jump in the fourth quarter of last year—an increase of some 22 percent, if I remember correctly. It showed a decline in the first quarter, but if you exclude the petroleum industry it showed virtual stability at the new higher rate. Appropriations in the petroleum industry have been a very volatile item over the years and analysts have learned to look at those figures excluding the petroleum component.

As to the McGraw-Hill survey for 1977 that you referred to, I just have not seen it. I do not know how I missed it. You say it is for 1977?

Senator PROXMIRE. That's correct.

Mr. BURNS. When did it come out?

Senator PROXMIRE. May 7.

Mr. BURNS. For 1977—or 1976?

Senator PROXMIRE. These are projections for 1977.

Mr. BURNS. Oh, wait, then.

Senator PROXMIRE. Expectations. It's a survey of expectations.

Mr. BURNS. Oh, well, that is too conjectural to attach much importance to.

Senator PROXMIRE. Well, somehow we have to conjecture on what is going to happen in the future. That is what we have been trying to do, what you've been doing. We have to do that.

Mr. BURNS. Let's try to do that on the basis of the best indicators available, recognizing that we can all go wrong.

Senator PROXMIRE. Well, I want to move along from this. But the McGraw-Hill survey, as I understand it, questions the business people themselves, the ones who are going to make the investment, and it was on the basis of their estimates—and I understand they questioned the thousand largest firms, so that what they get is some basis for a projection.

Let me move on to housing.

I was interested in your analysis of housing in which you—maybe I missed it, but I did not see any analysis of the effect of the continuing very, very high mortgage rates. They have been stable at a historically extremely high level—8¾ and 9 percent. It is hard for me to see how we are going to get much of a housing recovery, and housing is so important for a vigorous recovery, as long as rates remain that high. And, I cannot see any prospect that the rates are going to be significantly lower than that.

Mr. BURNS. Don't be a pessimist on inflation, Senator. If inflation comes down, long-term interest rates, including mortgage interest rates, will come down. Inflation is what has been holding them up.

Senator PROXMIRE. But you are expecting an inflation in the area of—unless I misunderstood you—in the area of 5 percent or 6 percent—the basic underlying inflation rate if you leave aside the fluctuations in food and oil?

Mr. BURNS. I did not tell you anything about my expectations. I merely indicated that as of now the basic underlying rate of inflation still appears to be about 6 or 7 percent.

Senator PROXMIRE. Well, accepting that, then——

Mr. BURNS. But I cannot accept that, Senator. That means trouble for our country. I cannot accept trouble for our country. It is your business and mine——

Senator PROXMIRE. Well, I do not like trouble for our country either.

Mr. BURNS. I know.

It is your business and mine to do what we can to bring the rate of inflation down so that, among other things, mortgage interest rates will come down. That would help to restimulate the homebuilding industry.

On that question, mortgage interest rates are a factor, no doubt. But there are other factors, as I indicated. We can go into that at length, if you wish.

Senator PROXMIRE. Now, the other element, I notice that the U.S. share of exports enormously increased last year. I think the world share went from something like 12 and a fraction to 17 percent, and it was an increase that I doubt very much we could duplicate. In fact, there is some question whether we could maintain that very high level based on our historic experience. Furthermore, as you point out, we are likely to increase imports in the coming year. So that factor would seem to me to be unlikely to give us the kind of stimulus in the next 12 months that it has given us in the past.

Put all together, it seems to me that with an unemployment level of around 7 percent, and operating below 80 percent of capacity, to be concerned about classical inflation, to be concerned about too much money chasing too few goods seems to me to be looking in the wrong direction——

Mr. BURNS. I don't think so at all.

Senator PROXMIRE. When the kind of inflation we have suffered has been peculiarly related to food and oil and the policies of the OPEC nations and the vagaries of weather and of Federal policies not related to demand and supply.

Mr. BURNS. Well, Senator, spending by the Federal Government and the huge Federal deficit have something to do with it. And, I am sorry to say—but we at the Federal Reserve have had no choice—the rate at which money has been expanding in our country has accommodated a moderate rate of inflation. Needless to say, we do not like doing that, but the alternative would be a bitter one for our country.

We do have inflation. It is still much too high. And if inflation were to heat up again, you can rest assured that before very long unemployment would be very much higher. That is the cruel dilemma that we face in this country. We will not have anything approaching per-

manent good times until we unwind the inflation from which this country and much of the rest of the world have been suffering.

Senator PROXMIRE. I agree with that. But my problem is that I do not understand how restraining our growth under present circumstances is likely to moderate inflation, when as I say, the inflation that we have suffered has been so clearly influenced by food and oil prices, which are aside and apart from this element. We have so much vacant capacity, so much personnel available for work.

Mr. BURNS. Actually food and oil prices, as I pointed out, have recently worked in the direction of moderating the rate of increase in our price indexes.

Senator PROXMIRE. They have indeed, and that is why, as you say, we have had a 4-percent rate of inflation in the first 4 or 5 months of the year.

Mr. BURNS. That's right.

Senator PROXMIRE. But over the past 2 or 3 years they have been the principal cause of the rate of inflation.

My time is just about up. I would like to ask just one more question if the chairman would permit. It is not related to this.

We had remarkable testimony before the Banking Committee the other day by a banker, a Chicago banker. I want to send you what he called for. He argued that if we are going to do anything about saving our neighborhoods in our big cities that we cannot rely on the Federal Government. We have to rely on the banks to do the job. They have the presence, they have the capital, thy have th know-how, they can have the motivation if we provide them with the proper motivation.

He called for an opportunity for them to have either preferential reserve requirements or an opportunity to pay a little higher interest—a series of proposals that would give them an incentive for investing in the local neighborhood and improving it. His bank, the South Shore Bank in Chicago, has done a superlative job there and has saved that neighborhood in a way I think the Government could not do. As I say—they have the efficiency, the presence, and the capital—the banking system has far more capital in aggregate than we are ever going to provide from the Federal Government.

So I hope that you will give these proposals this banker has made, careful consideration. It seems to me that it promises a good way to help our cities without enormous spending.

[Mr. Burns, nods affirmatively.]

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman HUMPHREY [presiding]. Thank you.

Mr. Burns, I'd like to take the position now for the moment of the devil's advocate after listening to your remarkable testimony.

Mr. BURNS. I think of you always as an angelic advocate. [General laughter.]

Chairman HUMPHREY. Well, thank you very much. You have disarmed me already. My wings have been clipped and my horns are appearing now.

I always thought—or should I put it this way, I have been dubbed by some folks around here as sort of the happy warrior, the eternal optimist, the man who always sees the bright side of life—which, by the way, I do not mind at all. There are enough of the professional pessimists—those with pen and typewriter and those with vocal cords. I prefer to be on the happier side.

But I do not believe I have ever managed to put together such a glowing collection of economic good news as you have assembled in your statement this morning. It bothers me a bit because I do not like to come in second best on most everything. I would like to be first in something. [General laughter.]

I am beginning to wonder whether you have given us a balanced picture.

Let me just go over this because I know you will have an appropriate response.

Mr. BURNS. May I interrupt?

Chairman HUMPHREY. Yes.

Mr. BURNS. In my statement I said:

> Much remains to be accomplished, however. Unemployment remains much too high. Productivity has been lagging. The expansion of our industrial plant is proceeding at too slow a pace. The homebuilding industry and other branches of construction are still depressed. And the menace of inflation is still with us.

Chairman HUMPHREY. Mr. Burns, I heard that and I want to compliment you. That is what we always call the saving grace statement in politics. When we have finally gotten down to where we have stated our case, we like to have a little escape hatch there.

I think you said it properly and it is fair.

But just let me run through what you have said and then get your comment on it in light of what you have just repeated.

You stated that "in the quarter now ending, the physical volume of total production will be about 7½ percent higher than a year ago." If so, and I gather we do not have all of the official statistics yet, it means that the growth rate slowed to 4½ percent in the second quarter. Now you did not point that out.

You state that "revised data show industrial production up 13½ percent since March of last year." You don't point out that in the last 2 months' industrial production has risen at a much slower 5.7 percent annual rate. You point out that in the paper industry and in some branches of the textile industry, capacity utilization exceeds 90 percent. You do not point out that in basic metal materials capacity utilization is still only 73.5 percent.

You point out that housing starts last month were 50 percent above their recession low point. You do not point out that there has been almost no upward movement of housing starts in the past 6 months. They are still at the very low annual rate of 1.4 million.

You point out in your statement that the deficit is still close to $70 billion. You do not point out that the fiscal 1976 deficit has recently been revised downward several billion from earlier expectations, or that Treasury borrowing needs have turned out to be less than anticipated.

My plea is to have some perspective.

You say, "The intensity of the economic recovery to date has been close to the average for cyclical upswings of the period since World War II." That is an accurate statement. That puts a proper perspective on the recovery. I just wanted to emphasize that. Since we are having an average recovery from a worse than average recession, I am somewhat puzzled by apparent administration fears that the recovery is too rapid, and this is what I am getting at.

The news so far is that we have to dampen things down, and the President has called this conference that he has just returned from,

and I heard the reports yesterday that Mr. Simon thought that the comments were extraordinary and Mr. Greenspan thought it was excellent and all the superlatives were used. I find it somewhat incredible to see the President summoning other world leaders and urging a coordinated strategy of slowing down the recovery, particularly in Puerto Rico where there is 20 percent unemployment. It just seems to me that the setting was not entirely proper. Dorado Beach, which is a place that I love to go to, is a beautiful place; but it is hardly representative of the conditions that exist in the Caribbean or in Latin America or in many places in the United States. From the point of view of staging a conference, of all the places in the world to stage it, why in Puerto Rico where there is 20 percent unemployment, and then say we are going to fast? That is sort of like saying we ought to shut off penicillin when people are all dying from infection.

Now, Mr. Burns, with unemployment at record levels in every major country and with the growth rate in this country apparently slowing down somewhat, at least in the current quarter, my question to you, very seriously after my editorial comment is, do we really face the imminent danger of uncontrolled world boom?

What bothers me is—you know, what I have always said about some liberals is they are never so unhappy as when they are happy, and they are never so happy as when they are unhappy. What gets me is in the financial community, the minute they see things getting good, somehow or other people get worried. You know, it is my background, I am sure, that creates such an attitude. I have never seen really—the folks that I know—great prosperity: I have seen it too depressed.

Now, what about this? Do you really feel that we face an imminent danger of a world boom that will bust out in wild inflation?

Mr. Burns. Senator, let me comment on your entire statement before I turn to your question.

Some of the additional facts that you presented, I have no quarrel with. If I did not put them in my statement, it was not because I intended to present anything but a balanced view before this committee.

As for the economy moving up at too fast a rate, you spoke of some people having that view. You were quarreling with other people. You were not quarreling with me. You were not quarreling with the Federal Reserve. That is not our view.

As to your specific question about the world economy, we are having once again a simultaneous expansion in the industrial world—that is, an expansion that is underway in practically every industrial country. When a simultaneous expansion develops among the industrial nations of the world, one does have to think of shortages that may soon appear in various raw material areas.

Sensitive raw material prices have been going up on the average for a year and a half now. With the recovery proceeding simultaneously in the industrial countries around the world, this is a matter of some concern to me.

I do not think that the recovery in the world economy is proceeding at too fast a rate at the present time. I do not think that steps ought to be taken to slow it down. But I do think that a warning that we may be at that stage 6, 9, 12 months down the road, is salutary. That is the best answer I can give you to your question.

Chairman HUMPHREY. That's very helpful, really, Mr. Burns. I truly appreciate your explanation.

Let me just say quite seriously to you that I recognize in the OECD countries, for example, that there has been a higher rate of inflation than we have had and that their unemployment rates may be slightly lower, but are high for their standards. What I am getting at primarily is in our own country, even though I realize that what we do here has a tremendous impact on the rest of the world, I sense that our conditions are just a little better. Our rate of inflation is down, compared to theirs. Our unemployment rate is higher and therefore we may want to have different policies here than we would recommend or than might be applied in other areas of the world.

I have the "Journal of Commerce," June 28. It says, "Unit labor costs rise less in U.S. than in most big trading nations," just as an indication of one of the differences that exist.

Here is a little story that appeared in the Washington Post today. The headline is "Applicants Flood Chrysler."

> The Chrysler Corporation, hit by an avalanche of more than 20,000 job hunters competing for 1,000 openings in its car assembly plant in suburban Fenton said today it will stop taking applications 8 days earlier than expected.

So we have the situation here on the one hand where our economy is showing a healthy recovery, some signs of healthy recovery, and our inflation rate, thank goodness, is down compared to others, but our unemployment rate is still very high.

My point is that we need not to generalize in terms of overall world conditions. We ought to target in a good deal on our own situation recognizing—and I must put this caveat to it—that what we do does have an impact on the rest of the world. The concern that I have is that there may be a desire on the part of some, who by background and sincerity of interest, of course, want to slam on the brakes before we have really gotten on the highway of solid economic growth. I just raise it as a point of caution.

My time is up.

Congressman Reuss?

Representative REUSS. I will yield to the Senator.

Chairman HUMPHREY. All right, Jack?

Senator JAVITS. Thank you very much, Henry.

Mr. Burns, I did not notice one thing in your statement, and that is any reference or analysis—if I am wrong please correct me as I did come late—to the $51 billion Federal deficit.

How does that affect our situation in terms of the recovery and what we ought to be doing about it? Shall we continue to accept this deficit; or shall we strive to balance the budget as many would urge us to do, including one of the leading Presidential candidates of my party? Or what?

Mr. BURNS. I do not see how we can balance the budget responsibly in fiscal 1977. We have to be realistic. On the other hand, to work toward a balanced budget and to work with some vigor in that direction I think is clearly not only desirable, but also essential. The economy is expanding. If you expect the economy to continue expanding, as I do, then the Federal budget deficit will simply have to come down very substantially; otherwise, we will find that private investors are excluded on a large scale from credit markets. Interest rates would then be bound to rise sharply, no matter what the Federal Reserve does.

Senator JAVITS. Should we phase it down in some orderly plan, or should we cut expenses on the ground that private enterprise is moving into the field? For example, our price tag for unemployment compensation is about $18 billion a year. Or, shall we find some way of raising more money, bearing in mind that notwithstanding the orators on the Senate floor about soaking the rich, even if you soak them so that they are out of business, it still would not make any big difference anyhow in the deficit?

Which way should we go?

What is your advice?

Mr. BURNS. I would certainly curb expenditures rather than raise taxes. I think if we raise taxes, we would be taking a grave risk with our economy. I would not do it at this time.

On the other hand, I would say that if Congress should be in a mood to exceed presently projected levels of expenditure, then the proper way to proceed would be to raise taxes. If we want spending to achieve this or that purpose sufficiently, we ought to be willing to tax ourselves. I would think that after we put the question to ourselves in that manner, we would choose the route of cutting back on expenditures rather than increasing taxes.

Senator JAVITS. There is still a third route which is indicated to us, and that is that many feel—or some feel, I cannot evaluate the number—we ought to change the brackets.

Mr. BURNS. We ought to change the what?

Senator JAVITS. We ought to change the tax brackets because income levels are rising, partially through inflation, and I am sure you will agree that even 6 to 7 percent a year ain't hay, it is a lot of inflation, generally twice or more than what we normally contemplate—and that therefore we ought to readjust the tax brackets so that they bear less heavily on lower- and middle-income groups.

Now do you believe that we ought to leave the tax brackets as they are, or that we ought to readjust them according to some measure of inflation, thereby bringing down the tax take, in effect, from the broad mass of the population?

Mr. BURNS. I think I would leave the tax brackets where they are at the present time. The argument is that we ought to index our tax rates—to adjust the tax rates to the rate of inflation. I think we have done too much indexing already, and I would not extend it any further.

Senator JAVITS. I gather the thrust of what you have just been saying to be don't rock the boat.

Mr. BURNS. I think that's a very fair statement, Senator. This is a time to stand still for a while.

Senator JAVITS. Is that not contradicted by the fact that there is no really important initiative in this country or in the world that will snap us out of the syndrome of successive recession or depression and recovery; and that everything that is being said or testified to bears out the fact that well, we are recovering and let's not interfere with the recovery, and the vitality and the health of the Nation will assert itself; sure we have a problem with endemic unemployment, but somehow or other we will make do with some 85 percent of the people doing pretty well. But do we have anything that is really enterprising that will put us on a new plateau? For example, a new arrangement with the Third World for long-term credits; Operation Independence

for $100 billion to make us energy independent; the reorientation and the revitalization of the obsolescent American cities, et cetera. Now isn't that the missing link in our approach to our present economic situation?

Mr. BURNS. I think that there are initiatives that we can take and should take. But unfortunately we have gotten into the habit of thinking of economic initiatives in terms of more governmental spending. I had breakfast yesterday with a New Yorker, a new Congressman from the Buffalo area, Mr. Lundine. He was recently elected in a special election.

Senator JAVITS. He, incidentally, put into effect our, and I said that advisedly, first labor-management public council, and very successfully.

Mr. BURNS. I know. He did not run to the Federal Government for held. Jamestown found that industry was leaving the city. They found also that some firms in the city were going broke. He, Mr. Lundine, being mayor of the city, decided to bring business managers and trade union leaders together. Here is our city; our city is declining. We have to raise productivity in our city. It is hard to get wages down. But if we improve productivity, we can leave wages where they are; or, to the extent that productivity increases, we can pay higher wages and still let the shareholders in the corporate enterprise share the benefits of improved productivity with the working people.

They have had very considerable success.

Nowadays, unfortunately, when we talk about revitalization of our cities, we tend to think exclusively or mainly in terms of new Federal programs. The kind of Federal program that I would like to see is one that would provide some seed money in our cities to establish productivity councils, or councils for the rehabilitation of our cities. Business people and labor people would get together, look at the tax climate, look at the labor climate, look at the facilities provided by the city in the way of education and other services, and try to answer such questions as, why is business leaving our community? Why are jobs declining in our community? Why are slums flourishing in our community when other places in our country are doing so much better?

That is the kind of effort that we need.

We have had labor-management committees in our country on a national level. I think they have done some good. I served on one for 6 years under Presidents Kennedy and Johnson. But that labor-management committee was concerned with high national policy in the sphere of taxation and so on. We did not talk about labor problems. They were too sensitive.

I think a national labor-management committee ought to have as its objective the establishment of local committees in our cities, and plant by plant within each city. I think we could then work marvels in our country.

Senator, I don't have to lecture you on this subject. This has been your theme. You went up to Jamestown—I learned about your visit up there—to find out what they were doing. You have been pushing this for years.

But I must say, Senator, although you are an energetic and wise man, you have not gotten very far in this direction. You ought to work harder.

[General laughter.]

Senator JAVITS. I will take your advice.

Chairman HUMPHREY. I have waited for that day, for somebody to tell Senator Javits that. That's really something.

[General laughter.]

Chairman HUMPHREY. Mr. Burns, we have lost two of our colleagues. They will soon be back and then I shall have to leave.

Are you doing down to vote, Senator Javits?

Senator JAVITS. Yes.

Chairman HUMPHREY. I was terribly interested in what you had to say about our cities. This is a area to which I give a good deal of time and attention.

I think the long-term financing needs of the cities are one of the great problems which private enterprise alone cannot take care of. There has not been the kind of coordination that is needed. I thoroughly agree with that. The emphasis has been on what HUD could do or what HEW could do without bringing in the private sector to the degree that it ought to be brought in. I could not agree with you more because the job is massive. Not only that, it cannot be done from here. Every city has its own personality and has its own unique set of problems. I agree with that and I thank you for your observations.

Mr. BURNS. Also Senator, if I may, we can get so much assistance from our colleges around the country.

Chairman HUMPHREY. Very much so.

Mr. BURNS. We have done that in the sphere of agriculture. But we have not done it in the sphere of small business, and we have not done it in the area of rehabilitating our cities. There are people in our business colleges eager to join a national effort, wanting to help, able to help, and they are not being mobilized for the purpose.

Chairman HUMPHREY. I could not agree more.

I do not want to make this record appear as if it is a personal production, but even years ago, when I was mayor of my city, I went to our university with Dean [Kazelka] and Mr. Blakeley and people over at the school of business administration. We organized what we called a city development committee, which literally projected the development of Minneapolis, which is a fact today. We had very little Federal help; we got some later on. We took the idea of the land grant college with the county extension system for agriculture and applied it to our city.

Mr. BURNS. But you see, that has to be done not only at the planning level. You need assistance for the individual business and the individual government department, as well as an overall city plan.

Chairman HUMPHREY. Right.

Mr. Burns, Congressman Reuss had to go to handle a conference committee report in the House. He left me a copy of his news release. I do not know whether or not you have seen it—yes, surely you must have. It is of June 17. It says, "Reuss Scores Federal Open Market Committee Secrecy." He makes note of the fact that for 40 years, since the beginning of the statutory Open Market Committee, it has made available detailed minutes, entitled "Memorandum of Discussion of Monthly Meetings." This complete record has been of invaluable help to journalists, economists, historians, and the Members of Congress themselves. Then he gives an example of the detailed minutes. He says

that the 55-page record contains a verbatim transcript of the statements of a dozen Open Market Committee members plus fascinating material from an even larger number of Federal Reserve officials present at the meeting of May 26, 1970. All of this is apparently ended by a terse one-line statement in the Open Market Committee's release of May 24, 1976. The statement is, "The Committee voted to discontinue its Memorandum of Discussion."

Now the Congressman feels that is a serious mistake, to discontinue it. He asked me to please ask Mr. Burns if he will give an order to change that and to permit the continuity of the "Memorandum of Discussion" policy which had prevailed for so long.

Mr. BURNS. Let me comment on that, Senator.

You are quite right in saying there was a terse, one-sentence statement in the release that we issued. But I held a press conference on this subject and indicated just what we were doing and why we were doing it. I was available for questioning and did answer questions on the part of the journalists who were assembled. There must have been about 20 financial journalists there at the time.

We had made inquiries, and found that the "Memorandum of Discussion," which was made available after 5 years, was hardly being used; very, very few individuals ever referred to it.

As to the monthly report on FOMC meetings—the policy record—as you know, for years we released it with a lag of 90 days. Then we reduced the lag to 45 days, and more recently—that was the occasion for the press conference—we reduced it to approximately 30 days—actually, a little more than that on the average.

Chairman HUMPHREY. Which, by the way, I think is commendable. I think that is most helpful.

Mr. BURNS. The policy record is something that people are interested in, and we decided to improve it. We have done it on the new basis for 2 months now, and as our secretarial staff learns how to do its job better, we will continue to improve it. The policy record now gives far more information than it provided before, and it is a more analytic statement than the "Memorandum of Discussion." The "Memorandum of Discussion" indicated what X said and what Y said; to get much sense out of it, you had to distill these statements by individuals and generalize from them. We try to do that in the policy record that we now issue.

Chairman HUMPHREY. I will have to go vote. I am sorry. I will come back shortly. Congressman Reuss is here.

Congressman, I am doing your work. You take off now and follow up on your press release here.

Representative REUSS [presiding]. Oh, fine. Thank you.

Chairman Burns, as you know, the Congress, when it set up the statutory Federal Open Market Committee in 1935, mandated that there be reports; and, pursuant to that, for the last 40 years the Open Market Committee has been issuing transcripts of the Open Market Committee meetings with a 5-year lag, which is perfectly understandable. It has been a tremendous help to economics, journalists, historians, and, of course, Members of Congress.

So, I was very disturbed the other day, on May 24, to read in the minutes of the Federal Open Market Committee, that, and I quote, "The Committee voted to discontinue its "Memorandum of Discussion.'"

Did the committee talk that over with anyone in Congress on either side?

Mr. BURNS. Not as far as I know. I certainly did not.

Representative REUSS. The decision, if that is what it is, I find very sad, because I think that, after a 5- or 6-year lag, people are entitled to know what transpired at those meetings. It will not inhibit discussion. I would think that anyone who fears what he urges as a public officer becoming public property after 5 or 6 years really should not be on the Open Market Committee at all.

So, I am wondering if, particularly in light of the fact that Congress in the law mandated a record from the Open Market Committee, the Open Market Committee at its next meeting would not consider whether to rescind that action?

Mr. BURNS. I certainly will take this up with the Open Market Committee. I assure you of that.

Before you came in, I commented on your statement. You were not here at the time. Let me just repeat very briefly.

The "Memorandum of Discussion," which we had made available to whoever was interested after a lapse of some 5 years, we found upon a close inquiry was hardly being used.

On the other hand, the monthly policy record is followed very closely. The Committee decided that we ought to put more effort into the monthly policy record, and make it a more informative statement.

We have done that for two months now. It is an analytic statement of the discussion. Our secretarial staff is still learning how to do this job, and the monthly policy record will continue to improve.

Representative REUSS. As I say, having read the staff's first effort in that direction, I found it sanitized, bland, and thoroughly uninformative. No names were mentioned. We do not know who said what.

Now it is a more current record, and if you want to improve it, that is fine with me. But I wonder, in the light of what you said, that you discontinued the "Memorandum of Discussion," because you could not really find anyone who wanted it. Let me assure you that I want it. I will let Senator Proxmire speak for himself, but I am sure that he wants it. We find it invaluable.

Mr. BURNS. I did not mean to say that no one wanted it. What I meant to say, and I believe I did say, is that upon close inquiry we found that very, very few people—journalists, scholars, or Congressmen, or anyone else—ever consulted those memorandums. It seemed to us that we ought to put more effort into the monthly statement.

As you say, the monthly policy record does not mention names. It does not mention names very deliberately. What the public needs to know is the thinking that goes into the committee's decisions on monetary policy as made from month to month, rather than who said what.

As far as formal votes of the committee are concerned, they are duly recorded, and any dissents from committee decisions and the reasons for them are indicated in the monthly policy record. That will always be done.

One more word. I do not believe you are right, Mr. Reuss, in saying that the Congress mandated the "Memorandum of Discussion." That is something we did because we thought it was useful. We recently decided, I think correctly, that a fuller and more analytic monthly statement would be far more useful. One indication that our judgment was right is that the press now pays a good deal more attention to the policy record than it did previously.

I think there are two reasons for that. One is that the record is put out with a shorter lag; the other is that the record is a fuller and more analytic statement.

You say that it is bland. Well, maybe it is. If the discussion is bland, then the record of the discussion unfortunately will have to be bland. Now and then we will have spirited disagreements within the committee, and I assure you they will be duly recorded in the monthly policy record.

Representative REUSS. At this point in the record, without objection, I will insert the "Record of Policy Actions" of the Federal Open Market Committee, the meeting held on April 20, 1976, a document of 16 pages, which is released by the Fed as an example of its expanded record of policy actions to be immediately released. It is called Record of Policy Actions. I hope that the press will look at it, and any member of the press or any historian or anybody else, who thinks that it is an adequate substitute for the traditional "Memoranda of Discussion," the more or less verbatim transcript which we have had at a 5-year lag for the last 40 years, is invited to file his name with the committee so that I can determine the true situation. Unless I find a surprising number of names, I am going to have to stick to my hunch that the Open Market Committee has taken a great step backward. I am glad to hear that you say you will ask them to reconsider whether or not they will rescind that order.

[The document referred to follows:]

[Federal Reserve press release, May 24, 1976]

The Federal Open Market Committee announced today that it has voted to speed up publication of the records of policy actions taken at each of its monthly meetings.

At its meeting on May 18, 1976, the Committee decided that the policy record for a meeting should be released a few days after the next regularly scheduled meeting, rather than 45 days after the meeting to which the record relates. Since the majority of meetings are held at 4-week intervals, the delay now will most often be about a month. For the minority of meetings that are followed by a 5-week interval, it will be about a week longer.

In view of this action, the FOMC and the Board of Governors today released the attached record of policy actions taken at the FOMC meeting of April 20, 1976. Under previous rules, this record would not have been made available until June 7.

A delay of approximately 45 days had been in effect since early 1975. From mid-1967 to early 1975, a delay of approximately 90 days had been in effect. Prior to mid-1967, when the rules were changed to comply with the Freedom of Information Act, the records of policy actions were published only in the Board's Annual Report to Congress.

As in the past, the policy record for a meeting will include information on any changes in the Committee's instructions to the Desk during the period before the next regularly scheduled meeting. Such changes in instructions ordinarily arise out of Committee consultations by telephone or telegraph that are held whenever necessitated by special developments.

It was understood that the record of policy actions would be expanded to include more information concerning members' views on longer-run and current policy. At the same time, the Committee voted to discontinue its Memorandum of Discussion. These Memoranda, which are detailed accounts of proceedings at meetings of the Committee, have been available to the public 5 years after the end of the year to which they apply.

The records of policy actions also are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on information that was available to the Committee at the time of the meeting.

Attachment:

Record of Policy Actions of the Federal Open Market Committee Meeting, Held on April 20, 1976

DOMESTIC POLICY DIRECTIVE

Preliminary estimates of the Commerce Department indicated that growth in real output of goods and services had picked up to an annual rate of 7.5 per cent in the first quarter—from a rate of 5 percent in the fourth quarter of 1975—and that the rate of increase in the GNP fixed-weighted price index had slowed substantially. Staff projections for the remaining quarters of this year suggested that growth in output would be moderate and that the rise in prices would be above the relatively low first-quarter pace.

In March retail sales had risen sharply—according to the advance report of the Commerce Department—reflecting a strong increase in sales at food stores and widespread gains among other types of stores. The increase in the first quarter as a whole was substantially larger than that in the fourth quarter of 1975.

Industrial production continued to recover in March, owing mainly to increases in output of automobiles, some other consumer goods, business equipment, and durable goods materials. For the second month in a row, output of all durable goods rose more than the over-all index of industrial production.

Gains in nonfarm employment were again widespread in March, and they were sizable in durable goods manufacturing industries, in trade, and in services and finance. The increase in total employment exceeded that in the civilian labor force, and the unemployment rate edged down from 7.6 to 7.5 per cent.

Private housing starts declined moderately in March—following a sharp rebound in February to the highest level in 2 years—while permits issued for private housing units remained at about the level of the preceding 2 months. Outstanding mortgage loan commitments at savings and loan associations had remained strong in February—the latest month for which data were available—and downpayment requirements on mortgage loans had been easing during recent weeks.

New orders for nondefense capital goods rose substantially further in February, recovering to about the pace of last October and November. The level of new orders was still relatively low, however, and the backlog of unfilled orders continued to decline. Nonresidential construction activity remained depressed.

The index of average hoursly earnings for private nonfarm production workers rose at a less rapid pace over the first quarter of 1976 than it had on the average in 1975. In the first quarter the schedule of labor contract negotiations was light and relatively few cost-of-living wage adjustments went into effect. In April, however, a new agreement was reached in one major industry which—if approved by the union membership—would result in substantial increases in wages and other benefits over a 3-year period, including a large increase in wage rates effective April 1.

The wholesale price index of all commodities rose slightly in March—following 2 months of decline—as a continuing increase in average prices of industrial commodities was not quite offset by a further decline in prices of farm products and foods. Over the first quarter average wholesale prices of farm products, foods, and fuels declined appreciably, but average wholesale prices of other commodities rose almost as fast as during the second half of 1975. In February the rise in the consumer price index had slowed appreciably further, reflecting additional declines in retail prices of food and energy items.

The acceleration of growth in real GNP in the first quarter reflected in large part a shift to accumulation of business inventories. In addition, personal consumption expenditures rose appreciably. On the other hand, State and local government expenditures changed little, and net exports of goods and services fell sharply.

Staff projections for the remaining three quarters of 1976 suggested that personal consumption expenditures would expand at a rate near the average of the past few quarters; that residential construction and business fixed investment would continue to recover; that State and local government purchases of goods and services would rise at a relatively slow pace; and that business inventory accumulation would be substantial.

In recent weeks the average value of the dollar against leading foreign currencies had been relatively steady: the dollar had appreciated substantially against the British pound and the Italian lira—which had remained under considerable downward pressure—while it had depreciated somewhat against most other major foreign currencies. In February, as in January, the U.S. foreign trade balance

registered a sizable deficit, in contrast with the large surpluses in almost all months of 1975. Reported net outflows of private capital remained moderate.

Total loans and investments at U.S. commercial banks continued to expand in March, in large part because banks again added a substantial amount to their holdings of Treasury securities. Business short-term credit demands remained weak: Outstanding bank loans to businesses declined for the second consecutive month, and the outstanding volume of commercial paper issued by nonfinancial corporations also fell.

M_1 growth in March—at an annual rate of 6½ per cent—was little changed from that in February. Growth in M_2 and M_3 also was moderate in March, compared with relatively high rates in the preceding 2 months. At commercial banks, inflows of time and savings deposits other than negotiable CD's fell substantially from the exceptional pace of January and February. Inflows to nonbank thrift institutions remained strong.

On the basis of quarterly average data, M_1 grew at an annual rate of 3 per cent in the first quarter, compared with a rate of 2½ per cent in the fourth quarter of 1975. However, M_2 and M_3 grew at rates of 6½ and 11 per cent, respectively, in the first quarter, compared with rates of 6 and 9 per cent in the preceding quarter.

System open market operations since the March 15–16 meeting had been guided by the Committee's decision to seek bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the period ahead. Data that became available week by week during the inter-meeting period suggested that in the March–April period M_1 and M_2 would grow at rates near the midpoints of the ranges that had been specified by the Committee. Accordingly, System operations were directed toward maintaining conditions of reserve availability consistent with a Federal funds rate of about 4¾ per cent—the rate prevailing at the time of the March meeting and the midpoint of the operating range that the Committee had specified for the inter-meeting period.

Market interest rates in general declined during the inter-meeting period, as as attitudes apparently were influenced not only by the stability of the Federal funds rate but also by indications of a slowing in the rate of inflation and by reports of continued sluggish business demands for short-term credit. In the short-term area, the outstanding volume of money market instruments was reduced. At the time of this meeting the market rate on 3-month Treasury bills was about 4.75 per cent, down from about 4.95 per cent on the day before the March meeting.

In the intermediate- and longer-term area, the decline in interest rates occurred even though in March the volume of funds raised by corporations, the Treasury, and State and local governments was exceptionally large. Offerings of new corporate bonds and stocks was the second highest monthly amount on record. Interest rates on new commitments for home mortgages declined slightly in the inter-meeting period.

The Treasury was expected to announce the terms of its mid-May refunding on April 28. Of the maturing issues, $4.1 billion were held by the public.

At this meeting the Committee reviewed its 12-month ranges for growth in the monetary aggregates. At the January meeting the Committee had specified the following ranges for growth over the period from the fourth quarter of 1975 to the fourth quarter of 1976: M_1, 4½ to 7½ per cent; M_2, 7½ to 10½ per cent; and M_3, 9 to 12 per cent. The associated range for growth in the bank credit proxy was 6 to 9 per cent. The ranges being considered at this meeting were for the period from the first quarter of 1976 to the first quarter of 1977.

During the discussion of policy, many members of the Committee observed that the economic recovery had been making good progress. It was noted that expansion in output of goods and services in the first quarter had been more rapid than had been anticipated and that the expansion in activity during the period ahead might well exceed the pace suggested by the staff projections. At the same time, inflation remained a problem, and upward price pressures could intensify in the near future.

In commenting on the longer-run growth ranges, many members favored reducing the upper end of the range for M_1 by ½ percentage point, to 7 per cent. It was noted that the recovery in economic activity had been under way for 1 year and that the end of the new period for the growth ranges would fall 2 years after the recession trough. Moreover, the recovery recently had gained strength. Accordingly, it was observed that this might be an opportune time for the Committee to take a small step toward its longer-range objective of returning growth in the monetary aggregates toward rates consistent with general price stability.

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It was stressed during the discussion that the rate of growth in M_1 needed to accommodate a good economic recovery had been overestimated earlier: Although M_1 growth in the past two quarters had fallen short of the lower limit of the range that had been specified by the Committee, it obviously had been sufficient to accommodate a strong recovery. In any case, the proposed upper limit of 7 per cent exceeded actual growth during both 1974 and 1975.

Some sentiment was expressed for reducing both the lower and the upper end of the range for M_1 by ½ percentage point—or even by 1 percentage point—with a view to giving more emphasis to the Committee's longer-run objective of general price stability. It was also suggested that it would be desirable to preserve the width of the range adopted by the Committee at its January meeting—by reducing the lower as well as the upper end of the range—in view of the uncertainties associated with growth in M_1 in this period of change in the public's demands for currency and demand deposits. No member advocated raising either the lower or the upper limit of the longer-run range.

For M_2, many Committee members favored reducing the upper end of the range by ½ percentage point for most of the same reasons that they favored reducing the upper limit for M_1. However, most members advocated retaining the 9 to 12 per cent range for M_3 that had been adopted at the January meeting. Over the past year, growth in M_3 had been faster in relation to growth in both M_1 and M_2 than had been projected, as inflows of funds into nonbank thrift institutions—which typically have been a major source of financing for home purchases—had been especially strong. By retaining the 12 per cent upper limit for M_3, the Committee would allow for the possibility that this relatively strong performance would persist.

At the conclusion of the discussion, the Committee agreed that the ranges for M_1 and M_2 should be narrowed by reducing the upper end of each by ½ percentage point: thus, the ranges projected were 4½ to 7 per cent for M_1 and 7½ to 10 per cent for M_2. The range specified for M_3, as before, was 9 to 12 per cent. The associated range for growth in the bank credit proxy remained 6 to 9 per cent.

As at earlier meetings, it was agreed that the longer-term ranges, as well as the particular list of aggregates for which such ranges were specified, would be subject to review and modification at subsequent meetings. It was also understood that, as a result of short-run factors, growth rates from month to month might well fall outside the ranges contemplated for annual periods.

In the discussion of current policy at this meeting, the Committee took note of a staff analysis suggesting that M_1 was expanding at a rapid rate in April, in large part because of a substantial decline in Treasury balances. In addition, it appeared that a somewhat more typical relationship between growth in M_1 and growth in nominal GNP might be in the process of being re-established. It was expected that in the period ahead growth of time and savings deposits other than negotiable CD's would remain relatively strong. Accordingly, the staff analysis suggested that, if prevailing money market conditions were maintained over the 4 weeks until the next meeting, growth in both M_1 and M_2 in the April–May period was likely to be high relative to the Committee's longer-run target ranges.

In view of their assessment that the pace of economic expansion would be relatively strong, most members favored directing operations in the period immediately ahead toward restraining growth of the monetary aggregates within ranges not very much higher than the longer-run ranges agreed upon at this meeting and indicated that they would tolerate some modest firming in money market conditions. It was observed that some firming in money market conditions in this period would reduce the likelihood of excessive monetary growth in subsequent months.

During the discussion, the view was expressed that an aprpeciable tightening in money market conditions in the period immediately ahead would be premature, for a number of reasons. Although the recovery had made satisfactory progress, the rate of unemployment was still well above a desirable level. Residential construction was just picking up again, and indications of a recovery in business expenditures for plant and equipment were only now beginning to appear. Business loan demands at banks remained weak. From the third quarter of 1975 to the first quarter of this year, moreover, growth of M_1—and to a lesser extent, growth of M_2—had been low relative to the Committee's longer-run ranges. Finally, financial markets were particularly sensitive at this time, and any appreciable tightening in money market conditions could have a substantial effect on short-term interest rates and could adversely affect flows of time and savings deposits at both banks and nonbank thrift institutions.

At the conclusion of the discussion the Committee decided to seek bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the period ahead. Specifically, the members concluded that growth in M_1 and M_2 over the April-May period at annual rates within ranges of 4½ to 8½ per cent and 8 to 12 per cent, respectively, would be acceptable. The Committee decided that, in assessing the behavior of the aggregates, approximately equal weight should be given to M_1 and M_2.

The members agreed that until the next meeting the weekly average Federal funds rate might be expected to vary in an orderly way within a range of 4½ to 5¼ per cent. They also agreed that, in the conduct of operations, account should be taken of developments in domestic and international financial markets.

In accordance with the understanding reached at a special meeting held on March 29, 1976,[1] the Committee did not specify an expected range for growth in reserves available to support private nonbank deposits (RPD's). At the March 29 meeting, the Committee had agreed it should consider the rates of growth in several reserve measures—including nonborrowed reserves, total reserves, and the "monetary base" (total reserves plus currency)—that were likely to be associated with growth in the monetary aggregates at the rates it specified for 2-month periods. It was contemplated that further experimentation and analysis would help the Committee to evaluate the relative usefulness of several possible reserve measures for operational purposes.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that growth in real output of goods and services picked up in the first quarter. In March retail sales rose sharply further and recovery in industrial production continued. Gains in nonfarm employment were again widespread and the unemployment rate declined from 7.6 to 7.5 per cent. Over the first quarter wholesale prices of farm products, foods, and fuels declined appreciably, but average wholesale prices of other commodities rose almost as rapidly as during the second half of 1975. Over recent months, the advance in the index of average wage rates has moderated somewhat.

The average value of the dollar against leading foreign currencies has been relatively steady in recent weeks, while the British pound and the Italian lira have remained under considerable downward pressure. In February the U.S. foreign trade balance registered a second successive monthly deficit; reported net outflows of private capital remained moderate.

Monetary aggregates expanded moderately in March. At commercial banks, inflows of time and savings deposits other than negotiable CD's fell substantially from the exceptional pace of February; inflows to nonbank thrift institutions remained strong. Since mid-March, both short- and long-term market interest rates have declined.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions that will encourage continued economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the period ahead.

Votes for this action: Messrs. Burns, Volcker, Balles, Black, Coldwell, Gardner, Jackson, Kimbell, Partee, Wallich, and Winn. Votes against this action: None. Absent and not voting: Mr. Holland.

Representative REUSS. Let me ask you, does the decision of May 24, to discontinue the "Memorandum of Discussion," mean that the Open Market Committee is discontinuing its practice of keeping a record of discussion which, as I understand it, is done both by a stenographic reporter and by electronic methods?

Is there any change in that?

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[1] The March 29 meeting had been called for the purpose of reviewing procedures for formulating and implementing the Committee's instructions to the Manager of the System Open Market Account at the Federal Reserve Bank of New York.

Mr. Burns. I should know the answer to that. At the moment I am simply not sure.

Representative Reuss. Would you be good enough to supply that for the record?

Mr. Burns. I will.

[The information referred to follows:]

The discussions at meetings of the Federal Open Market Committee are recorded electronically. No stenographic reporter is present. A few members of the staff take some long-hand notes during the meeting, primarily to help the typists who transcribe the tapes to identify those speakers whose names are not called before they speak.

These procedures were not changed at the time the Committee decided to discontinue the memorandum of discussion.

The transcriptions are used by the Secretariat in drafting records of the meetings, and are routinely disposed of after they have served their purpose. The tapes are reused in recording subsequent meetings.

Representative Reuss. I certainly would regret it if the Open Market Committee does not reverse its decision of May 24 and actually discontinues its "Memorandum of Discussion." When would that decision take effect? Are you going to release the 1971, 1972, 1973——

Mr. Burns. Oh, yes. They will all be released. That decision has been made.

Representative Reuss. Up through what year—1975?

Mr. Burns. Certainly through 1975; yes.

Representative Reuss. Well, that means that Senator Proxmire and I, at the worst, have 4 more years to go in terms of understanding the Fed, assuming we are reelected.

Mr. Burns. May I say this for the record?

The only criticism that I have heard of this action has come from you, Mr. Reuss, and from you, Senator Proxmire. That does not mean that there are not other critics. But they have not communicated with me. I have not heard one criticism except in your statement to the press and in a letter I received from Senator Proxmire.

Senator Proxmire. Of course, this is our responsibility. We are chairmen of the respective banking committees.

Mr. Burns. Of course it is. I understand that perfectly. I think the question you have raised is a very fair question. I merely want to underline this lack of criticism from others, since it confirms the exploration we made of the degree of interest in that "Memorandum of Discussion" which is made available after 5 years. As I say, there is very little interest in it as far as we can learn.

Representative Reuss. It is open to any of the press, radio, or television people here today to write Senator Proxmire and myself to say thanks for nothing, gentlemen; knock it off; we don't need it; we are glad to see it discontinued. Any such letters I will duly pass on to you.

Mr. Burns. I will read and answer them with due care.

Representative Reuss. Let me take up what Chairman Humphrey was raising; namely, the decision of the administration, communicated to the world at the OECD meeting last week and then at Puerto Rico earlier this week, that contrary to the view of the majority of this Joint Economic Committee, which is that we ought to fight unemployment and fight inflation with equal fervor, the new view of the administration, with which it seems to have inoculated some of the other industrial powers, is that fighting inflation comes first, very definitely, and fighting unemployment has a secondary role.

Part of the rationale behind that view is suggested by your statement, where you talk about utilization of industrial plant. Your point out that utilization is greater than it has been. For instance, you say, and I quote:

In the materials-producing industries, only about 70 percent of available plant capacity was effectively used during the second quarter of 1975. At present the rate of capacity use has reached 80 percent in these industries.

Well, that is true. But isn't a fairer statement of the matter that contained in your own release of the Federal Reserve dated June 28, earlier this week, in which you point out that the present 78 percent capacity utilization in materials-producing industries in the first quarter of this year, and I quote:

Indicates a significant recovery from the cyclical low in the new series of 70.6 percent in the second quarter of 1975; but the rate was still more than 14 percentage points below the new series' quarterly peak of 93 percent in 1973, when shortages and production delays generated intense upward price pressures.

Now I think that which I have just read is a very fair statement of the situation: Industrial capacity utilization has gone up by 8 percentage points since its low, but is still 14 percentage points below the high in 1973, which, admittedly, was too high. But this committee, as far as I am concerned, is not about to accept the view that 78 percent is such an ebullient use of capacity that we ought to blow the whistle and tell the unemployed that they are going to have to stay unemployed, not only in our country but in many others.

Let me call further to your attention the next sentence of your presentation this morning:

Where the recovery of production has been especially rapid as in the paper industry and some branches of the textiles industry, the utilization of capacity already exceeds 90 percent.

That, too, is an accurate statement. However, in using the Fed's own release of June 28, I note that basic metal materials during 1973 and 1974 were utilizing 95 percent of capacity. Today they are only using 73 percent of capacity. Durable goods materials in 1973–74 averaged 89 percent of capacity; today they are at only 73 percent of capacity.

So, I just want to register the feeling of one member that there is something wrong here. We are wasting tremendous resources. Oh, but you say, Congressman, look at what we did mention; namely, paper. Paper is indeed, as you say, now at 90 percent of capacity utilization. However, there is a kicker in paper. Their capacity utilization is always very, very high in times of boom. They must figure their capacity on a somewhat different basis. For example, in 1973 and 1974, paper capacity utilization was at 98 percent.

I now come to my point. Since so much of the industrial index is at a very low capacity utilization rate—70, 72 percent and since, I think you would agree that if we could get some uniformity we could certainly stand to run our capacity at 83, 84, 85 percent—that should not shock anybody or send us off to Puerto Rico all shaking about inflation. In the light of that, should we not work on supply and conservation of some of these things? Take paper—you know, an extraordinary part of the food that American families eat, or at least the price they pay for food, is paper. If you have visited a garbage dump recently, as I have, it does not look like a garbage dump. It looks like a paper dump.

Would it not have been an excellent idea if the heads of state had gotten together in Puerto Rico and concerted their efforts to conserve the wasteful use of paper? Do you really need to take, for instance, a bunch of bananas, on which the Almighty has put a nice protective skin, and put that in a paper envelope? Knowing your frugal habits, I know that your answer is a resounding "No."

So, would we not be more sensible, really, if instead of telling the unemployed of the world that we cannot do anything for them for a while because we have to fight inflation, we looked instead at the bottlenecks and did something by way of increased supply, by way of intercontinental movement to relax trade barriers, by way above all of conservation to see if we could not cure the bottleneck situations?

What about that approach?

Mr. BURNS. I am not going to comment on what happened at Puerto Rico beyond what I stated in my testimony.

As for the rest of your general statement, I have no quarrel with it. I think it is important—and I think you recognize this—not to be misled by averages. My only reason for referring to the paper industry and the textile industry was to call attention to the fact that an overall average can be misleading. Beyond that, if shortages of capacity should develop in some of our key raw material industries, they would become a limiting factor in the expansion of economic activity that both you and I hope will continue to take place in our country.

Your general point about the rate of utilization of industrial capacity is certainly valid. We have unemployed labor, and we also have unemployed machinery, and we also have unemployed plants. I look forward to a higher average rate of utilization. But these discrepancies among industries are of some importance because bottlenecks, as you recognized in your statement, may develop 9 or 12 months from now. There is a good deal of interest in and concern about that in the business world and among economists, and there should be.

Representative REUSS. Thank you very much. My time is up.

I would just like to reemphasize the point that man can do something about these bottlenecks by a variable tariff policy, by a supply policy, by a conservation policy, when it can foresee them.

Mr. BURNS. Also, man can do something about these bottlenecks by encouraging more investment, which I think is the most important thing that we ought to do.

Representative REUSS. That, too.

Thank you.

Chairman HUMPHREY [presiding]. Go ahead, Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, I would like to ask you a little bit about the future and structure of the Federal Reserve Board and its relationship with the Congress and the President.

As you know, this is something that the Congress is considering right now, and we may be considering even more vigorously next year. It will be very, very helpful to get your advice now and your guidance on it.

I am very conscious of the separation of the Federal Reserve Board and the moneymaking power from the Executive. It is clear in the Constitution. There are proposals to have the Chairman's term—it would not affect you because your term runs out in 1978. But from that point on the term of the Chairman of the Federal Reserve Board would coincide with that of the President, so that any incoming President

could name, in effect, his Chairman of the Federal Reserve Board. There are other proposals related to getting a greater degree of Presidential authority with the respect to monetary policy; but this particular one has been pressed hard, and I would like very much to get your advice.

Mr. BURNS. I think that if the term of the Chairman of the Federal Reserve were strictly coterminus with the term of the President, the degree of independence of the Federal Reserve might be curtailed and some politicizing of the Federal Reserve might take place.

I think this is a difficult area, difficult for the Congress and for me personally. It is difficult for me personally because of my responsibilities. I have no other difficulty.

I should think that if we were to move in that direction, it would be wise to specify that a period, let us say, of one year ought to elapse before the President moves to name his own Chairman.

Senator PROXMIRE. So, a President assuming office in 1981, for example, would name a Chairman in 1982?

Mr. BURNS. That's right, the thought being simply that when a new President comes in he has many hundreds of appointments to make, and political factors are necessarily, and rightly so, very important in his mind. I think the Chairman of the Federal Reserve Board ought to be put apart and that appointment ought to be made in a somewhat calmer period.

Senator PROXMIRE. Very good.

Now, in discussing housing and discussing some of these other matters, the future level of inflation of course becomes very important indeed. I would be very much in your debt if you could give us your estimates, any assumptions you would like to make with respect to this, any notion of your outlook for inflation. If we follow the kind of policies that you advocate, if we do our best to hold down spending and to reduce the deficit and follow other prudent policies, what level of inflation would you anticipate in the coming year?

Mr. BURNS. That is a very, very difficult question for me to answer.

I think I know the need. I think the need is to unwind the inflation. I think I know the objective. Senator Humphrey referred to the importance of setting economic objectives by the Congress, and I have always endorsed that, Senator, as you know. I think our objective should be literally a zero rate of inflation. That is going to be hard to achieve, but we ought to work toward that objective.

Senator PROXMIRE. Well, I was asking not about the objective, but about the expectation.

Mr. BURNS. I know.

Looking at the recent past, the way I judge it is that the improvement that we had in bringing the rate of inflation virtually came to an end around the middle of 1975. The recorded rates of inflation have moved lower. But I think that when analyzed properly—or at least in the way I analyze them—the figures indicate that the rate of inflation has recently been about constant. That seemes to me to mean that, with the economy continuing to expand, there is a danger that the rate of inflation will become higher. To prevent that, I think a very prudent course in the fiscal and monetary area, in particular, is desirable. Various structural policies that I have talked about before this committee would also help, perhaps very considerably; but the Congress has shown very little interest in moving in these directions.

Senator PROXMIRE. What I am trying to get at is you were emphatic in rejecting the notion that we would necessarily have 6 percent inflation in the coming year. You said that that may be the consensus, and that we could do better and we should do better.

Mr. BURNS. That's right.

Senator PROXMIRE. My question to you is what would you expect if we do follow prudent policies in the coming year?

Mr. BURNS. If we follow prudent policies in the fiscal and monetary area and make some structural adjustments as well, I would expect the rate of inflation to come down definitely from the 6 to 7 percent level where we, I think, are at the present time.

Senator PROXMIRE. To what point?

Mr. BURNS. Over the next 4 years, down to zero. Over the next year down to, let us say, 4 percent.

Senator PROXMIRE. Now how about unemployment?

Mr. BURNS. Unemployment now is, according to the latest count, 7.3 percent. It may move up and down a little, but I think the trend is down. By the end of the year I would judge that the unemployment rate should be a little under 7 percent; by the middle of next year, perhaps 6.5 percent.

Senator PROXMIRE. As you know, the chairman of this committee is the author of a bill which, as you say, sets goals for unemployment, the Humphrey-Hawkins bill a goal of 3 percent adult unemployment.

I have been very interested in modifying that bill to provide also a goal for inflation at the same time. Also I have been interested in, and have been discussing this with Senator Humphrey, modifying the bill to change the prevailing wage provision in the last title of the bill, which would require that those employed by the Government as the employer of last resort would be paid the prevailing wage—instead of that, have them paid somewhat more than the minimum wage or unemployment compensation pay, but clearly substantially below the private sector wage so there would be an incentive to work in the private sector and so you would not have an automatic inflationary effect.

That frankly was very much based on your advice to this committee and your speech in Georgia some time ago, in which you suggested a sharper reduction in the pay by the Government. Would you feel that this kind of compromise might have merit and might enable us to follow a policy of reducing unemployment without serious inflation?

Mr. BURNS. I think it would be a great improvement on the bill as it stands at the present time.

Senator PROXMIRE. I would like to ask about one other area that bothered me a great deal. The 1968 Housing Act, as you know, outlaws discrimination in lending. There have been several studies of discrimination in lending that have shown that it is most serious, that blacks in many areas, based on these studies, are denied loans almost 50 percent more frequently than whites are, with the same income, with the same job stability.

Now, although that law has been on the books for 8 years, the evidence that we had as of a couple of months ago, and I hope it has been improved since then, indicates that neither the Federal Reserve, nor the FDIC, nor the comptroller has done anything to enforce that law. We have a situation in which not a regulation has been issued by any of these agencies; a situation in which none of the banks

keeps records of turn-downs by race, which is fundamental data if you are going to determine whether or not there has been discrimination.

Why is it that after 8 years and in a credit economy, when blacks have such a difficult economic time anyway, that something like this, which by and large isn't as controversial as busing or some of these other things—why can we not act here to provide equity and justice when the law has demanded it. Why have we just not gotten results?

Mr. BURNS. Senator, I find it difficult to answer the question. I do not know the answer. The question that you have asked is a very important one. I would like the privilege of preparing a full reply to your question after I study the matter, and if I find that we have not done our job at the Federal Reserve, I want to assure you that I will say so in my report and indicate what steps we are taking to correct our way of life in this area.

Senator PROXMIRE. I would very, very much appreciate that. I do think that the Federal Reserve is not alone. The other banking agencies have been equally negligent. I am delighted to hear this response. If you will, get the answer and let us know as soon as possible.

Thank you, Mr. Chairman.

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

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., July 28, 1976.

Hon. WILLIAM PROXMIRE,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to respond to your letter of July 1 concerning our discussion of discrimination in mortgage lending at the recent hearing of the Joint Economic Committee. You asked why there has not been better enforcement of Title VIII of the Civil Rights Act of 1968.

I believe that there are several reasons why the efforts of the supervisory agencies to carry out the purpose of that Act have not produced more evidence of discriminatory practices by financial institutions. One reason is that the initiatives originally taken by the agencies and HUD were designed primarily to solicit complaints by persons who felt that they had been the object of discrimination and to obtain assurances of nondiscrimination from lending institutions. All banks were required to display fair housing posters in their lobbies giving the name and address of an office of HUD to which complaints could be addressed. Every complaint that was received was investigated. However, these actions have disclosed very few complaints of discrimination in housing credit. Apparently, prospective borrowers are either unaware of the complaint channels available to them or are reluctant to become involved in a complaint proceeding.

A second reason is that, as you know, discrimination can be accomplished in subtle ways that may be difficult for an examiner to detect. Since the lending process is inherently discriminatory, in the sense that some credit applicants are practically bound to be turned down, a bank examiner may find it hard to determine whether improper criteria have been employed in deciding whether or not to make a given loan. Also, there are many ways in which an applicant can be discouraged before an application is even filed, and the absence of an application leaves no record for the examiner to review.

A third possible reason is that it simply may be too difficult in a normal examination, with its primary focus on financial soundness, to uncover instances of such discrimination. For this reason, as I will explain below, the banking agencies have recently been studying the question whether it would be preferable to have special "compliance" examinations of one kind or another conducted by specially trained examiners.

I would like to outline some of the steps the Board has been taking to promote fair lending practices. As you know, the Board has participated in the Interagency Fair Lending Task Force set up recently under the auspices of the

Department of Justice. I believe you have received regular reports on the progress of this task force, which has provided a useful forum for discussing the practical issues involved in enforcement of legislation forbidding improper discrimination in housing credit. The work of the task force has already resulted in implementation of an agreement for the exchange of information among the various agencies on complaints of discrimination in the extension of housing loans.

In addition to strengthening our complaint and investigation procedures, the Board is also in the process of amending its Regulation B, Equal Credit Opportunity, to cover discrimination in the granting of credit on the basis of race, color, religion, national origin, age (provided the applicant has the capacity to contract), receipt of benefits from a public assistance program, and the exercise of rights under the Consumer Credit Protection Act. These bases of prohibited discrimination were added to the categories of sex and marital status by the recent amendments to the Equal Credit Opportunity Act.

On July 15 the Board published for public comment proposed amendments to Regulation B designed to implement these new amendments to that Act. Clearly, the Act includes the same aspects of housing credit that are covered by the Fair Housing Act. In connection with its responsibility to issue regulations under this Act, the Board has before it the question whether it will be feasible to develop a requirement for data notation on loan applications that will be acceptable to all the agencies with responsibilities in this area. This question deserves, and is receiving, the most serious study. The Board's proposed regulations ask for comment on the possibility of adopting a uniform requirement for notation of data relating to the race and sex of applicants for housing credit, and to certain essential economic characteristics of the applicants and the collateral offered. The Board's concerns in this area are that any requirement that is adopted shall be effective in accomplishing the purpose for which it is intended; that so far as possible any requirement shall apply uniformity to the various categories of applicants and of creditors, and that to the extent possible the costs and burdens to both consumers and creditors of unnecessarily duplicative requirements shall be avoided. We are, of course, mindful of the recommendations on this subject set forth in your Committee's recent Report on Fair Lending Enforcement.

The Board has recently been considering the benefits of establishing a special type of compliance examination to assure satisfactory performance under all of the consumer credit regulations issued by the Board. Two of the Reserve Banks are already experimenting with such an approach. Examinations of this kind could be conducted by specially trained examiners at the same time as the regular examination or separately. A special course to train examiners in these regulations has been scheduled for September, and it is expected that such a course will be given three or four times a year in the future. The Board's staff is developing and improving the necessary forms and manuals that would be used for compliance examinations.

The Board is prepared to issue remedial orders under the Financial Institutions Supervisory Act as necessary to obtain compliance from institutions that are not prepared to take corrective action when their lending practices are found to violate applicable statutes and regulations. Before we reach that point, however, I am convinced that our expanded enforcement efforts under the Equal Credit Opportunity Act will effectively supplement our earlier actions to provide a strong mechanism for achieving compliance with nondiscrimination legislation.

Finally, you have asked for assurances that a program will be developed to make systematic use of the disclosure data on residential mortgage lending to be obtained under Regulation C, which implements the Home Mortgage Disclosure Act. I can assure you that the Board has every intention of making use of such data to the extent that it is appropriate. I am sure you will agree, however, that it is not possible to predict the potential utility of data that are not yet available for study. The Board's staff will be studying the matter actively, and I expect them to submit recommendations for the Board's review at an early date.

Sincerely yours,

ARTHUR F. BURNS.

Chairman HUMPHREY. Mr. Burns, a good deal of what you have had to say today of course relates to the perception that people have of economic policy as well as the facts and the view that people hold relating to the general condition of the economy. For example, this

morning I listened on the television and the radio to the analysis made by Michigan State, or one of the universities in the Midwest, on consumer confidence. The analysis showed that the consumer confidence level was increasing appreciably for middle income and upper income folks, but was declining for lower middle income and low income groups. But it is, of course, the middle income and the upper income groups that buy the largest share of our products. Yet a great market is available, particularly in the upper levels of lower income—I mean, when you get to the $7,000, $8,000, and $9,000 income, which is, of course, still a very modest income.

Again, my point is in economics, what people perceive is sometimes as important or even more important than what really selected facts seem to indicate. For example, I believe you stated here that the fear of inflation, or the less fear of rampant inflation has contributed to a drop in the long-term interest rates, or interest rates on long-term borrowing.

I think that is true, and that comes to the point on which Senator Proxmire was directing his attention. Forecasts, for example, on inflation that could be backed up by any kind of sound economic policy I believe would have a very, very positive effect on the lowering of the long-term interest rates, corporate borrowing as well as mortgage financing. Therefore, getting a hold on the inflation factor is important. I think it is critically important. It is a struggle within me, and I am being very open with you. I am concerned about the low income people and the people who are unemployed, and the kind of economic policy and environment necessary to bring about employment and better income for those, and how you manage an economy or what you do with an economy to hold down the rate of inflation. It is a constant struggle. You are just caught between two contending forces and two contending necessities.

I believe it is fair to say that some of the reasons the economy has improved are as follows. No. 1, the people perceive at least that the Congress is getting a hold of its budget by the Budget Reform Act. I just spent some time with Senator Muskie here yesterday. We were going over some matters. We are both interested in the tax legislation and so forth. In our concurrent resolution for the 1976 period, we have stayed under the budget estimates. In other words, what we set as budget targets, we have not exceeded. To the contrary, we are below those targets.

Likewise our estimates of revenues are slightly above those which were the targets.

I cannot help but believe that just the fact, even though there is still a huge deficit, the fact that we do not let it get away from us beyond what was set as the target has had a very constructive and positive effect, in financial circles.

I believe you can be sure, I think this record should show, that we are going to stay within those budget figures. Obviously we have a way to review. As you know, come September we have our second concurrent budget resolution.

Word needs to go to the American people that the Congress is acting responsibly in terms of its authorizations and its appropriations. I have been here a long time and I want to say that I think that in the last 12 months under the Budget Control Act there has been the most sincere,

conscientious organized effort that I have ever seen in Congress to control Federal expenditures. We used to have a lot of speeches about budgets and people who would rip and roar about excessive spending, and others who were charging that we needed to spend more. Today we know we have to live within those budget constraints. I am chairman of an authorizing subcommittee and I know what a problem it is to keep the authorizations within the budget confines. We have to present our budget material by March 15, all of the authorizations which we intend to offer, and this really requires some projections and forecasting. Then we come to our appropriation process, and that, of course, is the critical part because that is where outlays are determined.

The off-budget items are still loose, and I think that is a matter that we still need to get a hold of. Some of us have been talking about that. I think that is our next effort here in the Congress because you have two shows going here. You have one that is visible, and you have another one over here that is behind us, behind the curtain so to speak. The off-budget items have to be looked at, I think, very, very carefully now; but like with most reforms, you cannot bite off more than you can digest for a while. It takes some time to get it under control. That is No. 1.

Secondly, I think that the action of the Congress in taxes and tax reduction, the kind of tax reduction bill that we have had has had a positive effect in terms of the economy—releasing purchasing power, generating some new economic activity. I believe that many professional economists that I hear from—and I surely respect them, they know much more than I do—sometimes underestimate what I call the basic vitality of the economy which reveals itself in the velocity of money and the use of money, which is even maybe more important than some of the monetary aggregates.

So, we see certain signs today that I think are very reassuring. I do not like to have these hearings send any scare waves out over the country because there are a few people who look at what we do and see. But I think it is also very important that they be as objective as possible. As we have indicated, there is still the need of greater use of our plant capacity. Frankly there is a great need for modernization of a good deal of plants which requires investment.

We have never been able to get a handle yet on what the investment needs of the country really are. I suppose that is very difficult because that is all projection. But there is a growing realization that investment capital is needed. Now that gets into tax policy and some of us argue over whether there ought to be certain types of favoritism as compared to other types of tax law.

Another thing that I want to note here is there has been no talk at all today about what I feel is a coming problem of great dimension, the food problem. Western Europe is experiencing the worst drought in 250 years, a total crop disaster—total. This crop disaster is not only of feed grains and cereals, but it has hit poultry and animals. There is mass liquidation of herds in many of the European countries right now, and it will get worse.

The Soviet Union's crop outlook is still uncertain. Estimates have come from 215 million metric tons to 190 million. I have gone through this Russian roulette business about five times here in the last 8 or 9 years, and I predict it will be lower than that.

We never know what the Russians' food supply is. I have a feeling they have a strategic reserve. They are not stupid as we are. They have a bad system——

Mr. BURNS. That is the one point where I differ with you. So far I have been going along beautifully with you.

Chairman HUMPHREY. What is that?

Mr. BURNS. The degree of stupidity of the Russians.

Chairman HUMPHREY. Well, I do not mean it that way. I think that when it comes to reserves, they look at it from a military security point of view. I do not think it has much to do with their civilian diets.

There are also indications of bad crops in Latin American areas.

Now, what I want to add up to is, who are the consumers of cereals? Believe it or not, it is not India, it is not Bangladesh. It is Western Europe and the United States because we convert cereals into protein, we convert it into animal, into meat.

We are going to have if it continues, if it continues 1 more month—and I want to put it into this record—we are going to have food price inflation like you have never seen it before. That is my judgment—except for a period of time in which there is liquidation of herds, which will cause a temporary drop in meat prices. But once that is over, the cereal market will tighten up and there is going to be trouble. That is something that has not been placed in proper perspective, from this man's point of view.

I hope I am wrong. I want to say again that temporarily there will be an easing of meat prices because of the liquidation. That will of course be a terrible capital loss in the Western European markets.

The American people and the economists of this country do not understand the capital requirements of animal husbandry. The real problem in this Government is that we have people who are financial experts, but most of them do not know anything about agricultural economics. They really do not. They have no idea of the capitalization of agriculture in industrialized countries, land values, the tremendous amount of capital that is required for animal husbandry for the type of protein agriculture that we have. Right now, the Soviet Union is liquidating their animal herds—a major setback for the Soviets. They have spent 10 years, since 1966, building up their herds, building up milk production, dairy production, beef production, pork production, poultry production, and they are now having to liquidate exactly as they did in 1966.

I hope that the Federal Reserve will get the information from the CIA that I have. I imagine you have. I hope you will get it from our agricultural attachés, if you don't already have it.

I read practically everything that is printed about food—well, perhaps not everything, but I get the synopses, the analyses and I read all of the private letters. The people who are in the grain business are not interested in figures that deceive them. They are not interested in nice little political statements. They are looking at futures, they are looking at markets, they are looking at demand, they are looking at supply. My information is there is trouble lying ahead in that area.

I want to just place today in the record that while I think there is a healthy recovery underway, it could be aborted by inflation on the one hand, general inflation; and No. 2, it could be seriously damaged by inflation in the food sector, because that has a tremendous impact on

consumers, particularly on our lower and middle income consumers in America. The thing I learned from Pat Caddell and Peter Hart and George Gallup and all of the people we have had in here, is that the American people identify the word "inflation" primarily with food costs. That has a tremendous effect upon consumer confidence. And, consumer confidence is absolutely vital if we are going to have a forward-moving economy.

That is my part of the testimony today. I do not have a chance to talk to you privately as much as I would like, so I thought I would do it publicly. I may be dead wrong on it.

Finally, I'd like to say this about the Humphrey-Hawkins bill. I think that the bill has done more than anything else to focus attention on what I call the economic policy mechanism of our government.

I have learned that legislation that is worth anything must provoke controversy, and this obviously has. There are features in that bill that I personally did not like; but I was a legislator trying to put together a package. It is my judgment that what Senator Proxmire said about having an inflation goal ought to be in that bill. If you are going to have an employment goal, or an unemployment goal, you ought to have an inflation goal. I think the bill is weak in terms of specifics on the inflation maters. I felt that way when we wrote it, but we needed to get something before the Congress with some support and we did it that way.

In other words, we need an incomes policy in this country. But the reason I hesitated in being specific is there are always people wanting to have wage and price controls. They can hardly wait to get the words out of their mouths. I, at one time, got caught up in that sickness myself. But I got over it and I do not want to get back into it again. It is sort of like a kind of ecoholic-alcoholism. I just want to be sure that we do not go running off here on the inflexible tracks of economic controls that I think are damaging to a vibrant economy. That is why we hesitated there.

On the matter of the prevailing wage, that will be adjusted. We are going to offer some amendments working with staff and committee so that the bill itself will, I think, be a much more acceptable instrument. I happen to think that title I of the bill, where we seek to get better coordination between the Treasury Department, the Federal Reserve, the Office of Management and Budget, the Council of Economic Advisers, and where we can present targets, targets to the Congress that are in a sense governmental forecasts as to what we would like to have, is a good section. Targets are not always realized, we know that. I saw a fellow here the other day who had a target. He wanted to high jump 7 feet and 7 inches, something like that. He only did 7 feet 5¼ inches. But if he had not had the target of 7 feet-7 inches, he maybe would have hit 7 feet-2 inches.

I believe in pushing people, in a sense a stretching. I believe in a stretch concept. If you don't have targets, like a low rate of unemployment, you are going to get accustomed to having 5-percent unemployment if you do not talk about 3 or 4. I do not want to get accustomed to that. We have a lot of that going on now in this country. We have a lot of mediocrity going on. There is no effort to promote excellence. Just like we said here about productivity—we need to insist

upon productivity. We need to have productivity targets. We need to have income targets. We need to have employment targets. Then we have a way of measuring our lack of performance or our performance.

It is just the set of values that I have in my personal operations. I have targets in my own office and I raise unshirted cain with my staff when they do not keep up with their mail. I say look, the people wrote to us; they are not waiting for history, and if you do not know how to answer the letter, find yourself another job. Well, we get mail answered once in a while.

When I go home and find some dear citizen comes up to me and says well, Humphrey, I wrote to you 2 weeks ago, have you been asleep—well, I used to be able to blame it entirely on the Postal Service. But I found out they will deliver before 2 weeks. So I came on back and now have a little target in my office. I want that letter answered, out, and replied. Knowing that it takes 3 days to get in and 3 days to get back, I will give you exactly 8 or 9 days, 9 at the maximum, to get the letter out, and if you do not get it out, you are going to be on your back. Do you know what? We have improved the flow of mail in our office by about 50 percent, and this with the same people, the same typewriters, the same machines—just a meaner boss. Well, I do not mean a meaner boss, but what we need is a little higher standard.

Would you like to go now, Mr. Burns?

Mr. BURNS. I can listen to you for hours. I love it.

Chairman HUMPHREY. Well, you may have to.

May I say it is a delight to visit with you, particularly when you listen.

Thank you very much.

Mr. BURNS. Thank you very much, Senator.

[Whereupon, at 12:17 p.m., the committee adjourned, subject to the call of the Chair.]