970

CRISIS IN THE BOND MARKET

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

SECOND SESSION

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CRISIS IN THE BOND MARKET

WEDNESDAY, MARCH 12, 1980

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

The committee met, pursuant to notice, at 10:10 a.m., in room 2247, Rayburn House Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senator Bentsen.

Also present: John M. Albertine, executive director; Deborah Matz, professional staff member; Betty Maddox, administrative assistant; and Charles H. Bradford, minority counsel.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. Let's get this hearing underway.

I have been at meetings for 6 days and nights, discussing our national economy. As you all know, the bond market is in total disarray.

We have seen bond market values drop over one-half a trillion dollars since October 1979. Soaring interest rates have caused a deferral of many new bond issues. Cities, States, and corporations have canceled or withdrawn over $600 million in bonds and notes in the first 2 months of this year alone.

Before the bond market calamity, it was predicted that 1980 would be a poor year for the housing industry, with only 1.1 to 1.2 million starts. Now it looks like that might be optimistic. A good deal of the forward commitments on long-term financing for housing has expired or are in the process of expiring. So I think there is a cumulative effect that's building up and I can see a very sharp dropoff.

In State after State subsidized housing, generally financed through bond sales, just won't be built because of high interest expenses. Even federally subsidized units are in jeopardy. With interest on long-term Treasury bonds rising to over 12 percent, fewer houses can be built without a budget increase and from what I have been through in the last 5 days participating in the joint anti-inflation committee process, that sure isn't likely.

It's clear that the bankers and the investment firms have taken some lumps over this and they have had some bond losses that are substantial, but they are not going to bear the major brunt of the inflation-induced crisis that we have. The housing industry, construction workers, low income families, schoolchildren and prospective homeowners are going to bear the major share of this. For every home,

road, or school unbuilt, we've going to have workers idle. Construction firms are going to be idle. Families are not going to be able to afford a house or even suitable rental quarters, and the elderly will be further cut off from assisted housing. City officials will have to defer needed facilities as a result of skyrocketing interest rates.

One way or another, we are all going to pay the price. Additional interest on Federal debt will amount to well over $1 billion if the same amount of bonds are sold this year as last year.

And I haven't seen the Treasury hone in on what's going to happen with the tremendous amount of refinancing that the Federal Government is facing and how that's going to be accommodated in the time ahead.

I know this situation is not going to be rectified overnight and there's no magic bullet for inflation, but we have to begin the process of healing this national economy. I think we have to balance the budget and I believe we have to bring about some kind of credit controls.

Paul Volcker, who is meeting with Members of Congress right now in that anti-inflation meeting, doesn't have total control of the monetary supply these days and he sure doesn't have control of the credit supply. I think we are going to have to do some things on the credit supply side that apply not just to banks that are members of the Federal Reserve but to all banks. We are going to have to do something on capital-asset ratios and capital-loan ratios. I think we have to fold into the system a targeted tax cut, starting probably about the summer of next year. We have gotten ourselves into a dilemma in that we're working for a balanced budget on the one side and I'm talking about a targeted tax on the other side.

But if we put it in and start it in the summer of next year and it was aimed toward increasing productivity, then most of the loss in revenue would spill into 1982 and we still ought to be able to achieve a balanced budget.

I don't think any one of these steps can curb inflation by itself. We have to take care of the money supply. We've got to cut the budget. We have to do something on regulations and I believe we have to have a targeted tax cut. Take all those things together and I think we can get back on the path of economic recovery.

I think it's equally important that that kind of a message go out to the financial world. I noticed on Thursday that the bond market stiffened for a little bit because there was a rumor that there were going to be some credit controls, and then when that didn't appear it went right back to where it was. I think we have to show that the United States is willing to make some of the sacrifices and that the level of pain is going to have to be one that's shared by everybody—businesses, institutions, and the people themselves. We have to prove to the world and to our own people that we have the discipline, that we have the tools, and that we have the will to bring about these changes, and that's not going to be easy.

Before proceeding, I have an opening statement from my colleague Senator Jim Sasser, who, unfortunately, will be unable to attend the hearing. So at this point, without objection, I will insert it into the record.

[The opening statement of Senator Sasser, together with an attachment, follows:]

OPENING STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Good morning. I want to commend Senator Bentsen for holding these very important hearings today. This country is in an economic crisis that we must face up to immediately. To forestall strong action is perilous to the American economy and unfair to the American people.

Certainly, we must have a balanced program of economic recovery that involves budgetary restraint, promoting reduced wage and price escalation, stimulating economic productivity, and curbing high interest rates. Action on one front alone will not help. And I think that the recent, excellently drafted, report of the Joint Economic Committee makes that point abundantly clear.

But there are some parts of our economic recovery program that we must begin to move on now. My prime candidate is curbing the disastrous escalation in interest rates this country is now experiencing.

Just yesterday we learned that the Nation's bond market has lost nearly half a trillion dollars in value since we started down the road of higher interest rates. Trading on the bond markets has come to a standstill, and many financial analysts are wondering whether long-term capital financing instruments will ever be a viable means of capital investment again.

This is an intolerable situation that can not be allowed to continue.

The prime rate is over 4 points higher than the 13½ percent rate of last October when the Federal Reserve Board formally began its policy of increasing interest rates to curb inflation.

This increase in the prime rate has greatly worsened our economic problems, rather than helped them. Interest charges have a ripple effect which forces up prices through all segments of the economy.

This inflation rate was 7.5 percent in November 1978; now it is 18 percent. The prime interest rate in November 1978 was 10.5 percent. That is when the Fed first started to increase the rates. Since then the annual increase in business investment has dropped sharply, from 10.5 percent in 1978 to 1.7 percent in 1979.

The high interest rates have brought the municipal and corporate bond markets to a virtual standstill. Cities and counties across Tennessee have postponed bond issues for important public projects because high interest rates have made the cost too great.

Families are being forced to postpone buying homes because interest charges on home mortgages have pushed monthly house payments beyond their reach. Net interest is taking a larger share of national income—6.2 percent in 1976 compared to 6.8 percent in the third quarter of 1979.

This policy, as I have contended for several months, is not working. Personal consumption continues to increase nearly twice as fast as the gross national product.

I sent a telegram to Federal Reserve Board Chairman Paul Volcker on Friday, March 7, urging the Fed to roll back interest rates to the level of last October. As a complement to this policy, I proposed that the Federal Reserve Board impose a set of selective credit controls to slow down inflationary borrowing practices. These controls would restrict speculative borrowing and other financial dealings which fuel inflation but do not contribute to our economic productivity.

The controls would not apply to the purchase of a primary home, domestic automobiles, agricultural and small business loans. There would be stringent controls on credit card borrowing and speculative borrowing by businesses and individuals.

I do not take this position lightly.

Credit controls should be instituted only under extreme circumstances. Credit controls were used successfully during and after World War II and during the Korean war to hold down inflation and cool the economy.

But we cannot allow inflation to continue at the current rate. We must do something to break the "inflationary psychology" which is crippling the economy, where people are borrowing at inflated interest rates to maintain their standard of living.

The credit controls, by themselves, will not solve our problems. We also must step up our efforts to decrease our dependence on expensive foreign oil. We must balance the Federal Budget for fiscal 1981 and set an example of austerity for

the country. We must increase productivity and modernize our industrial plants—our means of production—through tax incentives if necessary.

I believe credit controls should be implemented immediately, but they should be of a temporary nature. This move would help provide a cooling off period which will allow the President and Congress to formulate and place into effect long-range programs to stabilize the economy.

Senator Bentsen, I have attached a copy of my recent telegram to Chairman Volcker for your information.

I have no doubt that your hearings today will produce many constructive solutions to bring down our escalating interest rates. You have my support in this battle to bring about financial order to our hard-pressed financial markets.

Thank you.

Attachment.

MARCH 7, 1980.

Hon. PAUL A. VOLCKER,
Chairman, Federal Reserve System,
Washington, D.C.

DEAR MR. CHAIRMAN: The continuing rise in interest rates which may approach 20 percent in a short time is playing havoc with our national economic recovery.

Escalating interest rates have produced chaos in the bond market. Essential public and private long-term borrowing is grinding to a standstill. American consumers, panicked by rising interest rates, are dipping further and further into their disposable income to meet borrowing needs, some of which are counterproductive to long-term economic growth.

Although consumer borrowing has slowed somewhat, your recent actions to raise interest rates yet even higher acknowledges the failure of this policy to meet money supply targets.

Rising interest rates now appear to be adding to rather than stopping inflation.

Consequently, I would urge that within 30 days that you present President Carter with a credit control program that will have as its main components—(1) a major reduction in the prime lending rate down to the level of last October, and (2) a selective credit control program that will dampen down nonessential consumer borrowing and speculative business investment.

JIM SASSER,
U.S. Senator.

Senator BENTSEN. Gentlemen, we are very pleased to have you here before us this morning. I wish it was on a more pleasant subject, but once again it's trying to face up to this kind of problem. We have this morning Richard B. Fisher, who's the managing director, marketing department, Morgan Stanley & Co., Inc., Peter Goldsmith, vice president and manager, fixed income research department, Merrill Lynch; and Grady Patterson, treasurer of the State of South Carolina.

Mr. Fisher, you're first on the agenda.

STATEMENT OF RICHARD B. FISHER, MANAGING DIRECTOR, MARKETING DEPARTMENT, MORGAN STANLEY & CO., INC., NEW YORK, N.Y.

Mr. FISHER. Thank you, Chairman Bentsen. I am pleased to be here this morning. I am tempted to just say that I agree with you and let it rest at that, but in the hope some of the things we can say this morning might provide some information I will go ahead.

Senator BENTSEN. Now we have a number of people here who are behind you who would like to hear what you're saying, so please move that mike closer.

Mr. FISHER. At the outset, I'd like to make the point that I'm an operating businessman. I am responsible for our capital markets and

trading areas and not an economist. What I'd like to try to convey today is that our bond markets are in a seriously thin and unstable condition. These conditions are a result of a loss of confidence on the part of investors and the willingness of public policy to deal with the problem of accelerating inflation, and that time is running out in the sense that the next round of negative developments, if they come, will mean not only higher interest rates but some very fundamental structural changes in our capital markets which, once made, will be very negative for the American economy and, in our view, very difficult to restore.

Let me turn now to the specific questions that you asked us to address. The first was, what is the current situation facing the bond market. As I said earlier, it's clear to us that the suppliers of capital for our domestic economic growth have lost confidence in the willingness of public policy to deal with the problem of inflation. Events in the fixed income market since last fall clearly indicate that we have reached the point where if we do not do something about the problems of accelerating we are putting at risk the broadest and most effective capital market in the world.

You mentioned that since October we have suffered a loss in portfolio holdings in fixed income securities of approximately $500 billion. Despite returns of 14 to 16 percent which are now available on investment quality bonds, investors are reluctant to make commitments. Our markets have been characterized by fluctuations often as much as 100-basic points in several days of trading on very thin volume.

It seems to us that when an investor will not purchase an investment grade security at 16 percent—and we had one such offering last week—while it may be somewhat oversimplified, that investor is making the statement that they expect the inflation rate to remain at 12 percent or higher for the foreseeable future.

Obviously, another implication of these developments has been that very strong preference for liquidity. Probably the most dramatic piece of evidence there is, is the shift of funds into the money market funds. The latest number available shows those funds at about $60 billion, which is a tremendous increase in the last 6 months.

Senator BENTSEN. Everybody is going short term.

Mr. FISHER. Yes, exactly. We think it's fair to say that the current conditions in the bond market are extremely unstable with many investors questioning the viability of the basic contract which is represented by the long-term bond. One of the most frequent statements we have heard in the past 6 months made by professional investors is that under current conditions bonds are riskier than equities and all the old rules of thumb do not work. What is at risk, though, is much more serious than the staggering erosion of value which has been suffered by the holders of long-term bonds. In our view, we are risking the effectiveness of our capital-raising process in this country.

The second point you asked us to speak to was what is the future of the bond market. I think the point we would make here is that the normal kinds of things we would have looked at in the past really don't do much for us today. For instance, the question of a supply-demand imbalance. In many senses there is adequate capital formation going on today. The problem is really one of valuation. Investors will

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not buy 30-year bonds unless they believe there is a fair possibility that they will earn a real return by holding that security.

We think the single most damaging point is that each business cycle for the past 15 years has seen higher inflation and higher interest rates which is fairly compelling evidence that the secular trend is toward higher and higher inflation.

The future of the bond market, put very simply, depends on public policy initiatives in the next short period of time. If the market is not convinced that Government has the will to break this long-term trend, we will see not only substantially higher interest rates, but in our view the bond market as we know it will cease to function.

A third point you asked us to look at were implications of this situation for various sectors of the economy.

In our view, the fundamental problem is that, if uncorrected, we are headed down a boom-bust path. Economic activity is being driven at this point, 5 years into this particular business cycle, by inflationary expectations. You may have seen a report in the Wall Street Journal last week which we thought was interesting, interviewing families, and several families indicated to the reporter that they had now purchased their 1980 Christmas presents because they are convinced they will cost them 25 percent more if they wait until November. That's what is driving this economy today—inflationary expectations. Both individuals and businesses are spending beyond their means, and the one thing that's certain is that it will catch up to them.

The housing industry, as you pointed out, is being severely hurt by financing costs. Our concern is that it will not slow down but simply come to a halt. Business capital spending is going to be adversely affected in the near future both by the level of interest rates and, just as importantly, by the uncertainty of returns on investment.

Probably the most significant negative implication, however, in our view, is for the terms of our capital markets. Investors will defend themselves against these developments and if the current situation continues to prevail they will demand shorter maturities, faster amortization, better call protection, and extremely unfavorable features such as "puts back" to the issuer which invariably increase the cost of capital.

Senator BENTSEN. Our big advantage over the Europeans has been for years that we have had long-term financing in this country. We have been able to sell long-term bonds because investors felt there was some stability and some protection against inflation. This has certainly been a tremendous advantage to American business.

Mr. FISHER. That's exactly right. We trade securities in London also and whenever I'm over there talking to European investors they can't believe that it's possible for our telephone company to sell 40-year bonds without a sinking fund. It's completely foreign to what they have had to protect themselves against, and it's a national asset.

In our view, the changes that I described would mark a major negative step for the U.S. capital markets and the implication is that these steps would greatly increase the cost of raising funds, greatly increase rates for new investment, and have serious implications for further growth.

Now the fourth point you asked us to look at was the question of public policy options which could help alleviate this situation.

In our view, the most important point to recognize—and this has certainly been said before but we think it's absolutely critical—is that the Federal Reserve cannot do it alone. The market has lost confidence in the long-term trend because fiscal policy has not been supportive of what the Federal Reserve has been trying to do.

To restore confidence, we believe the market must see budgetary restraint which will result in lesser demands on the market by the Treasury and again, as you pointed out in your opening remarks, to the extent that some room for them can be developed, tax incentives must be developed which will encourage investment, productivity, and savings.

Probably the single worst thing in our economy today from the individual and smaller institutional point of view is that there's no incentive to save. There is no real return. The system has many, many artificial impediments and market impediments to the saver being encouraged, and you know what's happened to the savings rate in our economy.

Now again, as you pointed out, the market actually has acted well for the last couple of days. We did have a rally on Friday and the market had—the long-term fixed income market had a decent tone Monday and Tuesday and the reason for that has been some encouraging speculation about balanced budgets and other discipline on the fiscal side.

Confidence can be restored. I think the market is telling us that. It is possible. But there is not a great deal of time left. If the next several weeks do not bring positive developments in the public policy area, in our view, the credit markets will return to their crisis state, and we will be on our way to destroying our capital markets.

Thank you.

[The prepared statement of Mr. Fisher follows:]

PREPARED STATEMENT OF RICHARD B. FISHER

Chairman Bentsen and members of the Joint Economic Committee of the Congress. My name is Richard B. Fisher and I am a Managing Director of Morgan Stanley Inc. Since my operating responsibilities bear directly on all phases of the capital raising process, I am pleased to have the opportunity to address you today on the current situation in the bond markets.

That situation can only be described conservatively as a crisis. The effects of the sharp decline in bond prices in recent months extend far beyond the obvious impact upon and concern of those directly involved in the securities markets.

The decline has been the most precipitous to occur in a short period of time. It is estimated that the value of bonds held in portfolios has dropped some $500 billion since October. This is a loss of approximately 20 percent in the value of all bond holdings.

What is of particular concern is that even with interest rates in the range of 14 percent to 16 percent on new long-term offerings of investment quality corporate issues, buyers are few—and reluctant. While this may be somewhat oversimplified, it seems to us that a bond buyer who will not purchase a high-grade 30-year bond at 15 percent is making the statement that he or she expects the inflation rate to exceed 12 percent for the foreseeable future.

Traditionally, we might expect the market to "clear" as interest rates rise. And they have been rising quite sharply in the past several weeks. Changes of 50 to 100 basis points[1] or more in daily trading have not been unusual in certain maturities.

Nevertheless, higher returns have not tempted purchasers. What is particularly disturbing is that the sharp changes in prices have not occurred on significant

[1] Basis point is one-hundredth of a percent.

volume. The numbers of buyers and sellers in the bond market has been shrinking. Fluctuations have been wide precisely because of a relatively small number of bids and offers. The great hallmark of our domestic capital markets over the years has been that there were many factors on both sides of the market with the result that a minor price change would result in business being done.

The deterioration has been accentuated by the sharp increase in short-term borrowing costs which has discouraged investment firms from positioning securities to facilitate market-making. This further reduces the depth of the market and accelerates the trend toward sharper fluctuations in price. A less noticeable influential factor has been a substantial reduction, particularly since 1973, in the number of securities dealers with a consequent effect on market liquidity.

Consider some of the broader implications of these developments.

In 1974, the credit crunch appeared to offer significant bargains in bonds to individuals. High yields spurred individual purchases of $6.4 billion in bonds compared with $2.7 billion in similar commitments by private non-insured pension funds. But investors soon learned that continued inflation meant risk of loss in principal value and individual purchases of bonds declined in every year since 1974, dropping to an estimated $600 million in 1979.

The risk in bonds and the restricted returns on other fixed income investment media impelled investors to put substantial sums in money market funds where returns would be more commensurate with an annual inflation rate that was climbing above the 10 percent level. As of February 27 of this year, assets of such funds were a record $59.9 billion. Since the beginning of 1980, their assets have been growing by $6 billion to almost $8 billion every four weeks.

The trend is disturbing, but cannot be considered surprising. With last week's report on the trend of producer prices suggesting that the nation's inflation rate is now in the 18 percent to 20 percent range, one can hardly expect investors to be attracted to high bond yields which now offer less return than an apparently accelerating inflation rate and are on par with returns on short-term instruments where the risk of loss of principal is minimal.

The buildup of money market funds has contributed to disintermediation of funds from thrift institutions and from commercial banks. That, in addition to the portfolio losses which such institutions have suffered on their bond holdings, has forced them to pay higher market rates to obtain loanable funds on a short-term basis. Moreover, impaired liquidity of many financial institutions indicates possible danger for borrowers who are heavily dependent upon them as a source of financing. The construction industry, for example, is particularly susceptible to the liquidity status of thrift institutions. Furthermore, there is great risk with today's conditions to those institutions who have borrowed short to lend long. They will be strained and forced to sell securities for liquidity reasons at exactly the worst time.

Pension funds no longer feel assured, even with tax incentives, that long-term fixed income commitments should be relied upon as the major source of funds to help satisfy future pension obligations when inflation is accelerating. Future pension obligations, after all, will be related to retirement salary levels which are likely to climb in line with the pace of inflation. So pension funds are shifting to proportionately greater commitments in stocks. In 1978 private non-insured pension funds purchased $7.4 billion in corporate bonds and $5.3 billion in corporate stocks. In 1979, they purchased an estimated $6.3 billion in corporate bonds and $10.5 billion in corporate stocks.

The accelerating trend of inflation and interest rates and the uncertainty of return on new investment is also having a dampening effect on corporate financing plans which must be of particular concern to members of this Committee and, indeed, to everyone in the nation.

At a 15 percent coupon, financing costs are causing many companies to reconsider, postpone, or halt financing plans. Even the after-tax cost of borrowing at such rate levels raises serious questions about increased operating costs. To be sure, such costs often can be substantially passed on to customers—but not always, and not without upper limits from customer resistance and competition. The adverse impact of higher financing costs is particularly difficult for growing corporations which are not as seasoned but which demonstrate significant potential for growth as indicated, for example, by innovation and technology. Such companies currently may be faced with long-term financing costs of 17 percent or more. At that point, the hurdle rate—or minimum prospective return necessary to justify the investment—may not be attainable. When long-term investment in the private sector slows down, job creation and, consequently, income and tax revenue growth also suffer.

And investors—institutional and individual—are telling us through the marketplace that they simply don't believe that such coupon rates will compensate them for the risk of inflation which they see continuing to accelerate.

In that type of environment, desirability of investment in long-term bonds is questionable. At Morgan Stanley, we have two potential scenarios for returns on high grade bond investment over the next three years. The worst assumes continued slow economic growth of about 2 percent per annum with the underlying inflation rate rising to 17 percent and a meager total return of 3 percent per annum to 1983. A more probable scenario would be an underlying inflation rate of 9 percent, continued slow economic growth with a three-year total return of 17.4 percent per annum. But we still view short-term instruments as preferred investments because they have less risk than long-term instruments—especially if the forecast is wrong and the pace of inflation keeps stepping up. Furthermore, when we look at the experience of securities markets in other nations, the kind of fallout we have endured in the bond markets in recent weeks is usually followed by investor demand for a wider risk premium over the inflation rate stretching from 300 basis points to 400 or even 500 basis points.

In short, there is a pervasive fear that future returns on investment are increasingly difficult to estimate with any feeling of confidence. And where value in the future is increasingly less predictable and, consequently, less attractive to investors, commitments will continue to be made primarily in short-term instruments.

The reason for this preference for high liquidity should be obvious. It is the market's way of saying, in effect, "we see no convincing sign that inflation is being brought under control. Until we can believe that the major causes of inflation are being dealt with on a continuing and comprehensive basis, the future is simply too risky a place in which to make investments."

The evident determination of Federal Reserve policy—especially since last October—to stem monetary growth by focusing, for example, on availability of reserves in the banking system is salutary and will be effective. It doesn't help the current situation in the bond market but over time slower monetary growth will lead to reduced spending and lower inflation and that should have a positive effect on financial asset prices. Caveat—Once there is a widespread belief in the market that the Federal Reserve will stick to its policy of moderate expansion, the rate of inflation may be expected to decline.

But full restoration of confidence in the market also depends upon the credibility of overall national economic policy—fiscal and monetary—in combating inflation. There appears to be a consensus that control of inflation is desirable.

If monetary policy continues to bear an undue proportion of the burden alone, it can fail. And each time it fails, it becomes harder for policy actions to appear credible the next time around.

The Fed will find it hard to succeed without the support of a fiscal policy which addresses itself firmly to more effective control of the national budget, especially with respect to controllable programs. One must note that continued inflation wreaks havoc with such "uncontrollables" as the cost of debt service. A new 30-year Treasury Bond issued in mid-February with an 11¾ coupon is already yielding over 12 percent. The import for future financing costs is obvious—if the situation is not brought under control.

National expectations of fiscal prudence will be matched by scrutiny of the fairness of fiscal policy. Present projected increases in budget outlays for the next three fiscal years will be accompanied by an even larger increase in the Federal tax burden. If no changes are made in present rates, Federal receipts would rise to a record 22.4 percent of the Administration's assumed level of GNP during that period. That would compare to 21.9 percent of GNP at the peak of World War II. That suggests that widespread political pressure for tax reductions may be increasingly felt here in Washington. In that event, I hope that consideration will be given to non-inflationary incentives to the supply side of the economy which are designed to increase investment rather than immediate consumption which is clearly inflationary and would simply undermine any beneficial effects of a firm monetary policy.

Unless and until public economic policy is widely perceived to be aware of the continually depressing effects of inflation on long-term financing markets, crisis conditions will continue to prevail. This is not a situation that will unwind smoothly. Unless it is recognized and dealt with, the basic strength of the U.S. capital market will change unfavorably for issuer and investor alike.

The major implication is not simply that interest rates will head even higher. We are running a serious risk at the present time that the terms on which financ-

ing will be available will deteriorate significantly, particularly in the areas of maturity, amortization, call protection and the inclusion of extremely unfavorable features such as "puts back" to the issuer at the option of the holder. These developments, if they should occur, would mark a major structural change in our capital markets and the implications go far beyond the fact that the cost of capital will increase.

State and local governments will face rapidly rising financing costs while their revenue bases may be limited or declining—not to mention increasingly contentious about the level of taxation as indicated by the type of sentiment engendered by Proposition 13 in California.

Unless cost pressures—short-term and long-term—affecting issuers and dealers abate soon, the volume of financing and marketing of long-term securities may diminish at a rate which contributes to even greater volatility in bond prices.

The difficulties in the long-term markets are disturbing enough; we are now seeing distressing signs of illiquidity in the short-term market as well. Prices of financial assets are moving markedly lower. Sharp fluctuations in price have become increasingly frequent with wide spreads of as much as a full percentage point (100 basis points) or more between buying and selling prices for short-term instruments where the normal differential would be five to ten basis points. Worse still, availability of credit, even to high grade borrowers, is shrinking.

Now, the entire market—short-term and long-term—lacks confidence that the problem of inflation will be dealt with. If the market's perception is correct, the portents are dangerous for the securities markets and the entire nation.

There is an understandable fear of going "too far" to correct such problems. But the failure to act with the resolution required to achieve meaningful results has meant that each succeeding step has fallen short of what is needed to do the job.

The inflation rate is now telling us that the job must be done—and soon.

Senator BENTSEN. Thank you, Mr. Fisher. Mr. Goldsmith?

STATEMENT OF PETER N. GOLDSMITH, VICE PRESIDENT AND MANAGER, FIXED INCOME RESEARCH DEPARTMENT, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., NEW YORK, N.Y.

Mr. GOLDSMITH. Thank you, Senator. It's a privilege to be here to address maybe not this particular problem but to discuss it in terms apart, as with Mr. Fisher, from the economist's standpoint—from the standpoint of one who began trading Treasury securities some 15 years ago when interest rates were 4 percent. We have come a long way since then and we stand at risk and all of the commentary so far, including the opening statement, supports the fact that we recognize that there is a crisis in the bond markets and those long-term bond markets where that crisis is so severe are the source of funds for permanent capital for investment and for fixing a rate for the cost of funds over a prolonged period of time.

To judge from the comment that we see short-term rates going up and the cost to the Treasury, we are right now discussing cutting some $15 billion out of the 1981 budget. If we were to assume that the Treasury has in marketable debt some $200 billion of Treasury bills which must be refunded and refinanced in the coming year and we look at the market about 1 year ago where the cost of financing was somewhere around 8 percent—and you will notice I like round numbers—if we raise that simply to 16 percent or very close to current levels, we have used up the reduction in spending for 1981. It would appear perhaps that we are still pushing against a strain.

However, the marketplace in its crisis state is pointing to the fact that it too is looking, as have many voters around the country, for

some restraint on the part of the Federal Government as has been imposed, perhaps not as severely, as that imposed in some local municipalities. It would appear that the market is saying that if we cannot balance our budget, then we will have no incentive to create permanent capital and, therefore, no incentive to purchase or invest in long-term securities, and the problem would then become compounded.

As we shorten the average borrowing and as we use those funds for continuous working capital and it has to be rolled over on a continuous basis, then we are locked into a marketplace without confidence, where the cost of funds can rise on an ever-increasing basis, much more rapidly than if we maintain our market as it is.

Now what has created this loss of confidence on the part of the investors? We have already stated that this is a crisis condition, but it helps to review perhaps some of those numbers which support this.

We follow on a regular basis the capital markets of investment grade securities, those marketable investment grade securities, which at the moment represent some $593 billion in par value or redemption value of securities outstanding. At the end of December, the market value of these securities was some $512 billion. In the months of January and February, the total returns achieved on these securities—and we have to remember that fixed income investments pay a regular coupon that is stated, that coupon being 8¼ percent over a lifetime of some 11.67 years—lost approximately 8.5 percent in market value in the first 2 months of this year. This suffices to create that negative atmosphere and that crisis condition on the part of investors who indeed are seeking, as has been stated, to realize a real rate of return.

That real rate of return over inflation over the last 20 years or so has been in the neighborhood of 2 to 3 percent—not a very large return, but nonetheless, a positive return—and as Mr. Fisher pointed out, today the marketplace would be indicating that perhaps it is expecting inflation to be somewhere in the neighborhood of 13 percent, if indeed the investor is demanding 15 or 16 percent as an interest rate for a long-term investment.

These are the crisis conditions that prevail. The market is looking for definitive and continuous action on the part of budget makers in attempting to balance and bring into check the excess spending which has been occurring over the last 10 or 15 years. It's not a simple matter. We realize that. Nonetheless, the confidence has eroded over a period of time. Confidence can be restored, and it must continue, as you pointed out, not only for this year, but we must begin looking at next year as well, and anticipating conditions which, if we had crystal balls—and I showed a chart to Mr. Fisher here before we began and he said, "Gee, I wish you could have produced that back in October"—simply displaying what is on this board here now. We can't foresee what is going to happen specifically, but we can begin to work with these situations. If indeed we do not get some of the measures which we are looking for, then it would become apparent that renewed confidence which appeared and has appeared with each rumor coming from Washington on a regular basis can erode rather quickly and it's conceivable that having covered the ground that we have over the period of the last several months we can cover as much ground in a short time in the future—that is, looking for the possibility of a total loss of confidence

and seeing short-term rates approaching 20 percent and long-term rates following suit or indeed ceasing to exist.

Back in 1974, after the oil embargo, we experienced a credit crisis and we estimated that the value of the market or the level of interest rates was some 15 or 16 percent. Indeed, back in 1974, one could question whether there was a ceiling on long-term interest rates or, very simply, if investors had refused at that time to lend money long term to any but the highest quality borrower. At least today at this moment we are willing to lend to the high quality borrowers. The price is steep, but that willingness is going to disappear if we don't take the measures necessary to begin to correct the current problems. Thank you.

[The prepared statement of Mr. Goldsmith, together with attachments, follows:]

PREPARED STATEMENT OF PETER N. GOLDSMITH

The attached copy of Merrill Lynch's Bond Market Comment (Attachment No. 1) (Volume 3, No. 10, March 7, 1980) describes the fixed income capital markets as they have appeared for the last several weeks. It is difficult for a sometime observer to understand completely the nuances of what has occurred in the markets since the beginning of the year. Background for that understanding is also contained in the attached Fixed Income Selector (Attachment No. 2) (Volume 3, No. 2, March 1980) which attempts to translate the magnitude in the decline in bond prices in such a way that most part-time observers can better appreciate it.

INFLATION

The basic concern of most fixed income investors has been the erosion in the purchasing power of the fixed return (the coupon) against a continually escalating rate of inflation. Traditionally, fixed income investors have expected to earn somewhere between two and three percent after deducting the rate of inflation from their investment. In the last year, however, the rate of inflation has exceeded the return on fixed income investments; see Bond Market Comment (Attachment No. 3) (Volume 3, No. 9, February 29, 1980) for a further discussion. We are not here to attempt to define all of the causes of inflation but to translate the concerns that inflation has caused in the bond market and to discuss the problems of the bond market.

Beginning in early January, most investors concluded that very little, if anything, was being done to attack the underlying rate of inflation and that it was escalating more rapidly than had been assumed. The concern about Afghanistan and the ensuing call for greater defense appropriations convinced bond market participants that the budget for fiscal 1981 could provide little if any relief from deficit spending which, as we know by now, is highly stimulative to the economy. After the budget message was delivered, even the less skeptical investors were convinced that inflation would continue and would even accelerate. Judging from the Producers' Price Index and other measures, they were not disappointed.

To seasoned bond market observers, the impact of investor reluctance to commit funds at rates below that of inflation was almost startling. Interest rates in the bond market rose almost one full percentage point a week through the first part of February. The losses on existing investments amounted to about 15 percent in this brief period. I am sure that sometime in the future we will discuss the first quarter of 1980 as that point at which a "buyer's strike" occurred. Bond buyers are, for all practical purposes, long-term lenders. One may therefore say that long-term lenders refused or were refusing to lend money at levels which cannot compete with the rate of inflation. More recently, short-term rates have risen further than long-term rates, and short-term lenders are also refusing to lend money at rates below that of inflation.

HOUSING

A more common approach is to consider the impact of current capital market interest rates on borrowers. In this case, one must observe that, if lenders refused to lend, there is no money for the borrower to borrow. Since the last week in

February, we have begun to realize that indeed many borrowers are finding their source of funds severely limited. We refer to this process as "crowding out." Initially, those borrowers who are reluctant to pay the going price (for whatever reason although the most common is that money is too expensive) are crowded out of the marketplace. This crowding out seems to have occurred first (as it usually does) in the housing sector sometime in late 1979. This was when mortgage rates began approaching the low teens nationwide. Much of this earlier loss of funds to the housing sector began to occur when artificial rate ceilings were first reached and then as open market rates rose faster than mortgage rates could be increased. Interest rates in this sector today are at such a level that it becomes questionable if borrowers (even if the money were readily available) would be willing to pay the price.

The crowding out in the mortgage sector is likely to continue. Thus, a new major borrower has appeared in the tax-exempt market: the local housing finance agencies. Due to the supply of paper in this sector of the tax-exempt market, the proposed cost of money to the borrower is now approaching 11 percent. Thus, although funds are being reluctantly committed to housing, it remains to be seen whether mortgages can be committed at rates in excess of 12 percent or whether, at these levels, the borrower chooses not to take down the mortgage.

THE CONSUMER SECTOR

The consumer appears to continue to borrow, albeit not as quickly as he has over the last several years. As open market rates have not exceeded the usury ceiling in many instances, there is obviously a reluctance on the part of intermediaries such as banks and finance companies to continue lending at what would be negative spreads. In plain language, to do so would require committing funds for a lesser price than they cost; all of us recognize this as being a poor business practice. Another way of looking at this situation is to reflect that money market rates are finally becoming restrictive.

The restrictiveness is obviously felt first by the consumer who has an option of not borrowing by depleting his savings. As we are aware, the latter has been occurring, although by some accounts savings (if one includes other than passbook accounts), can be depleted still further. To date, the corporate borrower has not yet been crowded out of the marketplace. If one considers the automobile industry and the falling demand for U.S. cars, then the cost of money even without rebates and other discounts is continuing to jeopardize the profitability of the industry for dealers can no longer afford to carry inventory. However, as long as it appears that the consumer is capable of and willing to borrow to continue to purchase, major institutional borrowers will continue to borrow to finance inventories. These inventories will eventually be sold and, as long as prices are rising, those who accumulate them don't appear to be concerned as to the expense involved in carrying the inventories until they are sold.

Should the restrictiveness of current rates begin to slow consumer purchases, then the institional borrower will still have to continue to carry inventories. The level of these inventories would then begin to increase as sales ultimately decline. This process would continue to exert upward pressure on short-term interest rates until it becomes apparent that the entire process is beginning to create an obvious recession. Then, and only then, would it become apparent to many investors that they should be willing to commit funds at interest rate levels which will eventually begin to recede.

TURNING POINT

During this "topping out period," the markets would traditionally begin to experience a credit crisis. This crisis is different from a "credit crunch" in that the market perceives that the weaker credit cannot afford to borrow and therefore lends only to the most secure borrower. This process of crowding out will cause more concern to the investor and will reduce his willingness to lend money even more. Thus, it is usually at this stage that market observers become most concerned. The last time that this occurred was after the oil embargo in 1973 when, in 1974, investors became unduly concerned about the viability of less secure public utilities. Yet, the fixed income markets appear to be unconcerned about this aspect since no one yet perceives a credit crisis.

At this stage, with the availability of funds still plentiful from overseas, it is difficult to envision a panic other than that caused by inflation. However, should the inflationary spiral be broken, then it is possible that during a retrenching a credit crisis can occur.

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At the moment, the only factor that appears to be working is the actual level of interest rates themselves. Daily, borrowers are deciding not to fund themselves because the cost of borrowing is too high. The process continues to be most apparent in that sector of the market reserved for political subdivisions. Thus, it appears at the moment as if the public body will suffer the greatest problems throughout a period of restrictive pricing; this, in turn, tends to create the greatest concern to political officials. There is, of course, less apparent concern with the corporate entity who trys through pricing to recoup the price of financing inventories or even for the consumer who will ultimately purchase those goods as long as money is available to him. It appears that not until the consumer finds it too expensive to borrow, in order to continue to purchase, will potential lenders become convinced that the nation is dealing with all of the underlying problems of inflation.

As long as the fixed income markets observe that there is no real willingness on the part of government—both federal and local—to reduce spending, they will remain extremely unsettled. Lenders will continue to refuse to commit funds at interest rates that do not provide a real rate of return. Should this occur, the paralysis which has surrounded the long-term capital markets will spread.

Attachments.

Merrill Lynch
Pierce
Fenner & Smith Inc.

Bond Market Comment

Fixed Income Research Volume 3 Number 10

March 7, 1980

THROUGH THE LOOKING GLASS

It is exceptionally difficult to focus on the course of the fixed income markets over the foreseeable future, as events unfold daily -- if not with greater frequency. For the last several weeks, since it has become apparent to many observers that a state of emergency should be declared to encompass the credit markets, they have at least stabilized within a broad trading range. With the markets under seige, the concept of a state of emergency was easily accepted by the market as the economic data continues to indicate that the rate of inflation is escalating far more than had been expected. That definitive action would have to be taken is also a part of that concept. The initial focus of the market was upon definitive action regardless of what type. Therefore, emergency action was classified as controls since everything could fall into a single definition. The specifics could initially be avoided under that broad concept.

Since the concept of a state of emergency is easily understood and requires little time to initiate, controls or some form of levers became the immediate solution. However, most natural disasters are more easily understood and solutions more apparent than those applied to the economy. The state of the economy is more difficult to explain and the inflationary psychology even harder to break. Remedies appear relatively straightforward on paper. However, implementation of procedures to relieve the pressures of inflation are more difficult to establish. Complicating the process is the fact that this is an election year -- which means implementation can be achieved only if campaigning factions can accept them. In a democracy, politics becomes the art of compromise -- a drawn-out process at best. Therefore, it has been apparent since the inception of the state of emergency concept that the solutions would require several weeks or even a month to be resolved and that only those which were acceptable would be introduced. Thus, in developing a solution to the problem, one must consider the political implications and must focus only upon solutions which have a better-than-moderate chance of being implemented.

The problem in our view calls for a double-barrelled approach. In the first barrel are those measures which can be considered to immediately focus upon and perhaps temporarily alleviate the problem. In the second are those measures

(Continued on page 3)

The information set forth herein was obtained from sources which we believe reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation by us of the purchase or sale of any securities or commodities.

Money Markets

	ONE MONTH		52 Week		THREE MONTHS		52 Week		SIX MONTHS		52 Week		ONE YEAR		52 Week	
	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo
U.S. Treasury Bill	14.60	12.79	14.60	8.67	16.40	14.11	16.40	9.12	16.51	14.78	16.51	9.38	15.93	14.97	15.93	9.22
Federal Agency (F.I.C.)									16.53	15.37	16.53	9.20	15.45	14.32	15.45	8.92
Certificate of Deposit	17.95	14.85	17.95	9.63	18.70	15.45	18.70	9.83	18.90	15.85	18.90	9.80	18.90	15.25	18.90	9.75
Bankers' Acceptance	17.80	14.75	17.80	9.68	17.05	15.00	17.35	9.84	17.75	15.05	17.75	9.90				
Commercial Paper	16.35	14.50	16.35	9.86	16.25	14.88	16.25	10.10	16.30	14.00	16.30	10.24				
Finance Paper	16.25	14.50	16.25	9.38	15.00	14.00	15.00	9.38	15.00	13.00	15.00	9.13				
Eurodollar	17.80	15.50	17.80	10.27	18.35	16.30	18.35	10.22	18.43	16.55	18.43	10.12	17.53	15.95	17.53	10.20
Project Note					6.50	6.50	7.25	4.35	7.25	7.00	7.50	4.50	7.25	7.00	7.50	4.80

Governments

U.S. TREASURY

Maturity	3/7	2/29	52 Week Hi	52 Week Lo
3 years	14.04	13.59	14.04	8.61
5 years	13.25	12.64	13.25	8.57
7 years	12.93	13.17	13.22	8.69
10 years	12.47	11.82	12.71	8.78
15 years	14.45	12.59	14.45	8.82
20 years	13.62	12.36	13.62	8.73
25 years	13.43	12.17	13.43	8.73
30 years	12.97	12.30	12.97	8.83

G.N.M.A. Pass-thru (Yield to 12 yr. Avg. Life)

	3/7	2/29	52 Week Hi	52 Week Lo
8½% coupon	13.36	12.82	13.36	9.19
9 1/2% coupon *	13.47	13.30	13.64	9.00

FEDERAL AGENCY (F.N.M.A.)

Maturity	3/7	2/29	52 Week Hi	52 Week Lo
3 years	13.17	13.74	13.74	8.86
5 years	11.82	13.78	13.78	8.80
7 years	12.73	13.51	13.51	8.95
10 years	12.57	13.24	13.57	8.95
15 years	14.10	13.48	14.10	8.93
20 years				
25 years				

Corporates

	Aaa		52 Week		Aa		52 Week		A		52 Week		Baa		52 Week	
	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo
Utility:																
New Long-term	13.83	13.63	14.25	9.30	14.25	14.25	14.53	9.53	15.00	14.88	15.13	9.85	16.00	15.63	16.00	9.50
6.0% Long-term	12.65	12.33	12.70	9.80	13.43	13.00	13.50	9.10	13.75	13.60	13.85	9.30	14.75	14.70	14.75	9.75
7½% Long-term	13.10	12.70	13.10	9.05	13.50	13.20	13.55	9.25	13.85	13.75	13.85	9.50	14.40	14.50	14.60	9.90
9.0% Long-term	13.30	12.85	13.30	9.20	13.70	13.35	13.70	9.40	14.00	14.00	14.00	9.70	14.75	15.00	15.00	10.05
New Int.-term	14.00	13.75	14.00	9.00	14.25	14.25	14.25	9.25	14.75	14.75	14.75	9.50	15.50	15.25	15.50	10.13
Industrial:																
New Long-term	13.25	13.30	13.25	8.95	13.63	13.50	13.75	9.10	14.38	14.00	14.50	9.40	15.50	15.50	15.50	9.85
New Int.-term	13.88	13.63	13.88	8.85	14.13	13.88	14.13	8.90	14.50	14.13	14.50	9.15	15.50	15.00	15.50	9.65
Finance:																
New Long-term	14.03	13.75	14.33	9.37	14.38	14.13	14.38	9.45	14.88	14.63	14.88	9.70	16.30	16.30	16.30	9.95
New Int.-term	14.33	14.33	14.33	9.23	14.50	14.25	14.50	9.30	15.00	14.75	15.00	9.50	15.50	15.25	15.50	9.88

Municipals

NEW GENERAL OBLIGATIONS

Maturity	Aaa		52 Week		Aa		52 Week		A		52 Week		Baa		52 Week	
	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo	3/7	2/29	Hi	Lo
1 year	7.25	7.00	7.25	4.75	7.25	7.00	7.25	4.75	8.00	7.25	8.00	5.10	9.00	8.25	9.25	5.80
3 years	7.25	7.00	7.25	4.90	7.25	7.00	7.25	4.95	8.00	7.25	8.00	5.15	9.00	8.50	9.50	6.20
5 years	7.25	7.00	7.25	5.00	7.30	7.10	7.30	5.05	8.30	7.35	8.30	5.20	9.25	8.75	9.50	6.30
7 years	7.35	7.10	7.35	5.00	7.40	7.20	7.40	5.10	8.40	7.45	8.40	5.35	9.50	9.00	9.50	6.50
10 years	7.50	7.25	7.50	5.10	7.60	7.35	7.60	5.25	8.60	7.75	8.50	5.40	9.75	9.25	9.75	6.75
15 years	7.75	7.75	7.75	5.30	7.85	7.85	7.85	5.40	8.85	8.10	8.70	5.55	10.00	9.75	10.00	6.90
20 years	8.10	8.00	8.10	5.55	8.25	8.15	8.25	5.70	9.25	8.50	9.25	5.90	10.25	10.00	10.25	7.00
25 years	8.25	8.25	8.25	5.45	8.35	8.40	8.40	5.95	9.35	8.70	9.00	6.10	10.25	10.00	10.25	7.25
30 years	8.25	8.25	8.25	5.95	8.35	8.40	8.40	6.10	9.35	8.70	9.00	6.25	10.25	10.00	10.25	7.35

	3/7	2/29	52 Week Hi	52 Week Lo
Bond Buyer Eleven Bond Index	8.44	8.20	8.44	5.57
Sund Buyer Twenty Bond Index	8.94	8.72	8.94	6.38
ML Medium Grade Municipal Index	9.73	9.66	9.73	6.85
ML High Grade Municipal Index	9.22	9.15	9.22	6.34

PREFERRED STOCKS:

	3/7	2/29	52 Week Hi	52 Week Lo
New AA Perpetual	12.25	11.75	12.25	8.80
New A Perpetual	13.25	12.75	13.25	9.20
New A Sinking Fund	12.00	11.50	12.00	8.50

REVENUE BONDS

	3/7	2/29	52 Week Hi	52 Week Lo
Public Power ($100 mil, new gen. fac., net rev., 40 yr., A1/A+)	9.60	9.50	9.60	6.75
Toll Road ($100 mil, tpke. imp., net rev., 35 yr., A/A)	9.60	9.60	9.60	6.70
Housing Authority ($100 mil, Section 8 Fed. subsidy, mtge. payment, 30 yr., A1/A+)	9.70	9.50	9.70	6.90
Housing Authority ($50 mil, single fam. fully ins. mtge. payment, 30 yr., Aa/AA)	9.50	9.50	9.50	6.50
Hospital ($25 mil, expans. & renov., gross receipts, 30 yr., A/A)	10.00	10.00	10.00	7.00
Pollution Control ($25 mil, utility, 1st mtge. rank, 30 yr., A/A)	9.60	9.60	9.60	6.50
Pollution Control ($25 mil, industrial, debenture rank, 30 yr., Aa/AA)	9.00	9.00	9.10	6.25
Airport (117 mil., airpt. imp., net rev., 30 yr., A1/A)*	9.50	9.25	9.50	8.00

Money and capital market yields are based on offering prices and represent actual market rates or MLPF&S estimates as of Thursday afternoon. Aaa-rated utility rates are derived from Bell System subsidiaries and all other utility rates are derived from electric utilities. Preferred stocks are new money electric utilities. ML medium grade Municipal Index is a composite of long-term A and Baa-rated tax-exempt bonds. Terms of maturity of long-term Governments are approximate. G.N.M.A. Pass-thrus are secured by government insured mortgage pools having an initial average life of twelve years. Project Notes are government guaranteed and tax-exempt. Certificates of Deposit and Bankers' Acceptances are of large money center banks and are dealer placed. Commercial Paper is prime and dealer placed. Finance Paper is prime and directly placed. Eurodollar yields are London rates.

* 52 week his and los are as follwos: Airport Revenue from September 1979 and 9 1/2% GNMA from May 1979.

developed and implemented over time which lead to a long-term cure. Thus, the concept of temporary credit controls has served to stabilize long-term interest rates. Although, with each passing day, the potential effectiveness of credit controls dwindles as possible options are discarded as being either impractical or unsatisfactory. Nonetheless, the discussion of the possible need for them served to emphasize and clarify the severity of the problem.

In addition to the discussion of controls should come a measure from the Federal Reserve which will further restrict the availability of credit. Having been the only bastion waging war against inflation, the Federal Reserve must now continue to do so, possibly with renewed determination. According to speculation in the marketplace and judging from the relationship between the discount rate and the level of federal funds, the Federal Reserve should in our opinion probably raise the discount rate perhaps by as much as 2 percentage points. This effort should be accompanied by the continued support for orderly expansion of the banking system and continued determination not to support the speculative growth of credit. The situation is becoming more critical for Federal Reserve policy as the current high cost of money is beginning to show signs of arresting the demand for credit, particularly in the municipal sector where artificial ceilings are reducing the ability of municipalities to borrow. As the level of interest rates becomes even more restrictive to borrowers, the Federal Reserve will find itself in a position of having to guarantee that there is sufficient credit in sectors of the market that become particularly affected where such things as inventories must be financed to avoid a possible panic situation. This is a role that under normal circumstances the Federal Reserve does not play, but one should not lose sight of the fact that it is the lender of last resort to the banking system.

The longer range solution to the current problem is the eventual reduction in spending by the Federal Government. Traditionally, in an election year, budget cutting is an unpalatable exercise. However, in light of the current rate of inflation, limiting the budget appears to be gaining bipartisan support in the Congress. The current budget deficit appears to have escalated substantially without limits, too. Yet, when one attempts to locate areas of spending that can be reduced, one has great difficulty, but even a token cut should have a salutory impact on the debt markets. The 1981 fiscal budget introduced in late January can be cut, however. One could say that the bulk (approximately 90%) is uncontrollable and cannot be reduced. Nonetheless, a reduction in those items that can be cut should serve as adequate intent to begin to correct the situation at its source, particularly if the politicians are willing to include social welfare programs.

It is unlikely that the economic message which the President will ultimately deliver will contain any startling new proposals when it finally comes. In a democracy, one must remember that the art of compromise is paramount and the presentation of an economic package which will be totally acceptable to all parties involved is key. The market will have ample opportunity to respond and indeed has responded already to various proposals. Thus, one could begin now to focus upon the impact that this package will have upon the fixed income markets and to restructure strategies to take advantage of the purpose for which the package is intended.

It would appear to us that the fixed income markets are at a turning point and will remain there for at least several weeks. Should a strong message emanate

from Washington, the market will display a sense of relief. Although a strong message will create restrictive pressures in the short-term market and is likely to force rates still higher, much of the pressure should be relieved for the long-term markets. Although a sustained rally in long bond prices is not likely to take place, activity should begin to increase as investors begin to feel more confident that relief from current economic pressures is on the way. Should the ultimate message be a weak one, then short-term rates are likely to rise considerably further and could even approach the 20% level. Under this scenario, long-term rates are also likely to rise precipitously, perphaps by as much as 1-2%. Since the cost of money is already becoming restrictive, these possible levels should begin to assure a curtailment in the demand for credit. The attention being focused on the credit markets from Washington seems to be more constructive than a skeptical market might be anticipating. It would appear that no hastily conceived remedies are likely to be imposed. Therefore, we would caution investors to review strategies and to begin to establish positions at historically high current levels. Should policy review taking place in Washington be more successful than anticipated, the response in the marketplace is likely to provide little opportunity to reconsider investment opportunities.

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Fixed Income Selector

Fixed Income Research

Volume 3 Number 2

March 1980

A Monthly Discussion for Individual Investors Interested in Fixed Income Securities

Highlights:

- Retail sales rebound in January
- Has the market adjusted adequately to inflation?
- Can a case be made for Bonds?
- Investor guidelines

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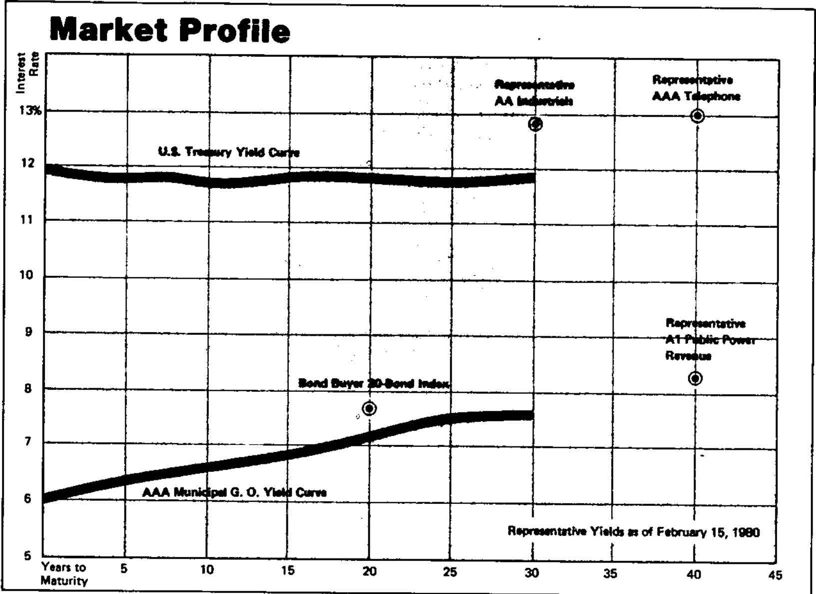


DEPTH, BREATH AND RESILIENCY

"Depth, breath and resiliency" was a phrase used to characterize the government bond market in the decade of the 60's. Today it is a phrase which is being introduced to describe the enigma of the U.S. economy. For almost two years, economists have been projecting a recession. As the decade of the 80's begins, that recession still appears on the horizon. To date, only the automobile industry, which appears to have misjudged American needs and mis-sized its product, seems to have been hit by severe economic woes. The housing industry is only now beginning to be adversely impacted by the exceptionally high cost of money. These two areas of the economy usually portray the economic situation as it affects everyone. However, with the consumer continuing to spend over a broad range of products, this has not yet been the case. Retail sales, after indicating some moderation in the final quarter of 1979, have rebounded smartly in January. Thus, the depth, breath and resiliency of the economy continues to confuse economic forecasters.

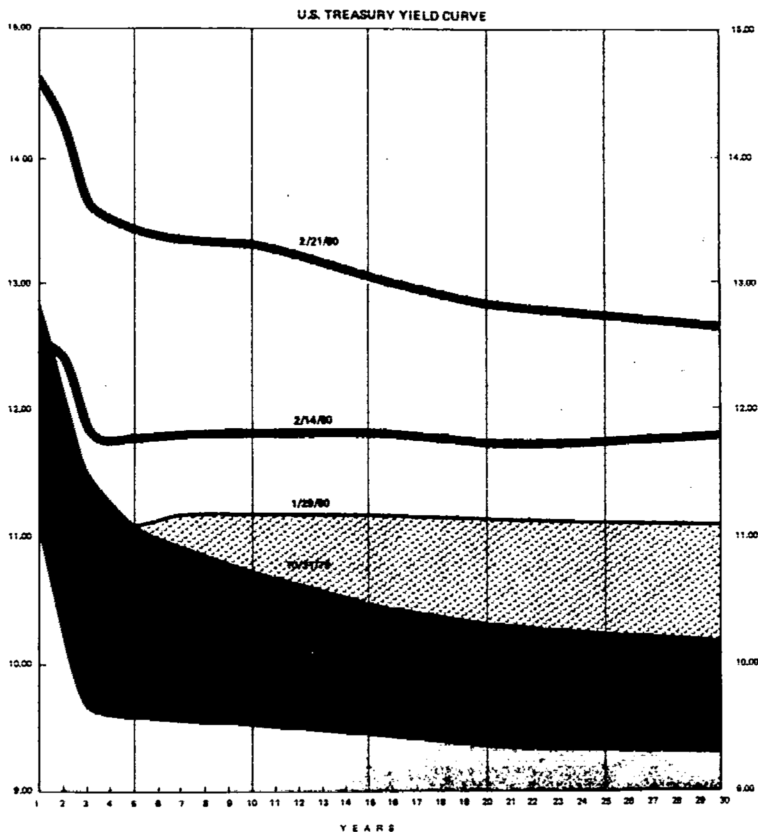
THE BOND MARKET

After an initial period of stability following the dramatic moves by the Federal Reserve on October 6, the bond markets appear to be unconfused by the resiliency of economic activity. Since the President's budget message, in which he called for an increase in defense spending in the aftermath of the Russian invasion of Afghanistan, the bond markets have focused almost exclusively on inflation. For the past 18 months, inflation has been a primary concern of market participants. This concern was manifested not only in the bond markets but also in the foreign exchange markets which repeatedly told investors in the United States that they (our trading partners) were dissatisfied with our progress in combating the problem. It was only after the October move that foreign investors seemed to become more satisfied with the Federal Reserve's apparent renewed determination. Not so however with the domestic bond markets, for they have come to focus solely on the underlying rate of inflation which has been gradually rising from 8% a year ago to 12-13%. Thus, in the first 10 days of February the bond markets went through an adjustment that, when added to the adjustment of January, totals almost 15 points in the long end of the Treasury market. (See Chart #1.) There are many who would argue even today that the market has not adjusted adequately to the underlying rate of inflation, and this indeed may be the case, but one must stop and consider the tremendous transition that has already taken place. In the past two weeks, the yield curve

for direct treasury obligations has flattened even more dramatically. No longer is it readily apparent that investors are being paid to stay in short-term maturities. Now, 12% returns are available for almost any maturity. It would appear that, should this flat curve remain for a short period of time, one must begin to consider the reinvestment risks of staying in the short-term market, for fear that, in an election year, President Carter is likely to embark upon a more positive or more direct approach to dealing with the underlying rate of inflation.

A POLITICAL POSSIBILITY

A year ago, the President was categorized as a "do nothing" president. Today, following Iran and Afghanistan, he has shed much of that image and appears to have garnered considerable support as an activist. Therefore, it is possible that, should the markets continue to focus on the most pessimistic scenario, the President might be forced to take a more definitive action, perhaps in the form of wage, price and/or credit controls, to deal with the problem. We agree



that in the long run this approach will not be satisfactory. However, we are all too aware that, in a political environment, it may be a more acceptable alternative to forcing interest rates still higher, and increasing the political risk that the economy lose its depth, breath and resiliency, and seeing unemployment begin to rise out of control. Should an attempt at some form of administrative intervention occur, it is likely to have a salutary effect on the bond market, causing prices to rise and opportunities to secure record yields to dissipate.

In the past, there have been clear strategies which have been invoked at given points in the market. Today the forecasts which detail those strategies are clouded by the continuing strength in the economy. Nonetheless, one must consider the fact that the fixed income markets have been achieving record yield levels almost daily. In the past, we have indicated that there would be sufficient time to commit funds to the market, when it becomes clear through declining retail sales, falling housing starts, and a reduced demand for both consumer and commercial credit to invest in fixed income securities. Given the tremendous movement in bond prices over the last several weeks, one must consider the possibility that when a turnaround becomes apparent, investment opportunities are likely to be reduced. Therefore, we would recommend a strategy of gradual entry into longer term investments, even considering the possibility that over the near term these investments might suffer price declines. As new levels are reached, continuing new investment opportunities should become available and additional funds committed. In this way, those potential opportunities will not be lost in the current investment cycle.

SINCE OCTOBER

The above chart reflects the rise in interest rates since October 1, 1979. The three periods depicted on the chart may be remembered as perhaps the three worst periods to have been experienced by the fixed income markets. When one considers the total loss in points, the results appear staggering. In terms of a 30-year security with a 10 3/8% coupon, the price declines are as follows:

Table 1
MARKET LOSSES

Period	Increase in Yield (Basis Points)	Dollar Loss (%/Par)
10/1-31	85	8.75
12/31-1/29	100	9.00
1/29-2/14	70	5.75
2/15-2/21	100	6.75

Much discussion has taken place about how much of a loss this has been in actuality. Since many bonds are purchased to be held to maturity, one is dealing in terms of relative paper losses. However, if one were to attempt to track this price movement against the Dow Jones, since on a per bond basis the absolute values are equitable, then perhaps one could establish a relative concept of the magnitude of the decline. One need only remember that for a bond one percent of par value is equal to $10. In this case, since the beginning of February the bond market has lost 125 points against the Dow Jones Industrial Index. Since October 1, the total decline measures almost 302.50 points.

Peter N. Goldsmith
February 14, 1980

CAN A CASE BE MADE FOR BONDS; BACK TO BASICS

Over the past year or more the expectation of a recession in the U.S. economy has implied the possibility of a reduced inflation and, in addition, a reduction in the high levels of interest rates being experienced in all sectors of the fixed income markets. Previous historical patterns in the economy suggested that such a scenario was quite probable. The strength in the major components of domestic growth had been growing for an extended period, consumer savings were at record low levels, and the burden of individual debt was growing at a rate many believed would soon become unsustainable.

In recent weeks, a number of developments have somewhat diminished the probability of a cyclical slowdown, and also reduced the expectation for an early end to inflation or high interest rates. Because of this changed psychology, we have experienced some of the most turbulent bond markets ever, and it is not hard to find newspaper articles suggesting that bonds are no longer a viable investment medium. We should like to examine two questions here, and perhaps gain a better perspective on what might be likely to prove profitable to the investor looking at the debt markets today. Put simply, the questions are:

1. Why do investors buy bonds?
2. What guidelines should the investor follow to obtain best results?

Table 2

TOTAL RETURN OF A 12% COUPON ON A $1,000 INVESTMENT

	Coupon Income		
Time Held	No. Coupon Reinvestment	Reinvestment @ 6%	Reinvestment @ 12%
5 Years	$ 600	687.83	790.85
10 Years	$1,200	1,612.22	2,207.17

Note: At maturity the $1,000 principal is returned.

Representative Selections

Corporate Bonds

Each of the issues in this list is traded on a major exchange and is regarded as having reasonably good marketability in amounts of 10 bonds or less and may be available in size. All of the bonds are marginable within Merrill Lynch's overall margin requirements. Interest is fully taxable and usually paid semi-annually. Although discount bonds typically offer lower current yields and yields to maturity than higher coupon bonds, a portion of that yield to maturity is in the form of a capital gain that receives tax treatment which may prove appealing to investors in higher tax brackets.

Ratings Moody's	S&P	Corporate Bonds	Recent Price	Call Price (A)	Yield to Maturity	Current Yield
Aaa	AAA	International Business Machines 9 3/8 10/01/04	75.50	108.00G89	12.62	12.42
Aaa	AAA	General Motors Acceptance Corp 12 2/01/05	88.73	102.00C90	13.58	13.53
Aaa	AAA	Pacific Northwest Bell 10 1/8 10/01/19	74.00	104.75G84	13.70	13.68
Aaa	AAA	Southern Bell 10.90 12/01/19	81.04	109.11C84	13.46	13.45
Aaa	AAA	Southwest Bell 11 3/8 1/15/20	83.75	109.02G85	13.59	13.58
Aa	AA	Houston Power & Light 11 1/4 12/01/09	82.42	110.65G84	13.70	13.65
Aa	AA	Public Service Electric & Gas 12 11/01/09	86.85	112.00G84	13.85	13.82
Aa	A-	Pacific Gas & Electric 12 3/4 2/01/13	90.13	112.75G84	14.16	14.15
A	A-	Consumers Power 12 1/5 1/01/10	88.18	111.75G85	14.20	14.18

Preferred Stocks

The dividend rate is usually fixed and cumulative and paid quarterly, but, in contrast to bond interest, is not a legal corporate obligation. Holders of preferred stock usually have no voting rights unless dividends are in arrears or certain sinking fund provisions have not been met. Although "new money" preferreds provide a tax benefit for corporations, that benefit does not pertain to the individual investor. Unless otherwise stated, par value is $100 per share.

S&P Rating	Cumulative Preferred Stocks	Recent Price	Call Price (A)	Current Yield
AA	Illinois Power 8.24% 50 par	34.75	53.92	11.44
AA	Public Service of Indiana 9.60% S.F.	96.00	109.60	10.00
A	Pacific Gas & Electric 9.48% 25 par	10.75	29.50	12.64

Convertible Securities

The basic appeal of convertibles stems from their ability to combine in a single security those features associated with common stocks along with those associated with corporate bonds or preferred stocks. As they may be exchanged for common shares, convertibles can participate in the price gains registered by their underlying equities. Equally significant, their status as senior securities with the obligation to pay fixed interest or dividends gives convertibles those qualities of non convertible bonds and preferred stocks that reduce risk. All convertibles possess such dual stock/bond characteristics; but the extent to which one or the other attribute is influential varies from issue to issue and even for a single issue over a period of time. Therefore, convertibles may satisfy a wide range of investment objectives.

Ratings Moody's	S&P	Convertible Bonds	Recent Price Bond	Recent Price Common	Conversion Ratio	Conversion Premium	Yield to Maturity	Current Yield Bond	Current Yield Common
Aaa	AAA	J.P. Morgan 4 3/4 11/01/98	68.50	43.13	12.50	27.1%	8.03	6.93	6.49
Aa	AA	First Bank System 6 1/2 6/30/00	84.75	37.25	20.62	10.3	8.03	7.67	5.48
Baa	BBB	Baxter Travenol 4 3/8 11/01/91	112.00	40.00	26.32	6.4	3.14	3.91	1.60
Baa	BBB	Economics Laboratory 5 1/8 6/01/91	89.00	23.00	31.25	23.8	6.52	5.76	4.52
Baa	BBB	General Amer. Trans 5 3/4 3/01/99*	73.00	37.38	16.67	17.2	8.67	7.88	5.35
Baa	BBB	Greyhound 6 1/2 1/15/90	99.50	18.25	54.42	0.2	6.92	6.70	5.70
Ba	BBB	ARA Services 4 5/8 6/15/96	54.00	33.13	9.87	65.1	10.61	8.57	5.94
Ba	BB	SCM 5 1/2 5/01/88	73.50	23.25	21.50	47.0	10.38	7.48	5.59
B	BB	Host International 5 1/4 4/15/99	59.50	15.39	23.67	63.4	10.94	8.82	3.90
B	B	Dayco 6 1/01/94	69.50	13.38	47.80	8.7	10.14	8.63	4.19
B	B	Western Union 5 1/4 8/01/97	49.00	24.38	15.15	32.7	12.50	10.71	5.74
NR	NR	Citicorp 5 3/4 6/30/00	65.00	20.75	26.39	28.4	9.73	8.85	6.27

S&P Rating	Convertible Preferred Stocks	Recent Price Pfd.	Recent Price Common	Conversion Ratio	Conversion Premium	Current Yield Pfd.	Current Yield Common
AA	Beatrice Foods $3.38	41.00	19.75	1.86	11.6	8.24%	6.08
A	United Technologies $3.875	61.13	48.87	1.25	NIL	6.35	4.50
BBB	Cooper Industries $2.90	39.50	70.25	.47	19.6	7.34	3.05
BBB	ITT $4.00 K	45.50	28.63	1.59	NIL	8.94	8.38
BBB	TRW $4.50	79.50	42.75	1.86	NIL	5.70	4.68
BB	Walter Kidde $4.00 C	47.00	35.38	1.16	14.5	8.51	5.09
BB	GK Technologies $1.94	32.00	25.50	1.19	5.5	6.06	5.10
NR	Georgia Pacific $2.24 A	35.00	31.13	1.00	12.6	6.40	3.90
NR	Pitney-Bowes $2.12	35.50	35.25	1.00	.7	5.97	3.97
NR	Time $1.575 B	38.00	53.00	.72	NIL	4.17	3.13
NR	Trans World $2.66	21.25	15.25	1.00	39.3	12.52	NIL

* Convertible into GATX Corporation common stock.

Representative Selections

Municipal Bonds

The interest paid on these bonds is exempt from Federal income taxes and in instances where the bondholder resides in the state of the issuer, state income taxes are also usually waived. Interest is paid semi-annually on bonds and usually at maturity on notes. Specific names and maturities are not likely to remain available for more than a short period of time, but a large selection of alternative issues makes it possible to find substitutes in the form of bonds of another issuer. Our selections represent nationally traded issues in which there is usually an active market, and which provide a guide to yields available to investors preferring to purchase local or regional issues.

Ratings Moody's	S&P	Municipal Bonds (K)	Recent Price	Call Price (A)	Yield to Maturity	Current Yield
Aaa	AAA	State of Connecticut Health and Educational Facilities Authority, GNMA Collateralized Revenue Bonds, St. Mary's Hospital Issue Series A, 8 7/8 7/01/10	101.00	100.00C90	8.78	8.78
Aa	AA+	State of Ohio, Highway Obligation Bond, Series I, G.O., 7 11/15/88	100.00	NC	7.00	7.00
A-1	AA+	Strte of Virginia Road Bonds, G.O., 8 3/01/05	97.88	100.00C98	8.20	8.20
A-1	A+	Tennessee Housing Development Authority Agency Mortgage Finance Program Bonds, 1980 Series A and 1980 Series B, 8 3/8 11/01/12	91.50	103.00H90	9.20	9.15
A-1	A+	New York State Mortgage Agency Home Mortgage Revenue Bonds, Series 2, 9 1/4 10/01/09	93.50	102.50H90	9.93	9.89
A-1	A+	Massachusetts Housing Finace Agency Residental Development Bonds 1980 Issue I, Series A (Section 8 Assisted) 9 1/4 5/15/17	92.75	100.00H90	10.00	9.97
Baa	A	Municipal Assistance Corporation for the City of New York, Second Resolution, Series 23, 9.10 7/01/08	90.00	102.00C90	10.18	10.11

U.S. Government Securities

Interest on these securities is paid semi-annually unless otherwise indicated. Although subject to federal taxes, the interest is exempt from state and local taxes on issues unless so identified. In amounts less than $100M in the secondary market, a graduated odd-lot differential will effectively reduce yields.

U.S. Government Securities	Recent Price (M)	Yield to Maturity	Current Yield	Minimum Denomination
U.S. Treasury Note 11 1/5 1/31/82	95.69	14.12	12.02	5000
U.S. Treasury Note 11 7/8 8/15/83	95.00	13.73	12.50	5000
U.S. Treasury Note 12 5/15/87	95.50	12.97	12.57	1000
U.S. Treasury Bond 11 3/4 2/15/10	93.63	12.57	12.55	1000

International Bonds

Each of the issues in this list is traded on a major exchange and is regarded as having reasonably good marketability in amounts of 10 bonds or less and may be available in size. All of the bonds are marginable within Merrill Lynch's overall margin requirements. Interest is fully taxable and usually paid semi-annually. However, interest is currently exempt from U.S. Federal income taxes, including withholding taxes, if paid to an individual who is not a citizen or resident of the U.S., or to a corporation organized under the laws of a country other than the U.S. These bonds may be issued in bearer form with coupons attached or in fully registered form.

Ratings Moody's	S&P	International Bonds	Recent Price	Call Price (A)	Yield to Maturity	Current Yield
Aaa	AAA	Kingdom of Sweden 11 5/8 12/01/84	92.50	NC	13.81	12.57
Aaa	AAA	European Investment Bank 11 7/8 1/01/87	89.50	100.00C86	14.33	13.27
Aaa	AAA	European Investment Bank 11 7/8 1/01/00	83.00	103.10G92	14.50	14.31
Aaa	AAA	Kingdom of Sweden 11 5/8 12/01/99	82.50	104.16G91	14.29	14.09
Aaa	AAA	European Economic Community 11.60 11/01/99	82.50	NA G91	14.27	14.06
Aaa	AAA	Kingdom of Norway 9 3/4 1/15/84	88.00	NC	13.87	11.08

A—Prices represent the first redemption or refunding price at the termination of the protection period in year shown or at the lowest call price prior to the current year-end if protection has terminated. C-Noncallable prior to year shown. D—Noncallable prior to year shown except for sinking fund. E—Noncallable prior to maturity except for sinking fund. F—Callable but not refundable at lower interest cost until year shown. G—Callable but not refundable at lower interest cost until year shown except for sinking fund. H—May be callable at lower price and earlier date depending on level of receivables. J—May be callable for sinking fund at lower prices. K—Municipal notes are generally issued in minimum denominations of $25,000. M—Round lot is less than 100 shares. N—Prices of Government issues to right of decimal are in 32nds. P—No specific exemption from state and local taxes. NC—Noncallable prior to maturity. NR—Not Rated. OM—Old Money Preferred. WI—Trading on when-issued basis.

MLPF&S was a manager or co-manager of a recent public offering of securities of this security.
MLPF&S, for the accounts of its directors, elected officers, employees and employee benefit programs may have an interest in the common stock of these companies.

Representative Yields

Municipals

New General Obligations

Maturity	Aaa FEB	Aaa JAN	Aaa 52 Week Hi	Aaa 52 Week Lo	Aa FEB	Aa JAN	Aa 52 Week Hi	Aa 52 Week Lo	A FEB	A JAN	A 52 Week Hi	A 52 Week Lo	Baa FEB	Baa JAN	Baa 52 Week Hi	Baa 52 Week Lo
1 year	7.00	6.00	7.00	4.75	7.25	6.00	7.25	4.75	8.00	6.25	8.00	5.10	9.25	8.00	9.25	5.80
3 years	7.00	6.00	7.00	4.90	7.25	6.00	7.25	4.95	8.00	6.25	8.00	5.15	9.50	8.00	9.50	6.20
5 years	7.00	6.00	7.00	5.00	7.25	6.00	7.25	5.05	8.25	6.25	8.25	5.20	9.50	8.00	9.50	6.30
7 years	7.00	6.00	7.00	5.00	7.35	6.00	7.35	5.10	8.40	6.25	8.40	5.35	9.50	8.25	9.50	6.50
10 years	7.10	6.05	7.10	5.10	7.50	6.10	7.50	5.25	8.50	6.35	8.50	5.40	9.50	8.40	9.50	6.75
15 years	7.40	6.35	7.40	5.30	7.75	6.45	7.75	5.40	8.70	6.70	8.70	5.55	9.75	8.70	9.75	6.90
20 years	7.75	6.70	7.75	5.55	8.00	6.80	8.00	5.70	9.00	7.00	9.00	5.90	10.00	9.00	10.00	7.00
25 years	8.00	6.95	8.00	5.45	8.75	7.05	8.25	5.95	9.00	7.25	9.00	6.10	10.00	9.00	10.00	7.25
30 years	8.00*	7.00	8.00	5.95	8.25	7.10	8.25	6.10	9.00	7.40	9.00	6.25	10.00	9.25	10.00	7.35

Index	FEB	JAN	52 Week Hi	52 Week Lo
Bond Buyer Eleven Bond Index	7.95	6.86	7.95	5.57
Bond Buyer Twenty Bond Index	8.46	7.28	8.46	6.08
ML Medium Grade Municipal Index	9.18	8.17	9.18	6.85
ML High Grade Municipal Index	8.61	7.58	8.61	6.34

Revenue Bonds

	FEB	JAN	52 Week Hi	52 Week Lo
Public Power ($100 mil, new gen. fac., net rev., 40 yr., A1/A+)	9.10	7.00	9.10	6.75
Toll Road ($100 mil, tpke. imp., net rev., 35 yr., A/A)	9.10	7.90	9.10	6.70
Housing Authority ($100 mil, Section 8 Fed. subsidy, mtge. payment, 30 yr., A1/A+)	9.00	8.30	9.00	6.90
Housing Authority ($50 mil, single fam. fully ins. mtge. payment, 30 yr., Aa/AA)	8.75	8.00	8.75	6.50
Hospital ($25 mil, expans. & renov., gross receipts, 30 yr., A/A)	9.25	8.65	9.25	7.00
Pollution Control ($25 mil, utility, 1st mtge. rank, 30 yr., A/A)	9.25	7.90	9.25	6.50
Pollution Control ($25 mil, industrial, debenture rank, 30 yr., Aa/AA)	9.10	7.60	9.10	6.25
Airport(117 mil., airpt. imp., net rev., 30 yr., A-1/A)*	9.00	8.25	9.00	8.00

Other Yield Securities

New International Bonds

	FEB	JAN	52 Week Hi	52 Week Lo
Int.-Term	14.00	11.70	14.00	8.62
Long-Term	14.38	12.15	14.38	9.00

New Equipment Trust Certificates

Aaa:	FEB	JAN	52 Week Hi	52 Week Lo
5 years	14.40	11.35	14.40	8.35
10 years	14.00	11.55	14.00	8.35
15 years	13.88	11.50	13.88	8.35

Aa:	FEB	JAN	52 Week Hi	52 Week Lo
5 years	14.50	11.45	14.50	8.40
10 years	14.13	11.65	14.13	8.40
15 years	14.00	11.60	14.00	8.40

Cost of Money

	FEB	JAN	52 Week Hi	52 Week Lo
Federal Funds	14.50	13.91	14.50	7.72
Discount Rate	13.00	12.00	13.00	7.25
Prime Rate	15.75	15.00-15.75 15.75	15.75	9.00

Representative Yields

Money Markets

	ONE MONTH FEB	ONE MONTH JAN	ONE MONTH 52 Week Hi	ONE MONTH 52 Week Lo	THREE MONTHS FEB	THREE MONTHS JAN	THREE MONTHS 52 Week Hi	THREE MONTHS 52 Week Lo
U.S. Treasury Bill	13.00	11.70	13.00	8.67	13.35	11.95	13.35	9.12
Federal Agency (F.I.C.)								
Certificate of Deposit	14.75	13.20	14.75	9.60	15.05	13.30	15.05	9.80
Bankers' Acceptance	14.45	13.15	14.45	9.68	14.60	12.95	14.60	9.84
Commercial Paper	14.00	13.00	14.10	9.83	14.38	13.00	14.65	10.10
Finance Paper	14.00	13.00	14.13	9.38	13.00	12.75	13.00	9.38
Eurodollar	15.85	13.75	15.85	10.07	15.85	13.75	15.85	10.22
Project Note					6.50	5.40	7.25	4.35

	SIX MONTHS FEB	SIX MONTHS JAN	SIX MONTHS 52 Week Hi	SIX MONTHS 52 Week Lo	ONE YEAR FEB	ONE YEAR JAN	ONE YEAR 52 Week Hi	ONE YEAR 52 Week Lo
U.S. Treasury Bill	13.36	11.75	13.36	9.38	13.28	10.83	13.28	9.27
Federal Agency (F.I.C.)	14.58	12.51	14.58	9.20	14.43	11.62	14.43	8.92
Certificate of Deposit	15.30	13.35	15.30	9.80	15.00	13.35	15.00	9.75
Bankers' Acceptance	14.55	12.70	15.89	9.90				
Commercial Paper	13.75	12.95	14.88	10.24				
Finance Paper	12.00	12.00	12.25	9.13				
Eurodollar	15.80	13.70	15.80	10.12	15.35	12.75	15.35	10.20
Project Note	6.75	5.65	7.50	4.50	6.65	5.55	7.50	4.80

Governments

U.S. TREASURY

Maturity	FEB	JAN	52 Week Hi	52 Week Lo
3 years	3.95	10.78	13.95	8.61
5 years	13.06	10.46	13.06	8.57
7 years	13.22	10.66	13.22	8.68
10 years	12.71	10.63	12.71	8.78
15 years	13.04	10.66	13.04	8.82
20 years	12.84	10.49	12.84	8.73
25 years	12.74	10.39	12.74	8.73
30 years	12.73	10.45	12.73	8.83

FEDERAL AGENCY (F.N.M.A.)

Maturity	FEB	JAN	52 Week Hi	52 Week Lo
3 years	13.17	10.98	13.17	8.86
5 years	13.23	10.88	13.23	8.80
7 years	13.26	10.97	13.26	8.95
10 years	13.57	10.92	13.57	8.95
15 years	12.93	10.61	12.93	8.93
20 years				
25 years				

G.N.M.A. Pass-thru (Yield to 12 yr. Avg. Life) ....

	FEB	JAN	52 Week Hi	52 Week Lo
8½% coupon	13.10	11.12	13.10	9.19
9 1/2% coupon*	13.64	11.60	13.64	9.72

Corporates

	Aaa FEB	Aaa JAN	Aaa 52 Week Hi	Aaa 52 Week Lo	Aa FEB	Aa JAN	Aa 52 Week Hi	Aa 52 Week Lo
Utility:								
New Long-term	14.25	11.50	14.25	9.30	14.63	12.00	14.63	9.50
6.0% Long-term	12.70	10.65	12.70	8.80	13.50	11.10	13.50	9.10
7½% Long-term	12.90	10.95	12.90	9.05	13.55	11.35	13.55	9.25
9.0% Long-term	13.20	11.10	13.20	9.20	13.70	11.45	13.70	9.40
New Int.-term	13.50	11.38	13.50	9.00	14.25	11.75	14.25	9.25
Industrial:								
New Long-term	13.25	10.95	13.25	8.95	13.75	11.25	13.75	9.10
New-Int.-term	13.25	10.88	13.25	8.85	13.50	11.13	13.50	8.90
Finance:								
New Long-term	13.75	11.70	13.75	9.30	14.10	11.90	14.10	9.45
New Int.-term	13.75	11.50	13.75	9.20	14.00	11.75	14.00	9.30

	A FEB	A JAN	A 52 Week Hi	A 52 Week Lo	Baa FEB	Baa JAN	Baa 52 Week Hi	Baa 52 Week Lo
Utility:								
New Long-term	15.13	12.50	15.13	9.85	16.00	13.00	16.00	9.50
6.0% Long-term	13.85	11.65	13.85	9.30	14.50	12.55	14.50	9.75
7½% Long-term	13.85	11.90	13.85	9.50	14.60	12.30	14.60	9.90
9.0% Long-term	14.00	12.00	14.00	9.70	14.85	13.00	14.85	10.05
New Int.-term	14.75	12.00	14.75	9.50	15.25	12.50	15.25	9.90
Industrial:								
New Long-term	14.50	11.65	14.50	9.40	15.50	12.65	15.50	9.85
New-Int.-term	13.88	11.38	13.88	9.15	14.75	12.00	14.75	9.65
Finance:								
New Long-term	14.75	12.30	14.75	9.95	15.75	13.00	15.75	9.95
New Int.-term	14.50	12.13	14.50	9.50	15.50	12.75	15.50	9.88

Preferred Stocks

	FEB	JAN	52 Week Hi	52 Week Lo
PREFERRED STOCKS:				
New AA Perpetual	12.00	10.65	12.00	8.80
New A Perpetual	13.00	11.40	13.00	9.20
New A Sinking Fund	11.75	10.00	11.75	8.50

Money and capital market yields are based on offering prices and represent actual market rates or MLPF&S estimates as of Thursday afternoon. Aaa-rated utility rates are derived from Bell System subsidiaries and all other utility rates are derived from electric utilities. Preferred stocks are new money electric utilities. ML medium grade Municipal Index is a composite of long-term A and Baa-rated tax-exempt bonds. Terms of maturity of long-term Governments are approximate. G.N.M.A. Pass-thrus are secured by government insured mortgage pools having an initial average life of twelve years. Project Notes are government guaranteed and tax-exempt. Certificates of Deposit and Bankers' Acceptances are of large money center banks and are dealer placed. Commercial Paper is prime and dealer placed. Finance Paper is prime and directly placed. Eurodollar yields are London rates.

* 52 week his and los are as follows: Airport Revenue from September 1979 and 9 1/2% GNMA from May 1979.

WHY DO INVESTORS BUY BONDS?

The answer seems so obvious. Bonds are bought to provide income. In this respect, they are certainly different from oriental rugs, bags of silver coins, or antique furniture. They are more closely akin to rental real estate or dividend paying equities, but here too there is an overwhelming distinction. Bonds mature, and at maturity have a known value. There is no such assurance with real estate or stocks, which can be higher or lower in value after an extended period than when they were purchased.

An extensive survey of U.S. households' financial attitudes, conducted over the past year, disclosed that as a group, so-called "Affluent Households" (annual income over $30,000), 59% of males and 89% of females were willing to accept only small or absolutely minimum risk in their allocation of financial resources. In addition, providing for retirement income was first among the primary goals listed by these individuals, suggesting that we are looking at goals with an extended time line, not the one or two year expectation framework associated with other types of investment. Bonds certainly fit these criteria, as perhaps only savings and insurance do as alternatives.

WHAT GUIDELINES SHOULD INVESTORS FOLLOW?

While it is presumptuous to give specific good advice to investors on a wholesale basis, some categorical statements are probably valid at this time. The first is, *Be Aware of Risk.* The bond markets today are subject to price risk as never before. Those with a long term frame of reference can accept this volatility much better than investors looking at near term price performance. On the bright side, at current interest rate levels, there is certainly a fairer measure of compensation for risk than has existed for a long time. While the presence of price risk becomes an inhibiting factor for many, the reward side of the coin has been polished nicely.

A second observation also deals with risk. *Buy the highest quality issues available.* Over extended time periods, credit risk can become a serious concern. Neutralizing this risk as much as possible is particularly prudent now, since there is no appreciable incentive at this time to buy lower rated issues for a very narrow yield advantage.

A third general bit of good advice relates to call features. *Bonds with the best protection from call probably represent the best current value.* Just as important as getting a good return, keeping it in a changed market environment can be equally rewarding. As shown earlier, many of the high coupon offerings of the last peaking market cycle were called or refunded when interest rates did decline. Holding issues that are less vulnerable to call makes good sense, and call or refunding data should be checked in detail at the time of purchase.

John H. Charlesworth
February 14, 1980

Merrill Lynch
Pierce
Fenner & Smith Inc.

Bond Market Comment

Fixed Incôme Research

Volume 3 Number 9

February 29, 1980

"The Reports of My Death are Greatly Exaggerated"

Recently, it has been said that the fixed income markets had deteriorated to such a degree that their potential viability was considered in doubt. Extreme pessimism provoked some to suggest that a state of emergency existed within the capital markets. This did appear to be the case. At that time, politicians (we cannot lose sight of the fact that this is a presidential election year) began openly to discuss the need for some definitive action. There has been much discussion of wage and price controls, including President Carter's position that they are out of the question. In addition to talk of possible credit controls and of restructuring the 1981 budget (submitted only a month ago), these discussions have succeeded in stabilizing the fixed income markets and allowed them to again function in an orderly manner.

The politicians seem to be receiving the message: "Where there is smoke there is fire." One must caution, however, that despite all the Administrative pronouncements of the last several years, the buoyancy displayed by the fixed income markets in the last week will not be maintained unless definitive measures are proposed in the near term in our opinion. Should a nondescript rhetorical policy be presented, speculation will once again arise as to the early demise of the long term capital markets.

Peter N. Goldsmith
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Inflation, Recession and Bond Yields

With economic indicators suggesting that a recession is not yet at hand, the bond markets have focused attention on the ongoing, high rate of inflation. A striving by market participants for a positive rate of real return has abetted an unparalleled plunge in bond prices since the beginning of the year. Our chart on page 4 illustrates annualized rates of inflation measured by the implicit GNP deflator and the Consumer's Price Index (quarterly average of monthly rates), bond yields measured by Aaa-rated Bell System debentures and the trend in real returns from 1965 through 1979. Shaded bars on the chart represent quarters of negative real growth in GNP. From this chart several points arise:

The information set forth herein was obtained from sources which we believe reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation by us of the purchase or sale of any securities or commodities.

Money Markets

	ONE MONTH				THREE MONTHS				SIX MONTHS				ONE YEAR			
			52 Week				52 Week				52 Week				52 Week	
	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo
U.S. Treasury Bill	12.79	13.00	13.00	9.57	14.11	13.35	14.11	9.12	14.73	13.35	14.73	9.33	14.97	13.28	14.97	9.22
Federal Agency (F.I.C.)									15.37	14.55	15.37	9.20	14.32	14.61	14.53	8.92
Certificate of Deposit	14.85	14.75	14.85	9.60	15.45	15.05	15.45	9.80	15.85	15.30	15.85	9.30	15.25	15.00	15.25	9.75
Bankers' Acceptance	14.75	14.65	14.75	9.65	15.00	14.50	15.00	9.85	15.05	14.55	15.39	9.90				
Commercial Paper	14.50	14.00	14.50	9.53	14.88	14.38	14.89	10.13	14.00	13.75	14.33	10.24				
Finance Paper	14.50	14.00	14.50	9.39	14.00	13.00	14.00	9.35	13.00	12.00	13.00	9.13				
Eurodollar	15.50	15.65	15.85	10.07	16.30	15.95	16.30	10.22	15.55	15.80	16.55	10.12	15.95	15.35	15.95	10.29
Project Note					6.57	6.50	7.25	4.35	7.00	6.75	7.50	4.50	7.00	6.65	7.50	4.80

Governments

U.S. TREASURY

Maturity	2/29	2/22	52 Week Hi	52 Week Lo
3 years	13.58	13.95	13.95	8.61
5 years	12.54	13.06	13.06	8.57
7 years	13.17	13.22	13.22	8.63
10 years	11.92	12.71	12.71	8.78
15 years	12.59	13.06	13.06	8.52
20 years	12.35	12.84	12.84	8.73
25 years	12.17	12.74	12.74	8.73
30 years	12.30	12.73	12.73	8.83

FEDERAL AGENCY (F.N.M.A.)

Maturity	2/29	2/22	52 Week Hi	52 Week Lo
3 years	13.74	13.17	13.74	9.36
5 years	13.79	13.23	13.78	9.40
7 years	13.51	13.25	13.51	8.95
10 years	13.26	13.57	13.57	8.95
15 years	13.49	12.93	13.59	8.93
20 years				
25 years				

G.N.M.A. Pass-thru (Yield to 12 yr. Avg. Life) ....

	2/29	2/22	52 Week Hi	52 Week Lo
8½% coupon	12.92	13.10	13.10	9.19
9½% coupon*	13.30	13.64	13.64	9.09

Corporates

	Aaa				Aa				A				Baa			
			52 Week				52 Week				52 Week				52 Week	
	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo
Utility:																
New Long-term	13.63	14.25	14.25	9.30	14.25	14.63	14.63	9.50	14.38	15.13	15.13	9.35	15.63	16.00	16.00	9.50
6.0% Long-term	12.30	12.70	12.70	8.90	13.00	13.50	13.50	9.10	13.60	13.35	13.35	9.30	14.20	14.50	14.70	9.75
7½% Long-term	12.70	12.90	12.90	9.05	13.20	13.55	13.55	9.25	13.25	13.35	13.35	9.50	14.50	14.60	14.60	9.94
8.0% Long-term	12.85	13.20	13.20	9.20	13.35	13.70	13.70	9.40	14.00	14.00	14.00	9.70	15.00	14.85	15.00	10.05
New Int.-term	13.75	13.50	13.75	9.00	14.25	14.25	14.25	9.25	14.75	14.75	14.75	9.50	15.25	15.25	15.25	9.90
Industrial:																
New Long-term	13.00	13.25	13.25	8.95	13.50	13.75	13.75	9.10	14.00	14.50	14.50	9.40	15.50	15.50	15.50	9.45
New Int.-term	13.53	13.25	13.63	8.85	13.88	13.50	13.88	9.90	14.13	13.88	14.13	9.15	15.00	14.75	15.00	9.65
Finance:																
New Long-term	13.75	13.75	13.75	9.10	14.13	14.10	14.13	9.45	14.63	14.75	14.75	9.20	16.00	15.75	16.00	9.95
New Int.-term	14.00	13.75	14.00	9.20	14.25	14.00	14.25	9.30	14.75	14.50	14.75	9.50	15.25	15.50	15.50	9.84

Municipals

NEW GENERAL OBLIGATIONS

Maturity	Aaa				Aa				A				Baa			
			52 Week				52 Week				52 Week				52 Week	
	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo	2/29	2/22	Hi	Lo
1 year	7.00	7.00	7.00	4.75	7.00	7.25	7.25	4.75	7.25	8.00	8.00	5.10	8.25	9.25	9.25	5.90
3 years	7.00	7.00	7.00	4.90	7.00	7.25	7.25	4.95	7.25	8.00	8.00	5.15	8.50	9.50	9.50	6.20
5 years	7.00	7.00	7.00	5.00	7.10	7.25	7.25	5.05	7.35	8.25	8.25	5.20	8.75	9.50	9.50	6.30
7 years	7.10	7.00	7.10	5.00	7.20	7.35	7.35	5.10	7.45	8.40	8.40	5.35	9.00	9.50	9.50	6.50
10 years	7.25	7.10	7.25	5.10	7.35	7.50	7.50	5.25	7.75	8.50	8.50	5.40	9.25	9.50	9.50	6.75
15 years	7.75	7.40	7.75	5.30	7.85	7.75	7.85	5.40	8.10	8.70	8.70	5.55	9.75	9.75	9.75	6.90
20 years	8.00	7.75	8.00	5.55	8.15	8.00	8.15	5.70	8.50	9.00	9.00	5.90	10.00	10.00	10.00	7.00
25 years	9.25	9.00	9.25	5.65	8.40	8.25	8.40	5.95	8.70	9.00	9.00	6.10	10.00	10.00	10.00	7.25
30 years	8.35	8.00	8.35	5.95	8.40	8.25	8.40	6.10	8.70	9.00	9.00	6.25	10.00	10.00	10.00	7.35

	2/29	2/22	52 Week Hi	52 Week Lo
Bond Buyer Eleven Bond Index	8.20	7.95	8.20	5.57
Bond Buyer Twenty Bond Index	8.72	8.45	8.72	6.09
ML Medium Grade Municipal Index	9.66	9.19	9.66	6.35
ML High Grade Municipal Index	9.15	8.61	9.15	6.34

PREFERRED STOCKS:	2/29	2/22	52 Week Hi	52 Week Lo
New AA Perpetual	11.75	12.00	12.00	8.50
New A Perpetual	12.75	13.00	13.00	9.20
New A Sinking Fund	11.50	11.75	11.75	8.50

REVENUE BONDS

	2/29	2/22	52 Week Hi	52 Week Lo
Public Power ($100 mil, new gen. fac., net rev., 40 yr., A1/A+)	9.50	9.10	9.50	6.75
Toll Road ($100 mil, tpke. imp., net rev., 35 yr., A/A)	9.60	9.10	9.60	6.70
Housing Authority ($100 mil, Section 8 Fed. subsidy, mtge. payment, 30 yr., A1/A+)	9.50	9.00	9.50	6.90
Housing Authority ($50 mil, single fam. fully ins. mtge. payment, 30 yr., Aa/AA)	9.50	8.75	9.50	6.50
Hospital ($25 mil, expans. & renov., gross receipts, 30 yr., A/A)	10.00	9.25	10.00	7.00
Pollution Control ($25 mil, utility, 1st mtge. rank, 30 yr., A/A)	9.60	9.25	9.60	6.50
Pollution Control ($25 mil, industrial, debenture rank, 30 yr., Aa/AA)	9.00	9.10	9.10	6.25
Airport (117 mil., airpt. imp., net rev., 30 yr., A1/A)*	9.25	9.00	9.25	8.00

* – Quoted on a discount basis NA – not available

Money and capital market yields are based on offering prices and represent actual market rates or MLPF&S estimates as of Thursday afternoon. Aaa-rated utility rates are derived from Bell System subsidiaries and all other utility rates are derived from electric utilities. Preferred stocks are new money electric utilities. ML medium grade Municipal Index is a composite of long-term A and Baa-rated tax-exempt bonds. Terms of maturity of long-term Governments are approximate. G.N.M.A. Pass-thrus are secured by government insured mortgage pools having an initial average life of twelve years. Project Notes are government guaranteed and tax-exempt. Certificates of Deposit and Bankers' Acceptances are of large money center banks and are dealer placed. Commercial Paper is prime and dealer placed. Finance Paper is prime and directly placed. Eurodollar yields are London rates.

* 52 week hi and lo as follows: Airport Revenue from September 1979 and 9½% GNMA from May 1979.

* From 1965 through 1972, real returns were always positive, averaging 2.85% against the CPI and 2.54% against the deflator. The 1973-79 period saw both positive and negative real yields. The "creeping" upward of inflation in the late 1960's gave investors ample time to adjust their peceptions. The upward explosion in 1973-74 did not. Rather than coming to grips with rapidly changing reality, investors chose to believe that inflation was so horrendous that it simply could not prevail for long. They were right, but perseverance was costly: From the trough in real returns in Q3-74 to their subsequent peak in Q1-76, the real yield captured by investors averaged about 1.3% against the GNP deflator.

* During each economic expansion (1966-69, 1971-73 and 1975 to present) real returns have trended downward. The effect of recession, however, is less clear. In 1969-70, a downward trend in real returns reversed and began upward just before recession began, but in 1974-75 real returns remained negative well into the recession. To repeat their performance of 1970 in terms of real return, Bell System yields should have peaked in 1974 at about 15% rather than at about 10%.

* There has been much recent discussion of reimposing wage and price controls, and how the bond markets would respond. Controls were initially imposed in August 1971 and were unanticipated. The initial effect was a 40 basis point drop in yields from Q3-71 to Q4-71. Inflation rates also slowed initially, but in mid-1972 prices began accelerating rapidly. The higher levels of real returns established in 1970 were preserved until then, rather than trending downward as is characteristic during economic expansion phases. Market participants apparently held yields at higher levels, reflecting a mistrust of artificially contained inflation.

* Real returns trended upward in the second half of 1979, similar to the uptrend prefacing the 1969-70 recession. This recent increase in real yields may be an important ingredient helping to produce a recession in 1980. In both of the last two cycles, however, yields peaked following two consecutive quarters of negative real GNP growth. Moreover, in both cycles, secondary peaks in yields occurred four quarters later when real returns of near historic average levels failed to be maintained.

* From 1965 to 1978, changes in the CPI were a good leading indicator of the future direction and extent of change in the GNP deflator. This relationship appears shaken by events of 1979. The divergence in real returns associated with each of these two measures is now uncharacteristically wide; returns versus the CPI have been negative since Q1-79, but have remained consistently positive versus the deflator. Inflation is now apparently being underestimated by the deflator (8.7% in Q4-79) or overstated by the CPI (12.8% in Q4-79) - or both. Problems with the CPI have been widely discussed, particularly the manner in which housing and mortgage costs are handled, while the deflator is a broader measure, not confined to a basket of goods typically purchased by one sector of the economy. Assuming the GNP deflator to be the more accurate measure, Q4-79 saw positive real returns on bonds of 2.47% - close to the 1965-72 average of 2.54%. The average yield on current coupon, long-term Bell System issues was then 11.17%, however, compared with about 13.75% today. This suggests that inflation as measured by the deflator should soon be reported at an annual rate above 11%. Thus, it may be that long term high grade bonds at present yield levels have not only reached, but have already exceeded the historically normal rates of real return for which market participants have been striving.

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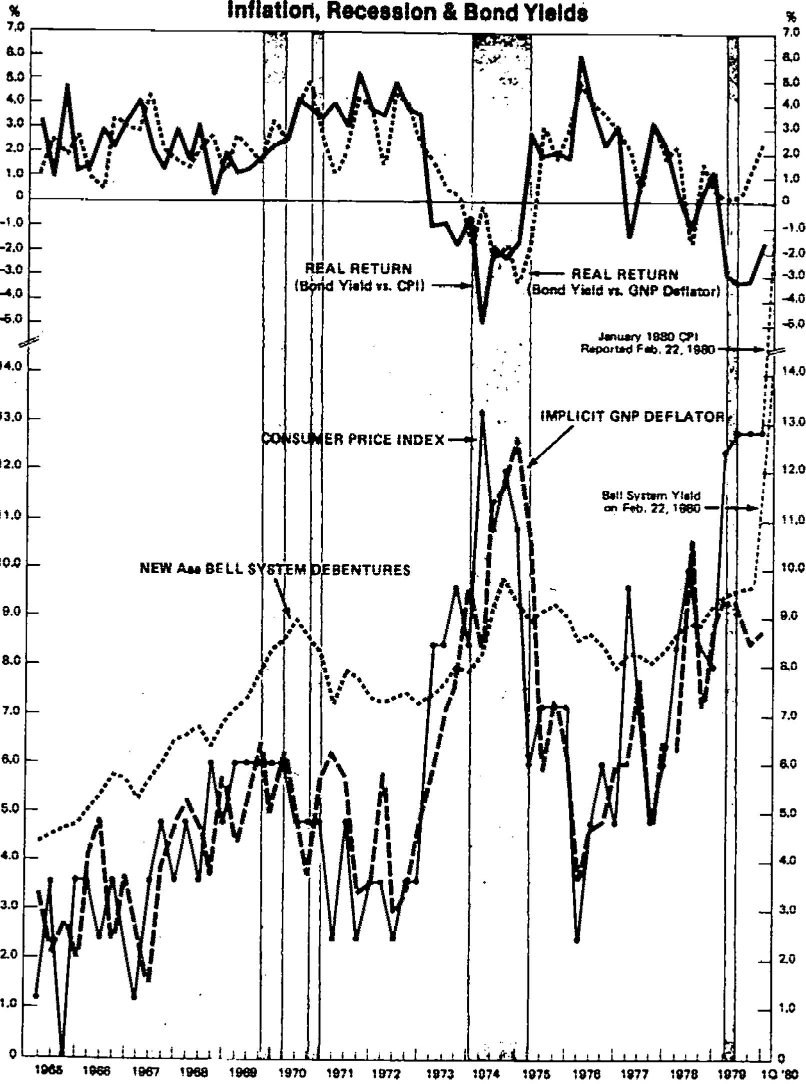
Inflation, Recession & Bond Yields
%
REAL RETURN
(Bond Yield vs. CPI)
REAL RETURN
(Bond Yield vs. GNP Deflator)
January 1980 CPI
Reported Feb. 22, 1980
IMPLICIT GNP DEFLATOR
CONSUMER PRICE INDEX
Bell System Yield
on Feb. 22, 1980
NEW Aaa BELL SYSTEM DEBENTURES
1965
1966
1967
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1Q '80

Senator BENTSEN. Thank you. Mr. Goldsmith. Mr. Patterson.

STATEMENT OF GRADY L. PATTERSON, JR., TREASURER, STATE OF SOUTH CAROLINA

Mr. PATTERSON. Mr. Chairman, first I want to express my appreciation for the opportunity to appear here today and it's good to see you again, sir. You were in South Carolina 3½ years ago and it's nice to be with you again, sir. I commend you for your great concern and efforts to try to bring some order out of the chaotic conditions that exist today in the bond markets, inflation, and our economy.

Senator BENTSEN. I'm sure glad to have a fellow testifying before me that doesn't speak with an accent.

Mr. PATTERSON. As we have already indicated, I think we can all agree that inflation is the worst menace and the greatest threat to our economic system in this country today, and I think it will destroy our free enterprise system and our individual freedom if it's not curtailed, controlled and curbed. The taxpayers of our State and your State and the taxpayers of this great Nation are suffering irreparable damage and injury because of the astronomical inflation that permeates the entire economy today; and I think if we go back for a couple decades, the greatest cause, or one of the greatest causes, is the deficit spending and the excessive governmental control and supervision and all of these things that permeate our economy.

Fiscal discipline is really what we are talking about. We should impose some fiscal discipline upon ourselves. It's rarely accorded it's rightful place in the spending process that was done here in Congress and other parts of the country. When the Congress sat down to annually make spending decisions, fiscal discipline was allotted a back seat or no seat at all, and I would hasten to add the Federal Government is not totally to blame. Business and State governments and other political entities have been on the inflation wagon as well, as I have indicated.

Another large governmental burden which contributes to inflation is the oversupervision and overcontrol and massive supervision of business and industry in this great country. People tell me almost daily, and I'm sure they tell you, of the never-ending burden of complying with the morass of regulations and forms required by the Government, not only the Federal Government but the State government as well. This excessive burden consumes an endless number of man-hours of all businesses, large and small, from the corner gas station operator to the largest corporations in this Nation, which adds to the ever-increasing cost of producing goods and services, and that's what it really gets down to.

Now the roots of inflation I think go even deeper. Inflation is enmeshed and entwined into our standard of living and the psychology of our level of expectations in this country. Over recent decades people were encouraged to spend and consume and our economy became a consumer oriented economy with little or no emphasis on savings and capital formation. In fact, many tax actions by the Congress had the effect of deterring savings, investing, and renewing the productive capacity of this great country.

This consumer oriented economy with the spending attitude and ease of consumer credit has absorbed much of the capital that was needed to expand the productive capacity of the United States.

What can we do about it and how can we deal with it? We have all said already and we will say it again, there's no simple solution to the problems and there's no painless solution. Much of it is a state of mind and an attitude of the country. I think we must adopt an attitude of individual as well as collective austerity and we must lower our level of expectations. I have heard you say this and I have heard the President say this and I think we've got to adopt this attitude as a Nation in order to deal with the problem. We should rededicate ourselves to making work honorable and respectable. We should stress the diginity of work and the respect and self-pride in performing a day's work for a day's pay. To reduce and eliminate huge deficits and the resulting borrowing, we must turn away from the extravagance in the use of all our resources. We must impress prudence upon all our elected officials at all levels of government.

The test applied to all issues should not be whether it's desirable, but whether we can afford it. The key to such an attitude is the approach that all of us in this room take as individuals and throughout the country. The responsibility rests with each of us in our free society. Government at all levels cannot and will not respond without the urge and demand of the individual citizens and I think there's a crying out for fiscal discipline all over this Nation. I believe the mood of the country requires prompt and decisive action to curb and reduce the current rate of inflation.

The financial markets, which have already been alluded to, and the bond markets are in chaotic conditions because of the unprecedented rate of inflation. This is causing an undue burden on the capital financing for South Carolina and all other States and political entities throughout the country.

I'm sure you know, and perhaps everybody in this room knows, that South Carolina enjoys the highest credit rating awarded any State by the rating services. I know, and I'm sure you know, that Texas also enjoys that rating. Senator, the AAA; and we can borrow money and sell our bonds as cheap or cheaper than any other State in the Union. Our bonds sell as well or better than any other State's that we know about.

South Carolina has operated for decades and generations within the discipline of a balanced budget. Our constitution dictates it. Statutory law requires it. The rules of the House of Representatives direct it, and just plain reason and logic demand it. We keep our financial house in order and we live within our means.

There is no economic sleight of hand that will allow a government, any government in my judgment, to spend more than it takes in. Such fiscal discipline has saved our taxpayers millions of dollars in interest costs in the financing of our capital programs over the decades.

Despite this fine image and reputation in the capital markets throughout the country, it is practically impossible to sell our bonds. We had scheduled a $72 million general obligation bond issue for February 26 of this year but elected to cancel the sale because of the volatile and chaotic bond market conditions which have worsened since that date. The last time South Carolina sold bonds was in January 1979

and the average annual interest cost was 5.24 percent. If we had proceeded with the February sale, the cost would probably have been 50 percent higher and would have cost our taxpayers approximately $10 million more on that particular bond issue. If the sale were held today, the State would pay approximately $20 million more than in January 1979.

Over the next several months—you asked us to indicate what we plan to do about our own situation—we plan to use short-term bond anticipation notes to finance the capital programs. Eventually, of course, we will have to issue the bonds because the projects are underway. Hopefully, some order will emerge from the chaotic conditions that exist today in the financial and capital markets in the country.

I do not believe that the escalation of interest rates will solve the inflation problem. Thus far it has had little effect in curbing loan demand. The psychology seems to be to borrow and buy now at the present prices and pay later with cheaper dollars next year and still in the future, and I think the key to all of this Senator, is the absence of a policy to deal with the problems that continue to fuel the fires of inflation.

Everybody is trying to hedge inflation and there's a psychology about it and it's a mood of the country. I therefore believe that the President, in the meetings that you're now in, should take prompt and bold action under the Credit Control Act of 1969 to authorize the Federal Reserve Board to regulate and control any and all extensions of credit, and such action can be taken at any time whenever the President, as you well know, determines such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extensions of credit and an excessive volume. I think it should be done promptly because the longer we wait the less effective the action by the President and the Federal Reserve Board will be because it will just be less effective if it's not prompt and bold and decision, in my judgment.

Now we have indicated there's no painless or short-term way to throttle inflation, but it must be remembered that everybody in this country now is suffering the loss in purchasing power of 15 or 18 percent, whatever the inflation rate is today.

Now as painful as these measures may be, I am convinced that inaction will cause far greater havoc and destruction to our economic system. In short, I believe the President should take the following steps which I have indicated for the Federal Reserve Board to move under that Consumer Act of 1969, and I think we should reduce the present year's budget and cut next year's budget so it will be credibly balanced, and I think we should impose, as you have indicated, tax cuts to offset the social security tax increase and the effect of inflation pushing taxpayers into high income tax brackets.

Now for the long term. I believe the following steps should be taken: the Constitution of the United States should be amended to require the Federal Government to operate on a balanced budget; two, the Constitution should be amended to limit annual expenditures to a percentage of the gross national product; and three, the Congress should enact laws this year that will encourage savings and investing as well as renewing and expanding the productive capacity of this great country.

In conclusion, I am reminded of a statement that was made more

than 200 years ago and it's attributed to a British historian by the name of Prof. Alexander Tytler. Perhaps you have heard it before. He said:

A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largess from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury with the result that a democracy always collapses over loose fiscal policy, always followed by a dictatorship. The average age of the world's greatest civilizations has been 200 years.

So in the 204th year of our great experiment in democracy, I think this is indeed a sobering observation. We see all about us shambles of financial affairs caused by loose fiscal policy and I think we stand at the crossroads in these meetings that you're attending now and the destiny of our great country really hangs in the balance. We cannot ignore the compelling requirement to return to fiscal sanity and fiscal discipline and our system derives its just powers from the consent of the governed and we must impose a fiscal year discipline upon ourselves in order to survive.

The question is—and this is a central question—can we muster the will and resolve as a Nation to bring about a renewal and a rebirth of the values that require living within our means? We really have no choice. We can and we must do it and by so doing we will renew our optimism, believe again in ourselves, and accept the responsibility that goes with a free society. Thank you, sir.

[The prepared statement of Mr. Patterson follows:]

PREPARED STATEMENT OF GRADY L. PATTERSON, JR.

Mr. Chairman and distinguished Members of the Committee, First I want to express my appreciation for the opportunity to appear before this Joint Committee of the Congress. I commend you for your great concern and efforts to bring some order out of the economic chaos that exists today in our country.

INFLATION: THE GREATEST THREAT TO OUR ECONOMIC SYSTEM

I think most of us will agree that inflation is the worst menace and the greatest threat to our economic system in this country. It will destroy our free enterprise system as well as our individual freedom if not reduced, curtailed and controlled. The taxpayers of South Carolina and this country are suffering irreparable damage and injury because of the astronomical inflation that permeates the entire economic structures of this country today.

Inflation Caused by Deficit Spending.—I believe a great deal of the inflation is caused by deficit spending and excessive spending by the government over the decades of the 60's and 70's. Fiscal discipline was cast aside and treated as a lonely orphan during that period of time. Fiscal discipline was rarely accorded its rightful place in the deliberative spending processes in these halls during those years. When the Congress sat down annually to make spending decisions, fiscal discipline was allotted a back seat, or no seat at all.

Excessive Government Regulations Cause Inflation.—Another large government burden which contributes substantially to inflation is excessive regulation, overcontrol and massive supervision of business and industry, which interferes with the daily activities of most businesses and citizens. People tell me almost daily of the never-ending burden of complying with a morass of regulations and forms required by some government or agency. This excessive burden consumes an endless number of manhours of all businesses, large and small, which adds to the ever-increasing cost of producing goods and services. The 1977 cost of regulations was $100 billion—$470 for each person living in the United States, and I am sure it is much higher now.

Inflation Is Enmeshed In Our Standard Of Living.—The roots of inflation go even deeper. Inflation is enmeshed into our standard of living and the psychology of our level of expectations in this country. Over recent decades people were en-

couraged to spend and consume, and our economy became a consumer-oriented economy with little or no emphasis on savings and capital formation. In fact, many tax actions by the Congress had the effect of deterring saving, investing, and renewing the productive capacity of this country.

Excessive Consumer Spending Consumes Capital.—This consumer-oriented economy with its spending attitude and ease of consumer credit has absorbed much of the capital that was needed to expand the productive capacity in the United States.

We Must Lower Our Level Of Expectations.—What can we do about inflation and how can we deal with it? There is no simple solution. There is no painless solution. Much of it is a state of mind and attitude of the country. I think we must adopt an attitude of individual as well as collective austerity and we must lower our level of expectations. We should rededicate ourselves to making work honorable and respectable. We should stress the dignity of work and the respect and self-pride in performing a day's work for a day's pay. To reduce and eliminate huge deficits and resultant borrowing, we must turn away from extravagance in the use of all our resources. We must impress prudence upon all our elected officials at all levels of government. The test applied to all issues should be not whether it is desirable, but whether we can afford it.

A Need And Demand For Fiscal Discipline.—The key to such attitudes is the approach we take as individuals. The responsibility rests with each of us. Government at all levels cannot and will not respond without the urge and demand of individual citizens.

I think there is a crying out for fiscal discipline all over this nation. I believe the mood of the country requires prompt and decisive action to curb and reduce the current rate of inflation.

Bond Market's Chaotic Conditions.—The financial and bond markets are in chaotic condition because of the unprecedented rate of inflation. This is causing an undue burden in the capital financing for South Carolina and all other states and political entitites in this country.

I am sure many of you know—perhaps all of you know—that South Carolina enjoys the highest credit rating awarded any state by the rating services, the cherished and coveted AAA credit rating. We can borrow money and sell bonds as cheap as or cheaper than any other state in the Union. Our bonds sell as well as or better than any other state's in the Union.

Fiscal Discipline Pays Dividends.—South Carolina has operated for decades and generations within the discipline of a balanced budget. Our constitution directs it. statutory law requires it: rules of the House of Representatives dictate it; and just plain reason and logic demand it. We must keep our financial house in order and live within our means. There is no economic sleight-of-hand that will allow a government to spend more than it takes in.

Such fiscal discipline has saved our taxpayers millions of dollars in interest costs in the financing of our capital programs.

Chaotic Bond Market Causes Cancellation Of Sale.—Despite this fine image and reputation in the capital markets throughout the country, it is practically impossible to sell our bonds. We had scheduled a $71.9 million State General Obligation bond issue for February 26, 1980 but elected to cancel the sale because of the volatile and chaotic bond market conditions, which have worsened since then.

The last time South Carolina sold bonds in January 1979, the average annual interest cost was 5.24 percent. If we proceeded with the February 26 sale, the cost would probably have been 50 percent higher, and would have cost $9,990,000 more. If the sale were held today, the State would pay $19,490,000 more than in January, 1979.

Over the next several months, we plan to use short-term bond anticipation notes to finance the capital programs. Eventually, we must and will issue the bonds. Hopefully, some order will emerge from the chaos that exists today in the financial and capital bond markets.

Escalation Of Interest Rates Will Not Solve Inflation.—I do not believe escalation of interest rates will solve the inflation problem. Thus far it has had little effect in curbing loan demand. The psychology seems to be buy and borrow now and pay back with cheaper dollars next year.

Absence of a policy to deal with the problem continues to fuel the inflation fires.

Recommended Short-term Actions.—I, therefore, believe the President should take prompt, bold action under the Credit Control Act of 1969 to authorize the

Federal Reserve Board ". . . to regulate and control any and all extensions of credit." Such action can be taken at any time ". . . whenever the President determines such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume."

The Federal Reserve Board could then:

(1) Prescribe maximum amounts of credit;

(2) Prescribe maximum interest rates;

(3) Prescribe maximum maturities;

(4) Prescribe allowable repayment schedules;

(5) Prohibit or limit any extension of credit under any circumstances the Federal Reserve Board deemed appropriate;

(6) Establish a system of required ratios that would limit credit expansion in relation to deposits or assets.

Such controls would cause short-term pain but would result in long-term gain. There is no painless way to throttle inflation, but it must be remembered that everyone is suffering 18 percent loss of purchasing power through inflation now.

As painful as these measures may be, I am convinced that inaction will wreak far greater havoc and destruction to our economic system. In short, I believe the President should take the following steps:

(1) Authorize the Federal Reserve Board to regulate and control any and all extensions of credit under authority of the Credit Control Act of 1969;

(2) Reduce the present year's budget and cut next year's budget so it will be credibly balanced;

(3) Impose tax cuts to offset the Social Security tax increase and the effect of inflation pushing taxpayers into higher income tax brackets.

Recommended Long-term Actions.—For the long term I believe that the following steps should be taken:

(1) The Constitution of the United States should be amended to require the Federal Government to operate on a balanced budget;

(2) The Constitution should be amended to limit annual expenditures to a percentage of the gross national product;

(3) The Congress should enact tax laws this year that will encourage savings and investing as well as renewing and exanding the productive capacity of this country.

Conclusion.—In conclusion, I am reminded of a statement that was made more than 200 years ago attributed to a British Historian, Professor Alexander Tytler:

"A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largess from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury with the result that a democracy always collapses over loose fiscal policy, always followed by a dictatorship. The average age of the world's greatest civilizations has been 200 years."

During this 204th year of our great experiment in democracy, this is indeed a sobering observation. We see all about us shambles of financial affairs caused by "loose fiscal policy." I think we stand at a crossroads and the destiny of the nation hangs in the balance. We cannot ignore the compelling requirement to return to fiscal sanity and fiscal discipline. The question is can we muster the will and resolve as a nation to bring about a renewal and rebirth of values that require living within our means? We really have no choice—we can and we must do it; and by so doing, we will renew our optimism, believe again in ourselves and accept the responsibility that goes with a free society.

Senator BENTSEN. Thank you very much, Mr. Patterson. I am delighted to see you again. Your State has a long history of responsible management of its fiscal affairs and you certainly fit into that mode as treasurer of a great State.

Mr. PATTERSON. Thank you, sir.

Senator BENTSEN. I think we do have the will. Sometimes, as I sit through that anti-inflation conference, after 6 days of all the problems of trying to arrive at agreement and consensus, I arrive at a better understanding of the Iranian Revolutionary Council.

I believe a lot of politicians today could say that this balanced budget is something we could have passed in the past. We can probably

pass it today because the American people are not just concerned, they are really looking for someone to take a lead and a strong lead in this regard.

I know that when these new budget proposals are made the professional lobbyists for every one of those interest groups are going to be up here knocking at the doors of all the Congressmen. But I seriously question that they truly reflect what their constituents in their group are thinking back home. I think that the American people in this instance are ahead of Congress in being ready to make some of the sacrifices that are necessary. If I'm wrong or the others are wrong and they don't win reelection, well, that's just part of the price of doing things that you think are right for your country.

Now we have been talking about monetary controls—and I have supported what Paul Volcker has done, but I think we have about used up what we can get out of increased interest rates. I support him; but he can't do it by himself. If we just depend on the monetary controls, ultimately that's a disastrous policy.

We have to do some things on the other side in the way of cutting this budget. I frankly think we need some sort of credit controls, but I'd like to hear what you gentlemen have to say. How about you, Mr. Fisher, do you think we are going to have to implement credit controls, and if you think we are, how do you think we can most effectively do it and yet avoid, to the extent we can, the enormous amout of bureaucratic overplay on the financial community?

Mr. FISHER. Well, I think that by far the most important thing to look at on the question of credit controls is that they certainly can work as part of a package, but controls themselves create artificial barriers. They get in the way of market allocation and I think we would urge you to——

Senator BENTSEN It certainly has to be a temporary approach.

Mr. FISHER. Yes. It has to be something to act as a transition while the more fundamental parts of the program are allowed to get underway, and certainly I think that the minimum interruption of market allocation is important. We certainly don't want to create a large amount of bureaucratic interference with the operations of the market, but I think that certainly there's a role for credit controls in this general program, but the market I think will react most favorably to the use of controls if the understanding is clearly there that they are a part of a transition period so that the fundamental program can be allowed to work.

Senator BENTSEN. Do you have a comment on that, Mr. Goldsmith?

Mr. GOLDSMITH. I think the basic concern from a fundamental standpoint or from a tactical standpoint is that it's all too easy for an individual to say, "I think controls should be put in place." I know I have done it myself and I probably will continue to do it until I start to think specifically—how does it affect me and how does it work? I think, if anything, it brings only the recognition of the severity of the problem down to the levels at which perhaps it should be recognized. I'm not sure at the moment, however, that the individual isn't beginning to notice that controls in the market allocation, which is far superior to controls in the long-run process, are beginning to work, that interest rates are now at such a level where our reliance on credit

cards—certainly our major bank credit cards with a ceiling of 18 percent—are beginning to restrict the use of credit.

Senator BENTSEN. That's tapering off some, isn't it?

Mr. GOLDSMITH. I believe it is, although—and without putting an onus on anyone—one wonders how in the weekend mail one can still receive a letter from a local bank that urges you to recognize the inflated value of your house by taking out a home improvement loan payable over the next 3 or 4 years.

Senator BENTSEN. What do you think of the commercial on TV which says don't worry about your overdraft; we'll automatically take care of it for you; we'll convert it to a loan.

Mr. GOLDSMITH. I think what we are experiencing there in both of the situations are really holdovers on programs which were put in place and in part are responsible for what has occurred. I thought to myself when we first started mentioning controls, "Wouldn't it be very nice if we could simply say every time a purchase was made in a store, and the sales clerk required, say a 10-percent downpayment, then revolving credit could be used." But, then I realized after getting caught trying to do some mandatory shopping after a long weekend "I didn't have enough for a 10-percent downpayment in my pocket."

I think the problem of controls over the long run is something that definitely has to be avoided and the major impact is to remind the public that the situation is difficult and that indeed levels are being reached or will shortly be reached where the allocation process will become restrictive enough to reduce the demands for credit.

Senator BENTSEN. So you say any kind of a temporary shortening of the installment repayment or the amount that can be charged to a credit card would be really to get the public involved and understand what's happening?

Mr. GOLDSMITH. I think so. I think that's what we can hope for.

Senator BENTSEN. Because percentagewise, it's not that big a part of the action. I know that.

Mr. GOLDSMITH. Right.

Senator BENTSEN. Although I'm told that over 60 percent of the credit is still available on credit cards, I'm not sure how they arrive at that number.

Mr. GOLDSMITH. If I could arrive at it myself, I would verify it, but I can't. I'm not sure how much is still left. I suspect a great deal of it. I suspect much less today than was available 2 months ago.

Senator BENTSEN. I'm told that too, and I'm also told that part of that—not necessarily on credit cards, but part of it has been because the credit unions have run out of money. They did in December. Some $400 million of the $1.5 billion reduction is attributable to that.

We have a lot of people saying that the only way to entice investors back into committing funds or to reduce interest rates is to bring about a recession. Would you like to comment on that, any of you?

Mr. GOLDSMITH. I think in a classical sense, and I'm not sure—having been one of those projecting a recession for the last 2 years and still projecting it—that it may not be inevitable that we experience something. I again go back to my example with my own downpayment on a credit card. If I suddenly find I can no longer make a purchase, I'm going to stop making purchases. If the consumer stops making purchases, business will not be as strong as it has been and some degree

of recession is inevitable. I think this is what we're looking at and as the consumer runs out of funds or adds credit that is available, whether for speculation or honest investment, credit begins to become unavailable. Then, that investment is no longer made and, again, the recession is inevitable.

I think what we're beginning to look at and certainly anticipate—and I think you in your opening comments are looking down 1 year from now and beginning to work on the 1982 budget which is realistic from a practical standpoint—is some weakness in the economy over the months ahead. If we reach 20 percent where investors and the general public suddenly find that investment is far more attractive than a purchase and, as Mr. Patterson or someone mentioned earlier, if we're anticipating on a purchase for next Christmas, that the price we pay for it in November might be 25 percent higher than it is now, then maybe that investment at 25 percent forces savings in lieu of spending stops and savings begin to increase.

So I think that aspect of the exercise that we are going through now is inevitable.

Senator BENTSEN. Mr. Fisher, you talked about the credit liquidity of our financial institutions and the problems for borrowers who are heavily dependent on those institutions. Does that also mean that we've got other crises that we may be facing? Do you see other Franklin National Banks in the future? Do you see that in savings and loans? Should that be a concern for purchasers money market certificates, for example?

Mr. FISHER. Yes. I think that if you look at the thrift institutions in this country and mark them to the market, as we say, in terms of——

Senator BENTSEN. That would be disastrous.

Mr. FISHER. Well, they are all technically bankrupt; there's no question about it.

Senator BENTSEN. Besides they've got to pay 2 times or 1½ times book and you've got a negative book—a lot of them have.

Mr. FISHER. That's right. Any institution that's in the business of lending long and borrowing short is in serious difficulty today, and certainly one of the implications of not reversing this confidence crisis that we've got right now is strain on financial institutions which they will not be able to meet. There will be Franklin National Banks in this cycle if we don't get it reversed now.

Senator BENTSEN. Mr. Patterson, you said that you withheld the sale of two issues. What can a State or city do? What happens to them? What are the alternatives when you have to withdraw the issue?

Mr. PATTERSON. I think there are perhaps three alternatives, Senator. The first circumstance, if the project is underway, then you would have to go ahead with some sort of financing. If the project is not underway, you could cancel or hold back on starting the project.

Senator BENTSEN. Well, what kind of financing do you go to if it's underway?

Mr. PATTERSON. If it's underway, there are two bad choices. You can go short term for 6 months or a short period of time and pay these exorbitant rates or you can go long term and pay the exorbitant rates. We have elected to go short term and just wait out the market. That's what we have elected to do. I don't know of any other alternative besides those three.

Senator BENTSEN. Do you think we are seeing a structural change insofar as long-term financing in this country?

Mr. PATTERSON. I don't see that, Senator. I think when the confidence is restored and a national policy is established with respect to what we are going to do about inflation, the confidence will rush back into the long-term markets and it will stabilize and I think you will see a continuation. I don't see any collapse permanently of the long-term financing markets.

Senator BENTSEN. Well, there may be some differing views here from the reactions of the other witnesses. What's the Canadian and the European experience? What have they done? Are there any parallels there?

Mr. FISHER. Well, there certainly are parallels in terms of what has happened in certain capital markets when you have had continuing inflation at high levels and the most common result is that the basic long-term bond contract as we know it today doesn't exist any longer. You look at the United Kingdom, for example, where there has been severe inflation for a long period of time. There are no long-term bonds in that market and almost more disturbing is the fact that even in some of the stronger economies—there isn't much of a long-term market in Germany and that really is still a holdover from the inflation of the 1920's in that country. It's been 60 years since they went through that, but it certainly has left permanent damage on the capital market of what is by most measures a strong economy.

So I think we are concerned about the potential—what is really happening in the market pschology is in October we unleashed a whole new set of forces when we began to force people, through what was done in October and through the market action that resulted from that, focus on the question that perhaps we really are in a different environment. In other words, it's not just interest rates being another 100 basis points higher, but an environment where you have to call into question the basic fundamentals of investing that have worked for us, and we think that's in jeopardy right now and I think Grady is certainly right in the sense that if confidence is restored, capital formation is adeqately going on in this country and there will be a return of buyers to the long-term market. But we are right on the edge and if we don't get it fixed this time our concern is that we are going to do permanent damage to the structure of the capital market.

Senator BENTSEN. I've got to leave and go to a meeting with Paul Volcker. I guess he's still there. I was supposed to have been there at 10 o'clock. But one of the things I'm sure will be a subject of that discussion is credit controls obviously. You touched just lightly on credit cards. Do you have any specifics for what we ought to be doing in the way of credit controls, any of you?

Mr. FISHER. Well, really just what I said earlier. I think I would not rely on credit controls as the fundamental fix to this problem. I think that they are a transition device and if the program is based on——

Senator BENTSEN. If we used them for a transition device, how would you do it?

Mr. FISHER. Well, I think we talked about the consumer area. Certainly there are some things like shortening the period on consumer credit to make the payments higher, requiring downpayments. Frankly, our view is that the market is already accomplishing that. I

think I would agree with Peter that the real benefit of that is to get the attention of the consumer rather than to have any economic effect.

Senator BENTSEN. Well, I think that may be right, but I recall I recommended credit controls to the Treasury Department and the Federal Reserve over 1 year ago and they said it wasn't necessary then. I think it would have worked very well, however, because the consumer really went on a binge. Maybe consumer credit is downtrending—I know it is at least temporarily, but I also know there's a lot of unused credit out there. So I can't help but have a concern.

Do you think it would help to have capital-to-loans ratios or capital-to-assets ratios—something more general, so we do not get into the detail of each and every loan?

Mr. PATTERSON. I think that would be much preferred and that would be one immediate action that the Federal Reserve could take, to establish a system of ratios that would limit credit expansion in relation to the assets of the institutions, and that would be a general credit control without zeroing in on one particular segment of the economy such as housing or automobiles or what have you.

Senator BENSTEN. What do you think, Mr. Goldsmith?

Mr. GOLDSMITH. Iwould support Grady on that point of view. It has to be general because you do not want to focus on the areas that are in particular jeopardy at the moment such as the housing or the automobile sector, but only from the standpoint of being purely a transitory function.

Mr. PATTERSON. That's what I'm talking about.

Mr. GOLDSMITH. If indeed the impact of this program and the attitude toward inflation are checked, then you have the problem of having to monitor controls that are put into place at a future point and particularly protecting those that may be in more serious trouble than others. We still come back to the same questions. Will people continue to spend money and continue to buy? Will manufacturers continue to borrow to the extent that someone suddenly can't borrow and then will we inevitably have a crisis such as the Franklin National Bank or the Penn Central or the Chrysler situation?

Senator BENTSEN. Yes. I'm very pleased with your testimony. I have some other questions, but I'm going to have to submit them to you in writing for answers in order that I can try to see what is happening in the other meeting. Thank you very much. The committee stands adjourned.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]

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

STATEMENT OF WILLIAM CURRIN, EXECUTIVE DIRECTOR, NORTH CAROLINA HOUSING FINANCE AGENCY

Mr. Chairman, members of the committee, my name is William Currin. I am executive director of the North Carolina Housing Finance Agency. I am pleased to have been asked by your staff to discuss the impact of the current crisis in the Bond Market on the production activities of the Agency which I represent. I do not presume to speak for the other thirty-eight state housing finance agencies in this country. I understand my purpose to be that of relating to you from a "grass roots" vantage point, some of the practical consequences of the current turmoil which exists generally in the national bond market and specifically in the North

Carolina housing market. I trust that my observations and comments will be of some assistance to you in your deliberations.

First of all, allow me to discuss something of the nature of the Agency which I represent. The North Carolina Housing Finance Agency was created as an instrumentality of the State of North Carolina for the express purpose of generating below market rate mortgage capital, to provide housing for persons and families of lower income. Toward this end, the Agency sells tax exempt revenue bonds, the proceeds of which are used to purchase mortgages.

North Carolina is recognized by the financial community as an issuer of triple A bonds. Our Agency takes very seriously that tradition of fiscal responsibility. We were convinced that, given the high cost of mortgage capital, an infusion of below market-rate mortgage money was necessary if the lower income citizens of our State were to have the option of purchasing a home. To that end we attempted to issue bonds totalling $100 million. Due to extremely unstable market conditions, we were unable to sell these bonds within what we considered to be the established parameters necessary to have a positive impact on the lower income housing market. The Agency opted for delaying the bond offering and waiting for a better day. Up to this point in time that better day has not arrived, as the market continues to show signs of weakness and instability.

It is perhaps too early for us to adequately judge the full impact of that delay, however, some preliminary observations can readily be made:

1. Approximately $90 million of mortgage capital will not flow into our State at the beginning of our building season.[1]

2. Approximately 2,500 North Carolina families with income less than $17,500 will not be in a position to purchase a home until these funds are available or until general market conditions are reversed such that mortgage rates are once again affordable.[2] We have determined that this income group cannot afford a decent home unless mortgage rates are approximately 9½ percent or less (this assumes a modest home costing approximately $40,000, as compared to the North Carolina median house price of $55,000 and a national median price of $62,000.)

3. Sellers of housing, must, under present market conditions, be willing to pay the lender from 8 to 10 discount points on FHA–VA loans. For example, the seller of a $40,000 home must pay $3,200 to $4,000 of his sales price to a financial institution. Under the North Carolina Housing Finance Agency program, the seller would have paid the lender two discount points, or $800.

4. A recent spot check of key realtors throughout the State indicates that sales are off twenty-five to forty percent, and construction is off approximately forty percent. Savings and loans deposits are generally down; Savings and Loans' lenders have indicated that mortgage loan originations are down 40 percent to 60 percent;[3] and FHA rates have increased from 9½ percent to 13 percent during the past year.[4]

In such an environment, our Agency is clearly the primary source of relief for marginal income families. Excluding figures from FmHA financed homes,[5] our projections indicate that the Agency would have provided over fifty percent of 1980 new construction financing for this income group, since very few homes exist or can be built at a cost affordable at the current FHA/VA rate of 13 percent and 8 to 10 discount points.

In North Carolina, where 5 percent of the work force is employed in the residential construction industry,[6] the impact of this situation on the employment rate will be profound. Builders, subcontractors, furniture manufacturers and build-suppliers will also be negatively affected.

North Carolina is a State where the 1980 median income for families of four is about $18,000.[7] Our program serves families with a maximum gross income of

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[1] $90 million of mortgage capital will be generated from $100 million bond issue. Remainder goes to reserve funds and cost of issuance. (Source: John Margeson, Director of Finance. NCHFA.)

[2] Approximately 2,500 North Carolina families will be served from the $90 million generated. (Source: Ibid.)

[3] Nationally, Savings and Loan deposits are down 71 percent over the past year; mortgage activity for the past year is down 48 percent. (Source: Raleigh News and Observer, March 11. 1980.)

[4] FHA rate increased in 1979 from 9¼ percent to 13 percent; effective yield increase was 10 percent to 15 percent. (Source: HUD, Greensboro. N.C., regional office.)

[5] Other government single family programs (figures for fiscal year 1979):
HUD Section 235=96 units (Source: HUD. Greensboro. N.C. regional office.)
FmHA Section 502=6,500 units (Source: FmHA, Raleigh. N.C.)

[6] North Carolina State Government Statistical Abstract, Fourth Edition, 1979; N.C. Department of Administration.

[7] Median income. North Carolina=$18.058, median income, United States=$20.428 (for period Oct. 1, 1980–Sept. 30. 1981; figures for 4-person families). (Source: Federal Register, Dec. 18, 1979; Vol. 44, No. 244.)

$17,400. That income will support, under present FHA/VA rates and standards, a mortgage loan of only $31,000, in a State where the median priced home is $55,000.[8] If we had sold bonds at a projected coupon rate of 9½ percent, the same income would have enabled those families to purchase a house costing up to $40,000, thus relating more effectively to available housing. This results from the fact that the differences in a 9½ percent and a 13 percent loan on a $40,000 house creates a monthly savings to the homebuyer of $100. Needless to say, many North Carolinians join us in a concern for the future direction of our nation's municipal bond market.

STATEMENT OF LAWRENCE H. BROWN, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, NEW YORK, N.Y.

Chairman Bentsen, The Public Securities Association (PSA) appreciates this opportunity to present its comments to the Joint Economic Committee (JEC) in connection with the above mentioned hearing.

PSA is a national trade organization representing some 300 member organizations which underwrite, trade and sell municipal and U.S. Government bonds. Since its inception three years ago, PSA has been actively involved in addressing all major policy issues relating to the public securities markets. Most of these issues have arisen in connection with Federal legislative and regulatory proposals.

Until now, it has not been necessary for the PSA to express concern over the effects of national economic developments on the condition of the bond markets. However, as generally dicussed in the JEC announcement of the March 12th hearings, inflation has caused these markets to suffer a virtual collapse which, in turn, inhibits the ability of public and private entities to raise capital to provide essential services and products. Thus, we feel constrained at this time to identify the major problems confronting our members in light of the crisis at hand.

Naturally, we recognize the grave impact of recent economic developments on the issuer of debt obligations. But equally significant, in our view, are the intermediate and long-term negative implications of the bond market collapse on the securities firms and dealer banks which underwrite and distribute debt offerings to the investing public.

Several PSA member firms have recently been forced to stop doing business as a result of market conditions. Others have significantly curtailed their involvement in the market. This, of course, leads to a cutback in employment in our industry, and in some cases, can subject customers of these firms to unnecessary hardships in connection with the handling of their investment accounts.

Small and medium size municipal bond firms, in particular, have been severely affected by recent market conditions. These firms, which provide specialized investment banking services to regional issuers across the country, simply cannot afford to maintain markets in thinly traded bonds as interest rates rise to record levels. To the extent that there is an absence of a viable marketplace for securities of this type, many small municipalities may be precluded from gaining access to the credit markets.

Unless the Administration's anti-inflation program can reduce interest rates and thereby provide relief to the bond markets, our main concern is that the basic structure of the public finance markets will more than likely undergo dramatic change. Given the uncertainties of the current economic environment, we question whether such change will be beneficial to the participants—issuers and investors—who have relied on the efficiency of these markets to meet their financing and investment needs.

In any event, PSA intends to closely monitor market conditions with a view toward determining whether Federal credit tightening and budget balancing measures are resulting in improvements in the operation of the public securities markets. We would be pleased to provide the Joint Economic Committee, as well as other appropriate Congressional and Executive authorities, with our findings on this matter as they are developed.

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[8] Median home price in North Carolina: (figures for 4-person families) New: $55,000 Existing: $50,000. (Source: North Carolina Homebuilder's Association, Raleigh, N.C.)

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95th Congress }
1st Session }

JOINT COMMITTEE PRINT

ISSUES AT THE SUMMIT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

together with

ADDITIONAL AND SUPPLEMENTARY VIEWS

MAY 4, 1977

Printed for the use of the Joint Economic Committee

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LETTER OF TRANSMITTAL

May 4, 1977.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of members of the Joint Economic Committee and other Members of Congress is a report of the Joint Economic Committee entitled "Issues at the Summit."

The report is based on mid-April hearings involving an outstanding panel of witnesses including representatives from Japan, Germany, Great Britain, the United Nations Conference on Trade and Development, along with American spokesmen for business and labor. It is intended to provide guidance to the President in respect to issues that he will be dealing with in the forthcoming summit meetings with foreign heads of State.

Sincerely,

Richard Bolling,
Chairman, Joint Economic Committee.

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ISSUES AT THE SUMMIT*

On May 7, 1977, President Carter will meet with the heads of state of six other leading industrial countries and the President of the Commission of the European Communities to discuss economic issues that confront all of these nations. While no representative of the oil producing or the non-oil-producing developing countries will be present at the meeting, the actions and requests of these nations have placed several issues on the agenda of the summit and will continue to have a major impact on the industrial economies throughout the foreseeable future. Moreover, meetings with both oil exporters and developing countries will occur shortly after the London summit conference.

On the basis of hearings conducted on April 20 through April 22, 1977, the Joint Economic Committee offers the President before his departure its views on some of the issues that he will be discussing with foreign leaders. In an attempt to include all relevant perspectives in our hearings, we invited not just Americans to testify but several prominent foreigners as well. These individuals from other countries included one of the five members of the Council of Economic Experts advising the German Government, a respected Japanese economist, an advocate of the proposals advanced by the United Nations Conference on

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* Senator Roth states, "Due to the press of Senate business, I have not been able to give this report the close attention it deserves, and thus I am not in a position either to endorse or to dissent from the report's findings and conclusions."

Trade and Development (UNCTAD), and an official of the Commonwealth Secretariat. The schedule of our hearings and a complete list of witnesses is appended to this report.

We offer our recommendations for President Carter's consideration and for possible discussion at the summit conference. They are also intended to provide a basis for congressional reflection on these international economic issues.

The recommendations are not intended to be the definitive statement on any of the issues. These questions are too complex to be answered neatly in a few sentences. We submit our views as sensible policy proposals for the United States or, in some cases, for industrialized nations as a group to consider. The United States would be guilty of arrogance if we were to go to the London summit meeting or any other international conference expecting policy decisions reached here to be accepted in toto by other countries. Witnesses at our hearings stressed the desirability, indeed the necessity, of consultations among the major advanced and developing countries before adopting and announcing major new policy initiatives if we are to find willing cooperation and support.

Growth in the Industrial World

The leading industrial countries should commit themselves to agreed growth rate targets and to the use of the policies necessary for assuring realization of these objectives. They should closely monitor current developments and modify stimulus programs as necessary. 1/

The deep world recession of 1974-75 and the sluggish recovery of the leading industrial countries have left most countries in the Organization for Economic Cooperation and Development (OECD) with historically high levels of unemployment. Slow growth in these leading economies has exacerbated the payments difficulties of both weaker OECD countries and the developing world. As a result, protectionist sentiment has been on the rise throughout the industrialized world.

Unemployment, payments imbalances, and the dangers of a trade war would all be reduced by a satisfactory rate of expansion in the industrial countries. The key to economic expansion lies with the stronger economies -- those of Japan, Germany, and the United States.

In Japan, the modest economic recovery that began in 1975 continued through part of 1976. Real GNP that had actually fallen in 1975 grew by 5.7 percent in 1976. The Japanese trade and payments position remained strong. In 1976, Japan recorded an $11.2 billion trade surplus, a $4.7 billion current account surplus, and continued to add to its reserves.

There were still, however, a number of trouble spots. Consumer prices in Japan increased 9.4 percent, more rapidly than in most other industrial countries. The unemployment rate rose slightly to 2 percent of the labor force. And by the end of 1976, the economy had stalled.

In response to domestic pressures for renewed growth and international pressures to increase the level of Japanese imports, the Fukuda Administration has adopted a three-step stimulus package. In fiscal year 1977

(the Japanese fiscal year runs from April 1 to March 31), the Fukuda Administration plans to increase spending on public works by $2.4 billion, decrease taxes by $2.3 billion, and lower the discount rate substantially.

The Fukuda stimulus package is based on the Japanese Government's target of 6.7 percent growth in 1977. Most economists, however, suspect that the growth rate will be lower -- around 6 percent. The Japan Economic Research Council, a private research group, is even less optimistic. In a recent study, the Council has projected a 5.1 percent growth rate for 1977, with private fixed investment, inventory investment, and personal consumption all growing at rates below the Government's projections.

German economic performance in 1976 was the envy of the Western world. Real GNP grew at more than 5 percent and consumer prices increased by only 4.5 percent. The German trade and payments position is very strong. In 1976 Germany achieved a trade surplus of slightly more than $14 billion despite a 14 percent increase in the value of the German mark relative to other currencies. Unemployment, however, remained a serious problem. Despite the relatively rapid growth of the German economy, the unemployment rate fell by only one-tenth of one percent to 3.7 percent of the labor force (figures adjusted for U.S. concepts). More than 1-1/4 million Germans are still out of work.

In early 1977, the German Government indicated that it would increase spending in public works by $5 billion. In late March, the German Government added $1.7 billion to its proposed package and specifically labeled the change as an attempt to respond to

President Carter's request for greater German stimulus.

The German Government foresees a relatively bright year with the economy growing at over 5 percent, consumer prices rising by only 3.5 percent, and exports growing at between 8 and 10 percent. Some forecasts put the German trade surplus in 1977 as high as $18 billion despite the expectations of further appreciation in the value of the mark. Not all the forecasts are so confident of German growth. For instance, the OECD foresees real growth in Germany hovering around 3.5 percent. If the OECD forecast proves to be correct, there would be ample room for further German fiscal stimulus.

For the United States, 1976 brought rather mixed economic results. GNP did grow by 6.2 percent and the rate of increase in consumer prices fell more than two full percentage points from 7.3 to 4.8 percent. Although unemployment fell to 7.7 percent for all of 1976, it was higher (7.9 percent) at the end of 1976 than it had been in the first quarter (7.6 percent). Economic growth at an annual rate of 9.2 percent in the first quarter of 1976 slowed in the rest of the year to an annual rate of 3.6 percent. In sharp contrast to Germany and Japan, the United States experienced a $9 billion trade deficit and a $0.6 billion current account negative balance.

Reflecting concern over the slowed economy and high rates of unemployment, the Carter Administration proposed a two-year, $30 billion stimulus package that mixed tax reductions with spending for public works and public service employment. Early 1977, however, brought more rapid rates of both

growth and inflation than had been expected. Despite the exceptionally cold weather in January, GNP grew at an annual rate of 5.2 percent in the first quarter. Industrial production rose by 1.4 percent in March, the biggest monthly increase since August 1975. Retail sales did slump by 2.1 percent in January, but grew 2.7 percent in February and an additional 2.4 percent in March. At the same time, wholesale prices rose sharply in February and March.

In response to the good news about growth and the bad news about inflation, the Carter Administration withdrew the bulk of its tax proposals. The result was virtually to halve the size of the stimulus package and concentrate its impact on 1978.

In its Annual Report, the Joint Economic Committee endorsed a real growth rate of 6 percent and agreed that a fiscal stimulus package in 1977 would substantially improve the prospects for economic growth. The Carter Administration had also drafted their original stimulus plan on the basis of achieving 6 percent real growth. Reflecting the withdrawal of the tax rebate proposal and a reduction in pace of Federal spending, the Administration now expects real growth in 1977 of only 4.9 percent. The recently announced energy plan of the Carter Administration may reduce the growth rate even further. We regret the impact that this reduction in the U.S. growth rate target is likely to have on domestic employment and on growth in other countries.

Despite modest recoveries from the recent recession, Japan, Germany, and the United States have made only limited moves toward fiscal stimulus. In part, this action reflects official expectations of relatively

high levels of economic growth in the year ahead. But it also reflects a broad-based apprehension about renewed inflation. Especially in Germany, but also in Japan and the United States, pressures for economic stimulation have been met by objections that additional stimulus would accelerate the rate of price increase. Inflation, it was argued, would increase business fears and further reduce already low levels of private investment in plant and equipment. In other words, additional governmental action would simply be self-defeating.

Fears of inflation, however, are probably exaggerated. High levels of unused capacity and unemployment suggest that there is little danger of additional inflation resulting from fiscal stimulus. Particularly in the case of the United States, the sudden jump in the Wholesale Price Index is mostly made up of increases in energy costs and a rise in agricultural prices caused by bad weather.

The danger for the world economy is that the three stronger industrial countries will all fall short of their targeted growth rates. If that should happen, not only will their own economies stagnate, but the payments position of the developing world and weaker industrial countries will become more serious.

1/ Senator Humphrey states: "I believe it is essential for the leading industrial nations to establish growth targets that will be sufficient to reduce the unacceptably high rates of unemployment which plague our economies. The restoration of full employment with relative price stability must be the first priority for our coordinated economic policies."

Structural Unemployment

All of the industrial countries are suffering from high levels of structural unemployment. As a first step, the problem of youth unemployment should be explored at an OECD-wide conference to be held in the fall of 1977.

As the industrial structures of the developed countries have become more similar, so have the economic problems -- persistent inflation, falling levels of investment, and high overall rates of unemployment. Throughout the industrial world there are large pockets of unemployment that are structural in nature, particularly among women, minorities, and young people. This problem does not respond readily to fiscal stimulus or eased monetary policy. There is one unemployment problem common to all the developed countries the severity of which demands immediate attention -- jobs for youth. Senator Humphrey and 18 other United States Senators have joined in sending a letter to President Carter calling for an OECD-wide conference on youth unemployment. Such an OECD conference could provide fresh impetus to reduce structural unemployment.

Trade Policy

<u>The December 31, 1977, target date for completion of the current General Agreement on Tariffs and Trade (GATT) negotiations should be extended. Congress and the Executive should cooperate in avoiding the erection of trade barriers and in assuring most-favored-nation access to U.S. markets. The OECD pledge against resorting to trade restrictions should be renewed.</u>

The Trade Act passed in December 1974 authorized the President to enter into a new round of trade negotiations with the objective of lowering tariff and nontariff barriers to trade in agricultural and industrial products. The first tasks for U.S. negotiators, once authorized to participate in what has come to be termed the Tokyo Round, were to agree with the representatives of other countries on how the multitude of individual issues was to be segregated for discussion purposes and on the priority assigned to each group of questions. Much technical preparation has been completed, including exchanges of tariff schedules, discussion of the merits and deficiencies of different proposed rules for reducing tariffs, and the elements of new codes of conduct regarding nontariff trade barriers. As the 1976 elections in the United States, Japan, and Germany approached, both American and foreign negotiators refrained from engaging in substantive negotiations on policy because neither could be confident that any agreement that was reached would be accepted by new political leaders.

During the Rambouillet summit meeting in November 1975, the objective of concluding the Tokyo Round of trade negotiations by the end of 1977 was accepted by the participating countries. This objective was reaffirmed at the Puerto Rico summit in June 1976. Given the limited progress, largely of a technical nature, that has been achieved to date and the need for the Carter Administration to formulate a comprehensive trade policy before the negotiators can begin to grapple with substantive issues, extending the deadline is appropriate.

The choice is one of concluding the negotiations by the end of this year and accepting a limited set of gains or of extending the negotiations within the January 3, 1980, deadline specified in the Trade Act of 1974 and attempting to achieve broader agreement as anticipated by the Act and the 1973 Tokyo Declaration. Significant progress in reducing tariff and nontariff trade barriers and in liberalizing agricultural trade, a chief U.S. interest, requires that the discussions continue beyond the end of 1977. Therefore, the previous target date should be set aside. In its place we should seek to establish a series of interim deadlines keyed to accomplishing each major step in the negotiations.

A number of U.S. domestic industries have appealed for relief from import competition, among them the shoe and color television industries. In both of these cases the International Trade Commission found that imports were in fact a source of injury. In the shoe case the Commission recommended imposition of a tariff-quota, and in the TV case a substantially increased tariff. President Carter rejected the Commission's

recommendation regarding shoes and asked the Special Representative for Trade Negotiations to conclude orderly marketing agreements with major producing countries that would reduce the volume of imports. Perhaps a similar solution will be sought regarding color televisions, especially since the Japanese Government has indicated its willingness to enter into such an agreement.

The President's decision on shoes has avoided the immediate imposition of a higher tariff on imports. But his preference for orderly marketing agreements has its disadvantages. Such agreements deprive producing countries of their right under the General Agreement on Tariffs and Trade (GATT) to demand an offsetting reduction in U.S. duties on other imports or to retaliate by imposing higher tariffs on American exports. From this country's point of view, therefore, orderly marketing agreements are apparently less costly, since we need not compensate foreign countries to account for the jobs and income lost through reduced exports to the United States.

Slow economic growth and high levels of overall unemployment have made it more difficult for workers and individual firms to adjust to rising levels of imports of shoes and television sets. A voluntary agreement may make it easier for the American economy to adapt now. But there are serious domestic costs. The Government collects no tariff revenues, and quantitative limits on imports raise prices to consumers. Purchasers of low-priced textiles, apparel, and shoes -- the type most directly affected by orderly market restraints -- are generally of modest incomes.

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An orderly marketing agreement to be effective requires the establishment of a global cartel in the particular product. Although these agreements are not intended to be permanent, once established they are extremely persistent and difficult to dismantle, as the history of orderly marketing agreements in fibers and textiles illustrates. Thus, consumers in importing nations as well as foreign workers who would have produced exports can suffer the consequences of such agreements for years, even decades.

The conclusion of additional orderly marketing agreements would perpetuate the trend toward bilateral solution of trade problems and further undermine the GATT. Since these understandings are generally concluded bilaterally, excluded third countries have little opportunity to represent their interests. Such agreements now exist in fibers and textiles, specialty steels, and a number of products the Japanese export to Europe, including steel, ball bearings, automobiles, certain electronic products, and ships. If this trend continues, the GATT will become so riddled with exceptions that it will no longer be a meaningful agreement.

The New York Customs Court recently decided that by failing to levy certain excise taxes on color television sets exported to the United States, the Japanese Government was subsidizing their sale to this country. The steel industry has brought a similar case regarding the application of the European Communities' value-added tax to steel exports to the United States.

The Court made its decision although it is the general practice of nations not to levy

excise taxes on exports and although non-application is sanctioned by the GATT. Indeed, this is the general practice followed by individual States and by the Federal Government. For example, the Federal excise tax on liquor is not applied to exports. The Common Market also does not apply its internal value-added tax to items that are sold to residents of nonmember countries.

This issue arises because the United States depends largely upon corporate and individual income taxes as the source of Federal revenues, while the European Communities rely upon the value-added tax. It can be resolved in a fashion that does not produce the seriously adverse consequences on trade flows that could conceivably result. The United States could modify its tax system, appellate courts could determine that nonapplication of excise taxes to exports does not constitute a subsidy, or GATT rules could be changed to permit nonapplication of corporate income as well as excise taxes on exported goods.

Trade with developing countries raises a different set of issues. The witnesses testifying, both spokesmen for developing countries and American economists, agreed without exception that one of the most important actions this country can take to help non-oil-producing countries counter the impact of high energy prices and to assist these nations in maintaining reasonable rates of growth is to keep our markets open to imports of their manufactured goods, as well as primary products. At the beginning of 1976 the United States implemented a Generalized System of Preferences (GSP) to assist developing countries in increasing their exports of manufactured goods to this nation. This system confers important benefits, particularly for nations that are

struggling to diversify their exports by selling manufactured goods abroad. For this reason, a system of preferences ought to be maintained. However, across-the-board tariff reductions would in the long run provide greater benefits to these countries. Hence, further expansion of preferences should be carefully examined.

Advanced developing countries and selected industries elsewhere in the Southern Hemisphere are becoming technologically competitive and soon will no longer require the benefit of preferences. These countries and industries should be assured continued access to U.S. markets on at least a most-favored-nation (MFN) basis. Negotiation of additional tariff reductions on an MFN basis can reduce or eliminate the obstacles industrial countries have raised against the processing of raw materials and manufacturing abroad.

Energy Policy

To reduce the pressure for higher world oil prices and to bring U.S. policies into agreement with the objectives of the International Energy Agency, Congress should act promptly to carry out the President's request to cut U.S. energy consumption and to develop domestic energy resources.

High energy costs remain the single most difficult economic problem for the industrialized countries. Quadrupling of oil prices in 1973, coupled with the supply disruptions of the Arab oil embargo, was a major cause of the economic recession in

1974-75. With recovery, demand for energy, and particularly oil imports, has risen again in all industrialized countries, continuing to aggravate the problem of payments imbalances.

In December 1976 the Organization of Petroleum Exporting Countries (OPEC) voted a 10 percent price increase. Saudi Arabia and the United Arab Emirates, however, split with the rest of the cartel by agreeing to hold their price increases to 5 percent and by unilaterally raising their own crude production to meet increased world oil demand. Whether motivated primarily by a desire for intra-OPEC leadership or a wish to bring pressure for peace in the Middle East, these two countries have shown serious consideration for the acute strains of higher oil costs on the world economy and deserve recognition for their responsible action. At the next OPEC meeting in Stockholm this summer, Kuwait and Iran have indicated they too may forgo a further price increase and produce a three-tier price system. The industrialized countries should continue to seek ways to encourage OPEC members to show restraint in future price increases.

The International Energy Agency (IEA) was formed following the 1974 oil price shock to bring the industrialized consuming nations together in a common front to deal with the oil producers. The IEA has succeeded in developing an agreement to share available resources in the event of emergency supply disruptions. It has further sought to promote cooperation in conservation, research, and development, and to consider joint guarantees for energy development schemes. According to the IEA evaluation, the United States has done substantially less well than Japan and most of Europe in its

conservation efforts. Lack of commitment in the United States to a serious energy program has been a major stumbling block to further IEA programs.

On April 20, President Carter announced a national energy program with stringent measures to cut domestic energy consumption over the next five years. While it is yet too soon to comment on the specifics of this program, we heartily endorse the President's strong leadership in announcing this tough program. Sharp reductions in the growth of U.S demand for oil imports are essential if we are to limit OPEC power to raise oil prices further. At the same time, the United States must move ahead on its program of stockpiling oil to reduce the potential impact of supply disruptions. In considering the President's program, we must give careful attention to minimizing the macroeconomic impact of higher energy costs. Appropriate measures must not be too stringent or phased in too rapidly lest they upset economic recovery at home and damage the world economy.

<u>Exchange Rate Intervention and Adjustment</u>

> <u>The International Monetary Fund should promptly develop guidelines regarding market intervention and other government activities that influence exchange rates. Official intervention in exchange markets should be discouraged except to curb disorderly conditions. Moreover, to promote global balance-of-payments adjustment, the industrial countries with strong currencies should not resist pressures in exchange markets tending to raise the value of their currencies.</u>

In contrast to 1976, self-interested intervention in exchange markets to manipulate relative competitive positions is not presently an issue among the major industrial powers. However, given continuing high unemployment rates and increasingly serious trade issues, the principle of refraining from the management of exchange rates to promote exports should be reaffirmed.

The individual member countries of the IMF are now approving amendments to the Fund Articles and a one-third increase in quotas. The Congress endorsed the amendments and quota increase in 1976. The ratification process should be completed by mid-1977.

The revised Article IV says, "The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to these policies." Recent policy of U.S. monetary authorities has been to avoid intervening in exchange

markets except as necessary from time to time to counter disorderly conditions. A manifestation of this policy is the new Foreign Currency Directive adopted by the Federal Reserve System on December 28, 1976, which states, "System operations in foreign currencies shall generally be directed at countering disorderly market conditions." The Joint Economic Committee has for some years maintained that disorderly conditions in exchange markets should be the sole grounds for intervention by U.S. monetary authorities and has urged U.S. officials to persuade the authorities of other leading industrial countries to adopt a similar policy.

In October 1976, the Subcommittee on International Economics conducted a hearing on guidelines for exchange market intervention. The purpose of this hearing was to investigate whether other industrial countries were intervening in exchange markets to hold down the external value of their currencies in order to expand exports. Of particular concern were Japan and West Germany, since both have strong export positions and both had occasionally intervened in exchange markets to prevent their currencies from appreciating. The extent of exchange market intervention by these two countries and the reasons for such intervention could not be clearly determined. However, it currently appears that if either nation had previously intervened in exchange markets on grounds that were not consistent with the revised Article IV, such practices have now been curtailed, if not eliminated.

Under the revised Articles of Agreement, IMF members shall undertake an obligation to "avoid manipulating exchange rates or the international monetary system in order to

prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members." Agreement to refrain from these practices is welcome, and the IMF should promptly establish guidelines or a set of operating procedures that will ensure against manipulation of exchange rates through market intervention, domestic monetary policy, tariffs, controls over capital movements, or any other governmental action that can affect exchange rates.

The strong currency countries can and should help deficit nations undertake the adjustments necessary to reduce their external payments drain. As discussed above, industrial nations can keep their markets open to imports of manufactured products from developing countries. The multilateral development banks, as is noted in the discussion below, can help finance the exploitation of new energy sources and encourage the growth of efficient export and import-competing industries. As a third factor in promoting desirable adjustments to reduce payments deficits, as distinct from deflation or protectionism, strong currency countries -- particularly Germany and Japan -- can choose not to resist but instead accept pressures in exchange markets tending to raise the exchange value of their currencies.

The witnesses from Germany and Japan endorsed such action. Both of these countries in 1976 accrued significant trade and current-account surpluses. These surpluses add to the financial strains already imposed upon weaker countries by high energy prices. Japan and Germany should follow the example of the United States in reducing their trade and current-account surpluses and should let the exchange value

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of their currencies rise whenever market transactions tend to push them upwards. To the extent that current-account surpluses persist, these countries should lend readily to deficit nations through commercial channels and via participation in the International Monetary Fund and contributions to the multilateral development banks.

Balance-of-Payments Financing

Even with the increase in quotas due to be approved this year, the International Monetary Fund's pool of lendable currencies could soon be depleted. Strong currency countries, including the United States, should contribute additional resources to the Fund that will be available to all members under conditions the IMF establishes.

Total payments deficits of non-oil-developing and weak industrial countries in 1977 will total between $30 and $40 billion (Table 1). These deficits come on top of sizable deficits for the last four years. At the same time, commercial bank lending to these countries may stop increasing and could even decline somewhat this year. Therefore an increasing burden is likely to be placed on the IMF to provide balance-of-payments financing and to enable borrowers to avoid deflationary or protectionist reactions to their difficulties. How these continuing payments are to be financed will be a subject of discussion at the London summit conference.

TABLE 1: Current-account balances

(Billions of U.S. dollars)

Group of countries	1973	1974	1975	1976[1]	1977[2]
OECD........................	2½	-33	-6½	-23	-25
OPEC........................	3½	70½	39½	41	45
Non-oil developing countries..	-2½	-21	-29½	-20	-22
Other countries[3]...............	-4	-9½	-15½	-12	-14
Unexplained discrepancy.......	½	-7	12	14	16

[1] Partly estimated.
[2] Projection
[3] Sino-Soviet area, South Africa, Israel, Cyprus, Malta, and Yugoslavia.

Sources: Department of the Treasury, Organization for Economic Cooperation and Development (OECD), and Council of Economic Advisers

The Fund currently has about $4 billion worth of lendable hard currencies. The quota increase due to be approved in a few months will add approximately $5 billion to usable IMF resources. Last year the Fund lent about $8 billion, up from $5 billion in 1975. Since drawings are likely to increase in 1977, available resources plus loan repayments would permit the IMF to function for only about 18 months. Additional funds totaling about $3 billion are currently available through the IMF's General Arrangements to Borrow (GAB). But this supplementary facility is available to only the ten major industrial countries, and it too could soon be depleted. More of a cushion is necessary.

During the 94th Congress, the Executive submitted for legislative endorsement a proposed $25 billion OECD Financial Support Fund. The congressional reaction to this proposal was cool. Although hearings were held in the Senate, the legislation was never reported to the Senate floor. No action was taken in the House of Representatives. This proposal, along with all other pending legislation, died with the conclusion of the 94th Congress.

There is little reason to expect that the OECD Financial Support Fund proposal would fare better in this Congress if resubmitted. Indeed, this proposal was fashioned primarily in reaction to the quadrupling of oil prices, and changes in conditions since that time have made the proposed facility less useful than it might have been earlier. The problem of paying for oil imports is now recognized as an important, but certainly not the only, source of international payments disequilibria. Inflation, business cycle variations, and fluctuations in commodity

prices are also contributing causes. Payments financing should be available to meet all of these difficulties equally.

Lending under the OECD Financial Support Fund was to be conditional on the borrowing nations' efforts to reduce energy consumption and to develop alternative supplies. The conditions attached to loans for financing payments deficits should also include an IMF-type requirement that the borrower adopt appropriate macroeconomic policies. The Fund's staff is experienced and well-qualified to establish the conditions associated with balance-of-payments loans and to enforce these requirements. To give another institution authority to engage in balance-of-payments financing and require it to assemble a staff to perform the same functions as the IMF would entail a wasteful and possibly disruptive duplication of effort. The International Monetary Fund is the appropriate institution to mobilize additional resources for official financing of payments deficits, to establish the conditions under which member countries may utilize these funds, and to disburse them.

How can IMF resources be expanded? Another quota increase would have the advantage of enlarging the potential drawing rights of all Fund members and should be considered. But it would suffer from the disadvantage that many of the currencies paid in as additional quota subscriptions are not readily lendable. Moreover, quota expansions require two or three years to negotiate and implement. The existing GAB is limited in that several of the countries that were potential lenders when the mechanism was established currently have weak external payments positions and are consequently no longer able to lend. A more suitable

supplementary source of resources for the IMF would include strong industrial countries and surplus oil-producing nations as contributors and would provide funds that could be lent to any Fund member for periods of up to two or three years. The conferees at the London summit should endorse the immediate creation of such a super-GAB.

In the last two years, the International Monetary Fund has lent vastly more through its regular resources than previously. OECD countries -- like the United Kingdom, Italy, and Portugal -- have borrowed from it both under the Oil Facility and the regular credit tranches. The number of developing countries turning to the Fund for balance-of-payments assistance, both under regular credit programs and those designed to meet their particular problems, like the Compensatory Financing Facility, is likely to grow in the immediate future.

While commercial banks were able to play an important role in financing deficits in the first years following the oil price increases, there is now growing concern about how much they can prudently further increase their exposure. At the end of 1976, approximately $80 billion was owed by non-OPEC developing countries to all commercial banks; overall external debt of non-oil-developing countries was estimated at $180 billion. While several developing countries are currently seeking rescheduling of their credits, a consensus of both public and private sources is that there is no serious prospect of default at this time.

Federal Reserve Board Chairman Burns has suggested that the International Monetary Fund play a greater role in both monitoring commercial bank credits to individual

countries and in assisting these countries to formulate appropriate stabilization policies. While there may be some disadvantages in putting all of the responsibility in one institution, this proposal should be explored thoroughly.

Increased resources for the IMF and suggested expansion of its role as guide for commercial bank lending to developing countries has focused attention on the kind of policies that the IMF pursues to promote economic stabilization. IMF programs have traditionally been short term (a year to 18 months) and have focused on bringing about balance-of-payments adjustment.

It is becoming evident that the adjustment process may be more complex than initially perceived. Sometimes inflation must be curbed, new energy sources must be developed and conservation implemented, recession must be combatted, or realistic exchange rates must be adopted. At other times structural adjustment in a particular sector may be necessary. The Extended Fund Facility was set up for the purpose of financing structural adjustments requiring several years to complete.

With the increasing activity of the Fund, questions have been raised about whether the same standards can, or should, be applied to all potential borrowers. Fund policies may have been too restrictive in some cases and too lenient in others. The Fund should reexamine the criteria behind the policies it employs. Within the confines of available resources, it should seek to pursue policies that are not excessively deflationary. However, the IMF should only finance problems that have foreseeable solutions.

Achieving a More Equitable Economic Order

Three weeks after the London summit, the industrialized and developing countries will meet at another session of the Conference on International Economic Cooperation (CIEC). CIEC has been one of the principal forums for discussing a broad array of issues raised by the developing countries since 1974.

The developing countries have born a disproportionate burden of current-account deficits resulting from the quadrupling of oil prices and the subsequent slowdown in the industrial economies. Efforts of the strong industrial countries to reflate their economies, to conserve energy, to curb trade surpluses, and to refrain from imposing protectionist trade barriers will benefit the poor countries.

Since OPEC raised prices, discussions between industrial nations and developing countries have become focused on demands of the poor for a new international economic order that would distribute the benefits of economic growth more equitably. While there is general agreement that some greater equity should be achieved, there is little agreement among poor countries on exactly how such a restructuring of the world economy might be achieved. The developed countries, on the other hand, have not been able to propose measures to assist the poor countries in the way that satisfies the latter group. Over the last three years, meetings in numerous forums on these subjects have deteriorated into rhetorical posturing and broken down over specifics.

Despite the seeming repetitiveness and lack of accomplishment in this "North-South"

dialogue, significant changes in economic policy and institutions have been initiated by the industrialized countries to benefit the poor nations. These initiatives are (a) expansion of the IMF Compensatory Financing Facility used to offset shortfalls in export earnings due to commodity price fluctuations; (b) establishment of the IMF Trust Fund to subsidize balance-of-payments loans to the poorest countries with the proceeds of IMF gold sales; (c) a shift to a greater willingness on the part of the United States to negotiate commodity price stabilization agreements; (d) establishment of a compensatory financing facility under the Lome Convention between members of the European Communities and countries in their former colonial areas; and (e) extension of trade preferences for imports of manufactured goods from developing countries by the United States, the European Communities, Japan, and Australia.

On the part of the developing countries, the discussion has produced some more realistic redefinition of the issues. For example, demands for generalized debt relief have largely been dropped. The Group of 24 communique issued at the IMF meetings in Manila in October 1976 reflected the concerns of the more advanced developing countries about maintaining their own access to capital markets and did not demand a general debt moratorium. These countries, nevertheless, do continue to be concerned with the need for debt relief for the poorest nations.

At the summit the industrial countries will be considering what they can and should do for developing nations. Some of the demands raised under the new international economic order -- indexation of raw material prices or a common fund to stabilize the prices of

unspecified commodities, for example -- are clearly not in our interest nor that of a viable international economic system. Other demands of developing countries may make greater economic sense, such as aid transfers, but they require budget commitments within the United States that are difficult, given competing demands. Moreover, the developing countries must themselves adopt appropriate domestic economic policies to be able to take advantage of opportunities when they arise.

In considering remedies to problems the poor countries face, we should seek solutions that mutually benefit both the industrialized and developing nations. Only if we can create a healthy and growing world economy will we be able to accommodate the needs for greater equity of those who have been disadvantaged. Probably the most important single benefit to developing countries would come from the expansion of trade mentioned above.

Commodities

To protect poor countries from sharp fluctuations in export earnings, the United States should continue to consider, on a case-by-case basis, commodity price stabilization agreements, additional needs for compensatory financing, and the adequacy of resources for diversifying exports. In discussing proposals for joint funding of buffer stocks, the United States should not agree to commit funds unrelated to the establishment of specific commodity agreements or to any attempt to raise prices above market trends.

Commodity agreements and the stabilization of the export receipts of developing countries in order to promote uninterrupted growth remains a key issue in the North-South dialogue. The developing countries want to reverse the decline in the terms of trade of raw materials that they have experienced; they see agreements to stabilize earnings in these commodities as critical to achieving this goal. The Integrated Commodity Program proposed by the United Nations Conference on Trade and Development (UNCTAD) would set up a common fund to finance buffer stocks for a core of 18 commodities as they are negotiated.

With a growing recognition of the need for stable export earnings to assure continuing development, the United States has been willing to consider commodity price stabilization agreements on a case-by-case basis. Over the last year, the United States

Government signed and ratified agreements in coffee and tin and indicated its interest in participating in the pending cocoa agreement if specific price levels are renegotiated. We are currently participating in several UNCTAD discussions for other commodity agreements.

Commodity agreements to stabilize prices around an underlying trend could facilitate planning both in the developed and the developing countries and help control inflation. Identifying and agreeing upon this underlying trend of market equilibrium prices, however, is extremely difficult, and there are added problems in policing any commodity arrangement. On the other hand, agreements that fix prices at levels above the long-run market-clearing equilibrium, or that seek to transfer resources by maintaining artifically high prices would not be successful in providing the development benefits sought by poor countries. Such agreements would lead to substitution of alternative products, uneconomic investments, and threats of politically motivated trade restraints.

Because of the difficulties in negotiating individual commodity agreements, the United States has favored stabilizing export earnings rather than prices. The IMF Compensatory Financing Facility was expanded for this end. The United States has also recognized the need to find individual solutions for particular commodities. In some cases, chronic oversupply has led to a declining long-term price trend; then diversification into other crops and manufactured exports is the only way to stabilize export earnings. In other instances, the difficulty of storing

agricultural commodities makes buffer stocks inappropriate.

When and if suitable stabilization agreements that benefit both producers and consumers have been negotiated, adequate funding will probably be forthcoming. Since joint financing of several stocks could be more efficient than independent financing, such possibilities should be explored as soon as enough agreements have been reached. Attempting to appropriate monies for a common fund before concluding the individual agreements would unnecessarily complicate commodity price stabilization negotiations.

Multilateral Assistance

The multilateral development banks should assist the developing countries' adjustment to higher energy costs by financing projects to exploit domestic energy resources and to create efficient export and import-competing industries. The United States should eliminate the arrearages in its pledged contributions to the multilateral development banks and should authorize a $2.4 billion contribution to the Fifth Replenishment of the International Development Association.

The poor countries need aid at concessional terms. According to the World Bank, per capita annual incomes for the 30 poorest countries still average less than $160 while those in industrialized countries average over $5,000. Without transfers of real resources financed by concessional aid from the industrialized nations, few developing

countries can look forward to steady economic growth, since they are not yet able to rely entirely on private capital flows and the benefits of trade.

Higher oil costs severely aggravated the payments deficits of the developing countries. These countries were initially able to forestall necessary adjustments by spending their reserves, borrowing heavily in the private capital markets, and drawing on the emergency programs of the International Monetary Fund. Because many of these countries are nearing their borrowing limits and their deficits are expected to persist, serious attention needs to be given to how these countries can meet higher import costs without relinquishing the goal of continuing economic growth.

The multilateral banks can play an important role in assisting the developing countries' adjustment to higher import costs. In close cooperation with the International Monetary Fund, the development banks should provide financing to foster efficient export- and import-competing industries. They should also seek ways to help poor countries develop competitive domestic energy resources and thereby reduce energy imports.

If the multilateral development banks are to continue helping the poor nations grow and encourage constructive adjustments to payments difficulties, they will need additional capital contributions. The Inter-American Development Bank agreed upon its capital increase last year and the World Bank and the Asian Development Bank are currently seeking capital increases from donor countries. The Fifth Replenishment of the International Development Association (IDA V), agreed to in March 1977, will provide

$7.6 billion over the next three years in concessional assistance for the very poorest nations. Congress should move quickly to appropriate funds for IDA V and for the agreed capital expansions.

Even with these increased resources, all the development banks must give continuous scrutiny to the quality of the projects that they fund as available resources -- even though seemingly large -- will fall short of the needs of the poorest countries. In addition, attention must be given to ensure that the recipient countries not only meet necessary criteria of creditworthiness, but that they pursue domestic policies generally supportive of the goals of growth, equity, and the improvement of the human condition that underlie our humanitarian support of development efforts.

Support of the International Development Association (IDA) -- the soft loan window of the World Bank -- is particularly important to demonstrate the seriousness of the U.S. commitment to help the Third World. In the past several years, Congress has been slow in providing funds for IDA; in fiscal year 1976 we actually fell behind on our commitment to IDA under the Fourth Replenishment by not appropriating the full amount authorized. Although our portion of the Fifth Replenishment Agreement appears large, as it must be if IDA is to maintain the real value of its ongoing lending, our percentage share continues to decline. While meeting our remaining commitments under the Fourth Replenishment, the United States should strive to commit new funds in step with other donors.

OPEC Participation

<u>The industrial countries should encourage the OPEC countries with large financial reserves to participate more fully in the international lending institutions. OPEC and multilateral development bank aid programs should be coordinated in order to maximize the effective use of available resources.</u>

The OPEC nations have increasingly participated in funding the development banks through contributions and purchases of bonds. This year the oil producers have pledged modest contributions to IDA V. The OPEC nations with financial surpluses however should be encouraged to play an even larger role in the IMF and the multilateral development banks. As mentioned above, these countries should be encouraged to contribute to any expanded super-GAB facility that is approved.

OPEC donors should also be asked to join with the OECD Development Assistance Committee in coordinating aid projects. Whenever suitable, projects should be financed jointly among private investors, the development banks, and OPEC aid institutions.

ADDITIONAL VIEWS OF SENATOR JACOB K. JAVITS

In general this report is well written and contains constructive suggestions for guiding the Administration at the forthcoming May 1977 Summit Conference. I wish particularly to emphasize the recommendations on structural unemployment, the pledge against resorting to trade restrictions, guidelines regarding market intervention, strengthening the resources of the International Monetary Fund (IMF) and the multilateral development banks, and encouraging greater participation of surplus OPEC countries in the international lending institutions.

The first recommendation of the Report, that "The leading industrial countries should commit themselves to agreed growth rate targets and to the use of policies necessary for assuring the realization of these objectives," reflects an unrealistic view of the situation. In my view, the governments of other industrialized countries such as Germany and Japan are not in a position to -- and are highly unlikely to -- take this rigid a view of committing themselves to specific economic growth rate targets.

At the present time the OECD and the Working Party Three afford excellent forums for Cabinet and Sub-Cabinet level coordination of domestic economic policy actions by the OECD member countries. However, I believe that international interdependence has reached the level where activities of this kind must be carried on at the highest political level.

Several references are made in the report to the need to promote freer trade and to encourage trade as an instrument of economic development, and I agree with the recommendations incorporated in these analyses. But, I believe that the role of private enterprise in international development and in the development of the less developed countries is consistently understated and underemphasized.

The national development plans of less developed countries continually rely on large infusions of private capital. These infusions in turn depend on what has now become an extraordinarily sophisticated and efficient worldwide mechanism for transferring funds, resources and technology vast distances in order to produce and to employ persons all over the world. The LDC critics of multinational corporations and international banking activities are often, as citizens of the world, major beneficiaries of that system.

While I do not believe that competition condones the alleged malefeasance of some international corporations, the fact is that roads, harbors, health care supplies, communications equipment, educational materials, and billions of dollars of other goods and services have found their way to the LDC's through their activities. The thrust of our foreign economic policy, therefore, should be to develop incentives for further liberalizing trade patterns with the LDC's as an integral aspect of our policies towards those countries.

In my view, the issues raised by the call for a New International Economic Order form the key economic -- and therefore, political -- world issues of the coming decade or

decades. Therefore, policy must aim at providing the incentives for private sector growth in such a way as to "internationalize" the mentality of U.S. business -- large and small.

I have some misgivings over one aspect of the report's analysis. While I agree with the fact that the International Monetary Fund is the appropriate institution for mobilizing additional resources for official funding of payments deficits, I do not agree with the implication of the report that the United States should abandon the proposal for the $25 billion OECD financial support facility. Although, as the report points out, the reception to that proposal in the United States Congress has been cool, the fact is that other OECD countries have enacted or have in place legislation authorizing participation in such a facility.

The need for flexibility in coping with the balance of payments difficulties of both the less developed countries and the weaker industrial countries requires that different financial institutions with different capabilities be put in place, much as business itself has developed new forms of enterprise to deal with the opportunities of world trade. The new, so-called Witteveen Facility proposal recently taken up at the Interim Committee Meeting of the International Monetary Fund, has some practical advantages over the OECD financial support facility, and my views are not meant to recommend a substitute of the latter for the former. However, the OECD facility represents an agreement which has already found considerable acceptance and which would implement the principle that oil payments imbalances between OPEC and the world's industrialized countries can be resolved by

SUPPLEMENTARY VIEWS OF REPRESENTATIVE CLARENCE J. BROWN REPRESENTATIVE GARRY BROWN AND REPRESENTATIVE JOHN H. ROUSSELOT

While we agree with several of the recommendations in the Committee Report, there are others to which we take exception.

The first is the recommendation that "The leading industrial countries should commit themselves to agreed growth rate targets and to the use of the policies necessary for assuring realization of these objectives."

What the Committee really means by this is something less innocuous. The recommendation should be translated to read, "Japan and Germany should be pressured into deficit spending and faster money creation in order to eliminate their current account surpluses. They should expand their economies more rapidly to encourage imports, in order to help stimulate the economies of the rest of the world by running balance-of-payments deficits."

Should We Pressure Germany and Japan?

We feel that the governments of Germany and Japan know far better than anyone else just how far they can go in expanding their economies before they run into socially and economically unacceptable inflation, with its attendant risk of recession and unemployment. It is not our place to make such a recommendation.

Could Such Pressure Help?

Even assuming that Germany and Japan were willing to try to reduce their current account balances by $5 billion each, would it help the worldwide economic recovery? No. The size of the impact must be minor.

German trade is roughly $100 billion of imports or exports a year, out of a gross national product (GNP) which will approach $500 billion this year. Thus, one-fifth of German spending is for imports. To get an extra $5 billion increase in imports, in addition to what is expected to occur, German GNP must grow by an extra $25 billion this year above the amount anticipated. The amount anticipated is already about $25 billion (5 percent of $500 billion). If Germany needs to grow by another $25 billion, that implies a doubling of her real growth rate to 10 percent per year. What fiscal or monetary policy could work that kind of miracle?

Japan, which has let the yen rise sharply for months, and which is not expected to have a current account surplus in 1977, is surely not guilty of misbehavior. Nonetheless, it is being urged to run a deficit of a few billion, say $5 billion, to help the Third World. Japan's imports are only about one-eighth of a GNP of nearly $600 billion, so that Japan would have to add an extra $40 billion to GNP to bring about an extra $5 billion in imports. Coincidentally, Japan is already growing by about $40 billion a year, or at a rate of 6 percent. Thus, like Germany, it would have to double its growth rate to provide a $5 billion deficit for the benefit of other countries.

Suppose that these countries could, in fact, return to fixed exchange rates, double their growth rates, and cause a $5 billion reduction in Germany's current account surplus, and a $5 billion current account deficit for Japan. Would this help?

Germany's $5 billion would be only one-tenth of one percent of the Free World's GNP of $5 trillion. Adding Japan, we get an increase in demand of two-tenths of one percent. This is truly negligible. Furthermore, most of that will flow to their major trading partners, the United States, Britain, France and Italy. Two of these, Britain and Italy, will simply use part of the money to repay debt while maintaining their austerity programs. This proposal does next to nothing for the Third World.

The Impact on Borrowers in the Third World

As implied above,Germany and Japan can be expected to run an actual payments deficit only under fixed exchange rates. There are a vast number of conceptual problems in saying that a country can run a balance of payments deficit while on floating exchange rates. (While both the German and Japanese floats have been "managed," both the mark and the yen have been allowed to rise significantly over the past year or more.)

Over the past year, both nations' current account surpluses were largely offset by capital account deficits (lending abroad). That is how the balance of payments balances under floating rates.

The implication of the Committee's recommendation that Japan and Germany continue with floating exchange rates *and*

eliminate or reverse their current account surpluses is that they ought to eliminate or reverse their capital account deficits -- that they should stop lending and start borrowing! Such a policy might aid those Third World nations which would furnish exports to Germany and Japan. However, it would injure those which are deepest in debt and need to restructure or renegotiate their loans. These countries do not want to see an end to German and Japanese lending. Still less do they want to compete with German and Japanese borrowing! This problem was not dealt with during the hearings.

Exchange Rate Adjustments

Later in the report, the Committee recommends that "industrial countries with strong currencies should not resist pressures in exchange markets tending to raise the value of their currencies." We agree. However, the Committee is implying that Japan and Germany have held down the values of the yen and the mark, and that this has contributed to their current account surpluses.

In recent years, both the yen and the mark have risen substantially, with no noticeable impact on the current account balances of either country.

The mark has risen more than 10 percent with respect to the dollar since the beginning of 1976. The yen has risen more than 7 percent. Germany is participating in the EEC currency snake, or joint float. This has somewhat curtailed the free movement of the mark. Nonetheless, substantial increases have been realized.

It is the conclusion of many international trade theorists that devaluations and revaluations have no permanent impact on a country's trade balance.

Old style devaluation theory stated that devaluations could help a country's trade balance, as follows:

"Suppose Britain devalues the pound by 10 percent, and that all British products continue to sell at the same number of pounds as before the devaluation. Then the price of imported wheat in terms of pounds goes up 10 percent, discouraging wheat imports, and British steel looks 10 percent cheaper to foreigners in terms of their own currencies, encouraging British exports of steel. If the effect is strong enough, Britain's trade deficit shrinks. (All this assumes fixed exchange rates, of course, such as under the Bretton Woods system.)"

Modern devaluation theory says:

"That is a nice first step, but will Britain's pound price of wheat and steel stay constant, or of any other product either?" The answer is "no."

British steel was always sold partly in Britain and partly abroad. It could have been sold entirely abroad, but since the British price equaled the world price, some was sold at home. Now, however, foreign steel is selling for 10 percent more, in terms of pounds, overseas. If any steel is to be sold in Britain, the pound price of steel must rise 10 percent, or all of it will be exported.

Similarly, foreign and British producers of wheat would charge the world price, which

enables them to command the same purchasing power over foreign (and domestic) steel (i.e., all other products) as before. That is, wheat would sell for 10 percent more in terms of pounds after devaluation.

This rise in the pound price of all trade*able* goods (whether actually trad*ed* or not) *is* followed by an equal rise *in* the price of British haircuts and other non-tradeable goods. Why? Because nothing has changed the *real* costs of haircuts versus wheat versus steel, or the public's view of them. If people tried to shift purchases away from the now more expensive steel and wheat into haircuts, the price of haircuts would rise until it was back at the same relative price, compared to steel and wheat, as before.

The conclusion is that devaluation of "x" percent does not permanently alter the trade balance. It simply reflects a simultaneous inflation of "x" percent, *or triggers one*. On the other hand, a rise in the value of a currency of "x" percent reflects a reduction of "x" percent in the rate of inflation, or helps to bring it about.

The Committee's recommendation is not going to produce the results it assumes.

Commodity Price Agreements

The Committee recommends that "To protect poor countries from sharp fluctuations in export earnings, the United States should continue to consider... commodity price stabilization agreements."

This is a plan to help the Third World indirectly, instead of directly through grants, loans, or freer trade.

The neediest of the Third World countries will need grants to get them through the energy crisis. Those among them and those among the more developed Third World nations with sound plans for permanent growth and adjustment, deserve to be able to get loans to tide them over, either from private banks or from an expanded International Monetary Fund (IMF) or International Bank for Reconstruction and Development.

However, we are now being asked to create a price support program for commodities as part of a long-run solution. As several witnesses noted, this will not bring about efficient development or industrialization of the Third World. It will only create increased dependence on one or two commodities for countries which are already too dependent on this type of production. It would tie up their resources producing commodities for storage instead of valuable goods for trade.

The alternatives of grants, lower tariffs, private investment and multinational lending are to be preferred to commodity price fixing plans.

If commodity stabilization funds are necessary, one should be established for each commodity, as President Carter suggested in his address on Latin America. If one fund were to be established for all commodities, as the Third World has proposed, the various Third World countries would be tied up in knots for years bargaining over how much of the fund would go to support each commodity, and what the support price should be. For

example, Third World nations heavily dependent on coffee production and tin imports would want a large coffee fund with a high support price, and a low tin fund with a low support price, while tin producers who import coffee would want the converse.

Efforts at Self-Help

The implication of some of the witnesses that the developed world has exploited and suppressed the Third World has to be challenged. The United States is more than 90 percent self-sufficient. We import or export less than 10 percent of our GNP. And, what we import, we pay for with exports. We do not seize products, or conduct trade, at gunpoint.

Therefore, we feel it proper to ask the question, "What has the Third World done to help itself?"

Some of these countries have welcomed foreign investment. Some have not.

Some of them have removed exchange rate and foreign exchange controls. Some still stifle their own financial markets.

Some of them have low tax rates and never threaten to nationalize industries. Some scare private help away through threats and political instability.

Some of them allow investment in a normal, honest fashion. Others impose enormous taxes on business in the form of red tape and bribe-taking, which costs multinational companies money and gets them into political trouble at home.

One of the witnesses remarked that "governments feel that it is their business in some measure to choose the pattern of political-economic organization." That is true, provided they are willing to take the consequences. If their political-economic form of organization discourages self-help and private assistance, do they have as much of a claim on foreign sympathy as do those countries which seek private development and encourage self-help?

We should not forget that the Government of the United States is also free to choose its pattern of "political-economic organization." The United States has every right to decide that its own "pattern" is best served by favoring nations which have encouraged their own development and sought after private investment before applying to the U.S. Treasury, over those which have made a bee-line for the money of American taxpayers.

Mrs. Anne Krueger testified that, "No matter what the external environment, or the level of resource transfer, anything that represents a genuine step forward in raising productivity and living standards of the people is going to require at least 90 percent of the inputs from domestic efforts."

We concur, and we are more than willing to help, in as efficient a manner as possible, those nations which share that view.

SUPPLEMENTARY VIEWS OF SENATOR ORRIN G. HATCH

I support the reservations expressed in the Supplementary views of Rep. Clarence G. Brown, Rep. Garry Grown, and Rep. John H. Rousselot, and I would like to express some additional concerns.

It seems to me that implicitly the Committee Report is recommending world inflation and international price-fixing. Both would, of course, increase the economic misallocation of the world's resources and lessen human welfare.

The scheme to establish price supports for Third World commodities will cause a wasteful misallocation of their scarce resources into the overproduction of the price supported commodities at the expense of their economic development.

The scheme to reflate the domestic economies of the United States, Germany, and Japan will turn these net suppliers of international loans into net borrowers of international loans. To dump the United States, Germany, and Japan into the already crowded international market for loans will only make the financial situation of Third World, large debtor countries more difficult.

Already Italy and Britain have trade deficits and to cover them they have to compete against Third World countries for international loans. If we pressure Germany and Japan out of their trade surpluses and into trade deficits, they also will have to compete against Third World countries for international loans. Every country cannot be a debtor country. The economically

underdeveloped Third World countries need to be debtor countries, because they need to import investment. Therefore, come countries elsewhere must have trade surpluses in order to be able to supply loans.

Germany and Japan cannot simultaneously have trade deficits and supply loans except by transferring their foreign exchange holdings as gifts to the Third World. This would require flexible exchange rates to be abandoned and the German and Japanese central banks to peg the foreign exchange rates of the mark and yen. Otherwise, the exchange rates of the mark and the yen would move, until the payments deficits were eliminated.

If Third World countries want grants, they should ask for them outright instead of concocting inefficient schemes that will reduce their economic development prospects. Our response to these requests must be based on their economic merit and not on any alleged moral compulsion. We have no obligation to lands whose economic opportunities are largely foreclosed by the nature of their political and economic systems and by the absence of extensive and secure private rights to property. We have no obligation to subsidize lands whose only elite is the government class that rules.

On the other hand, those countries that seek to extend economic opportunity to their citizens, rather than restrict it to government, will find that the opportunities created by the energies of private people will generate helpful investment and support from people abroad.

HEARINGS ON ISSUES AT THE SUMMIT

GROWTH, TRADE AND ENERGY
April 20, 1977

GERASSIMOS ARSENIS
Director, New York Office of UNCTAD

ARMIN GUTOWSKI
Member, German Council of Economic Experts, Frankfurt am Main, Germany

SABURO OKITA
Special Advisor, International Development Center of Japan, Tokyo

GEORGE POULIN
Vice-President-elect, International Association of Machinists and Aerospace Workers, Washington, D.C.

ROBERT V. ROOSA
Partner, Brown Brothers Harriman and Company, New York

J. ROBERT SCHAETZEL
Consultant and Writer, Washington, D.C., Former U.S. Ambassador to the European Communities

BALANCE-OF-PAYMENTS
FINANCING AND ADJUSTMENT
April 21, 1977

RICHARD S. ECKAUS
Professor of Economics, Massachusetts Institute of Technology

PETER B. KENEN
Professor of Economics and International Finance, Princeton University

WILLIAM J. McDONOUGH
Executive Vice-President, First National Bank of Chicago

ISSUES IN NORTH-SOUTH DIALOGUE
April 22, 1977

LAWRENCE S. KRAUSE
Senior Fellow, Brookings Institution, Washington, D.C.

ANNE O. KRUEGER
Professor of Economics, University of Minnesota, Minneapolis

JOHN P. LEWIS
Professor of Economics and International Affairs, Woodrow Wilson School, Princeton University

SRIDATH S. RAMPHAL
Secretary-General, Commonwealth Secretariat, London

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