485

DOMESTIC AND INTERNATIONAL IMPLICATIONS OF THE FEDERAL RESERVE'S NEW POLICY ACTIONS

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BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

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MONDAY, NOVEMBER 5, 1979

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 305–C, Federal Plaza, New York, N.Y., Hon. Henry S. Reuss (cochairman of the subcommittee) presiding.

Present: Representative Reuss and Senator Javits.

Also present: Helen Mohrmann, professional staff member; and Carol A. Corcoran, minority professional staff member.

OPENING STATEMENT OF REPRESENTATIVE REUSS, COCHAIRMAN

Representative REUSS. Good morning. The subcommittee will be in order on the subject of "Domestic and International Implications of the Federal Reserve's New Policy Actions."

In the beginning was the word, and the word on October 6 was that the Fed was going to respond with greater vigor to the international monetary imperatives, and for that reason it was ridding itself of its Federal funds preoccupation and concentrating on the money aggregates. There was also an extension of reserve requirements for certain managed liabilities and an increase in the discount rate.

A month has now elapsed since that fateful Saturday announcement. It is our purpose today to take a look at what has happened since, what benefits have accrued—there have been some obvious ones—and what burdens, there have been some obvious ones there, too. We also want to get a better insight from the leaders of the financial community, of business, and of labor into the effects of October 6, and what other policy initiatives, if any, may be needed.

I am most grateful that our thinking and action in this field has been bolstered by our old friend Senator Javits, who suggested this morning's hearings. I would like to recognize Senator Javits for such welcoming remarks as he may want to make.

OPENING STATEMENT OF SENATOR JAVITS

Senator JAVITS. First, Congressman, thank you so much for being here and presiding. Without you we could not have had this hearing.

I would like to thank Senator Bentsen from Texas and the ranking member in the House, Congressman Brown, for making this hearing possible. Especially to you for your willingness to chair it.

Senator Bentsen, our chairman, has been very cooperative. I appreciate it very much.

I would also like to thank the witnesses who were recruited on rather short notice, but whom I believe represent a very fine cross section of the best which we have to offer in New York on this subject.

My views, Congressman, prior to the hearing, are simply that while the October 6 determination of the Federal Reserve Board was essential, I believe that it is not sufficient for ending the inflationary spiral in the United States. It gives us a chance—my best estimate is 6 to 9 months—in which to deal with the other matters which are of such critical importance to us in terms of energy, productivity and our expenditures, all of which are vital to any final result.

As I see it, and I hope very much the witnesses will address themselves to this, our problems are as follows: Our nonmonetary policy on energy, productivity, taxation, and the uncalculated but critical factor of morale, that is, confidence in the system, and what sacrifices the American people are willing to make to break inflation and, in addition, end inflationary expectations; and what action we propose to take on the wage, price and credit front.

One of the major questions I have is, Are we in such a jam that we have to put on controls? I cannot personally rule that out in any way.

Second, what can we do about a good many restrictive laws on our books that raise the prices to consumers of sugar, grain, textiles, meat, and other items critical to the cost of living?

Third, what about diversification or substitution in the international monetary field? I believe that the danger to us is of a monetary destabilization which would be so grave as to very much deepen the coming recession.

Fourth, how well are our allies in Europe working together with us economically? How can we improve these relations? In that connection, as an element of it, what about the fact that only we sell gold?

Fifth, the problems which are engendered by the heavy debts of the less developed countries and what should be the relation between the IMF and the commercial banks in surveillance of what is going on both in respect of the deficit countries and the countries running continuous surpluses?

Finally, there is the ever present and omnipresent energy problem and the tremendous job of skimming off the economy, which will probably cost our country along the lines of $70 billion this year, in order to pay an uneconomic price for oil.

These are the key questions as I see them, and for the witnesses. Thank you again, Congressman Reuss, and I thank our witnesses. I think you have about the best brains in the country here; probably the world. I hope this will come out as we talk, that on their native turf, as it were, where these men do business and develop their views, we may get what would be a characteristic New York financial market view of our situation.

Thank you.

Representative Reuss. Thank you, Senator. Your chauvinistic views about New York are well-known and understandable.

[Laughter.]

[The written opening statement of Senator Javits follows:]

WRITTEN OPENING STATEMENT OF HON. JACOB K. JAVITS

We are here in New York City, which is both the financial and business center of the world, to hear the views of leading members of the private sector on the health of and the outlook for the U.S. and international economies in light of the Federal Reserve's actions of October 6.

That date represents an important watershed in U.S. economic policy; for on that day, we in the U.S. finally recognized that international economic forces play an unprecedented major role in the formulation of our domestic economic policy. The restrictive monetary measures of October 6 were necessary to restrain substantially inflationary expectations, but they are not sufficient to end the inflationary spiral in the U.S. This critical factor was recognized by Federal Reserve Board Chairman Volcker before this Committee on October 17 when he told us that "we should not rely on monetary policy alone * * * (and that) we also need a sustained, disciplined fiscal policy * * * effective energy policy * * * regulatory and tax policies that will help stimulate investment, cut costs, and increase productivity; and * * * international cooperation and understanding." I see no significant movement in these areas. Unless the Volcker policy gets this support from the Administration and the Congress in these critical areas, the economy can be thrown into a severe depression with, however, no perceptible drop in the inflation rate and only a lowered standard of living for the American people.

High interest rates and tight money will have very little impact, for example, on the OPEC oil cartel and domestic oil prices, food prices and housing costs. Only a broad and tough economic program dealing with structural U.S. economic deficiencies along the lines of the one I proposed on the floor of the Senate on October 5—the day before the Fed's dramatic move—will effectively meet the problem. Until we put in place such a program, the present Federal Reserve Board policy remains the only anti-inflation game in town since the foreign exchange markets are watching the Fed's every move closely. Under the present circumstances, it cannot be relaxed.

Mr. Chairman, I was particularly struck by recent reports that former Treasury Secretary Blumenthal, in a retrospective analysis of economic policy in the Carter Administration, said that the President had not developed "a clear, simple economic philosophy devoted to fighting inflation." Blumenthal reportedly admitted that one of the key mistakes of the Administration was its policy on the dollar and that it failed to catch on early enough to "the vicious circle" between inflation and a weaker dollar.

Mr. Chairman, while the Administration was learning its fundamental economic ABC's, leading bankers, financial economists, and businessmen were correctly analyzing the situation and were calling for a U.S. policy committed to fighting inflation, increasing productivity, and strengthening the dollar. Mr. Chairman, that is why we are here today: because we in Washington—and I include the Congress—can no longer pay attention only to what is thought or said in Washington. The collective wisdom of gentlemen, like our witnesses here today, who have had so much experience in the market places of the banking, finance, and business must be given greater consideration.

Mr. Chairman, these as I see them are the critical issues:

1. Non-monetary policies on energy, productivity, taxation and morale that would complement the Fed's recent actions and would achieve real inroads in our fight against inflation. And, if these complementary actions are not taken, how long would a tight monetary policy have to be in place to achieve a break in inflation, if at all? Will wage, price, or credit controls become necessary or will they worsen the situation? And, what sacrifices are called for from the American people to break the back of our inflation and end inflationary expectations.

2. How can we improve our productivity growth performance? We continue to be in the cellar among the industrialized countries. As a key international reserve currency, the dollar must be strong if we are to restore confidence in the monetary system. A strong currency makes it, however, especially important that we act to regain our international competitive position through increased productivity growth since we cannot rely on a weak dollar for that competitive edge.

3. Can we wage a credible anti-inflation fight with restrictive and agricultural laws that raise the price to our consumers of such commodities and products as sugar, grain, textiles, and meat? Is it not time that we put in place effective adjustment assistance programs that will train workers who are presently in redundant industries to take their places in the new and emerging sectors of our economy? Is not a massive export program geared to capturing new markets abroad required for balance of payments opportunities and for new employment opportunities for U.S. labor?

4. In the international field, how can the diversification be stabilized that is now underway in both official and private currency markets away from the U.S. dollar and into the currencies of other major industrialized countries, such as Germany, Switzerland, and Japan? What are the chances for successfully establishing the IMF Substitution Account that was recently discussed in Belgrade, and is it not important to begin to plan now for an orderly diversification out of the dollar over which the major governments have control rather than continuing with the present policy of uncontrolled diversification by both private dollar holds and the smaller central banks?

5. Is it not time for us to insist that our economic allies cooperate more closely with us in stabilizing foreign exchange markets and especially in undertaking a better mix between fiscal and monetary policies when they wage their own fight against domestic inflation? Can we any longer endure the interest rate war that is now underway, which results directly from the almost exclusive reliance by some of our main economic partners on monetary policy to fight inflation.

6. Should we not insist that the other industrialized countries join us in selling gold? While I recognize that continued and irregular gold sales by the U.S. Treasury have a dampening effect on the gold market's price volatility, are not our gold sales just providing gold to the coffers of others that do not share our policy of gold demonetization?

7. How can the international financial system cope with the recent OPEC price increases? Are the increased strains on the non-oil poorer developing countries as a result of the most recent and the expected OPEC price increases going to break the creditworthiness of these countries? Some analysts project that these countries, which are unable to cut back on their vitally needed oil imports because of their development plans, will have a $50 billion current account deficit in 1980 with OPEC countries having a collective surplus of $50 billion (and up to $80 billion) if there are further significant oil price increases. Many of these oil importing developing countries are heavily loaned up and, with the increased surveillance that bank authorities are imposing on commercial banks in the lending industrialized countries, these developing countries may very well be facing a serious credit crunch.

8. Should the IMF be brought into a closer relationship with the commercial banks in providing surveillance of the economic programs not only of these deficit countries but also of those industrialized and OPEC countries that are running continuous surpluses?

9. And finally, what can be done internationally to restore order in the oil markets? Must we not insist that consuming countries develop a real joint plan to deal with OPEC and not try to gain unilaterally preferential access to OPEC oil.

Mr. Chairman, in the last few weeks, it has been fashionable to analogize our present economic circumstances to those of 1929. A consensus has developed that, as opposed to 1929, a worldwide economic failure would not result from a stock market crash but could result from a failure in the international financial structure. The imbalances caused by OPEC, the close to one trillion dollar Euro-currency market which to this day is still unregulated, and the continued deficits that many countries will run because of high energy costs require us to search for long-term international solutions which will eschew protectionism and keep international trade and capital flowing.

Regrettably, every country appears to be going its own way, reminiscent of the 1930's when the Depression in the U.S. was internationalized by worldwide protectionist policies and the drying up of capital flows between the surplus and the deficit countries.

Charles Kindleberger, the eminent Nobel Prize winning economist, in his work on the Depression of the 1930's, explains that the Depression was internationalized because England, after World War I, was no longer able to con-

tinue to exercise its global leadership and to assume the responsibility for the proper management of the world economy. The U.S., although having the wherewithall, did not have the willingness or desire then to assume that leadership role. Without a leader, Kindleberger argues, each country followed its near-sighted economic self-interest. Today's scene is more reminiscent of that scenario than of any other with the U.S. no longer able to carry on the leadership role it accepted after World War II and the Germans, Swiss, and Japanese not willing to share that responsibility with us which comes as a necessary corollary of their new economic strength.

While I recognize that we have in place international monetary and trade institutions such as the IMF, GATT and the OECD, without leadership and international cooperation these institutions cannot, by themselves, ensure the cohesiveness and stability of the international economic system.

Mr. Chairman, I welcome these leaders of the New York financial, banking, and business communities to our hearing and look forward to hearing their views on these critical issues.

Representative REUSS. We are delighted to have a major legal panel to start us off, consisting of Tilford Gaines of Manufacturers Hanover, who I believe will be with us in a moment, Alan Greenspan of Townsend-Greenspan, a man for whom all our respect continue at the highest level. He has been so helpful. He appears before the Joint Economic Committee regularly on Mondays. I can promise you next Monday you won't have to be with us. That is Veterans' Day. You may have the day off.

Mr. GREENSPAN. I thank you, Congressman.

Representative REUSS. And David Jones of Aubrey Lanston & Co. Thank you for being with us.

Would you proceed first, Mr. Greenspan.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, N.Y.

Mr. GREENSPAN. Thank you very much, Congressman. I want to say first that I share the Senator's chauvinistic views about the city and State of New York. I am certain that in the somewhat cloudy atmosphere of this city we have a certain degree of perception which perhaps when we go to Washington we lose. So hopefully things that you get out of us here would not have been available in the Nation's Capital.

There is a tendency in the popular rhetoric to assume that interest rates in this country are determined largely by the whim of the Federal Reserve Board of Governors and Open Market Committee. We are here, in fact, to evaluate the moves of Chairman Volcker and his colleagues last month, implying that some alternate policies were feasible at that time. However, given the state of the world financial markets, had the Fed not opted to initiate a sharp interest rate increase in this country, the market would have done it for us. There is, in fact, no way in today's environment that interest rate can be driven down by the Federal Reserve.

A generation ago in periods of fixed exchange rates and modest levels of inflation, there was some meaning to the concept of independent, domestic monetary policies. There was a sense in which the Federal Reserve could initiate policies with little advertence to the state of either international finance or specific policies initiated by other central banks. That is no longer the case.

In recent years, we have seen a transition from "country" money markets to "currency" money markets on a worldwide basis. There is not a world market for dollars in which interest rates in London, New York, Frankfurt, and Hong Kong on dollar-denominated securities are fully arbitraged against rates in Frankfurt or Singapore.

In this type of new international financial environment, independent monetary policies by the Federal Reserve or, for that matter, any other central bank, have ceased to exist. We talk as though Federal Reserve policy is still largely discretionary. But in today's inflationary environment, Fed policy is probably being made more in Frankfurt than in Washington. This is perhaps best illustrated by examining the pattern of policy and interest rates in the United States since the beginning of the year.

Early this year, 3-month CD's, offered in both the United States and in the Eurodollar market, were holding relatively steady in the area of 10 to 10½ percent. However, with the inflation in the United States running persistently in the double digits and expected to continue far above that of Germany, the dollar was being heavily discounted in the forward exchange markets. Earlier this year 3-month forward deliveries of the mark were being quoted at approximately a 6-percent premium—at an annual rate—above the spot position. Not surprisingly, therefore, the 10-percent dollar interest rates arbitraged into a 4-percent 3-month interbank deposit rate for DM's in Germany. Moreover, the forward premium on the DM has remained relatively stable all year, owing mainly to the persistence of the high inflation rate in the United States relative to that of Germany.

There are other conditions but they get complex. The main issue here is the differentiation of expectations.

Earlier this year the German Government became concerned that its economy was overheating and decided that major restraint had to be exerted on credit expansion. As a consequence, DM 3-month interest rates were driven sharply higher, reaching 9¼ percent last week. The combination of 9¼ percent deutsche mark interest rates, plus 6½ percent exchange rate premiums yield a dollar equivalent of approximately 16 percent.

In a fully arbitraged market, this, then, is where one would have expected Eurodollar rates to move, as in fact they did. With slight differentials for technical factors of liquidity and reserve requirements.

Hence, since there is close arbitrage between dollar interest rates in Europe and those in the United States, 3-month CD's offered by domestic U.S. banks have risen in line with Eurodollar CD's.

The key question is, Could the Federal Reserve have prevented this 5-percentage-point rise in interest rates during the summer? The answer is "No." In order to do so, they would either have had to prevent deutsche mark interest rates from rising, which strikes me as unlikely in the extreme, or create a significant reduction in the forward premium on the deutsche mark in the foreign exchange markets. Since inflation expectations were not changing, that could have been done only through a massive forward sale of deutsche marks by either the Federal Reserve or the U.S. Treasury. With success dubious at best, such a policy could not have been seriously contemplated.

Had the Fed merely attempted to suppress the rise in short-term U.S. money market rates, there would have been a massive run on the dollar. In such a case, converting dollars into deutsche marks, buying 3-month deutsche mark CD's, and simultaneously selling deutsche marks 3 months forward at the 6-percent premium, would have, at the end of the 3-month period, created an interest rate yield in dollars well above that available in the United States or in the world dollar market generally.

This would have induced a significant conversion of dollars to deutsche marks in the spot exchange markets which probably could have been supported only with huge—possibly $5 billion a week—levels of intervention. Ultimately the market would have prevailed, and such an intervention strategy would have failed. Hence, short of reducing the perceived differential rate of inflation in the United States relative to Germany, there was no practical means by which the Fed could have failed to accommodate deutsche mark interest rate increases.

Perhaps, they could have allowed the DM to rise sharply in the spot markets until the 3-month forward premiums weakened, thereby allowing dollar interest rates to temporarily hover below what they otherwise would have been. This might very well, however, have set off even greater expectations of inflation in the United States, eventually pushing dollar interest rates up in any event.

Confronted with this dilemma, there has been considerable discussion of a joint venture between the Bundesbank and the Federal Reserve to bring down both dollar- and DM-denominated interest rates concurrently: Deescalate international interest rate competition, so to speak. This strikes me as a dubious policy since, if there were an attempt at implementation, it is quite likely that credit expansion both in Germany and in the United States would accelerate. There is in the world a general level of interest rates which reflect deep-seated inflation expectations and time preference and cannot be arbitrarily lowered without massive inflationary consequences.

I thus conclude that for the United States there is little leeway for policy maneuvering in the monetary area and that the focus, as it should have been all along, must be on defusing underlying inflationary pressures. A combination of severe retrenchment in Federal borrowing requirements, both direct and indirect, coupled with reasonable restraint on the monetary aggregates is the only way interest rates can reasonably be expected to be brought down.

Unless credit demands ease significantly in Germany and short-term, deutsche-mark-denominated interest rates fall, interest rates here can be brought down only by lowering the D-mark premium in the forward exchange markets. That, in turn, would probably require a significant lowering of inflation expectations in the United States.

In the interim, sharply higher interest rates here will surely lower the demand for mortgage money with the consequent slowing in house turnover, lowered housing starts, declining rate of realized capital gains on home sales and, as a result, weakened consumer markets.

1980 is likely to be a recession year and high interest rates are unquestionably going to exaggerate and prolong any recession. It would

be a mistake, however, to attribute the interest rate increases to the Federal Reserve. Its options are limited. The problems reflect earlier inflationary policies. Unless and until we can reverse them, a restoration of balance in our economy will remain illusive.

Representative REUSS. Thank you, Mr. Greenspan.

Mr. Jones.

STATEMENT OF DAVID M. JONES, VICE PRESIDENT AND ECONOMIST, AUBREY G. LANSTON & CO., INC., NEW YORK, N.Y.

Mr. JONES. Thank you very much for the honor of addressing this subcommittee this morning.

I thought I would focus my attention primarily on the basic domestic side of the Federal policy decisions. We have had, obviously, serious international difficulties which Mr. Greenspan so clearly enunciated.

But I would like to say this this morning I want to focus a bit more on the domestic side. I wanted to focus, if I may, particularly the Fed options which they faced in this circumstance, in which they faced severe difficulties.

I would like to talk about the effectiveness of monetary action, if I might. Was the action too abrupt in terms of implementation of the specifics of Fed policy, and whether or not the Fed will continue to show resolve in attacking monetary growth on the domestic side. Perhaps I will mention also what other policies might be taken in complement to Federal Reserve policy.

In a general way, the actions of the Fed could not be avoided. The inflation factor as Mr. Greenspan so well pointed out was an extreme problem. Beyond that Fed Chairman Volcker sensed, and I certainly share his views on this matter, speculation and fever of inflation was becoming rampant, particularly in the commodities market, precious metals, including gold, and generally other areas of the economy such as real estate.

Finally, the economy was stronger than expected as we moved up to the special October conditions. The September figures came out much more strongly than I anticipated and it appeared much more strongly than the Fed anticipated. In particular, the unemployment rate in September dipped to 5.8 percent, although it ticked up to 6 percent in October.

In general, the economy was running ahead even through the third quarter, at a much higher than expected rate.

I would like to focus on the specific actions of the Fed for a moment. In general, there were two features of the Fed's program which were anticipated by the financial markets. One was the increase in the discount rate of 12 percent to 11 percent. The other was an 8-percent reserve requirement on what we called managed bank liabilities. The bond and money markets were generally looking ahead to the very strong prospects that the Fed would have to take these actions against the background of a weakening dollar in the foreign exchange markets, and as I pointed out, excessively strong domestic inflationary conditions.

Perhaps the most important point to make here, though, is that the third and indeed most significant action by the Federal Reserve, that

of attempting to give up on what we call the crawling Federal funds rate peg and focus instead on the supply of bank reserves and its relationship to monetary policy was highly significant and had a major impact on the bond market in general.

The first and most important effect of this action was for the Federal Reserve to create extreme uncertainty in the minds of bank and other lenders both as to the availability of funds and the cost of funds. This will likely result in a substantial cutback in mortgage credit in the months immediately ahead, possibly consumer credit and very likely small business credit as well.

I would like to underscore an important fact of life for the bond market that came as a result of this third item in the Federal Reserve's October package. In view of the uncertainty that was created by this new day-to-day Fed operating technique, we have seen market rates move higher than ever in the history of the country.

In general, I would like to turn your attention to some long-term Treasury bond rates, 30-year Treasury bond rates, and just touch base in terms of some levels. If we look back to pre-Volcker a year, back into August of 1978, long-term Treasury bonds were yielding 8.55 percent. On August 1, 1979, just before the new Fed Chairman was appointed, we had long-term bond rates at 8.92 percent, up, but as you would expect in a period of economic expansion and rising inflationary expectations.

Come October 3, just before the October 6 package, we saw long-term Treasury bond rates at 9.35 percent. Come October 16, just before another factor that we will talk about in a moment, the money supply on this date, we saw long-term bond rates at 9.81 percent, and finally, as of last Friday, long-term Treasury bonds, 10.43 percent.

What I want to underscore is this: In the period from October 3, 1979, the increase in long-term Treasury bond rates from 9.35 percent to 10.43 percent, more than a percentage point, was the largest for such a short period in the history of this country. The bond markets were extremely unsettled. During periods of time there was, in effect, no bond market. Bids were not forthcoming as the market in terms of price was in a free fall, tending to push these yields higher.

In essence, I want to say this, that in terms of concept, the Fed's package of October 6 was appropriate. In terms of execution, the Fed's package left a good deal to be desired. And in terms of uncertainty created in the market, particularly as a result of this third item, the item of relating reserves directly to money supply growth and creating uncertainty in the markets, we saw perhaps a greater increase in bond rates, a higher cost to the Treasury of borrowing than had been anticipated or would have been appropriate.

Allow me to push into another area which is the money supply mistake. One can put that $4.5 billion mistake that we saw in the money supply in the first 3 bank statement weeks in October—it has been revised down slightly from $4.5 billion to $4.2 billion, nevertheless being a significant number.

If I could just underscore the post-money supply/pre-money supply mistake periods. The Fed in a sense had already shaken the markets by the October 6 package. The last thing we needed at that particular point in time was a major mistake in the money supply. That bond rate

that I just quoted, moving up 9.81 percent on October 16 to 10.43 percent was also perhaps one of the largest increases in bond rates for such a short period we have ever seen.

To put it in a nutshell, the Fed shook up the bond markets considerably as a result of its October 6 package, created a significant amount of uncertainty and then compounded the problem by an unfortunate money supply mistake.

I am not blaming the Fed directly for this, but I am saying its quality control procedures should be improved in this respect, and it was most unfortunate that this mistake occurred during a period of extreme uncertainty.

Let's move on to the question of whether or not the Fed will show resolve in this matter of attempting to control money supply regardless of the technique used.

It appears that Mr. Volcker is indeed determined to bring money supply under control, and that he will persist even into 1980, the election year, to do so. Therefore, one can easily conclude that interest rates will remain high as we move into 1980 and perhaps as the economy begins to weaken in the recession period.

The likelihood will be, therefore, that we will have the worst of all possible worlds as we move into early 1980. We will have exceedingly high interest rates, we will have inflation, an inflation carryover from last year, and we very quickly will see very sharp declines in economic activity, particularly in the housing sector, as we move into that period.

Let me just underscore one alternative possibility in terms of Fed policy, the implications if the Fed doesn't hold strong. In this sense, the Fed's resolve should be given a great deal of emphasis, and should underscore this factor very much.

If the Fed does not hold strong, my view is that the economy is destined in the 1980's for a boom/bust cycle. We will have excessive inflationary expectations, a weaker U.S. dollar in the foreign exchange markets, accelerating inflation and, in fact, an economy that is so difficult to control that, in general, frustration will reign supreme in policy circles.

The point here is that we almost had the ball game won in the 1974 period. People say that periods of recession and slowdown do not reduce inflation. I offer the following facts to suggest otherwise.

We saw as a result of the deep recession in the 1974–76 period a drop-off in the inflation rate from 12.2 percent in 1974 measured on a consumer price index December to December, to 7-percent inflation in 1975 to 4.8 percent in 1976. Good progress. Needless to say, the economy went through the wringer in the process, but we did reduce the inflation rate. The problem was the resolve was not strong enough, either in the monetary realm or the fiscal policy realm in terms of reduced budget deficits.

We moved up in inflation in 1977 by two points to 6.8 percent, 1978 to 9 percent, and an estimated 13 percent now in 1979.

The question is this: While one may debate the precise techniques used by the Federal Reserve and the difficulties in collecting numbers, the point is that the resolve needs to be maintained. If we don't see further maintenance, we have problems.

Finally, in terms of the complementary policies, I might say that in general I think the only real limits to economic activity must lie in monetary resolve to control money supply growth and in fiscal policy resolve, perhaps including some tax incentives ultimately to generally reduce the problems of excessive consumer spending.

Perhaps we will need some tax incentives that in general will reduce consumer spending and shift incentives to the investment area where we can see more spending on plant and equipment as a result, perhaps, of an accelerated depreciation. Perhaps in general we can look ahead and hope in the future that we see some more investment in plant equipment and improvement in productivity, which is our only salvation over the long term.

Thank you very much.

[The prepared statement of Mr. Jones, which was subsequently supplied for the record, follows:]

Prepared Statement of David M. Jones

The Federal Reserve's monumental October 6 package of tightening actions and change in day-to-day operating procedures was commendable and most appropriate. In terms of general policy strategy, strong Fed restrictive action was desperately needed to counter excessive U.S. inflationary pressures, a sudden surge in speculative fever in markets for commodities and precious metals, and a slumping U.S. dollar on the foreign exchange. At the same time, U.S. economic activity remained surprisingly strong through September, suggesting the economy could withstand stepped-up Fed restrictive measures.

The most important feature of the October 6 package was the Fed's shift in emphasis in favor of attempting to limit the availability of money and credit and away from primary emphasis on trying to ration money and credit primarily through increases in cost (i.e., interest rates). More specifically, the Fed decided that in the conduct of its day-to-day operations it would focus primarily on limiting growth in bank nonborrowed reserves to a pace consistent with the monetary authorities' targets for money growth. At the same time, the Fed discarded its previously emphasized weekly Federal funds rate target, disaffectionately referred to by some as "the crawling funds rate peg". (One foreign central banker was reported to have observed that in 1978 never had a central bank wasted as many eighths of a percentage point as the Federal Reserve had in its attempts to tighten policy by means of gradually increasing its crawling funds rate peg.) The upshot of the Fed's new procedures is that they have greatly increased the uncertainty of banks and other lenders over the both availability and cost of lendable funds. As a result there is likely to be a sharp near-term cut back in funds available to mortgage borrowers, consumers, and smaller business borrowers. This drop off in credit (and money) growth may, in turn, be associated with a deeper and longer recession than earlier expected.

FED MISTAKES IN EXECUTION

While the new Fed policy initiatives were necessary, the monetary officials' method of implementation was unnecessarily abrupt and unsettling to the financial markets. Actually, the Fed's implementation of its new day-to-day procedures for limiting the supply of bank reserves was so hastily effected that there were apparently no internal operating procedures or guidelines in place to assist the System Account Manager. This uncertainty on the part of the monetary authorities was inevitably magnified many times over in the financial markets where participants were already in a shell-shocked state due to the comprehensiveness of the Fed's October 6 package. The result was a plunge in stock market prices and recurring periods of near chaos in the money and bond markets.

To make matters worse, the Fed appeared to tighten its policy stance even further on October 18 in response to an apparent continuation of excessive monetary growth in early October. (This added Fed pressure on bank reserves could be seen in day-to-day Federal funds trading as the funds rate jumped to a 15.14 percent average level in the bank statement week ended October 24 from 13.22

percent in the statement week ended October 17.) With negative psychology already mounting and feeding on itself, this apparent further tightening move by the Fed triggered extremely violent conditions in the money and bond markets and both short- and longer-term interest rates rose to record highs, well above the levels they might otherwise have reached in the absence of the Fed's actions.

To make matters worse, the M_1 monetary aggregate (demand deposits and currency) was grossly overstated by $4.2 billion in the first three bank statement weeks in October, due to a bank reporting error. Unfortunately, this error could not have come at a less opportune time, with market psychology already in a state of upheaval. Furthermore, the major damage to finacial market psychology had already been done by the time the error was belatedly disclosed by the Fed on October 25.

Perhaps the most striking illustration of the extremely unsettled financial market conditions in October can be seen in movements in the long-term Treasury bond rate. Over the period from October 3 (just before the Fed's announcement of its October package) through November 2, the rate on 30-year Treasury bonds rose more sharply than in any comparable period in history, from 9.35 percent to 10.43 percent. This current Treasury bond rate level compares with a level of 8.92 percent on August 1 (just before Fed Chairman Volcker's appointment on August 6) and 8.44 percent a year earlier at the beginning of August, 1978.

More recently, the Fed has apparently stabilized its policy stance, in view of the fact that revised money growth for October now shows the smallest month-to-month increase since last May. Rates on bank CD, Treasury bills and most other money market instruments—with the exception of the primate rate—have generally adjusted downward in response to the Fed's steadying efforts.

Looking ahead, every sign points to the likelihood that Fed Chairman Volcker will seek the support of other Fed policy-makers in efforts to continue to limit bank reserve growth until money growth is reduced to a more moderate pace, following four months of excessive growth. Undoubtedly, the monetary authorities would prefer that the October 6 "knock-out" punch will turn out to be sufficient to dampen monetary growth and, eventually, to reduce inflationary pressures. However, should further Fed tightening actions be required to counter a renewed bulge in money and credit growth, Chairman Volcker shows every inclination that he intends to lead the way.

IMPLICATIONS FOR ECONOMY IF FED RESTRICTIVE RESOLVE FALTERS

In the event that the monetary authorities should fail to hold to a restrictive stance until money growth drops to a decidedly slower growth path, the U.S. economy is in for roller-coaster, boom-bust economic cycles in the 1980's. If, for example, the Fed should give in to political pressure in 1980 as the Presidential election approaches and ease its policy stance prematurely, it would almost certainly kick off a wave of renewed speculative activity in commodities, precious metals and real estate. The premise on which this speculative psychology will be based is that the Government, in being obsessed with full employment, allows no downside economic risk, thus, virtually guaranteeing the speculator a fast buck. In these circumstances, inflationary pressures will accelerate, and the U.S. dollar will almost certainly weaken still further in the foreign exchange markets, thereby increasing the prices of imported goods and materials and reinforcing the inflationary spiral.

The point is that Fed restraint can work to curtail inflationary pressures, but only if such restraint is applied forcefully and maintained for a sufficiently long period of time. The 1974 experience helps illustrate this point. Few would fault the Fed for failing to act forcefully enough in bringing on the credit crunch of 1974. In fact, inflationary pressures began to ease dramatically in the wake of the Fed's restraint and the ensuing recession. The only problem is that the Fed appears to have reversed course too soon. This premature easing by the Fed is suggested by the yearly inflation figures for this period. For example, the consumer price index (December-to-December) peaked at 12.2 percent in 1974 and then fell sharply to 7 percent in 1975 and on down to 4.8 percent in 1976. However, in light of less than total Fed resolve (along with excessive fiscal policy stimulus) consumer prices accelerated sharply to 6.8 percent in 1977 and on up to 9.1 percent in 1978.

COMPLEMENTARY POLICY ACTIONS

It goes without saying that Federal Reserve policy can hardly be expected to effectively shoulder the entire burden of fighting inflation in the 1980's. In marked

contrast with the 1930's, late 1940's, and 1950's when depression, deficient demand, stagnation, and economic drift dominated policy thinking, the 1980's (as more than hinted at in the late 1960's and 1970's) will be a period of resource scarcity (notably energy), lagging capital investment, supply limits, and spotty productivity gains. This entirely new setting for policy will be extremely intolerant of the stop-go Fed policies to which we have become accustomed. Moreover, complementary policies could well play an even more important role than Fed policy in the effort to hold down inflationary pressures in the 1980's. At a minimum, there must be persistent fiscal restraint, with absolute assurances that the Federal budget is balanced over each economic cycle (i.e., Federal budget deficits in recession years are offset by budget surpluses in expansion years). Moreover, there must be a complete reordering of fiscal incentives away from periodic boosts for consumption in favor of stimulating saving and investment. Favorable consideration must be given the 10, 5, 3 accelerated depreciation plan or other similar incentives for stepped-up business spending on new plant and equipment. In this way, it would be possible to re-ignite productivity growth thereby helping to counter domestic labor cost pressures and rendering U.S. exports more competitive in foreign markets.

Representative REUSS. Thank you, Mr. Jones and Mr. Greenspan.

Mr. Jones, you have just suggested that if the Federal Reserve doesn't hold the course and hold fast to its present policies and restriction on the monetary efforts, we are going to have a worse situation in 1980 with a boom/bust element to it?

Mr. JONES. Correct.

Representative REUSS. The administration has, in general, endorsed the restrictive elements of the Federal Reserve policy, and that is a good thing.

The President recently in a San Diego speech said that the Federal Reserve's anti-inflationary policy could operate without anybody losing a job. What do you think of that reassurance?

Mr. JONES. I must respectfully disagree with the President. His choice of audiences in particular was a difficult matter. Because the first and most important area hit as a result of the October 6 packages of extreme monetary restraint will be the construction industry. There are generally no immediate figures to support the conclusion. But most banks and mortgage lenders I talked to have perhaps reacted more strongly to the uncertainties created by that October 6 package than we have seen any time in post-World War II history. In many cases, there was a complete cutoff in mortgage commitments which will, perhaps in a matter of a few months, have a much more devastating effect on the housing market than expected earlier.

Don't get me wrong. I think the Fed's action was necessary. But the first point hit will be the construction and housing industry.

So I am afraid that in order to cool off inflation, the construction industry will be hit very hard.

Representative REUSS. They will not be the only ones hit, will they?

Mr. JONES. No. We will generally see a down——

Representative REUSS. We will see people getting pushed out of their jobs?

Mr. JONES. In general. We will see the economy pushed into a deeper and longer recession as a result of the monetary restraint. Necessary, but painful.

Representative REUSS. Now let me define a little bit this phrase which you used and almost everybody uses. The Federal Reserve, it is said, must hold its course.

My question is, What course? I take it that you mean its post-October 6 course of concentrating on the monetary aggregates and seeing that the various aggregates don't entirely get out of control.

Mr. JONES. Two parts. Excellent question, yes. One is the aggregates. That is the most immediate target that I think the monetary authorities are using. But I think one of the side effects, one of the secondary effects of this action, is on the credit side of the economy. By creating uncertainty in this environment, at least temporary uncertainty in the minds of lenders, it means also corresponding to slowing in money growth, basically a significant curtailment in credit in the mortgage market, perhaps to the consumer, and in the business sector of the economy.

So there are essentially two parts to this monetary squeeze we are talking about.

Representative REUSS. I am just wondering if you aren't splitting the atom here a little more than is necessary. If you do control the money supply in the various aggregates, you thereby do keep a rein on credit, do you not?

Mr. JONES. In some sense you do. But I want to divorce my thinking from the purely monetary viewpoint. You should not simply take a slice of the monetary side of the bank balance sheet and say money is everything. In some sense it is important, but in terms of a focus of monetary policy, it isn't. Because banks in general have used many sources other than deposits to find footings for lendable funds, Eurodollars, other kinds of sources.

So that money supply number does have a counterpart in the form of somewhat broader kind of bank lending process which involves funds that are other than in the money supply.

Representative REUSS. What you are really doing, though, is defining money in a broader way.

Mr. JONES. If you would do it that way, then we would be in agreement. That slowing money growth is the ultimate policy objective.

Representative REUSS. You will see what I am up to in this line of questioning in a moment.

Mr. JONES. Yes.

Representative REUSS. You also said that while you approve of the Federal Reserve's October 6 policy of restraint on the monetary aggregates, that there was a greater decline in bond rates than was appropriate.

Mr. JONES. Bond prices, yes.

Representative REUSS. Bond prices. That is the same as saying that interest rates went up more than was appropriate for the economy in light of the degree of control over the monetary aggregates that the Federal Reserve began to exercise on October 6; is that not so?

Mr. JONES. Yes, as a result of the uncertainty created from the package, yes, in the bond market.

Representative REUSS. I think what you are saying is important because if the Federal Reserve will keep control over the monetary aggregates, as you wish, and if it will also operate on the monetary aggregates so as to keep credit—not just money, but credit—reasonably tight, you don't think it benefits the economy for interest rates to be any higher in this country than is the natural result of market forces

playing with the monetary and credit aggregates the Fed produces, do you?

Mr. JONES. I think in general the answer is no, I would not want them to be higher than fundamentals would dictate, inflationary expectations and supply and demand for credit.

Representative REUSS. That is a very important point, if you and I are right, and of course we think we are; it used to be, before October 6, that in an inflationary period a banker or other supplier of funds could equate patriotism with high interest rates.

Now that the Federal Reserve has, I think happily, changed its stance and since October 6 is focusing on the monetary aggregates, it no longer is, in and of itself, a virtue for a moneylender to brag about how high his interest rates are. Is that not so?

Mr. JONES. In general, I would think the focus of the attention is in that direction. The lender should not brag about his interest rates. He probably will become more selective in terms of making credit available to various buyers, particularly since the Fed in its new policy is emphasizing the availability of reserves and the monetary aggregate situation. So essentially we have to say that interest rates will move perhaps eventually in line with money market forces. But at this moment they seem to be on the high side.

Representative REUSS. Just to conclude, since I am sometimes called political, and of course I am because I have to get elected every 2 years, if I join with you in urging the Fed to hold to its monetary and credit course with respect to the aggregates and support them in that, I am perfectly justified, am I not, in doing what I can to keep interest rates from being higher than are required by a competitive money market in order to be in synchronization with the Fed's monetary policy?

Mr. JONES. Yes, with one exception. And that is—economists always have to give exceptions, you realize that—in general, in theory, the Fed's emphasis on reserve supply and monetary aggregates is supposed to turn interest rates loose essentially to reflect these market forces.

What I am saying in effect was that the hasty implementation of the Fed's new linkage between the Fed's reserve supply and money along with an unfortunate mistake in the money supply which has unfortunately pushed us to rates, which, in my estimation are on the high side. In theory, if market forces again reappear, we could see some moderation in rates.

But you are right, at this moment it would appear that because of the extreme uncertainty and perhaps the mechanics of the Fed's implementation of this new program, rates at the moment would be higher than perhaps fundamental market forces would suggest.

Representative REUSS. Then to conclude, if people like Senator Javits and myself do what we can to make market forces reappear and thus bring interest rates down a bit from their present astronomical levels, we are doing God's work, are we not?

Mr. JONES. Yes. And I hope the Federal Reserve is, too.

Representative REUSS. Thank you.

Senator Javits.

Senator JAVITS. I had some questions of Mr. Greenspan. I would like to just top it with one question to you.

Assuming what you have just said, suppose we go to work on the fundamentals, to wit: Energy. We now have bills in the Senate beginning today looking to important conservation and other energy practices. We could conceivably deal with issues of productivity by tax incentives for greater capital investment as against tax incentives for consumption.

Suppose we do all that. How would we best cause those fundamentals to manifest themselves in respect to inflation and inflationary expectations?

Mr. JONES. In a sense, it is a timing question, just as the bond business is a timing question. In the short term it appears that the economy is indeed headed into a recessionary period. Typically, productivity and other factors of that nature have behaved badly in recession periods. So in the short term we are going to be disappointed.

But in the long term, I think the key emphasis is twofold. One is clearly on tax incentives, as you so well suggest, on the investment- and productivity-enhancing side, accelerated depreciation that you can determine in Washington and in Congress.

The second point I think is also one which you highlighted at the beginning of your remarks, confidence. I think more than at any other time in the history, in the contemporary history of this economy, we need to be able to build confidence in Washington. In that sense I would hope we can see something other than the stop-go policies which have dominated both the monetary and the fiscal side.

In general, we need a steady hand on the tiller, and I hope that in general, we can see that from Washington. In other words, when we do slip into a slow growth period, not to see some attempt to slam the accelerator to the floor in hopes of increasing monetary and fiscal expansion.

Senator JAVITS. Mr. Greenspan, you have had enormous experience in finance and government. And you have heard from Mr. Jones' side. It is sometimes said in business—I was a lawyer long before I was a politician—that any answer is better than no answer or an indecisive answer.

We are in that position now. The effort to select, giving the Congress the benefit of every doubt, the best answer has caused us to give no answers. As a matter of policy guidance to the Congress, now that you are in the private enterprise field, what would you suggest to us is our best policy?

Let me give you a very practical example. We have before us today a bill to provide $20 billion for synfuels over a period of years. We have a counterbill to provide only $9 billion. The theory of the nine is much more careful selectivity and a much more deliberate approach to demonstration projects for various types of fuel substitutions: tar sands, oil shale, and coal conversion, et cetera.

Another example. You have pointed out in your testimony today, and it is traditional—you told me about this months ago personally as a friend—the grave danger to the homeowner market, the fact that people had bought high, weren't able to sell low because they were committed heavily in high level mortgages, and that there would be a very grave squeeze which could, again, shake confidence very materially.

Senator Cranston and I, just the other day, last Thursday to be exact, tried to enact a measure which would have enabled the Ginnie Mae to take off the hands of the thrift institutions quite a few of the long-term mortgages at low interest rates that these institutions are stuck with, under good conditions, we thought, in order to enable them to reinvest that money into new mortgages at higher rates, thus providing mortgage money to the market and making the thrifts more viable.

However, this approach didn't have much support and we had to opt for an amendment to establish a 3-month interagency task force to study the matter.

There are two examples of giving an answer or deferring an answer. I would like, based, as you say, on your vast experience in government and now your experience in the private sector, to know how you would guide us in the Congress.

Mr. GREENSPAN. First let me say that I appreciate those very kind remarks, Senator. I wish that experience per se created the right answers to problems which unfortunately seem to plague us and become ever more complex.

There is no question that there has been a growing skepticism about governmental policies and actions in the last decade. The incoherence of many policies and the reversibility of numbers of them have created a sense of concern in a very general way that government is unstable and that its actions tend to create underlying instability in the business decisionmaking process.

So I would first say that the principle that perhaps has to be initiated is not the one which you suggest, which in many instances would be right, but not in this case; namely, that an answer is better than none.

It strikes me in this case, that if the Congress were to reduce the degree of its activities: new laws, new actions, and the like, and try to maintain a steady hand, it would certainly contribute to a restoration of confidence which is so sorely needed in the private sector.

I have been very favorably inclined to these large synfuel projects. We know little about the developmental stage of some of these very major projects. Their costs are huge, and to the extent that you use capital for one project, in effect it is not available for another one. And we need vast quantities of capital to meet our energy supply requirements in this country. To the extent that we divert it in huge amounts into projects which in all likelihood will not bring on any supplies for at least a decade, it strikes me that we would be far better to be more selective.

The major issue which is inflation which can only be diffused if we reduce aggregate credit requirements. The thing that Congress and the administration can do is to reduce the amount of preemption of credit which the Federal system engenders directly and indirectly, not only though its on-budget and off-budget financing, but through its guarantee program, through regulation which mandates various types of expenditures which must be financed through matching grants to State and local governments which often require borrowing by the State and local governments.

If we can reduce that aggregate level of credit, we will be well on our way to creating a much more stable environment.

So it strikes me that the problems that we now have are really not resolvable in the short run. We have, unfortunately, created an

environment in which there is no alternative to a sharp contraction in the availability of mortgage credit for the next 9 months or more.

Mortgage credit, by its nature, is the type of vehicle the elasticity of demand for which is always the highest, since it is the most postponable asset, or it finances the most postponable asset in the financial sector, namely, homes. Therefore, it is the most volatile form of credit we have. As you know, at $100 billion a year, it dominates our markets.

If we endeavor to prevent the contraction of credit at this stage, we will do so only by exacerbating inflationary processes. At this stage we have got to write off the next year from the economic policy point of view. I think we have gone too far, made too many mistakes.

I know of no simple procedure which will turn it around. Policy must now focus on how do we get back on track a year from now, and then stay on track.

Excessive endeavors to try to deflect the symptoms of our past policies during the next year, in my judgment, is likely to create more, rather than less, problems than the last year.

Senator Javits. I think you have said some very, very pertinent things to our situation. I think the country should be very grateful to you.

I note that Mr. Wallich and Mr. Pardee are in the audience. I hope very much that we will get their comments because they represent the Government.

My last question is this. I hope you don't take it as too provocative because I am very serious about it. If we are going to have to defer this situation of stringency, high unemployment, greater danger to the economic system, even a continuance of relative lack of confidence, until it can really be restored with very substantive measures, isn't this precisely the kind of a situation in which you need controls or what are tantamount to controls—wages, prices, credits, and foreign credit—to keep the ship on course? There is a lot of money that pours out of this market into other countries. The tremendous wash of money in the Eurocurrency market, heavily controlled by American banks. What about that? We have to face it realistically, especially if we are in this for the long swing. It is going to be very expensive. I know because I have been the man handling these bills on the floor during the 1974–75 recession.

You begin to get, as we know, Congressman Reuss and I—because we are not going to let people starve, you know that—you begin to get these $18 and $20 billion pricetags for unemployment compensation, welfare payments, food stamps, and so forth.

What do you say to that? I know it is no good, you are all against it, I am against it. But if we have to protract this sweating out process, why isn't the control process a necessary concomitant?

Mr. Greenspan. Leaving aside the reasons that we are all against it, it wouldn't work. It won't work in the context of 6 months.

It is conceivable that if you put on a wage and price freeze in the United States, it would hang together for a matter of weeks. You may recall, Senator, that in August 1971 we put on, as I recall, a 60-day freeze, which in retrospect surprised me that it held together as long as it did, but couldn't be viable much beyond that.

But the inflation rate then was a third of what it is today. I don't know what the tradeoff is. But I am sure that if you try to impart a full

freeze in today's environment, the system would break down, meaning that the exemptions that would be required under law would become so large so soon, and the hardship on individual producers so great, that the control apparatus would unravel very rapidly.

You might say it is better to try and fail than not try at all. That would certainly be true if the cost of policy failure was zero. But regrettably, a policy failure merely increases the degree of uncertainty that now confronts the private sector. We can no longer, at this stage, afford to create policies that fail.

I cannot consider a reasonably coherent mandatory wage and price system functioning in this type of environment.

So leaving aside the questions of one's view of political economy and how a society should function and the longer term consequences of these various types of controls, I doubt very much if they can hold together, and they would have very significant costs as they broke down.

I think the Eurocurrency market is another vehicle. If you tried significant controls over the Eurocurrency market, it would move elsewhere.

These are policies which many of us, of course, have thought about in great detail for the same reasons, Senator, that you have been thinking about them. To my mind, no one has brought forth any set of control policies which have the remotest chance of working.

It has often been stated that our monetary and fiscal policies aren't working, therefore we must advert to controls. The implication, of course, is that the controls would work. But they wouldn't.

Senator JAVITS. My last question is a corollary to this. What about a moratorium on new mortgages under these circumstances, a provision for mortgage forbearances, under these circumstances? Deferring the date on which the mortgage comes due and is then subject to foreclosure, knowing full well that the lending institution will wish to foreclose?

Mr. GREENSPAN. It depends on whether we are talking about a self-amortizing mortgage on which there is a default of payment and effect——

Senator JAVITS. That may happen. Let's even assume just mortgages that are due where you can't refinance except in outrageous terms.

Mr. GREENSPAN. There are actually rare mortgages which are not self-amortizing. By that I mean that they are paid off month by month. Usually when they come due, there is only one monthly payment left.

I think, however, the issue that is perhaps more important, and more the type of issue which you are probably concerned about, is what do you do with mortgages that are in sufficient arrears so that the lender either threatens or embarks upon foreclosure.

Fortunately, despite the tightness and despite the problems which are emerging, that has not yet become a significant issue, although it could. We should keep a very close eye on the process.

I wouldn't jump prematurely because the markets work reasonably well. Lenders tend to be quite lenient in periods such as this and have been in the past. Before any major Federal action takes place or any major programs take place, it would be wise to see how flexible the existing thrift institutions and commercial banks are with respect to this particular problem.

Senator JAVITS. Do you want to say something?

Mr. JONES. I just want to add one point, a critical point, on the mortgage picture. I think we need to make a distinction between speculation in real estate and mortgages and legitimate home demands by the public who need one house to house themselves. I am afraid we have begun to see as a flavor of the real estate market a speculative bubble, particularly in this cycle we have been going through.

My fears are we may, one even bigger in the first half of the 1980's as we have the postwar babies buying homes. The only trouble now, the postwar baby buys one house, and then decides that the best place for tax advantages is to buy a second house mainly for investment purposes.

My feeling is that if we give any support to deferring repayments or buoy the market, all we do is build a speculative bubble for the future. So the answer is short term gains in the form of easing burdens on people could lead to a very serious longer term boom/bust cycle in that housing market.

Senator JAVITS. Thank you.

Representative REUSS. I would have just one short question of Mr. Greenspan based on his excellent testimony.

What you have described as the German–United States problem really is in the nature of a Greek tragedy. Here you have the German Bundesbank confronting a situation where inflation in Germany, largely OPEC-led, was alarming, and thus, the Bundesbank over a 6-month period raised the interbank interest rate from, as I recall, something around 4 percent to its present 9.5 percent.

Meanwhile, the part of the Federal Republic of Germany which the Bundesbank doesn't control, that is, the government, was pursuing the same stimulative fiscal program that they had adopted 18 months before, a deficit for fiscal 1980 which in terms of GNP is three times our own expenditures for this and that—tax decreases along the line including some coming due in January 1980.

Then, since monetary policy is the only game in town for the Bundesbank, they raised the interest rate. This, as you also point out, compelled in this same Sophiclean manner the U.S. Central Bank, the Federal Reserve, to raise its interest rates.

What to do, you say, and I am quoting, confronted with this dilemma; there has been considerable discussion of a joint venture between the Bundesbank and the Federal Reserve to bring down mortgage interest rates concurrently, to deescalate international interest. so to speak.

You say I think, that this is a dubious policy for the simple reason that all the central banks can do is to fool around with monetary aggregates, and that wouldn't seem to be the problem.

My question is, wouldn't the world be better off if the Government of the Federal Republic in Germany and the Bundesbank tightened their very loose fiscal policy, thus permitting the German Central Bank not to pursue such a supertight monetary policy, which, of course, communicates itself to us and we communicate it to the Canadians, and then it bounces back across the Atlantic, with the result that men and women are unnecessarily thrown out of jobs, businesses unnecessarily go bankrupt, and the less developed countries really take it on the chin.

As a general matter, wouldn't that be a good thing for the world?

Mr. GREENSPAN. Unquestionably, Mr. Congressman. The only thing I say with some sadness about such a policy is that it was the United States which 2 years——

Representative REUSS. Which put them up to it?

Mr. GREENSPAN. Exactly.

Representative REUSS. Thank God you and I were AWOL on that piece of advice.

Thank you very much, gentlemen.

Now we will ask Governor Henry C. Wallich of the Federal Reserve, System to come forward.

Governor Wallich, would you be kind enough to proceed. You have some very interesting testimony I'm sure. You may proceed in any way you care to.

STATEMENT OF HON. HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, WASHINGTON, D.C.

Mr. WALLICH. Congressman, since my testimony is not very long, I wonder if it is agreeable to you if I read it.

Representative REUSS. Would you either read it or hit the high spots as you choose.

Mr. WALLICH. If it is agreeable, I would like to read it.

I am pleased to be able to testify before this subcommittee concerning the international implications of the measures announced by the Federal Reserve on October 6. These measures included added restraints on the availability of credit together with the institution of a more effective technique of controlling growth of the money supply and related monetary aggregates. Our actions were designed to assist in curbing the unacceptable inflation the United States is experiencing. They are expected to bring about improvement in both the domestic and the international aspects of our economy. My assignment here is to discuss the international aspect. But I am sure you understand fully that the domestic and the international effects are closely interrelated.

As background, I would like to review briefly some of the most important developments in the weeks and months leading up to our October 6 decisions.

The monetary aggregates, after growing at quite low rates in the fourth quarter of 1978 and in the first quarter of this year, began to expand at a very rapid pace in the second and third quarters. Growth of M–1 averaged about 10 percent at an annual rate, and growth of M–2 averaged nearly 12 percent over the course of the latter two quarters. The rapid expansion of the aggregates in the third quarter occurred despite increases in the Federal funds rate totaling about 1¼ percentage points over that quarter. Continuation of growth at these rates would have meant that we could not achieve our longer run targets for the growth in the aggregates from the fourth quarter of 1978 to the fourth quarter of 1979. Under the provisions of the Humphrey-Hawkins Act, the Federal Open Market Committee had set these targets in February and reaffirmed them in July.

At the same time as incoming data revealed a surprising degree of real strength in the economy, consumer prices continued to show

monthly increases at a 13-percent annual rate in July and August, while the producer price index increases at nearly a 16-percent annual rate over the third quarter, portending possibly a near-term acceleration rather than a slowdown of consumer price increases.

In the foreign exchange market, the dollar had declined by 5½ percent on a weighted-average basis from mid-June to the beginning of October, despite a substantial appreciation against the Japanese yen. The dollar's exchange value, adjusted for relative U.S. and foreign inflation rates, had declined by somewhat less. This occurred despite very heavy official purchases of dollars—particularly, at times, by U.S. authorities.

Exchange market pressures on the dollar intensified in September; the DM/dollar rate, for example, had declined to nearly the October 1978 lows. Because of these developments, exchange market participants were anticipating some sort of policy "package" from the United States. Talk in the market tended to be focused on possibilities for macroeconomic policy action, particularly monetary policy action. This reflected the view that the fundamental cause of the dollar's weakness in exchange markets was the severe U.S. inflation rate and that until prospects brightened for bringing inflation under control even augmented exchange market intervention could do little to help the situation. A sign of the importance that the exchange market attached to action on inflation by the United States was the dollar's sharp advance on October 2 on the news that Chairman Volcker had left the Belgrade meetings early to return to Washington.

Speculation in the gold markets reached feverish proportions from late August until early October, with the price of gold soaring by $100 per ounce to a high of almost $450 in London trading on October 2. The price was doubled that prevailing at the beginning of the year. The infection soon spread to other metals markets, and from there to still other commodities. The BLS index of industrial commodity prices rose at an annual rate in excess of 50 percent over the month of September, with metals prices rising faster than the average. These developments in gold and other commodity markets were symptomatic of a general rise in inflationary expectations that tended to feed on themselves.

It was against this background that the Federal Reserve announced on October 6 its package of complementary measures: (1) an increase of 1 percentage point in the basic discount rate from 11 to 12 percent; (2) the establishment of an 8 percent marginal reserve requirement on further expansion in the managed liabilities of the larger banks—liabilities that had been actively used to finance the rapid recent expansion in bank credit; and (3) a change in short-run operating procedures—placing more emphasis on the supply of bank reserves and less emphasis on managing the interest rate on overnight Federal funds—in order to achieve better control over the growth of the monetary aggregates. The last action was intended, in particular, to provide greater assurance that the growth of the aggregates over the remainder of the year would be consistent with the previously adopted longer run target ranges.

In making the announcement and later in letters addressed to the Federal Reserve member banks and to the branches and agencies of

foreign banks, Chairman Volcker made clear that these measures were intended to bring about a slowing but not a halt in the flow of credit. He particularly stressed the need for bankers to provide a continuing reasonable flow of credit for small businesses, consumers, home buyers, and farmers and pointed out the inadvisability of loans to finance essentially speculative operations in commodities, gold, and foreign exchange markets and of unproductive financial loans. To guard against the possibility that lending by foreign banks to U.S. resident borrowers might undermine the restraint exerted by the marginal reserve requirements, Chairman Volcker requested the cooperation of U.S. branches and agencies of these banks as well as their foreign affiliates.

Bank credit and the expansion of the monetary aggregates appear to have slowed significantly since these measures were adopted, although initially these effects were obscured by errors in the data concerning the money supply. In the financial markets, the reaction of the interest rates and exchange rates was immediate and sharp.

By the end of the first full week, interest rates on short-term dollar assets had jumped by as much as 1½ percentage points. Prices in stock and bond markets tumbled. In the exchange market, the dollar advanced over 1½ percentage points on a weighted-average basis—by 2 percentage points against the German mark—and this did not prompt any central bank intervention support. The price of gold did not show any further significant decline, though it had dipped below $400 a few days earlier, and remained very volatile. Other commodity prices dropped back from their early October highs.

Commentary on the Federal Reserve's actions in the domestic and foreign financial press and by foreign monetary authorities was predominantly favorable, emphasizing that the United States was doing something fundamental about its inflation problem. Some skepticism was expressed, however, as to whether the Federal Reserve would "stick to its guns" in moderating money and credit growth should a widely forecast recession actually materialize. Among exchange market participants, foreign dealers tended to be more skeptical in their comments than American dealers.

By the end of October, conditions in financial markets had become more settled. Short-term rates were somewhat higher, but were generally less variable, except for the Federal funds market where the effective daily rate ranged from more than 17½ percent to about 12 percent. Somewhat greater variability in the Federal funds rate was, of course, expected in view of our new operating methods. Stock and bond prices, which had declined sharply for about 2 weeks following the October 6 announcement, regained a moderate portion of their earlier losses and also tended to stabilize.

In the exchange markets, some of the initial skepticism about the Federal Reserve's actions waned, and the dollar advanced even further, despite substantial sales of dollars by a few central banks in support of their currencies. The dollar remained near these higher levels despite the release of trade figures showing a large U.S. deficit for September and an increase in the German Bundesbank's discount rate at the end of October. The dollar was underpinned by the Treasury's announcement of two new issues of DM-denominated securities in the

German capital market. By month-end the dollar's weighted-average exchange value was up by 3¾ percent from its October 1 level. Gold prices at least temporarily declined to below $380, partly reflecting the announced increase in the size of the Treasury's auction held on November 1. In other commodity markets, prices declined further—the BLS index was off 3 percent over the month.

Our actions seem to have prevented any further aggravation of inflationary psychology and, at least for now, may have broken its gathering momentum. Over the longer run, the principal effect of the new monetary policy procedures of the Federal Reserve will occur through the impact that these measures can be expected to have on growth of the money supply and on inflation. If the monetary aggregates are firmly controlled, and if this is followed by complementary energy, tax, regulatory, and structural policies, inflation should come down over a period of time, and the dollar should maintain its strength. If at the same time the current account moves in the direction of surplus, as now seems likely, this should add further strength. Obviously there are numerous uncertainties in the present situation, including the risk of a major further increase in the price of oil. This risk underscores the importance of an effective energy policy.

In the context of the dollar's exchange value, a greater volatility of the Federal funds rate such as may be associated with the new procedures should not have major significance. For one thing, day-to-day fluctuations in the Federal funds rate are unlikely to be interpreted as an indications of changes in Federal Reserve policy, as they have tended to be interpreted in the past.

Second, other short-term interest rates and, particularly, long-term interest rate, need not be expected to follow closely, if at all, the daily fluctuations of the funds rate. Such behavior would reflect both the lesser policy significance now attaching to the funds rate and the fact that 90-day rates and, even more, longer term rates, tend to reflect the average level of the funds rate over the life of the instrument rather than to follow its daily level. For instance, fluctuations in rates for daily money in London and in Frankfurt do not seem to influence very much the rate for 90-day money, and also do not seem to influence very much the exchange rates of the pound sterling and German mark.

In the third place, the interest rate is only one of several factors bearing upon the exchange market and is probably not the most important. Interest rate differentials are more fully exploited by investors and arbitragers when markets are reasonably stable. Interest-bearing investments in a currency must be held for some time, after all, before the expected benefits from a more attractive interest rate accrue.

An example of this can be seen in the behavior of the foreign exchange value of the dollar during the years 1975–77 as contrasted with interest rate developments during that period. The dollar went from a position of weakness early in 1975 to a condition of greater strength during late 1975, almost all of 1976, and the first part of 1977, only to weaken thereafter. U.S. interest rates actually moved inversely, falling, on balance, from mid-1975 through mid-1977, and rising once more beginning in the latter part of 1977. To be sure, U.S. interest rates must be viewed in relation to interest rates in foreign countries and in

relation, particularly, to rate of inflation. The data do, however, warn against the acceptance of any simple correlation between interest rate and exchange rates.

If our economy should slow down, as is widely predicted, it could be appropriate for interest rates to decline as growth in money and credit subsidies and inflationary expectations diminish. I do not believe that such a development would be viewed as a source of weakness of the dollar. Inflation and current account developments are more fundamental determinants of the exchange rate, than are nominal interest rates. The measures announced by the Federal Reserve on October 6 should assist in the effort to make progress in effectively dealing with these fundamental factors.

Thank you, Congressman.

Representative REUSS. Thank you very much, Governor Wallich.

Your overall assessment on the first monthly anniversary of the Federal Reserve's new economics is that, and I am quoting you, "Your actions seem to have prevented any further aggravation of inflationary psychology and at least for the time being, may have broken its gathering momentum."

To that you correctly point out that monetary policy is nothing unless it is complementary to fiscal policy, and I quote you again, "Energy, tax, regulatory and structural policies are felt." I think that is a very important qualification.

It is significant that you are testifying that in your judgment the results of monetary policy following October 6 have been good.

You also say that the money aggregate figures appear to have slowed significantly since October 6. That is good news, surely. Then you add, "Although initially these events were obscured by errors in the data concerning the money supply," and I think the word "initially" there is the operative word, in the light of all this you certainly aren't advocating that lenders of money drive up interest rates more than is needed to accommodate the Federal Reserve's control over the monetary aggregate and more than results from free and full competition?

Mr. WALLICH. We have urged specifically that the member banks bear in mind the legitimate needs for credit on the part, especially, of smaller borrowers—farmers, small businesses, and homeowners—and we have made clear that this is not to be interpreted as a desire for a cessation in credit expansion but rather for a slowing in its flow.

It is essentially an increase in its cost at the margin and a reduction in its availability through the combined action of the reserve requirements and the more deliberate supply of reserves.

Representative REUSS. Friday, the Nation's second biggest bank, Citibank, refused to increase its prime rate, already at a very high 15¼ percent, because it perceived just what you testified here today that the checking of the expansion of the monetary aggregates had been, in your phrase, "obscured by errors in the data concerning the money supply."

Being made aware of that, I took the occasion to congratulate the Citibank, in what I think was an act of statesmanship in not aggravating the country's problems and not throwing people out of work in the businesses and farms.

Would you join in that congratulatory feeling?

Mr. WALLICH. I certainly would. But I fear I cannot tell the Citibank how to handle their prime interest rate. They have a formula for deriving it. But at the time when uncertainty has undoubtedly increased, it seems to me that caution is the course of wisdom.

Representative REUSS. Particularly when the formula, for reasons that we went into a week ago and don't have to rehash this morning, was infected, infected because it overstated the increases in the money supply. That Citibank formula which, of course, is based on certificates of deposit for a month or so prior to the date of action does reflect any abberations in the interest on certificates of deposit which may be due from wrong money supply figures; does it not?

Mr .WALLICH. It could be.

Representative REUSS. Would you join me in the hope that we look forward to similar statesmanship this Friday?

Mr. WALLICH. I cannot say what they are going to do. We do feel that the banks are the best judges of their credit policy. That relates primarily to whom they lend, subject to the cautions that we have expressed.

As far as interest rates are concerned, the sooner they come down the happier I will be. But it has to be consonant with the course inflation takes. The only way to get interest rates down in a reliable and sound way is to get the inflation rate down.

Representative REUSS. As a general proposition, no one can fail to applaud that analysis. But it is also true that it would not be helpful at this juncture, since you do say that you have now got the monetary aggregates under control, for interest rates to be raised by man-made fiat to over what they are now, is that not so?

Nobody but a sadist would really want to raise interest rates now more than are necessary to reflect the interplay of competition upon the Federal Reserve's control of the monetary aggregates, wouldn't you agree?

Mr. WALLICH. It is precisely the interplay of competition that we have given more scope to by this new technique. That is to say, instead of operating via the funds rate to control the money supply, we are supplying reserves.

That means that interest rates, as it were, fall out as a result, a byproduct, of that process. The first thing that falls out is the Federal funds rate. The funds rate is likely to be less stable than it has been in the past. But it is also clear that that is not an objective of Federal Reserve policy.

Our concern is with the money supply and how we can get a grip on it via reserves.

I would think that the funds rate will come to be more unlinked, uncoupled for other interest rates, and its ups and downs are less likely to have such an effect on the rest of the rate structure, particularly short-term rates, as we have seen in the past when the funds rate was the fulcrum of policy.

Representative REUSS. I think that is very reasonable. The Federal Reserve banks, including Mr. Pardee's bank here in New York, are essentially banker-controlled institutions. One can't really expect institutions which are linked with banks to take the lead in suggesting to banks that they ought to observe caution against further escalation of interest rates.

However, as a matter of overall justice and equity, quite apart from the Federal Reserve, since we now jawbone labor to keep their wage requests down, parity of persuasion would indicate that it is all right to do a little jawboning with the banks and other members to keep their interest rates down. Wouldn't you agree?

Mr. WALLICH. We have exhorted the banks in these letters.

Representative REUSS. The letters were very good. They had to do with who should be remembered in the credit-giving calculus: Namely, small business, agriculture, capital investment, and so on. And who should be forgotten: Namely, commodity speculators and conglomerate takeover operators, all good, but that has to do with the allocation of credit. The price of credit is another matter. There, while I can understand and applaud your inhibition in being bumptious about telling the banks: "Please don't raise your interest rates any more," there is nothing wrong, is there, with other branches of the Government subsequently suggesting that since labor has been asked to hold its wage increase requests down, that lenders of money do the same with their interest rates?

Mr. WALLICH. I think the effect of making relatively more credit available to small borrowers, to small business, to farmers, and to homeowners will have an effect on the interest rate and will get the result that you desire. Because if the system does work competitively, which I think it does, then the relatively greater supply will have a favorable effect on the interest rate.

Representative REUSS. Yes; I agree. I will not use the term "credit allocation," which is a no-no, at least on this end of the island.

Senator Javits.

Senator JAVITS. Thank you very much, Congressman Reuss.

I wondered about the comment which Mr. Greenspan made when we were discussing credit restraint and where it is all taking us.

Mr. WALLICH. In many respects I agree with Mr. Greenspan. I see no way out of this inflation other than by a combination of actions restraining money supply and credit, the budget, regulatory cost increases, plus, in my opinion, an incomes policy, such as one we have now or one that I would prefer based on taxes.

I would also agree with him fully on the problem of wage and price controls. I think they are bound to cause a great deal of damage with probably no gain. So I quite support such views.

If you were thinking of his view on international matters, such as the suggestion that the Federal Reserve policy has been made in Frankfurt, because everything is interrelated, would it not be equally precise to say that German monetary policies are made in Washington, since the United States is so much bigger a country and the dollar is much more important in the world than the D-mark. The fact is that though monetary policy is made on the basis of the needs of each country, we cooperate. We are aware of one another's situation and try to take that into account. But, of course, the decisions are made in the light of each country's overall interests.

I am not sure whether I have responded adequately to your question, Senator.

Senator JAVITS. I think you have.

I would like to get your view, without in any way being contentious about it, as to how much time this gives us to engage in fundamental

reforms. If I remember correctly, Chairman Volcker in testifying before the Joint Economic Committee in Washington spoke of 6 to 9 months as being a period which should give us to address this issue, perhaps somewhat on the analogy of what we did 2 or 3 years ago in this respect, we didn't use the time which those actions gave us then.

Would you have any view on that?

Mr. WALLICH. I think the actions that have been taken can point us in the right direction. If they do that, they will change expectations. And that is our main task now, because interest rates and inflation all ride on expectations. So, of course, do exchange rates.

I think that change in expectations can be brought about—but I will not try to set a time frame such as 6 or 9 months. But it has to be tested in a difficult situation, and it will require the combined use of both Federal Reserve and Federal Government anti-inflation policies. In those circumstances inflationary expectations will come down.

My fear is that it will take longer, because of the built-in character of the inflation we are dealing with—the leap-frogging, the 3-year labor contracts, and interest rates built into the price structure. But I should note that many interest-bearing payments may be prepaid. Thus, mortgages, for instance, could be prepaid with no great loss if interest rates came down generally. Further, many bonds have call features after 5 or 10 years so that adjustments in effective interest rates could be made in this way, as expectations improved. But it would still be a process of years before the inflation could be wound down.

Senator JAVITS. I wondered about your observations on a number of related points. For example, it is believed that the debts of the less developed countries which have been increasing so markedly within the last 5 years, having probably quadrupled in that period of time. With their reserve positions deteriorating, it certainly makes for an important point of weakness with the large number of U.S. banks involved. What is your reaction to that?

Mr. WALLICH. I think the condition of developing countries certainly will be exposed to a much greater strain now as a result of OPEC price increase, but not beyond what can be handled.

I think we will have trouble spots. We have had them all along. Some countries have moved out of their difficulties. Some countries have encountered difficulties.

By and large, the critical ratios, the ratio of export debt service to exports, total debt to GNP, and so forth, have not, on the average, significantly deteriorated.

Reserves are very strong in these countries and they could afford relatively to slow down their borrowing because of the high level of reserves.

As far as American banks are concerned, they have been pulling back quite a bit in the last year or so. Most of the expansion has been carried by foreign banks, especially German and Japanese.

We monitor this, of course. While so far the historic loss experience has been very good, nevertheless we do look at the exposure of banks very closely.

Senator JAVITS. I understand that Mr. Pardee, who, sitting with you, is the New York Fed's chief foreign exchange trader.

Is that correct?

TESTIMONY OF SCOTT PARDEE, SENIOR VICE PRESIDENT AND ACCOUNT MANAGER, FEDERAL RESERVE BANK OF NEW YORK, NEW YORK, N.Y.

Mr. PARDEE. Senator, that is one of my responsibilities. I have a joint responsibility as senior vice president of the Federal Reserve Bank of New York and I am the account manager.

Senator JAVITS. I think Americans are very much troubled about this Eurocurrency market situation. What can you tell us about that situation, especially as it relates to the cooperation of central banks and foreign exchange market intervention?

We understand, we just heard a minute ago, the feeling that the D-mark of the German Central Bank has kind of gone off on its own.

Mr. PARDEE. Let me answer the second part of the question first and then get to the Eurodollar market. Much of my responsibility relates to working directly with the foreign central banks. I talk to my counterparts at the German Bundesbank, the Bank of England, and even the Bank of Japan from time to time.

As far as the people are concerned on the operational level, there is good, if not better, cooperation than we have ever had. As Governor Wallich explained there are difficulties in some of the broader policy areas. But on the operational level we are cooperating very closely and receiving cooperation, as well, from our counterparts abroad.

The Eurocurrency market has had a long history. It is a very private market in many ways, outside of the control of central banks. It is part of the real world. We have to work with it as we do with a lot of other things that are outside of our control.

I don't think that current problems for the dollar or for any other currencies relate directly to the Eurocurrencies market, as such. For the United States, I prefer to focus the attention on our inflation, the balance of payments deficit, and the oil problems we have, rather than simply the operation of the Eurodollar market or the Eurocurrency markets.

Senator JAVITS. What can you tell us about the threat that this vast amount of dollars sloshing around abroad is to us in our present situation?

Mr. PARDEE. The dollars are going to be somewhere. There are holders of dollars who quite frequently express their concerns to us about the various problems I have mentioned. Whether the dollars are held in New York, in London, or in Nassau, or wherever else, those who hold them, if they feel uncomfortable with the policies of the U.S. Government, we'll share these concerns.

I would not describe the Eurodollar market as a separate force for currency instability or broader inflation. It is part of the problem, but not a separate force.

Senator JAVITS. Nonetheless, the dollars held in the Eurodollar market can be presented in the United States to pay for goods on demand.

Mr. PARDEE. Yes; it would be good if they would take those dollars and buy goods and services.

Senator JAVITS. What about those dollars that are hanging out over there overshadowing these markets?

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Mr. WALLICH. The numbers that we read about are enormous, $900 billion or thereabouts. These are mostly interbank deposits. When you net that out and net out not only what the BIS and the Morgan Guaranty data do, the interbank deposits of the reporting banks, but all banks anywhere in the world, the magnitudes are much less even though still respectable, the order of $150 billion.

When one looks at it in terms of how much of that, by some theoretical construct, should be regarded as part of the U.S. money supply, the level comes down to that of the 1960's.

Having said that, although it is much less than the $900 billion, it is nevertheless a large sum and cause for concern because it is growing at something like 20 or 25 percent per year. So it is something we do need to watch.

But we do not have to worry about the entire $900 billion.

Senator JAVITS. When you say "watch it," you mean that we should be doing something about it?

Mr. WALLICH. We are trying to do something about the Eurodollar market, namely, to put reserve requirements on it. But we need the cooperation of the countries whose banks these reserve requirements would affect. There are the Germans, the Japanese, the British, and so on. I do not know whether we are going to be able to negotiate that. But I think conversations will go on concerning some form of a restraint of this market all the while the level grows. Eventually it will grow to the magnitude at which everybody agrees that something needs to be done.

I think we are quite close in terms of technicalities. Actual agreement as to what to do in a policy way farther down the road.

Senator JAVITS. It is believed that our problem is far greater than may be 60 billion, in the sense that these Eurobank deposits are nonetheless usable as a form of credit. That is true or false?

Mr. WALLICH. The interbank deposits are like a chain from bank A to bank B to bank C. If you were, for instance, to consolidate this banking system into one big balance sheet, they would all disappear and all you would have is the deposit of the non-bank owner of the money and the credit to the non-bank borrower made by the last bank in this chain.

Senator JAVITS. But we are not going to collapse. We can't, as a matter of fact. It is still usable as credit by those banks which carry these credits on their books.

Mr. WALLICH. So long as the banks owe these sums one to the next, there is no way of breaking out of that chain. If one of them does want to use its money, then the bank that loses the deposit would have to replace it from some source. The position of the banking system would not change.

This is very similar to what we do domestically in netting out interbank deposits in computing our money supply.

Senator JAVITS. As a practical matter, you yourself have advocated some very strong action respecting the element of reserves, which are held primarily in dollars, for central banks. Of course, you have been a party, as I understand it, to a very considerable debate which is taking place on the issue of whether we should have the use of the SDR's, the socalled IMF substitution account, or a diversification of bank reserves.

Could you tell us how that would bear upon our problem?

Mr. WALLICH. I have observed some, not very much, but some activity on the part of the smaller central banks in acquiring other currencies. This is likely, if it goes on, to lead to a multicurrency reserve system where the dollar would still be very predominant. There would be D-marks and Swiss francs. This could give rise to instability if there were much switching from one currency to another.

I would think, therefore, it would be better, if we could make headway in the direction that we have agreed internationally to go, namely, toward an SDR-based system. That could be moved forward—not immediately accomplished by any means—for instance, by the substitution account.

Senator JAVITS. My final question is, will that not fail to reach privately held dollars and reach only governmentally held dollars?

Mr. WALLICH. That is a very big consideration. Ultimately I could visualize, and in fact it would almost be essential, for the SDR to become privately held. I am not thinking necessarily of those issued by the IMF, but of the so-called SDR claims, which are claims denominated in SDR which, theoretically, any bank in Europe could issue.

So, ultimately, it seems to me that that is where the world is going. But we have a lot of problems between here and there.

Mr. JAVITS. Thank you very much, gentlemen.

Representative REUSS. Thank you Governor Wallich and Mr. Pardee.

Our next three witnesses are Mr. Geoffrey Bell of J. Henry Schroder Bank & Trust, Rimmer de Vries, of Morgan Guaranty, and Mr. Tilford Gaines of Manufacturers Hanover.

Mr. Bell, you have an excellent prepared statement which, without objection, will be received into the record.

Will you present your testimony, by summarizing it, or in any way you please.

STATEMENT OF GEOFFREY BELL, EXECUTIVE VICE PRESIDENT AND DIRECTOR, SCHRODER INTERNATIONAL, LTD., NEW YORK, N.Y., AND DIRECTOR, J. HENRY SCHRODER WAGG & CO., LTD., LONDON, ENGLAND

Mr. BELL. Thank you very much.

It is a very great honor, especially for a non-American, to be invited to testify.

I am an executive vice president of Schroder's in New York and director of the J. Henry Schroder Wagg & Co., Ltd. Bank in London. So I will concentrate my remarks on the international aspects, if I may.

I will summarize my prepared statement. U.S. interest rates have been raised to a positive level in real terms. But from an international point of view, I think the initial impact of the increased interest rates was, more importantly, to increase the differential in favor of dollar deposits from those of deutsche mark deposits.

For example, 3-month deposits in the Eurocurrency market were yielding 12⅞ percent as of October 1, as compared to 7$\frac{7}{16}$ percent for deutsche marks on deposit on the same day.

A few days after that, dollar deposits are risen to 14⅞ percent for 3 months and deutsche mark deposits are risen only to 7⅞ percent, given advantage to the dollar, 7 percent.

What is important to note is that the differential is beginning to be eroded since that time. Last week the Bundesbank raised the discount rate by 1 percent. The Dutch Central Bank raised its rate by 1 percent from $8\frac{1}{2}$ to $9\frac{1}{2}$ percent.

On Friday, the Swiss National Bank raised its discount rate by 1 percent.

What is also quite important is that the Swiss Bank reduced the negative interest rate on foreign deposits in Swiss francs from an annual rate of 40 percent to an annual rate of 10 percent, a very substantial reduction.

These changes in official interest rates reflected a prior change in market rates. Thus, despite the fact that U.S. deposit rates in the Eurocurrency market, which is important here, had risen from $13\frac{1}{4}$ to $15\frac{11}{16}$ percent over the period from the measure to last Friday, German interest rates rose from $7\frac{9}{10}$ to $8\frac{7}{8}$ percent, namely, a very substantial rise.

If you actually look at the ratio between U.S. deposit rates, either in the 3-month area or in the 6-month area, and deutsche mark deposit rates in the New York currency market, which has been a useful indicator we have found of relative attractiveness in the past, that the ratio has risen only very slightly, from 1.75 to 1.76.

The absolute differential has risen but is beginning to contract. And the ratio has remained more or less stable.

Also I think it is worth pointing out that rather more dramatic changes have taken place in Swiss franc rates. The rate early in October was $1\frac{13}{16}$. Today it is $4\frac{5}{16}$. It is the first time it has exceeded 4 percent in a very long period of time.

So I think it is fair to argue that raises in interest rates in Western Europe have gone quite a long way to offset the increases in the U.S. domestic rates.

Nevertheless, of course, the October measures have led to a strengthening of the dollar and the dollar does remain buoyant and it is very strong against the yen and the pound.

Obviously, looking further ahead, the dollar strength in the foreign exchange markets will depend in part, in fact in very large measure, on the success of dampening of inflationary pressures domestically.

What I would like to concentrate the rest of my remarks on is what I feel can be done. I believe the measures were correct and necessary and the measure was coming under pressure in October and that a crisis would have resulted if these measures had not been taken, I believe, as we say in England, to have belt and braces to keep your trousers up; that we need to introduce some structural changes in the international financial system.

I think, while it is possible that the Fed's actions will curb inflation at home and stabilize the dollar abroad, I think it does leave too much to chance. I do believe that we need extra measures internationally.

Already we see the interest rates escalating. What worries me again is that many governments, almost all governments, it seems, have fallen in love with the idea of rising currency values, which is a mathematical impossibility for the system as a whole. In fact, I think there is a danger, however, I wouldn't want to overstress this.

You will remember, Congressman and Senator, that several years ago many of us used to worry about the fact that every country in the world wanted to have an export surplus, a current account surplus, which meant that somebody had to have a current account deficit, and that was usually the strongest, the United States.

If one wants every currency to have a plus value, there is a danger that that puts pressure on the dollar. I think that is something concerning our system.

Also, I have the impression that central banks are becoming increasingly reluctant to intervene in the foreign exchange market. We had a case in point in Germany, because that leads to a giving up of control of their domestic money supplies. Therefore, if a depression happened again, then I think some of these central banks are less reluctant than they were a year ago to intervene.

Moreover, I think these policy problems are taking place against a background where there is a longer term desire for asset diversification on the part of many both official and private holders. This I think is only partly related to problems of inflation and balance of payments in the United States.

Representative REUSS. Can I go back just a minute? You said, though maybe I heard you wrongly, that central banks are less reluctant to intervene. You meant more?

Mr. BELL. Forgive me. I meant more reluctant to intervene.

I believe what is a matter of some concern is the long term trend toward asset diversification or the emergence of a multiple reserve currency system.

I would like, if I may, to insert in the record a speech I made on this subject before the Columbian Bankers Association on October 26, 1979.

Representative REUSS. Without objection, the speech will be printed in the record together with your prepared statement.

Mr. BELL. To take care of the emergence of a multiple currency system, I believe that a substitution account at the IMF is required, and one of substantial size. Perhaps $50 billion.

But what bothers me is that from what one understands about the negotiations is that this is still a good long way away. We have to live in a world which is moving toward a multiple currency system, and yet there is no, in fact, official mechanism in place to smooth the way.

I believe that an SDR system would be of help. Following Senator Javits' point, I believe that while an SDR system introduced through a substantial account at the IMF would be restricted to official holders, that in turn would encourage the backing sector to introduce what one might describe as Euro-SDR's in the same manner as they deal in Euro-deutsche marks and Euro-pounds, and so on.

So I believe that the introduction of a substitution account would help the introduction of an SDR private-based system. That is another reason for trying to encourage the development of the substitution account.

However, I believe there are two problems: one, the account doesn't exist and is going to be at least several, perhaps 2, years away. And we have to deal with a foreign exchange market which remains relatively unstable.

Second, many official holders do not wish to have SDR's. They prefer, as one might say, to mix their own currency cocktail.

Therefore, I believe that in this interim period, before the introduction of the substitute account, that we need more facilities whereby central banks of Germany, Japan, Switzerland, and so forth, allow those official holders wanting to diversify to acquire assets in these currencies with ease.

At the present time one might describe the situation is that we have the emergence of a multiple currency reserve system the hard way; namely, if someone wants to buy deutschemarks, that they sell dollars and buy deutsche marks in the market. That means either that the deutschemark goes up in value or that the Bundesbank intervenes and that leads to an expansion in their money supply.

My preference, and a number of people have made the same suggestions. Governor Wallich, I believe, and Mr. de Vries, an article in the World Financial Markets, I would like to see facilities offered by the central banks of the emerging reserve asset countries to official holders so that the transactions are taken off the market. I believe that a number of smaller central banks would be most willing to approach the German authorities with an agreement that if they were allowed to purchase deutsche marks or other currencies, that those currency holdings would not be used for speculative purposes: Namely, they would be long-term holdings. I believe this would be a very useful way of smoothing out the exchange rate ups and downs and allowing an emergence of a multiple reserve asset system to take place without so much exchange rate disturbances as we have in the present system.

Second, I would like to suggest that at least thought be given in the same context to a slight variant—a more than slight variant, on the use of Carter bonds. The present system is for the U.S. Treasury to issue bonds in Germany and Switzerland, and so on, and receive local currency. The currency is then used in the later stage to intervene in the foreign exchange markets.

I think there are arguments at least for what one might describe as preemptive Carter bonds; namely, for the U.S. Treasury to issue bonds denominated in deutsche marks, yen, or other currencies, issued in New York or Washington, which would allow central banks wishing to diversify to purchase a central-bank-denominated asset, which would then reduce the possibility that those official holders would go to the market and buy the deutsche mark, which would then have the Federal Reserve intervening in the market with funds resulting from the sale of Carter bonds.

I believe that that, in effect, would be a mini-U.S. substitution account and would be preemptive. I think there is something at least to be said for thinking along these lines.

Basically what I feel, Congressman and Senator, is that we are leaving too much to chance, that the measures taken by the United States were excellent and in fact will probably work domestically. But our system internationally is such that there is too much possibility, what with diversification, with the movements of currencies from one currency to the next, that the system can be unstable, and I believe that we need more safety nets in order to move toward a less unstable system.

Representative REUSS. Thank you, Mr. Bell.

[The prepared statement of Mr. Bell, together with a speech entitled "The Management of International Reserves," follows:]

PREPARED STATEMENT OF GEOFFREY BELL

IMPLICATIONS OF THE FEDERAL RESERVE'S ACTIONS ON THE DOLLAR AND WORLD FINANCIAL MARKETS

My name is Geoffrey Bell, I am executive vice president and director of Schroder International Ltd., New York, and director of J. Henry Schroder Wagg and Co. Ltd. in London. I thank the subcommittee for giving me the opportunity to express some views on the international situation for the dollar.

The October measures taken by the Federal Reserve have succeeded in raising U.S. interest rates to a level that makes them positive in real terms. This is the first time in a long period that interest rates have shown a positive yield. Perhaps more importantly from an international point of view, the interest rate differential between dollar deposit rates and deutschemark deposit rates rose initially by one and a half percentage points. For example, three month dollar deposits in the euro-currency market were yielding 12⅞ percent on October 1st as compared with 7⁷⁄₁₆ percent for deutschemark deposits; by October 11th, dollar deposits had risen to 14⅞ percent while deutschemark deposits had risen only to 7⅞ percent so giving a favorable differential of 7 percent.

However, since that time, the positive interest rate advantage of U.S. dollar deposits has begun to be eroded. Last week, the Bundesbank raised the Discount Rate and the Lombard Rate by 1 percent to 6 percent and 7 percent respectively. The Dutch Central Bank simultaneously increased its secured loan rate from 8½ percent to 9½ percent and on Friday the Swiss National Bank raised its Discount and Lombard Rates by 1 percent and reduced the negative interest rate penalty on foreign deposits to 2.5 percent per quater from 10 percent (i.e. from 40 percent per annum to 10 percent per annum). These changes in official interest rates reflect the trend in market interest rates. Thus, despite the fact that U.S. deposit interest rates in the euro-currency market have risen from 13¼ to 15¹¹⁄₁₆ percent (three months) and 13¹³⁄₁₆ percent to 15⅜ percent (six-months) between October 5th and November 2nd, Deutschemark deposits rates have also risen from 7⁹⁄₁₆ percent and 8⅞ percent (three months) and 7⁹⁄₁₆ percent to 8⅞ percent (six months).

As a result, the ratio between dollar and deutschemark interest rates, which has been a useful indicator of relative attractiveness in the past, has risen only marginally from 1.75 to 1.76 since the announcement of the Federal Reserve measures. Looked at from this perspective, the recent increases in Deutschemark and other interest rates have gone a long way to offset the effect of higher U.S. interest rates internationally.

Nevertheless, the October measures had the immediate effect of strengthening the dollar in the international markets and the dollar continues to be buoyant across the board and strong against the yen and the pound. Looking further ahead, the strength of the dollar will depend in part on whether the measures will succeed in dampening domestic inflationary pressures but the other witnesses are better able to forecast in this area than myself. What I do believe is that, from both a domestic as well as international perspective, the Federal Reserve's measures were courageous, right and necessary. The dollar was coming under growing selling pressure and confidence was beginning to disappear rapidly. It was also admirable that the Fed decided to tackle the problem at its root, namely to try and control domestic inflation rates rather than relying on temporary support measures in the foreign exchange market.

However, to try and secure more stable international financial conditions, I believe that other actions are needed aimed at changing the structure of the international financial system. While it is possible that the Fed's measures will succeed in curbing inflation at home and stabilizing the dollar abroad, this leaves too much to chance. Already interest rates are escalating in Europe and Japan (and may well rise further), while government after government seems to have fallen in love with the idea of a rising currency value (which is a mathematical impossibility for the system as a whole). At the same time, central banks are increasingly reluctant to intervene in the foreign exchange markets to support the dollar when necessary because of the fear of losing control over their domestic money supplies.

Moreover, these policy conflicts are taking place against a background of a long-term asset diversification process away from the dollar.

The desire on the part of many large-scale asset holders to reduce the proportion of their assets in one currency, namely the dollar, is only partly related to the inflation and balance of payments outlook of the United States. A deteriorating situation in the United States will speed up the diversification process but it is doubtful that an improvement will reverse the trend. This is because the desire for asset diversification is related to the changing structure of the world economic and financial system. (I would like permission to submit a recent paper on this subject given to the Colombian Bankers Association.) As a consequence of these factors, a number of structural changes in the international financial system (or safety nets) are required to complement the domestic measures taken by the Federal Reserve.

The introduction of a Substitution Account at the International Monetary Fund of substantial size ($50 billion or more) is essential, but appears to be at least two years away. Such an account would allow official holders of dollars to deposit those dollars (or any other currency) at the IMF in return for Special Drawing Rights so taking pressure off the foreign exchange market. However, apart from the fact that the account does not exist, official and private holders of assets, currently want to buy deutschemarks, Swiss francs, yen, pounds, etc., rather than a composite unit such as the S.D.R. What then is required as a pre-requisite to the achievement of more stable conditions in the foreign exchange markets is a mechanism whereby central banks can buy the assets they want outside the market.

For example, when an asset holder currently sells dollars and buys deutschemarks, the transaction is undertaken in the foreign exchange market either pushing up the value of the deutschemark or leading to an expansion in the German money supply if the Bundesbank intervenes. If, however, the Bundesbank allowed the asset diversifier to purchase the Deutschemark in an agreed amount and in a form mutually acceptable, the transaction could be arranged outside the foreign exchange market. Not only would the exchange rate be unaffected, but the transaction would minimize the risk that asset diversification by some central banks triggers short-term speculative movements of capital.

The recommendation is that such facilities only be offered to central banks and not to private holders. Some central banks have proposed this to the German authorities and would be willing to relate purchases to the needs of trade and regard their holdings as being of a long term nature. On the other hand, they do not want to buy long-term bonds, having a preference for deposits even if they would be rolled-over on a continuous basis.

Put another way, a multiple reserve currency system is emerging but it is developing the hard way—through the mechanism of the foreign exchange market. Special facilities offered by the central banks of Germany, Switzerland, Japan etc. to official asset holders would provide a very welcome safety net to the system so reducing periodic exchange market pressures.

In this same context, a variant on the use of "Carter Bonds" may be given consideration. The present practice is for the U.S. Treasury to issue such bonds in Germany and other countries in order to raise local currency to be available at a later stage for foreign exchange intervention by the Federal Reserve Bank of New York. An alternative would be for the U.S. Treasury to issue a given amount of bonds in New York denominated in deutschemarks, yen and other currencies but with subscriptions paid in U.S. dollars. The bond sales would be limited to central banks in the first instance but the bonds would be traded in New York giving the asset holders liquidity if needed.

Such a facility would be, in effect, a United States Substitution Account with the idea of anticipating asset diversification rather than waiting until the dollar comes under pressure in the foreign exchange market and then intervening. So far, the Bundesbank has been opposed to the use of the deutschemark internationally, but it is interesting to note that no objection has been raised to the forthcoming European Investment Bank deutschemark bond to be issued in the London market later this month. Moreover, these deutschemark denominated bonds would satisfy the desire for diversification without having an immediate or necessary impact on the German money supply. Thus, to help set the groundwork for a less unstable foreign exchange market, the domestic U.S. measures should be supplemented by a number of "safety nets" to reduce the impact of capital movements on exchange rates.

Finally, the decision by the Federal Reserve to impose marginal reserve requirements on increases in managed liabilities of banks, has no direct implications for the foreign exchange markets. This action was taken to try and avoid the circumvention of a tighter domestic monetary policy through borrowing in the euro-dollar market in particular. Unfortunately, the market is very large and there are a number of loopholes. The main deterrant to the use of the euro-dollar market is the same as in the domestic market—the very high cost of borrowing. It will be a very interesting test whether monetary policy will succeed in slowing down leading given the continued easy availability of funds both in the United States and in the euro-dollar market.

Thank you.

[Speech presented before the Colombian Bankers Association, Oct. 26, 1979]

THE MANAGEMENT OF INTERNATIONAL RESERVES

It would only be a modest exaggeration to say that a revolution is taking place in the management of international reserve assets. During the last few years, and especially since early 1977, the strategy of international money management has changed. And, the adoption of new policies has by no means been confined to so-called "Sophisticated" multi-national companies and Swiss "Gnomes". Many central banks in the developing world have been in the forefront of this revolution.

The basic decision on the part of many large-scale international holders of reserves has been to reduce the proportion of assets in the form of US dollars. As the proportion of dollars held has been reduced, holdings of Deutschemarks, Swiss francs, Japanese yen, Sterling and Frecnh francs have risen. But, this trend is not easily discerned from an examination of the figures. For example, despite the fact that the gross size of the euro-currency market has risen from $110 billion in 1970 to approximately $1000 billion at the present time, the proportion of dollars in the market has remained at between 75 percent and 80 percent. Similarly, while foreign exchange holdings of central banks have grown tremendously, the proportion of foreign exchange reserves held in the form of dollars has remained stable at about 80 percent since 1970.

However, these figures are very misleading and especially for central banks. Individual central banks do not publish a breakdown of their assets by currency and a certain amount of detective work is required to discover what is really happending. Total official reserves curently exceed $700 billion of which $300 billion is in the form of gold valued at today's price and virtually all of the rest in the form of foreign exchange (80 percent dollars). Given these amounts, it is small wonder that so much attention is given to the investment policies of central banks.—a decision to sell even a very small proportion of dollars for another currency can have a very big impact on the foreign exchange market.

The critical fact is that there are very large differences between the investment management policies adopted by the Group of 10 central banks (i.e. the United States, West Germany, Japan, the United Kingdom etc.) and other central banks. There is no question but the central banks of non-industrial countries have been actively reducing the proportion of their foreign exchange reserves held in US dollars. This applies especially to non-OPEC developing countries but there is also ample evidence that many, if not all, OPEC countries have begun to acquire non-dollar assets. The process is called "Reserve Asset Diversification".

An immediate result of the decision to sell dollars either by central banks or private investors and buy Deutschemarks and other currencies has been to force up the value of these currencies. Yet, the central banks of these countries have tried to stop their currencies from rising by buying dollars. The result has been that while some central banks have reduced their dollar holdings (the reserve diversifiers) others have increased their dollar holdings so leaving the overall proportion of central bank dollar holdings more or less unchanged. More over it is worth noting that the central banks of Europe and Japan would have prefered not to have intervened if possible because purchases of dollars (with equal sales of their home currencies), gives rise to an immediate increase in domestic money supplies.

Thus a more careful examination of the behaviour of central banks suggests that the world of central banks may be sharply divided between what might be described as "willing" diversifiers and "unwilling" dollar holders, none of which shows up in overall official reserve asset figures.

Apart from the movement out of dollars, there has been a substantial fall in holdings of sterling assets by central banks since 1970. As is well known the pound Sterling has been in process of being phased out as a reserve asset along with the disappearance of the old Sterling Area. It may almost go with saying that the mismanagement of the United Kingdom economy throughout much of the last decade helped to speed up the process. But, since October 1976, when the pound collapsed and domestic policies changed, sterling has come back in favour as a reserve asset especially this year and has been an excellent investment.

The most favoured asset for diversification by central banks and private investors has been the Deutschemark both in the form of bonds (tax free) bought within Germany and in the form of Eurodeutschemark deposits placed with German banking subsidiaries in Luxembourg and with large international banks in the euro-currency market. Secondly, the Swiss franc and yen have been favoured and, in the last year, so has the pound sterling. Other currencies such as Dutch guilders and French francs have played a minor role. On the other hand, Special Drawing Rights and other composite assets have not been a favoured vehicle for currency diversification.

What are the reasons for diversification, especially by central banks which are very conservative institutions usually more concerned about safety of principal than the rate of return? Interestingly enough, the fundamental reason for diversification is that a diversified reserve asset portfolio is less risky than one in which one currency predominates. Thus, the trend towards diversification is a way of reducing uncertainty in today's world of wildly fluctuating exchange rates. Just as a domestic investor avoids investing in only one assets, the same principle is now being applied internationally.

Since the introduction of generalized floating exchange rates in 1973, nominal exchange rates have moved by truly massive amounts. Movements of 3 percent in a day have not been uncommon; 10 percent in a week not unusual and some exchange rates have risen or fallen over 30 percent in a year. More over, the scale and direction of movement has been next to impossible to predict.

Any international investor should be cautious about individuals or banks offering an exchange rate forecasting service; their crystal balls are not only cloudy but all too often pointed in the wrong direction. But, once the view is taken that it is not possible to forecast exchange rates in a sustained manner over anything but a short period of time, a different approach has to be adopted for the management of international reserves.

Some central banks have decided to spread their holdings of currency assets more or less in accordance with the pattern of their country's international trade. For example, if 50 percent of a country's trade is with the United States and 50 percent with Western Germany, foreign exchange holdings will be divided equally between the two currencies. Thus, if the Deutschemark rises against the dollar, although the price of German imports will tend to rise this will be offset by an increase in the value of Deutschemark assets. Usually, adjustment is made in the central bank's portfolio for foreign debt with currencies being held to match overseas debt liabilities. Again, if the cost of debt increases because of a rise in an exchange rate, this is offset by an increase in the capital value of an asset.

Other central banks have taken a slightly different approach basically spreading their currency holdings into a number of units on the view that some will rise and others fall but, on balance, the portfolio will be protected. This might be called the "currency indexing" approach just as many investors in stock markets have bought a basket of stocks on the view that they cannot outguess the market about the future price of an individual stock.

The question will be raised of why the weakness of the United States balance of payments has not yet been mentioned as a reason for diversification out of the dollar. The U.S. balance of payments deficit and escalating U.S. inflation rates has given rise to concern about the dollar and hence to a shift of funds out of the currency. The anticipation of a falling dollar was important in 1977 and 1978 in the process of diversification. However, and most importantly, it is very uncertain whether an improvement in the U.S. balance of payments will bring about a sustained reversal of the diversification process. There is little evidence, for example, that central banks sold non-dollar assets and bought dollars in 1979 after the November 1, 1978 measures.

Large-scale asset holders seem to have made a basic decision to reduce the proportion of assets held in one currency almost regardless of the fortunes of the U.S. economy. Put in terms of a longer perspective, this was surely inevitable. If the United States economy accounts for 35 percent of OECD output and

16 percent of foreign trade, the probability is that it would not be possible to sustain a situation in which 80 percent of the average international portfolio remained in dollars. This is a structural problem of the system and the relative position of the dollar is being reduced in the same manner as the position of the pound Sterling declined in the 20th Century as the relative economic position of the United Kingdom fell.

Finally, and purely from an investment point of view, investors, who have diversified their portfolios, have almost without exception shown better returns than those who have not. It is a winning combination to have portfolio theory, history and most of all, performance on your side.

Naturally, this process of asset diversification has important implications for the international financial system. The desire to remove the actual and potential disruptive effects of dollar sales on the foreign exchange market by central banks lies behind the new-found urgency to establish a Substitution Account at the IMF. This account would enable these central banks wishing to sell dollars to achieve a substitution of dollars for S.D.R.'s with the account then continuing to hold dollars so taking unwanted dollars off the market. This is of potentially very great importance to those OPEC countries holding massive amounts of dollars, working to diversify to some degree but afraid of disrupting the markets.

Unfortunately, the establishment of an IMF Substitution Account is at least two years away. Thus, in the meantime, there is a continuing threat to exchange rate stability. The international financial system is evolving towards one based on multiple currencies with a background of floating exchange rates. Despite the wishes of the German authorities, the Deutschemark is a reserve asset as is the Swiss franc and Japanese yen. The chances are that the role of these currencies will increase but there are no existing mechanisms in place to ensure that the evolutionary process will be smooth. At present. central banks of the newly emerging reserve asset centres, in combination with the Federal Reserve Bank of New York, are faced with the unhappy choice of allowing their currencies to appreciate (depreciate) or losing control over their domestic money supplies.

This is a very unstable situation which forces many observers to conclude that the outlook continues to be one in which exchange rates will fluctuate by substantial amounts just has been the case for the last several years. The outlook is made that much more gloomy by what appears to be the desire of most countries to have appreciating exchange rates (or not depreciating rates) which is a mathematical impossibility for the system as a whole. Now US interest rates seem to be reaching for the moon. all of which makes the role of the international investment manager an unenviable one. The only thing that looks to be increasingly likely is that the industrial countries, led by the United States, will enter a period of sharp recession if not this year then in 1980.

Senator JAVITS. Mr. Gaines, are you going to speak to this same subject?

Mr. GAINES. I apologize for being so late. I am a victim of a railroad. I was to talk with Alan Greenspan on the domestic implications.

Representative REUSS. I think we have long since established that domestic and international are all one. Why don't you tell us your views of October 6 and thereafter.

Mr. GAINES. I don't have a statement with me. My monthly economic report for October, though, is called "Federal Reserve Policy Versus Inflation." It deals directly with the subject of this hearing.

Representative REUSS. Would you be kind enough to supply that for the record?

Mr. GAINES. Yes.

Representative REUSS. Without objection, it will be made part of the record at the end of your testimony.

While I am at it, Mr. de Vries, you have the October 1979 Morgan Guaranty's "World Financial Markets" bulletin. If it is all right with you, and without objection, we will have that printed in the record at the close of your oral testimony.

Mr. DE VRIES. Right, thank you.

STATEMENT OF TILFORD C. GAINES, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, MANUFACTURERS HANOVER TRUST CO., NEW YORK, N.Y.

Mr. GAINES. In this October economic report I open by asserting without any equivocation that we are now on the path toward price stability. The reason being the three broad actions taken by the Federal Reserve on October 6.

The increase in the discount rate a full point was rather dramatic. But in a sense it was symbolic as anything else. The imposition of additional reserves on marginal money market balances is going to prove to be an effective instrument of policy.

What I find most interesting about it is that it is the first effort by the Federal Reserve to get a handle on foreign banking activities in the United States.

By all odds, the most important part of the Federal Reserve actions was the announcement that they were shifting the base on which they conducted their actions. In other words, they would no longer attempt to stabilize short-term interest rates by stabilizing the Federal funds rate. But instead they would look at what might be called the bottom line, in other words, the availability of net reserves in the bank system.

Many of us over the past couple of years or so have been openly critical of the Federal Reserve for its Federal-funds-related operations. I needn't explain how they operated. But it seemed to me that in the process of notching short-term interest rates up a quarter of a point at a time in an effort apparently to make money so expensive that less money would be held or credit used, it seemed to me that that effort probably, by the time Paul Volcker became Chairman of the Fed, had already created a level of interest rates higher than we would have had if they had been aiming at the basic reserve figures all along. There is no way to document this, of course, or prove it. I felt a great deal of sympathy for Paul. It seemed to me that he inherited a situation in which his latitude for action had already been taken away from him. In other words, interest rates were so high that going in that direction could push us into some pretty serious ground.

Under the new operations, it seems likely to me that interest rates will advance a bit further from present levels. But I do not share the concern that some people have expressed that interest rates will be driven up to stratospheric levels under this new policy. In other words, by ignoring rates of Federal funds, I don't think that the Fed is running a serious risk of a 20-percent prime rate, let's say.

As a matter of fact, if the policies are as successful as I think they will be, within the next 6 to 9 months we could easily see a turn in interest rates tied to a turn in the rate of inflation.

By the way, that would simultaneously be of great assistance to the position of the dollar in world markets.

The advantage of the reserve base target, as I see the principal advantage, is that it gives the Federal system considerably more ease. In other words, by adding to their net reserve target, they could gradually close in on the market until they had developed evidence that credit restraint was actually working.

How would that evidence be developed? In the first place, we don't have data on the residential construction industry since the October 6 moves. But I would judge that the stortage of mortgage credit will very appreciablly reduce the level of new housing starts. I think housing, in other words, will be the first victim.

Second, these actions were taken at a time when some important sectors, and in particular the auto industry, were already in the recession phase. I think the availability of credit for consumer purchase of automobiles and other items will be restrained, not so much as mortgage and housing credit, but I think appreciably restrained.

I think the simple hard fact of the matter is that with the prime rate now at 15¼ percent, with an 18-percent ceiling on what a bank can charge on the credit card credits and so forth, there is very little incentive left.

As a matter of fact, consumer lending becomes a nonprofitable operation.

So to the extent that the banks are rationing their credit, there will be a tendency to cut back on the level of available consumer credit. None of this, by the way, is all one way or the other. But there will be a tendency in that direction.

Finally, in the case of business borrowing, I think that the new element that has been added is uncertainty as to whether or not credit will be available if the company needs the credit. They have shown that even at 15¼ percent prime rate, it is only a couple or three points above the ongoing rate of inflation, so there is not a terrible disincentive effect coming from interest rates.

I think to rely on them as the Fed has in the last couple of years was a mistake and would be a mistake if we were to do it again.

But the uncertainty generated, I think, is already visible in business loan demands. In our case, in the couple of days immediately after October 6, we had a rush of credit users coming in to borrow against their existing lines.

In other words, attempting to lock up the money while it was still available.

But lately we have seen some decided rethinking of credit use. We have moved in the direction of achieving that, incidentally, by adopting the same language that Paul Volcker used in the limitations upon the types of loans we would make.

In other words, there are severe restraints—and I am sure this is true at the other big banks as well—upon loans for strictly financial or speculative purposes. There is not a complete black listing of such loans. But it must be a rather unusual situation before a loan of that nature would be granted.

Taking these pieces together, I am confident that working through reduced credit availability and reduced credit use, the Federal Reserve will maintain control over the monetary aggregates for the many months ahead, and with the kind of line that monetarist economists have always pointed to, a 2 to ¾ line, I would expect to see this reflected on the rate of growth in the basic money supply.

As I say, I think we are within 6 to 9 months of that. I put myself out on a limb with that. I venture the guess that if all goes well that by the fourth quarter of the next year the rate of price inflation will have fallen to no more than about half of what it has been running in 1979.

In other words, I am talking 7 to 8 percent, 6½–7½ percent by fourth quarter 1979.

If we assume that that is feasible, and I believe it is, partly because there is quite a bit of froth in the recent inflation statistics that will not necessarily be repeated—hopefully, for example, oil prices will not rise as much in the next 12 months as they have——

Representative REUSS. Excuse me. You said, I think, that you envisaged a 6½ to 7½ percent inflation by the fourth quarter of 1979.

Mr. GAINES. Excuse me. I mean 1980. Thank you.

Hopefully, and I emphasize hopefully, there will not be further oil increases of that magnitude in the next nine to 12 months.

We had a year of record farm production so that food prices should not be the powerful inflation on inflation that they have been. In every way—I expect, for example, this Christmas season to be a poor one for the merchants, partly because of the squeeze on money and credit.

I think that we will run into the phenomenon this year of pre-Christmas days and so forth.

Individually, these little cuts in prices don't seem to add up to anything. But you take tens of thousands of retail outlets cutting prices on special sales, and it does have an impact on the price of goods.

So, as I say, I am confident that within the next year we will have been able to cut about half of the inflation out of the system. That will be the easy part of the thing.

It will take another 3 years or so, I would guess, of constantly tight money to get price inflation down to the level that we would be prepared to live with.

Meanwhile, if the time comes, as I expect, no later than next spring, we should expect interest rates to turn down almost simultaneously with the appearance of a drop in the inflation rate, and we should expect the dollar, from that point on, assuming progress is maintained, to be a much more stable currency than it has been.

A lot of this is sheer speculation, obviously. But I am so impressed that at least one of the Government agencies is moving forcefully to get a handle on inflation, I do think they have an excellent chance of succeeding.

Representative REUSS. Thank you, Mr. Gaines.

[The report, referred to by Mr. Gaines, entitled "Federal Reserve Policy Versus Inflation" follows:]

Federal Reserve Policy Versus Inflation

By TILFORD GAINES
Senior Vice President and Chief Economist

Manufacturers Hanover Trust

OCTOBER 1979

Economic Report

Within the next few months the rate of price inflation should turn lower and continue to trend lower indefinitely into the future. In the absence of major new shocks, the rate of consumer price inflation could be brought down by about one half from its recent 13 per cent plus level within the course of the next year or so. This unqualified assertion that we could and will control inflation is based principally on confidence that the Federal Reserve's new policy initiatives will be successful.

On October 6, the Federal Reserve announced three new policy moves. The first of these was an increase in the discount rate to a record 12 per cent. In some ways, this part of the package could be considered more symbolic than real. While it is desirable that the discount rate be kept in line with money market rates of interest, in order to forestall borrowing at the discount window that might undercut the thrust of Fed policy, the fact is that the Federal Reserve is in a position to prevent excessively large borrowing through the use of moral suasion. The Fed has always operated on the principal that bank borrowing at the discount window is a privilege, not a right, and for a bank to use such borrowing not as a last resort measure but simply because the money is cheaper than Fed funds is improper borrowing and the Fed is able to do something about it.

The second part of the package is considerably more interesting and still is not generally understood. It consists of the imposition of an additional 8 per cent reserve requirement on marginal amounts of certain types of purchased money. Included were Fed funds purchased from other than member banks, money raised through repurchase agreements, large denomination certificates of deposit, and funds brought in from the international money market. It should be stressed that the reserve requirement applies only to those funds in excess of the amount held in the base period. What is particularly interesting in this part of the package is that the reserve requirement on funds brought in from abroad (primarily the Eurocurrency market) is intended to apply to United States branches of foreign banks, not just to U.S. banks. This innovation was clearly necessary to plug a major loophole that otherwise would have existed.

In addition, there is a suggestion that the Federal Reserve might have gotten prior agreement from other central banks to use their influence upon their local banks not to undercut the Fed's efforts. There has been considerable discussion over the years about the need to impose some restraint upon the movement of Eurodollars and about actions that might be taken toward such an end. It is perhaps reading too much into recent events to conclude that a first step has been taken toward regulating the Eurodollar market, but appearances create a strong likelihood that this has happened.

Finally, the third part of the package was an announcement that for the time being the Fed would abandon its efforts to control money and credit supplies by regulating short-term interest rates and instead permit short rates to fluctuate in line with market conditions and would instead concentrate upon the bottom line, i.e., the availability of reserves in the banking system.

This third action probably is most significant of all. Many economists, including this *Economic Report*, have argued for a long while that attempting to manage the monetary system by jiggling short-term interest rates was self-defeating. What has happened in the past two years is that each time the Federal Reserve wanted to signal that its policy was being tightened, it increased the Fed funds trading rate at which the Fed moved into the government securities market either to absorb or to supply reserves. Professionals in the money market followed the Fed's actions very closely, and as soon as there was evidence that the target rate for Fed funds had been increased, the dealers would ratchet other short rates upward, followed promptly by the commercial bank prime lending rate. Under this system, the prime rate advanced from under 7 per cent to 13½ per cent in the space of about 18 months, but even at that lofty rate there was absolutely no evidence that money or credit were in tight supply. Banks still had abundant funds to lend, and competed aggressively to make new loans. In actual fact, the steadily increasing level of the bank lending rate probably was, of itself, a minor influence toward more inflation.

The remainder of this *Report* will focus primarily upon the third portion of the Fed's new policies. It will attempt to explain the way in which Fed policy actions are expected to contribute to a slowing in the rate of price inflation and will offer judgments on the likelihood of success in these endeavors.

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Policy Flexibility

A good part of the adverse reaction in the securities markets to the Fed's new policies grew out of ignorance as to what the policies implied and as to how they might affect the economy. In actual fact there is no mystery in what the Fed is attempting to do. Throughout the decade of the 1950s and into the 1960s, Fed policies were aimed at regulating a magnitude called free reserves (or net borrowed reserves). This was a measure of the net reserve position of banks after deducting the amount of money they were borrowing at the discount window from the total of their excess reserves. In practical application the concept was very close to what the Fed has just announced it would be using. The difficulty with the free reserves-net borrowed reserves measurement was that required reserves were a part of the measurement from which the target was derived. Therefore, the money supply might be growing at any given rate and, in pursuit of the target, the Fed would supply whatever reserves were needed to support the growth in deposits. It is to be assumed that this time around the Federal Reserve will avoid this trap and instead focus upon total reserves (the monetary base) and the money supply.

A distinct advantage that the new approach to open market operations will have is that it gives the Fed considerably more latitude for flexible operations than was true when short-term interest rates were the target. From one week to the next, the Fed could alter its reserve target in relatively small increments, while simultaneously reining in the use of the discount window, in a search for a reserve position that would both restrain credit and bring the growth of the money supply within target ranges. It is a fairly obvious principle that if the Fed could reduce the reserves available to the banking system, while at the same time keeping borrowing at the discount window under control the net effect upon banks as a group would be to cause them to restrain their lending for the simple reason that they would not have funds available to lend.

In the first couple of weeks under the new policies, both money supply and commercial lending spurted upward, but this development should by no means be considered as evidence that the effort will fail. As noted, the Fed will have to grope its way toward a reserve position that will impose the desired degree of restraint. The process will not be a simple one and immediate success should not be expected. But with the flexibility the Fed has to change its reserve targets, ultimate success would seem to be virtually assured.

In speaking of the new Fed efforts, Chairman Paul Volcker has urged banks not to make "speculative or purely financial" loans. It is likely that the banks will follow Mr. Volcker's advice. It was one thing to put on huge amounts, for example, of acquisition loans when it appeared that there was an unlimited amount of money available for making loans. As the new policy begins to bite into the supply of reserves, however, that situation will no longer obtain. And if banks are to be in a position where it is necessary for them to ration their available funds, the kinds of loans Mr. Volcker referred to would be among the first to be cut back. In a sense, this gives the new policies something of an appearance of being selective credit controls, but that really is not the case. The banks will be free to pick and choose among loan applications with no flat prohibition upon any particular type of loan. The net effect, however, will be to reduce the total of new loans and, thereby, reduce the total of new money being generated.

Will the Policies Be Successful?

There is every reason for confidence that the Fed efforts will succeed in reducing the rate of price inflation, although that success might be at the cost of a somewhat longer and deeper recession that otherwise would have occurred.

One industry that has already felt the brunt of tight and more expensive money is residential construction. Housing starts in the first three quarters of this year remained stronger than most people had anticipated, averaging a 1.8 million unit annual rate, down only 10 per cent from the strong performance in 1977 and 1978. There has been a great deal of anticipatory moaning that housing will suffer unduly under a tight money regimen, but there is no easy way to avoid that outcome. It is, of course, unfortunate that any one sector of the economy might have to carry a heavier burden than others, but it must be kept in mind that housing costs have been one of the principal contributors to the ongoing inflation, and if the back of inflation is to be broken the housing market will have to be curtailed. There already is highly, preliminary word of mouth evidence that the resale market for existing homes has slumped and within a few months that slump probably will be reflected in the statistics for new housing starts.

Consumer credit might also be restrained. To the extent that credit can be allocated, there will be considerable incentive for banks to limit their provision for consumer credit. Traditionally, the effective rate of interest on consumer loans has been significantly higher than that on business loans. With the prime rate now at 15 per cent, and with consumer lending rates restricted by usury laws, the attractiveness of consumer paper has been appreciably reduced. The result of the tightening of consumer credit is likely to be felt first and most in the financing of automobiles and other consumer durables. Auto sales have already weakened from last year's high rate, but they have continued to run at a relatively strong pace. Further weakness could complicate some of the problems that already exist in the auto industry but, as in the case of housing, there seems to be no alternative but to go this route.

Most important of all, the new Fed policy should have a sharply limiting impact on business borrowing. Business loan demand has been strong for the past several months reflecting an internal cash flow situation in which

growing inventories and receivables and, to an extent, capital spending, have generated a large need for external financing. There is no conclusive evidence that inventories have gotten out of line to the extent that they did five years ago, but the sheer effect of inflation alone upon book values has generated larger and larger needs for credit to carry inventories.

So long as the rate of interest on business borrowing was below the anticipated rate of price inflation there was little incentive for businesses to restrain their inventories since the cost of carrying them was nil. With interest rates at present levels there now is a net cost in positioning inventories. Add to that the new uncertainty as to whether or not credit will be available at any rate of interest, and there would appear to be strong incentives for industry to peel inventories back even further.

In these various ways the restraints on bank lending and the high levels of interest rates will reduce economic activity. In the context of an economic setting where the possibility of a recession already was quite strong, the reduced level of business activity flowing from Fed policy will almost surely increase the likelihood of recession. As the expression goes, however, one cannot make an omelet without breaking some eggs. There is as yet no reason to fear that the recession will be other than mild, although the period of slow business activity probably will be protracted. The test of the new Fed policies will come not from whether or not there is a recession but from whether or not they succeed in curbing inflation.

Matters of Timing

A question that has been raised since the new Federal Reserve policies were announced is whether or not the Fed will be able to resist political pressures and stick to their restrictive policies long enough to get the job done. In responding to this concern, the issue of timing becomes extremely important. In the first place, the gross national product figures for the third quarter, just released, showing a 2.4 per cent growth rate, lend support to the Fed's position that the economy is stronger than most analysts had expected, and strong enough to tolerate the rather bitter medicine the Fed is applying. Most economists believe that the economy will turn lower in the fourth quarter of this year and probably not go anywhere through 1980, but meanwhile the central bank has time to operate.

If the policies bite as outlined above, evidence of their effectiveness should be available fairly early in the new year. In addition to the impact of the policy actions, the success of the Fed's efforts will be supported by the fact that agricultural prices have not recently posed much of a new threat and by the fact that the bulk of the last round of oil price increases has been absorbed. Even though there have been some oil price increases since last spring, and even though the OPEC oil ministers are scheduled to meet again in December, the chances are that whatever inflationary impact their actions might have will be much less than what we have been absorbing in recent months. In other words, the emergence of a declining inflation trend should be apparent before the end of the first quarter of 1980.

Once a declining inflation trend has become evident, short-term rates of interest should peak and begin to decline. It might take a bit longer for long-term interest rates to begin to slide, but under the time frame specified here, long-term rates also should be slipping by mid-year. Chairman Volcker of the Fed has made it clear that while central bank authorities see little likelihood that they will actively promote easy money and lower interest rates over the course of the next year, they will not resist a declining rate trend that emerges from market forces. Therefore, as the economy softens and demands for credit recede, the resulting drop in interest rates will occur with the Fed's blessing, if not active support.

All of this fits into the context of a year divisible by four, i.e., an election year. It is perhaps here that the matter of timing becomes most significant. It is interesting to note that not only has the present Administration supported the Fed's actions to correct inflation, these actions generally have not been criticized by other announced or potential candidates for President. In a sense, Paul Volcker and the Federal Reserve have the politicians fenced in. In the face of a concensus that inflation is our number one economic problem, no active politician would be disposed to attack the one arm of government that is attempting to do something about inflation. This swords-point truce should be maintained for at least a few months. Meanwhile, if the timing forecast implied here is right, evidence that inflation is coming under control will appear before the truce is broken and make it that much more difficult to break the truce.

During the primary campaigns in late winter and early spring, it should be anticipated that a principal plank in President Carter's campaign will be that inflation is coming under control. His opponents will be put in the position either of denying that statistically provable fact or of arguing that they can do the job better. To pursue the latter line of arguing would require that they accept what the Federal Reserve System is doing. In short, the Fed appears to be in an unassailable position. In spite of record high interest rates, somewhat higher unemployment, a weak housing market, and all the rest it would appear that the Fed can pull it off without a major confrontation.

In Conclusion

Often the case for monetary policy as an instrument for economic stability rests on the assertion that if the rate of growth of one or more of the monetary aggregates can be brought into a noninflationary pattern, that by itself will be sufficient to prove the case. It certainly is true that the nominal growth in the economy

can not for long exceed the growth in the money supply needed to support the nominal economic growth rate. This brief *Report* attempts to go a little more deeply into the process through which monetary policy becomes effective. Its effectiveness is based on the availability of money, the availability and expected availability of credit, levels of interest rates, and a variety of other measures. The net effect is to restrain both consumer and business spending so as to produce some slack in the economy, a slack that through competition in the marketplace is translated into reduced pressures on prices.

I am personally confident that this time around the Federal Reserve will stick to its policy long enough to get the job done. The central bank is in the hands of seasoned, professional central bankers. They are aware of the failures of the central bank in recent years that have permitted inflation to get so badly out of hand. They are aware that success in controlling inflation will require economic restraint or stagnation in the short run and reduced aspirations in the long run. But they also are aware that tolerating inflation would do far more damage than is likely to be done by the assertion of monetary discipline.

Finally, there should be a word about the international implications of all this. Temporary support for the dollar was generated last November when the package of policies was announced that put together a $30 billion safety net to protect the dollar. But, as many of us warned at that time, no safety net under the dollar could be adequate so long as there was a deep seated lack of faith in the economic policies of this country. The crumbling of the foreign exchange market in the week or two before the Fed acted, creating a real crisis of confidence, was evidence of this fact. The actions by the Fed have not put completely to rest the uneasiness abroad about our determination to manage our own affairs responsibly.

But the new policies have held. And if, as asserted here, the Federal Reserve System is at last on the long trail toward wiping out price inflation, the dollar could steadily improve in the months ahead. Were that to happen, it would be of far greater significance than simply restoring our pride in ourselves and our currency. Such a development would make possible the restoration of order in the entire international financial system, carrying with it a host of political and military, as well as economic, advantages.

Representative REUSS. Mr. de Vries.

STATEMENT OF RIMMER DE VRIES, VICE PRESIDENT, MORGAN GUARANTY TRUST CO., NEW YORK, N.Y.

Mr. DE VRIES. Congressman, thank you for your earlier request to include our October 1979 bulletin entitled "World Financial Markets" in the record.

Just to briefly repeat, that article dealt with basically four issues; namely, the need for the Federal Reserve to follow through on its monetary tightness, and then going to new areas; namely, the need to restore order in the oil market and the need for offmarket diversification facilities and a need to enlarge the IMF role.

I am not going to repeat what was said in that piece. But I would like to amplify some of the numbers and make perhaps a couple of specific suggestions.

I am particularly concerned with the oil price situation. I hear from my colleague, Mr. Gaines, that he does not expect the same magnitude of oil price increases next year compared with this year. He probably is right. But we cannot bank on that.

Just to recapitulate, in the fourth quarter of 1978, now nearly a year ago, the average oil price was $13. That was the official OPEC average. Then in the first quarter of this year the average price moved up to $15. By June, before the OPEC meeting and before the Tokyo summit, it moved to $17. After these two meetings it went up to above $20 early in July.

Now it is $22. That is not even taking into consideration the activities in the spot markets. If we bring in the spot markets, I think the effective average OPEC price is probably around $24 at the moment. The spot market is now between 12 and 15 percent of the total oil traffic.

There are two issues facing the oil producers. First of all, we have Saudi Arabia, the moderate among the OPEC countries, charging $18, while the official average OPEC price is $22. Also, Saudi Arabia is not participating in selling to the spot market.

So there is a real tension between the price that Saudi Arabia charges and what the other OPEC countries charge.

I think the difference between what the Saudis are charging and what the average market price is does not come to your and my benefit, but it comes basically to the benefit of the international oil industries at various levels. It does not reach the consumer level. The benefit is not passed on.

The other problem is the tension between the difference of the official OPEC price, which I say is $22, and the average spot price which is somewhere around the middle $30's. There obviously is a wide range of prices in the spot market. But I would say in the middle $30's is a reasonable figure. And that market is getting increasingly bigger.

The question we should raise is: What would the oil price be if there were no OPEC, if there was not an official OPEC price? I keep asking this question of knowledgeable people in the industry and I never get an answer.

But my guess is it could be anywhere from $32 to $42, and maybe $36 might not be a bad average.

So there is a great deal of tension in the oil price situation today. I would not necessarily bank on the fact that next year we are going to get a great deal of amelioration from the oil price effect on the rate of inflation. It might be a little less, but it may also be about the same.

So there is a great deal of disarray in the oil field generally. Whatever the outlook is, the 1980's will be a decade filled with problems. We know we cannot produce alternative oil resources very quickly. And it will take 10 years, even if we do our very best, to make a measurable impact. But I think we should prepare ourselves for a fairly erratic oil price situation, with sharp cutbacks and sharp increases.

And I would not rule out that the average oil price could very well rise from 50 to 100 percent over the next 2 to 3 years.

It is difficult to forecast specific numbers. But the point I want to make is that we should not be unprepared to meet the financial problems stemming from the oil situation.

If we were to have further significant oil increases in the next few years, what are some of the consequences? I deal with some of them in the article: One, obviously, is the creation of a new international balance of payments of substantial magnitude. With what we have gotten now in oil price increases, we would assume a $55 billion to $60 billion OPEC surplus this year, before transfers. For next year we are now thinking in terms of three scenarios: An average oil price of $25, one of $30 and one of $35. To repeat, the effective OPEC price today is $24. So the first scenario of $25 represents a very small increase, and would be very optimistic.

A $30 average OPEC price would probably be more realistic for next year, and $35 clearly is a pessimistic forecast, although this cannot be dismissed altogether.

Under the first scenario we project an OPEC surplus of about $70 billion—again before transfers. And under the $30 average OPEC price next year, the OPEC surplus could move up to nearly $90 billion.

What this all adds up to is that if we add this year's surplus to that for next year and 1981, it is not impossible at all that OPEC will accumulate surpluses of $150 billion to $200 billion before official transfers over these 3 years.

Today's OPEC assets I would say on a net basis are about $210 billion. On a gross basis they are probably very close to $300 billion. What I mean by net is that some OPEC countries have significant debts. So there are maybe about $80 billion of debts in these countries. But on a gross basis, the OPEC countries have about $300 billion of external assets.

There is a chance that they could increase to about $500 billion over the next couple of years, including what they have accumulated this year.

Now these are sizable numbers. They have to be invested. As my colleague already has expressed, there is the issue of investment diversification.

Most of the OPEC nations are relatively poor nations. They are interested in retaining purchasing power. They have important economic decisions to make. First of all, they had to be convinced to produce oil and accumulate assets: then there is the pricing issue. They want to maintain purchasing power. They have to use these reserves at some future date for their imports.

They have a different attitude from some of the rich Western countries, which accumulate assets and hardly ever use them, except in war conditions.

But the OPEC nations still require a great deal of economic development, so they are interested in diversifying and maintaining the purchasing power, in terms of exchange rates, interest rates, and so on, of their assets.

How can we cope with these surpluses?

I don't think that the international monetary system at the moment is prepared to handle this adequately.

We have been talking for a little over a year, and actually for several decades, about substitution accounts. Very interesting reading. But when you get down to the nitty-gritty, we know that there are formidable problems, and I am not very convinced that the Congress is very eager to start issuing its guarantees on those so-called SDR claims which would be issued by the substitution account.

So it should be clear that the substitution account has many technical problems and probably also very severe political problems in the United States. It may be a very interesting thing to dream about over the next few years, and it may take a long time before it is written on paper and becomes effective. But it does not deal with the current, immediate issue of diversification.

I think it probably would be very useful for the Congress to let the negotiators know in the United States and abroad—know that it is a very nice thing what they are trying to negotiate, but that it would be better to get on with the issues of today, that is, the surpluses and the asset diversification.

I have a feeling that Europe and Japan, haven't really got the message of August 1971. At that time we went off gold. We told them that they were strong enough in their balance of trade to stand a little dollar devaluation. We needed to be more competitive. But they haven't really gotten the message in the financial area. In this area, too, they have to assume a greater responsibility.

Obviously, the issue of the reserve currency role of other currencies is normally approached with fear and trembling, but I think that this development is really needed today. The governments or central banks of leading nations, not only Japan and Germany, but Switzerland, France, Holland, England, and maybe others, should issue bonds and make them available to foreign countries like OPEC nations and other nations as off-market diversification facilities.

These nations should not have to accept the straitjacket the SDR which may not suit their needs. And this all can be done, fairly neatly, either directly with these countries or through the B.I.S. framework. It would give a much greater flexibility and remove a good deal of the potential tensions in the exchange markets.

I think there is an added advantage. We have debated the Euromarket over the last few years a great deal—how much it has mushroomed and that it may be too liquid. Obviously, one of the major sources of liquidity to that market has been the central bank deposits. We estimate today perhaps not less than $150 billion of money is invested in that market by central banks. This could grow significantly further on account of the projected OPEC surplus.

So these off-market diversification facilities offered by leading industrial nations might have an additional beneficial effect that they may remove this constant source of liquidity to the Euromarket and thus tidy up that market to some extent.

So we might kill two birds with one stone if we press other nations to go this route of offering these off-market facilities. This could contribute to the exchange market stability and could also tidy up the Euromarket and slow down its growth.

And there is a further impact. We have often wondered how the relationship between the IMF and the commercial banks can be improved and how the deficit countries can be encouraged to go to the IMF. I find that of all the ways, the best one is to make funds scarce, tight, and expensive in domestic and the Euromarket; and then, when the banks' books are full and the market is tight, some of the deficit countries then may be compelled to go to the IMF.

So I suggest we stop dreaming about the substitution account, and attack the urgent problems of the next couple of years, and that we press the authorities in foreign countries to think of establishing a much more flexible arrangement that I call "diversification facilities," which I think has great merits.

Maybe I could add one more point. What are the implications of these oil price projections for the U.S. current account? The U.S. Treasury has used a $10 billion-plus figure based on, I think, no change in oil prices.

We have internally used a $6 billion surplus figure. But if we assume an average OPEC price of $25 for next year, my guess is that the United States will not have any surplus in the current account. It will be in about equilibrium.

If the OPEC oil price next year would be about $30, my guess is that we would move again toward a sizable deficit of between $5 billion and $10 billion.

So I think the current account surplus is probably a little bit of wishful thinking at this stage.

Thank you very much.

Mr. REUSS. Thank you very much, Mr. de Vries.

Senator JAVITS. Thank you very much.

[The bulletin referred to by Mr. de Vries follows:]

World Financial Markets

Morgan Guaranty Trust Company of New York

October, 1979

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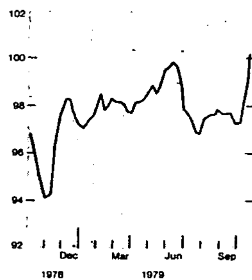
Effective dollar exchange rate
*index, March 1973=100**



*Latest plotting October 23

In quest of international monetary stability

Inflationary pressures, rising inflationary expectations, and speculation in financial, foreign exchange, and commodity markets have provoked a vigorous response from the United States. On October 6 the Federal Reserve announced a series of measures that included a full percentage point hike in the discount rate to a record 12%, an unprecedented 8% marginal reserve requirement on increases in managed liabilities, and a change in the Federal Reserve's operating procedures for controlling growth in the money supply that places greater emphasis on the supply of bank reserves and less emphasis on the level of the Federal funds rate. Shortly thereafter, on October 16, the U.S. Treasury Department announced that it would no longer hold gold auctions on a regular basis and would vary the amount of gold to be sold in the auctions in order to deter speculation.

The Federal Reserve actions, which were approved by all seven members of the Federal Reserve Board, received strong support from the banking and business communities, Congress, and the Secretary of the Treasury. Even several critics of recent U.S. monetary policy, including Senator William Proxmire and Congressman Henry Reuss, endorsed the latest measures.

The foreign exchange markets also responded positively to the Federal Reserve's actions. Shortly after the announcement of the measures the dollar rebounded to around the DM 1.80 level, after having reached a low of DM 1.73 in late September and early October. The yen, which had been weakening on its own, fell from the 220 yen per dollar level in early October to a low of about 235 yen toward the end of the month. Since October 5 the dollar has appreciated by about 2¾% against the mark and other EMS currencies, while climbing about 5½% *vis-à-vis* the Swiss franc and 5% against the Japanese yen (see Table 1). At the same time, the dollar has risen about 2% against the Canadian dollar and more than 3% against the British pound. On a trade-weighted basis, the dollar's level as of October 23 was up about 3% from its level on October 5 and slightly above the former 1979 peak reached in June (see chart). Meanwhile, in the commodity markets the price of gold, which reached a record level of about $450 in September, fell under the $400 level in mid-October.

The emphasis of the latest Fed-

Table 1

Exchange rates for the dollar vis-à-vis selected currencies
in foreign currency units per dollar, except Canadian dollar and British pound

	Oct. 5, 1979	Oct. 23, 1979
Canadian dollar	$ 0.86	$ 0.84
Japanese yen	223.80	235.50
British pound	$ 2.18	$ 2.11
German mark	1.76	1.81
French franc	4.13	4.24
Italian lira	816.35	831.95
Belgian franc	28.50	29.05
Dutch guilder	1.95	2.00
Swiss franc	1.58	1.67
*Effective dollar exchange rate**	97.30	100.20

*March 1973=100

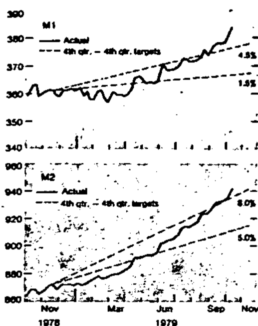
eral Reserve measures differs significantly from the November 1 actions a year ago. At that time the dollar was under pressure against virtually all of the major currencies, and the combined Federal Reserve-Treasury actions were geared toward restoring exchange rate stability. The November 1 measures featured a $30 billion currency support package and a renewed commitment on the part of the United States to intervene in the foreign exchange markets to support the dollar. In comparison, the latest Federal Reserve actions have been directed at dampening both inflationary pressures and rising inflationary expectations within the United States by improving the Federal Reserve's ability to control the rate of expansion of money and credit. To the extent that these objectives are achieved, the measures should also benefit the dollar and help to curb speculation in commodity markets.

The latest Federal Reserve actions occurred against a background of less than expected weakness in the domestic economy. Whereas real GNP declined by 2.3% at an annual rate in the second quarter of this year, it advanced at a 2.4% rate in the last three months, fully offsetting the second quarter decline. There has been considerable evidence of the partial rebound in economic activity in recent months. Industrial production rose by five-tenths of one percent in September — the largest increase since last May — after a decline of almost one percent in August. Similarly, the unemployment rate, which had climbed to 6% in August, declined to 5.8% in September. Housing starts rose by 4.2% in September. Contrary to many forecasts, the pattern of U.S. economic activity thus far has not been that of a typical U.S. recession.

Consumer and wholesale prices continued to rise at more than 13% annual rates during the latest three months. During September, the finished goods component of the wholesale price index surged at an 18% annual rate — the most rapid monthly increase in five years. At the same time, the money supply and bank credit continued to grow at rates that were inconsistent with the achievement of longer-term targets. M1 increased at a seasonally-adjusted annual rate of 10% in the latest three months, while M2 rose at a 12% annual rate. Bank credit has expanded even faster, at a 14% annual rate in the latest three months.

While there was no general dollar crisis, the dollar, nonetheless, was weak against the German mark despite substantial improvement in the U.S. current account position and a deterioration in Germany's current account. During September heavy central bank intervention, estimated to be on the order of $4-$5 billion, was required to support the dollar. The vast majority of these dollar purchases were conducted by the Federal Reserve. Consequently, by the latter part of September virtually all of the proceeds of the $3 billion in Carter bond sales in Germany were exhausted, as well as a substantial portion of the Federal Reserve's $6 billion swap line with the Bundesbank. When the German authorities were approached about the possibility of augmenting resources for intervention, they reportedly pointed out the difficulties that continued heavy exchange market intervention would pose for controlling German money supply expansion and evidently stressed that provision of additional resources should be preceeded by more fundamental steps. The discussions apparently ended with agreement by the German and U.S. authorities that continued heavy central bank intervention alone was not the answer to

Money supply growth and target ranges
in billions of dollars



the dollar-mark problem. Instead, more fundamental action to curb inflationary pressures in the United States was needed to arrest the dollar's decline against the mark and to curb speculation in gold and other commodity markets.

This point was very much stressed by M. Jacques de Larosière, Managing Director of the IMF, at the IMF/World Bank meetings in Belgrade. In his opening remarks M. de Larosière focused attention on the need to reduce inflation in the industrial countries as a necessary condition for restoring international monetary stability. He emphasized that any anti-inflationary strategy must include two lines of attack: one to deal with demand management, and the other to deal with the various structural factors contributing to inflation. On the issue of demand management, he noted that the policy of "gradualism," which was widely agreed on by the industrial countries a few years ago, has failed to bring about a reduction of inflationary expectations: "Greater decisiveness and firmness will need to be exercised in the conduct of monetary policy, and the change will have to be supported by fiscal policy. The fundamental aim must be to achieve credibility of fiscal and monetary policies so as to roll back inflationary expectations and restore confidence."

The measures adopted by the Federal Reserve on October 6 are very much along the lines suggested by M. de Larosière. They are directed at one important underlying cause of international monetary instability — namely, the problem of high and accelerating U.S. inflation. To be sure, they appear to signal a departure from the previous U.S. policy of gradualism, and there is reason to expect the stance of U.S. monetary policy to remain firm in the immediate future. Nevertheless, it should be recognized that there are many other sources of instability — such as potential oil price developments, ongoing reserve diversification, and the inability of the IMF to play a larger role in the balance-of-payments adjustments process — that also need to be dealt with in the near future in order to foster an environment for world monetary stability.

The Federal Reserve measures and their implications

A stated objective of the Federal Reserve actions is to assure better control over the expansion of money and bank credit, which in recent months have been growing above the upper end of the long-run target ranges (see chart). Instead of setting new monetary targets, the Fed announced on October 6 that it was altering procedures that it has used to attain its money-supply targets. For about ten years now, the Fed has tried to regulate the growth of the money supply by pegging the Fed funds rate at a level believed to be consistent with the desired pace of monetary expansion, and then supplying whatever volume of reserves was required to keep the funds rate at that level. This operating procedure, however, has been criticized on grounds that it provided too many bank reserves in expansionary periods, as the Federal Reserve resisted upward pressures on interest rates, and too few reserves in recessions, when the Fed moderated pressures for interest rates to fall.

The Federal Reserve now proposes to estimate the volume of reserves that is consistent with the money-supply targets and to supply that amount of reserves, letting market forces determine the Federal funds rate. As a result of this change, much greater variability in the funds rate is anticipated, although the au-

thorities probably still have at least some broad limits in mind. The funds rate, indeed, fluctuated widely in the first few days following the October 6 announcement. Subsequently, after centering around 13%-14% in mid-October, the Fed funds rate rose to 18% compared with a level between 11⅝%-11¾% prior to October 6. While the Federal Reserve is still working out the exact procedures it will use in aiming for its money-supply targets, it is expected that it will try to limit the volume of non-borrowed reserves whenever it wishes to tighten credit. This action may force commercial banks to resort increasingly to the discount window, at least in the short run. Policy signals to the market, therefore, will be reflected in the level of non-borrowed reserves that is supplied and in trends in member bank borrowing at the discount window. In this regard, the decision to raise the discount rate from 11% to 12% may be more than a symbolic gesture. In fact, the Fed is likely to resort to discount rate changes more frequently than in the past in order to influence the volume of borrowed reserves.

The 8% marginal reserve requirement on increases in the aggregate of managed liabilities above a base amount for each bank is also designed to improve control over the volume of bank reserves, as well as to convince market participants of the Federal Reserve's determination to reduce the availability of bank credit. Increases in these managed liabilities (large-denomination time deposits with maturities of less than a year, net Euro-dollar borrowings, and Federal funds borrowings and repurchase agreements against U.S. government and Federal agency securities with nonmember institutions) funded about half of the increase in bank credit during the last three months. The new marginal reserve requirement boosts the effective cost to banks of raising additional funds through increases in the total of their managed liabilities above the base by more than 150 basis points at current interest rate levels. To the extent that banks' managed liabilities exceed their base level, the additional reserves they are required to hold will further curb liquidity and push up interest rates in the absence of offsetting open market operations. In the case of large, 30-179-day CDs, for example, the new marginal reserve requirement raises the total reserve requirement ratio to 16%.

Several aspects of the new marginal reserve requirements merit special attention. This marks the first time that the Fed has imposed mandatory reserve requirements on the U.S. agencies and branches of foreign banks. Under the International Banking Act of 1978 the Fed was given the authority to impose reserve requirements on the agencies and branches, similar to those imposed on member banks, and had already issued proposed regulations to that effect. While the Federal Reserve is still awaiting comments before implementing the proposed regulations, it has gone ahead with the marginal reserve requirements. The U.S. agencies and branches of foreign banks have increased their total assets from less than $32 billion at the end of 1973 to more than $113 billion in July 1979. Their commercial and industrial loans have grown from $11 billion to more than $33 billion during this period, and currently account for about 12% of the total of such loans by all commercial banks in the United States. Thus, they have become important sources of business credit. They also have relied very heavily on increases in managed liabilities to finance their loan expansion.

The new reserves, nonetheless, put U.S.-based banks at a competitive disadvantage. Credits extended

Table 2

Selected 3-month interest rates[a]
percent per annum

	1978 end Oct.	1979 Oct. 5	Oct. 23
United States	10.37	12.60	14.95
Japan	4.25	6.69	6.78
Germany	3.85	8.30	8.95
France	7.25	12.00	12.37
United Kingdom	11.06	13.94	14.25
Switzerland	0.50	1.62	2.87
Canada	10 05	12 05	13.40

a 3-month interbank deposit rates except for the United States and Canada (3-month CD rates) and Japan (3-month repurchase agreement)

to U.S. residents by the foreign branches of U.S. banks are subject to the 8% marginal reserve. However, foreign banks' loans made directly to U.S. residents from abroad are not subject to the reserves, giving these banks a decided competitive advantage. At the end of March 1979 such loans by these banks to nonbank U.S. residents amounted to less than $5 billion, but presumably they could expand rapidly. To lessen this potential inequity, the Chairman of the Federal Reserve Board has told the U.S. agencies and branches of foreign banks that credits to U.S. residents normally extended by them should not instead be booked by their affiliates outside the United States and that, in general, lending to U.S. residents by their overseas affiliates should not depart from normal patterns. Thus, the Federal Reserve has indicated to foreign banks that it does not expect them to circumvent the program by making loans to the United States from abroad.

Turning to the economic implications of the measures, it is clear that they have had an important effect on financial markets, with interest rates on virtually all credit instruments rising substantially. Following the Federal Reserve announcement, the commercial bank prime lending rate rose to 14½%, and then to 15% in late October, up by 1½ percentage points since October 5, while rates on three-month CDs increased by about 225 basis points to almost 15%. Similarly, three-month rates on Euro-dollar deposits rose by about 225 basis points to about 15½%, while rates on three-month commercial paper were up about 175 basis points to 14%. Yields on long-term bonds also increased considerably, although by a smaller amount than at the short end of the spectrum. Yields for long-term triple-A corporate bonds and for ten-year government bonds, for example, were up by about 135 basis points.

As a result of these developments dollar-denominated assets are now yielding a positive real rate of return for the first time in a long while. Rates on short-term money market instruments, for example, presently are about 1% above the current rate of U.S. consumer price inflation. Moreover, they have become more attractive relative to assets denominated in foreign currencies as a result of a further widening of interest-rate differentials in favor of the dollar (see Table 2).

Nevertheless, while these measures clearly are an important first step, they cannot, in themselves, assure that the objectives of slower growth of the money supply and credit will be met, particularly if the Federal Reserve does not limit the volume of bank reserves that it supplies. For example, U.S. commercial banks, by altering their asset mix, have still some scope for increasing their domestic lending without having to increase their managed liabilities above their base levels. Even to the extent that the new marginal reserve requirements begin to bite seriously and contribute to slowing the expansion of domestic bank credit, there are several potential channels that may permit further growth in credit. Despite Chairman Volcker's admonitions, foreign banks could increase their direct lending to U.S. residents. Indeed, there have already been several reports that some foreign banks have been aggressively offering to make loans from their overseas offices to U.S. residents. Furthermore, foreign subsidiaries of U.S. companies could approach banks overseas, including the foreign branches of U.S. banks, for credit and then could relend the funds to their U.S. parent companies. In this way, domestic borrowers could avoid the cost effects of marginal reserve requirements. The in-

crease in domestic banks' funding costs resulting from the marginal reserve requirement also will widen the interest-rate differential between domestic bank credit and domestic nonbank credit channels, such as the commercial paper market, further encouraging business credit to flow around rather than through domestic banks. Nevertheless, the effects of the Federal Reserve's credit tightening will eventually spread through all credit markets, including the Euro-dollar market, in the form of generally higher interest rates.

Under these circumstances commercial banks and other lenders can be expected to become even more conscious of individual credit risks than in the past. Their willingness to extend new credits will hinge on their perceptions of the added risks, as well as on their ability to pass along added funding costs. Similarly, businesses can be expected to postpone investment decisions and take a more cautious stance on inventories given the increased cost of borrowing, the uncertainty about the future availability of credit, and the prospect of greater weakness in the economy. In the mortgage market, moreover, higher interest rates, as well as the effect of usury laws in many states, are likely to curtail housing activity. Each of these factors should have the effect of dampening economic activity, thereby moderating inflationary pressures.

The Federal Reserve's actions, however, cannot be expected to turn U.S. inflation around overnight, given the built-in forces that have been at work in recent years. Rather, at this juncture, it is essential that public confidence in the U.S. resolve to fight inflation be restored, to avoid imbedding the current rate of inflation in expectations and in wage settlements before price increases begin to subside. Thus far, hourly wage increases in the United States have not accelerated, having averaged slightly less than 8% in the last two years. But wage earners can be expected to try to recoup some of their lost purchasing power, especially if inflationary expectations are not lowered. A strong commitment on the part of the U.S. government to fight inflation, therefore, is vital to maintaining wage restraint.

It is necessary for the Federal Reserve to follow through on its October 6 measures by limiting the volume of bank reserves that it supplies, which could very well imply even higher interest rates in the near term. It is equally important for the actions on the monetary front to be buttressed by a policy of fiscal restraint that, at the same time, fosters an environment for a sustained increase in productive capacity. Considerable progress has been made on the fiscal front this year, with the budget deficit down to a $9 billion annual rate in the first half of the year, but a substantial deterioration could occur next year, especially if a sizable tax cut is enacted. At present there appears to be widespread agreement on the part of the Administration, Congress, and the Federal Reserve that an anti-recession tax cut is premature. Moreover, no new major spending programs to stimulate the economy are now being contemplated. Furthermore, should the time come when a tax cut seems appropriate, it is generally recognized that it should be structured to help stimulate investment and cut costs and should be accompanied by continued spending restraint.

The need to restore order in oil markets

While the United States is taking steps to reinforce its anti-inflation-

ary policies, a major new threat to international monetary stability is emerging from the current disorderly oil price situation. After a relatively calm third quarter, the world oil price structure was upset in early October by increases in the official prices of Mexico, Kuwait, Libya, Iran, and Iraq, and by the announcement that BNOC (the British National Oil Corporation) has requested "prémiums" above world market prices on its forward sales based on the greater security of British oil and the high spot prices. Although Mexico is not an OPEC member, its price increase by $2 to a level of $24.60 per barrel effectively broke the OPEC ceiling of $23.50. Kuwait's 10% increase to $21.43 kept the price below the OPEC ceiling, but it brought the quality differentials among the various OPEC crudes even more out of line with each other. These actions set the stage for the subsequent price rises by Libya, Iran, and Iraq of 12%, 7%-14%, and up to 10%, respectively. Further increases by Nigeria and Algeria to match that of Libya and by other Persian Gulf producers to match those of Kuwait, Iran, and Iraq are now likely.

The new round of increases in official prices has been influenced to a large extent by the strength of spot prices. In recent months spot prices have remained at 50% or more above official levels, in spite of an improvement in the world oil supply situation relative to that of early 1979. Continued uncertainty about the political situation in Iran and fears of oil production cutbacks next year by Saudi Arabia, Kuwait, and other OPEC members, have helped maintain demand for stockbuilding and hence demand for oil imports. In addition, curtailment in the volume of oil sold by OPEC members to the international oil companies, their traditional customers, has increased the number of oil buyers in the spot market. Spot transactions are now estimated to account for 10%-12% of total oil traded internationally.

In view of this, stocks have continued to rise. Although data are incomplete, estimates place world oil stocks in early October at more than 75 days of oil consumption, compared with less than 68 days in the spring of this year. Indeed, as early as end-June 1979, OECD data indicate that middle distillate stocks (the bulk of which is used for residential heating) in major industrial countries, except the United States, were at or above the levels of a year ago. Even in the United States, where the heaviest stock drawdown took place in early 1979, these stocks by mid-October had reached the Administration's goal of 240 million barrels, a level 12% above that of a year ago. Crude and gasoline stocks as of that date were also up by 2%.

The heavy buying for stockbuilding purposes has more than offset the slowing in oil consumption and has put pressure on oil supplies, even though they are higher than a year ago. According to OECD, the year-over-year increase in oil consumption in seven major industrial countries (United States, Japan, Germany, France, Italy, the United Kingdom, and the Netherlands) was only 0.1% in the second quarter of 1979 compared with 1.1% in the first quarter of 1979 and 3.5% in the fourth quarter of 1978. Preliminary data indicate that third-quarter aggregate oil consumption in these countries actually may have declined relative to a year ago. In the United States, the world's largest oil consumer, consumption in the first half of 1979 was down 1.1% from a year ago, and the decline appears to have continued in the third quarter of 1979.

In terms of oil production, during the first eight months of this year

Table 3

Nominal and real oil prices

period averages as index numbers, 1974=100

		Nominal oil prices[a]	*OPEC import prices*[b]	*Real oil prices*[c]
1970-72		19	66	28
1973		31	84	37
1974		100	100	100
1975		98	111	89
1976		106	113	94
1977		114	124	92
1978		117	144	81
1979	*QI*	125	155	81
	QII	153	156	98
	QIII	185	163	114
	mid-October	193	166	116

a official sales price of OPEC "marker crude" in U.S. dollars through 1978; weighted average of all OPEC official oil prices thereafter, including surcharges.

b wholesale prices of nonfood manufactures in industrial countries expressed in U.S. dollar terms and weighted by these countries' share in OPEC imports

c ratio of nominal oil prices to OPEC import prices

OPEC output was 5.1% *above* that of 1978. By August it had reached 31.5 million bpd, compared with 29.2 million bpd in the first quarter of 1979. Mexican and North Sea production have also steadily risen, averaging 3.3 million bpd in the first half of 1979, 700,000 bpd more than a year earlier. Part of this increase has been offset by the 150,000 bpd decline in U.S. output.

Therefore, while the present levels of oil consumption and production could have been expected to lead to a relatively stable oil market and pricing situation, prices have, nevertheless, continued to rise because of fears and uncertainty about the future. The recent increases in *official* sales prices have brought the weighted average OPEC price to $21.50 per barrel, compared with $20 60 in September and $17.80 in June. This mid-October 1979 price is 66% above that of a year ago, an increase in absolute terms similar to that of 1973/74. During the same twelve month period, by contrast, the rate of inflation in major industrial countries has been 11% (measured on the basis of wholesale prices of nonfood manufactures in twelve industrial countries). However, in the wake of the November 1978 measures, the dollar has strengthened during the same period by 3.8% (measured on an OPEC import-weighted basis), so that the increase in OPEC import prices in dollar terms is less than 7%. Thus, adjusting for both these inflation and exchange rate changes, the nominal oil price rise so far in 1979 translates to one of almost 55% in real terms. This year's real increase has more than offset the decline of the preceding four years, so that oil prices in real terms are now some 16% above their 1974 average (see Table 3). In view of the rising volume of spot transactions in recent months, average oil prices are even higher than that.

In the event that the present disorder in oil markets and the price leapfrogging continue unchecked, it is not impossible to conceive that the average oil price could reach $25 per barrel by early next year. If that were to happen, the average oil price for 1979 as a whole would be up 45% from last year, and that for 1980 would be up some 30% to 35%. Even without any further adjustments during the course of 1980, this would imply a doubling of nominal oil prices in two years and a real increase of almost 60%. Under these circumstances, the 1980 OPEC surplus *before* official transfers could approach $70 billion, compared with $55 billion this year, and only $7 billion in 1978. Further upward adjustments during the course of 1980, to an average oil price of $30 per barrel by year-end, could push the OPEC surplus before official transfers to nearly $80 billion in that year.

The implications of these not entirely inconceivable events for the oil-importing countries would be even higher rates of inflation and slower rates of economic growth than currently projected and a further sharp deterioration of their combined current account deficit. For the industrial countries, the absence of a slackening in the rate of annual oil price increases will mean little or no reduction in the oil-price component of their inflation, making it more difficult to bring about a decline in the overall rate of inflation. Furthermore, the rate of economic growth, now forecast for industrial countries at about 1% for 1980, may dwindle to zero or become negative. This bleak economic outlook could tilt the present anti-inflationary stance of economic policy in industrial countries toward maintaining economic growth and preventing a steep rise in unemployment. For the United States, oil price rises to the $25-$30 level would most likely pre-

vent the 1980 current account balance from moving into surplus.

The impact of new, sharp oil price rises will be even more serious for the developing countries. They will be adversely affected both by the increase in oil prices and by the higher inflation and reduced economic growth rates in industrial countries, their major trading partners. As a result, the combined current account deficit of the non-OPEC LDCs, which is now expected to deteriorate from about $30 billion in 1978 to well beyond $40 billion this year and more than $50 billion in 1980, would worsen significantly, thereby increasing the likelihood of external financial difficulties for some of these countries.

With oil inventories restored to more adequate levels and with oil consumption leveling out or declining in response to higher prices and slower economic activity, it would seem possible to restore some order and regularity to the oil pricing situation. Nevertheless, while the current situation does not seem to be hopeless, there is a real danger that if the present leapfrogging continues unchecked, a new and potentially much more serious oil crisis may develop. Therefore, new international initiatives may well be required to ensure that any real oil price rises take place in an orderly fashion.

Among the actions that could be taken are stronger measures by oil-importing governments to reduce oil demand. At the Tokyo summit, although much-needed targets were set to limit 1985 oil imports, little was done to significantly affect the immediate situation. In particular, the objectives for 1979 and 1980 were rather vague and entailed few sacrifices. Another area requiring immediate action is the spot market. Measures by both the oil-importing and oil-exporting governments to restrain participation in the spot market and to reduce its influence would be helpful. Furthermore, efforts to reduce expectations about future oil supply interruptions are needed. Co-ordinated efforts by oil-importing and oil-exporting governments to explore ways that will help maintain reasonable oil production levels are desirable. In this regard it may also be useful if Saudi Arabia's suggestions at the recent IMF/World Bank meetings for a dialogue between oil-producing and oil-consuming countries on international energy policy issues and the transfer of technology, and for more lending by the IMF to developing countries, were seriously pursued.

The need for off-market diversification facilities

The prospect of much larger OPEC surpluses makes all the more urgent the quest for mechanisms to ensure that the investment of those surpluses is channeled in orderly fashion without unnecessary disruption of exchange markets. At present, official foreign exchange holdings of all countries except the Group of Ten (G-10) and Switzerland total approximately $250 billion, of which OPEC members hold some $150 billion. By the end of 1980 OPEC official holdings could approach $230 billion, of which Saudi Arabia may account for $90 billion and Kuwait $40 billion. The portfolio management of these official international assets has serious implications for exchange market stability because of the magnitudes involved and the effects of actual and rumored official portfolio diversification on private market participants.

Official asset holders outside the G-10 industrial countries cannot realistically be expected to arrange their portfolios to the convenience of industrial nations. The main ar-

guments for diversification from dollars into other currencies and from short-term money assets into longer-term financial assets are the desire for stability of returns in relation to the multi-currency patterns of imports and debt obligations, and the desire for higher average returns than dollar holdings have provided in recent years relative to the performance of alternative assets. Oil-producing countries, exporting a product whose price is widely assumed to be on an indefinite uptrend in real terms, are not encouraged to supply more oil if the financial proceeds offer only negative returns after inflation. Therefore, it is important for the United States to maintain positive real interest rates on dollar assets, a monetary stance consistent also with fighting domestic inflation.

Nonetheless, even with the firmest U.S. policies, the major central banks must face up to the probability of diversification pressures on the part of asset-holders seeking portfolio balance. Reliance on moral suasion and attempted prohibitions are an inadequate response to an urgent problem. Indeed a main reason why some $150 billion of official assets are held in the Euro-markets has been the negative attitude of many G-10 central banks toward reserve-currency responsibilities. A change of heart on this matter by the G-10 countries could be the most effective way of curtailing growth of the Euro-markets through removing a principal source of funds — and is certainly more promising and practical than the imposition of reserve requirements on Euro-activity.

The substitution account proposal developed in the IMF constitutes one approach to the challenge of diversification. The proposal would allow central banks to exchange dollar assets for SDR-denominated claims on a special account, thereby offering an alternative asset to the dollar for reserve holdings with the hope of deflecting outright diversification of reserves into other currencies. As discussed in September's *World Financial Markets*, the substitution plan's SDR offers no sure advantage over the dollar in terms of capital value and interest yield. The plan's appeal lies mostly to G-10 central banks who have no practical alternative to the dollar for their reserve holdings at present, but it offers limited attraction to other countries who are less inhibited about diversifying through private channels. Moreover, there is something fundamentally deficient in seeking to cope with a diversity of interests among potential diversifiers by offering only a single asset alternative such as the SDR. While many countries may eventually participate, at least in a token way, the substitution account offers no promise for dealing adequately and in a timely manner with the diversification issue.

A more promising direction for intergovernmental endeavor would be to channel diversification investments into the desired currencies in an orderly fashion. This would imply a need for governments and central banks of G-10 members to provide the instruments denominated in their own currencies — marks, yen, Swiss francs, guilders, sterling and so on — that diversifiers legitimately seek. This should be done by off-market techniques. Close cooperation among the central banks, perhaps most naturally in the Basle framework, would be important in working out specific coordinated procedures. For example, the German authorities could take dollar deposits in return for mark-denominated liabilities bearing interest at prevailing Euro-DM rates, repayable at Germany's choice in marks or in dollars with changes in capital value in dollar terms

as implied by developments in the mark-dollar exchange rate. The dollar deposits would be reinvested by Germany in U.S. obligations just as with Germany's other reserve holdings. Other G-10 central banks would offer parallel facilities in their own currencies.

In contrast to the IMF substitution proposal, an array of offerings by the major central banks has the important advantage of flexibility, involving no dependence on a technical formula of doubtful attractiveness to diversifiers. Of course, some would object that this approach would increase world reserves and liquidity. The increase is mainly the result of double counting, and there could even be a useful tightening of liquidity as central bank deposits are withdrawn from the Euro-market. Furthermore, the increased dollar reserves accruing to the central banks offering the special paper would entail an exchange risk to them. However, it needs to be recognized that no real solution to the diversification problem can protect the major countries from the exchange valuation risks of their own policies. Assumption of those exchange risks by the central banks — shared in some manner by the United States — is the necessary price for orderly containment of the otherwise destabilizing impact of diversification on exchange markets.

The need to enlarge the IMF's role

Given the magnitude of the current account deficits faced by non-OPEC LDCs and the need for some of these countries to take corrective measures in order to avoid potentially serious financial difficulties, it is important for the Fund to play a much larger role than it did in 1974-75 or has in more recent years in providing balance-of-payments financing and in promoting adjustment.

The IMF now has sizable resources available for lending to member countries. At the end of August 1979, the Fund's holdings of "usable currencies" and SDRs plus its unused lines of credit under the General Arrangements to Borrow and the Supplementary Financing Facility totaled approximately $30 billion. The Fund's resources will be increased when the 50% increase in quotas proposed under the Seventh General Review of Quotas becomes effective, probably next year. The non-OPEC LDCs have a maximum cumulative borrowing potential of about $47 billion under the Fund's major facilities (credit tranches, extended facility, supplementary financing facility, and compensatory financing facility). For individual countries experiencing difficult adjustment problems, Fund assistance is now available in larger amounts and for a longer period than was the case in 1974-75.

Non-OPEC LDCs' use of these Fund facilities has been very limited. These countries' net use of Fund credit (excluding repayment of previous Oil Facility drawings) increased by only about $700 million in 1977-78, and by less than $450 million in the first eight months of 1979. Their outstanding use of Fund credit as of end-August 1979 amounted to only about $4.7 billion, not including $1.9 billion still outstanding under the 1974-75 Oil Facility and $1.5 billion under the Trust Fund. Moreover, only a relatively small proportion of non-OPEC LDCs' outstanding use of Fund credit — less than $1 billion — entails conditionality, i.e., drawings on the higher credit tranches and the extended facility. The bulk of their use of Fund credit consists of the first credit tranche and the compensatory facility. Thus, most non-OPEC LDCs clearly have been reluctant to submit to Fund conditionality even though the potential

amounts of credit available to individual members are now quite substantial and even though the charges for Fund facilities are generally well below private market rates. For example, the charges for drawings under credit tranches and extended facility range from 4⅞% to 6⅞%, depending on the maturity of the drawing. Instead, these countries have continued to rely on banks and other private market sources of funds for balance-of-payments financing.

The Fund earlier this year completed a review of the conditionality attached to the use of credit tranches and established new guidelines that, in effect, provide for somewhat greater flexibility in the setting of performance criteria and for increased sensitivity to countries' economic priorities and domestic social and political objectives. The Fund, in its periodic consultations with members, is also directed to intensify efforts to encourage members to adopt necessary corrective measures with the support of Fund resources at an early stage of balance-of-payments difficulties. As yet, there is little evidence that these new guidelines have had much effect in terms of increasing the use of the Fund's conditional credit.

What steps could be taken to increase the use of Fund resources by the developing countries? One direction would be to increase the proportion of Fund resources available on reduced or minimal conditionality. Indeed, the Fund recently liberalized the compensatory financing facility by broadening its scope to include certain services, as well as goods, exports in the calculation of temporary export shortfalls, and by increasing the amounts available under the facility from 75% to 100% of members' quotas. Proposals have been made for still further liberalization of this facility and for increasing the proportion of Fund resources available on first credit tranche conditions. Increasing the availability of largely unconditional credit from the IMF probably would lead to increased use of Fund resources and would increase the extent of official international risk sharing in the provision of balance-of-payments financing. However, because of the limited degree of conditionality involved, this use of Fund resources might not go very far in promoting needed adjustment. Nevertheless, use of the first credit tranche at least requires that the country present a program representing reasonable efforts to overcome its balance-of-payments difficulties, while drawing on the compensatory facility necessitates that a member be willing to cooperate with the Fund in finding appropriate solutions to its balance-of-payments problems. These are very modest conditions, but they at least get the Fund involved and are better than nothing at all.

Another proposal for inducing countries with payments difficulties to increase their use of Fund credit is to lower the cost of Fund credit, but this is unlikely to have much impact. As noted earlier, Fund charges for most of its facilities are already well below the cost of bank credit, and it is unlikely that a further widening of the cost differential would induce many countries to submit to Fund conditionality.

Yet another approach to getting non-OPEC LDCs to make greater use of IMF resources could involve efforts by the Fund to influence the availability of balance-of-payments financing from the private markets via a broader dissemination of its views and appraisals of countries' external payments situations and policies. However, there appear to be major institutional, if not legal, obstacles to this kind of public disclosure, including the Fund's insis-

tence that the absence of confidentiality would significantly impede IMF consultations with member countries.

Measures to reduce the liquidity of private financial markets generally may be the best way to compel countries with balance-of-payments problems to consider use of Fund resources sooner rather than later. The tightening of monetary policies by the Federal Reserve and by authorities in a number of other major industrial countries in order to curb inflation will tend to increase the cost and reduce the availability of bank credit. Liquidity in the Eurocurrency market could also be tightened by steps to limit additions to central bank deposits in the market or to bring about withdrawals of existing official deposits. The central banks of the Group of Ten countries already have agreed not to increase their deposits in the Euro market. This agreement could be broadened to include more countries in conjunction with an attractive off-market facility for reserve diversification discussed above. Such steps to tighten market liquidity could lessen the availability of balance-of-payments financing from banks and other private market lenders, and thereby engender increased use of Fund resources.

Senator JAVITS. Gentlemen, I would ask you, Mr. Bell, and you, Mr. de Vries, it takes two to tango, as the saying goes. Both of your propositions, whether you call it substitution or diversification, require cooperation from foreign central banks and foreign private banks which have not been forthcoming. The complaint, as a matter of fact, is that our allies are not cooperating by running some risk themselves. We are carrying all the risk. We have that catch-22 situation where we have no choice because it is our credit that is out there, and yet it can't be solved and concluded unless they share the risk.

What would you suggest to bring that about?

Mr. BELL. I think the first thing, Senator, is to recognize that a multiple-reserve asset system is emerging. If you actually look at the numbers for deutsche mark deposits held outside of Germany, in Luxembourg, and in London, it is now very substantial indeed. The Japanese have opened up their markets now. The Germans have not.

What can be done to push them in the right direction?

I think that unfortunately the old theory used to be that if people wanted to buy the deutsche mark, that would push up the value of the deutsche mark and the Germans would then be willing to supply deutsche marks.

Unfortunately, that doesn't appear to be a strong weapon in forcing or persuading the German authorities to allow the deutsche mark into the reserve asset system.

I would think that the way which one would do this is, for the Bundesbank to accept that the deutsche mark system is in existence internationally, and, secondly, to encourage this further in some other countries.

Here I note that on Friday an announcement was made in London that the European Investment Bank will issue a deutsche mark bond in London, and the Bundesbank has not opposed this issue. If it is possible in London, then it is possible in other parts of the world.

You will recall, Senator, I think it was last year, that a brokerage house here in New York launched with a German bank a deutsche mark CD, and the Bundesbank then asked them to withdraw that certificate of deposit denominated in deutsche marks.

If the European Investment Bank example in London is a precursor of things to come, it would appear to me that the adamant opposition of German authorities to the use of the deutsche mark internationally is beginning to wane.

What I believe, though, the way around this on a much bigger way is that the German authorities, with outside pressure, have to recognize that there is a quid pro quo starting with official institutions. I would not suggest that private market participants be given special facilities, shall we say the Bundesbank. But to start with the official market, which Mr. de Vries has mentioned, is now very large and growing rapidly.

If the central bank of OPEC, Latin America and some others in the Far East want to have deutsche marks for trade reasons—increasingly the deutsche mark has been used as an international trade asset as well as investment asset—pointed out that central banks have a legitimate need for nondollar currencies as a hedge against trading needs or to cover nondollar liabilities.

In fact, I think with this type of pressure including perhaps a Carter bond issue in deutsche marks in New York would help the same process.

Senator JAVITS. I gather from what you have—you haven't told us, perhaps you are too modest—how we can make it come. It has to come. There is some glimmering of it. But it is that old song from Gilbert and Sullivan's "Pirates of Penzance," of the policeman. They sing we go and would go, and one lone voice says, "But you don't go." And that is our problem.

Mr. de Vries.

Mr. DE VRIES. Very briefly, I would first of all make it very clear to the negotiators of the substitution account, that so much time has already been wasted on this idea, which is not the answer to the immediate problems. I think this has to be made very clear. It is probably interesting from a long-term monetary reform point of view, maybe for 1990 or 2000, but it does not really hold any promise of dealing with the problems of today or tomorrow.

Second, how can you get them to do this? I think our policies of November 1978 and last month, which indicate that we no longer have an attitude of benign neglect toward the dollar and have a policy of dealing with inflation, we also can exert more leadership in international monetary matters. It is difficult for the United States to negotiate with foreigners if we have a very weak base and inadequate policies. But if we are forceful dealing with the dollar as we have done this year, and stick with this policy and with fighting inflation, we are in a better position to tell other countries what to do.

It is very hard for us to put pressure on foreign nations if we really do not have a firm international policy ourselves.

So I think the road we are now on, starting from last November and now this October, puts us in a much better bargaining position with foreigners.

The third point is, that it should be very clear, that the arrangements I have suggested are in their interest. I do agree with Mr. Bell that they are beginning to show interest. The Swiss, for instance, are beginning to issue Swiss franc bonds to the World Bank which can be purchased by foreign monetary authorities. There is also some movement in Germany. In this connection it is worth noting that there are a great deal of changes in central bank governorships in Europe coming up and this may also affect thinking and attitudes. The Europeans should be interested in cooperating because otherwise their exchange rates may become unstable and too strong: I think the Germans are beginning to see this. They appear to be happy to the $1m. rate stabilize at $1.80. The German current account is weakening and turning into deficit, which they do not like. Unless they cooperated the mark could get stronger and their current account could weaken further.

Senator JAVITS. Gentlemen, just you two, and I have another question of Mr. Greenspan: Suppose that this doesn't happen. Do you suggest that we in the United States, if we have to go it alone, therefore will become even leaner and harder than we otherwise would need to be in terms of all of the problems that ail us, including oil consumption and productivity, two of our very major problems, and a rather free

hand in our domestic programs. Do you suggest that we would really have to be Spartan if they won't cooperate and can we make it if we are?

Mr. Bell.

Mr. BELL. I think if in fact cooperation doesn't take place, I think you'll see periodic crises in the exchange pressures on the dollar, inflationary pressures here, and so on. It means that it would be very difficult to see your interest rates coming down. I think that that would be obviously a very nasty world.

That would then invite pressures for exchange controls and separation of markets.

Mr. JAVITS. Protectionism?

Mr. BELL. Exactly. I think that again is a pressure that can be put on these other countries. That is the quid pro quo.

So it is a very nasty world that one is envisioning, but basically as I see it, with some exaggeration but not much, we don't really have a current financial system. We have a series of ad hoc arrangements. So the answer is that it is a very nasty outlook and invites——

Mr. JAVITS. Mr. de Vries.

Mr. DE VRIES. If they do not cooperate they will hurt themselves. They might find their currencies stronger and less stable than they would prefer and this could hurt their trade performances.

From the United States point of view, in these circumstances, we have no alternative but to have a more attractive energy policy which focuses on cutting consumption in the short run.

Actually, the supply of OPEC oil production has been ample and substantially higher more than a year ago, mostly on account of Saudi Arabia, but consumption has been holding up a good deal better, partly because of inventory building purposes.

We could do more in this country in the way of conservation. If the economy begins to weaken next year, I hope that lawmakers would give some thought to integrating energy policy with general economic policy. The two should be much more intertwined. When the time comes to cut taxes we should tie tax cuts to energy performance—give tax cuts to those who conserve and develop alternative energy sources. Energy is too much of an integral part of the economy.

I would move in that direction, whether the Europeans or Japanese cooperate or not. We can do a great deal more on the consumption side, and we should consider energy policy to be an integral part of macroeconomic policy.

Senator JAVITS. Isn't it a fact that we couldn't maintain the national security policy that we maintain if we were faced with that kind of alternative, spending as we do one-third of our budget for military preparation? Wouldn't you gentlemen agree to that?

Mr. BELL. It seems to make sense.

Mr. DE VRIES. It would tend to weaken, yes.

Senator JAVITS. Remembering, we are not just running our own security policy, we are running the security policy of the world. There is no question about our preeminence there, whether we like it or not.

Mr. BELL. I wonder if you would indulge me if I could just make one other comment on a question you raised with Mr. Wallich, namely the Eurocurrency market.

There is a tendency, I believe, to almost net everything out in this market. Governor Wallich doesn't do this, but you can almost take the reductio ad absurbum to say that it almost doesn't exist.

I think there are three things that are worthy of thought. One is its effect on monetary policy. And also the reserve measures were the introduction of reserve requirements on borrowing in that market, which suggests that it has some relationship to monetary policy.

The second area is its effect on exchange rates. I think no one can pretend that the Eurocurrency market in itself has any independent effect on exchange rates. But I believe that the facility of movement and the size of that market has some relationship to exchange rate volatility.

Third is this question that you raised, Senator, of lesser developed countries and the questions of lending prudence.

I believe, very briefly, that the more the central banks can get together and slow down the rate of increase of that market—and it doesn't matter really whether it comes from reserve requirements or it comes from capital-to-equity ratios, or it comes from other different ways, I believe to slow down the rate of the increase at that market from 25 percent to a lesser figure is a matter again of some priority and would also add to the stability of the system.

Senator JAVITS. Mr. Gaines, I have just one question for you. I heard your scenario, which is a very interesting one, about monetary aggregates.

My question is this: There are some medicines that are very good for you but their side effects are dreadful. Have you in your estimate of the situation, considered bringing down inflation by one-half by the fourth quarter of 1980 and reducing inflation to what one would have to consider, in modern terms, as fairly normal, 2 or 3 percent, in 3 years thereafter; what is that going to do to small business, to profits, to new innovation, to new business, to consumer credit, upon which so many of our big ticket item industries now live? What happens to the patient while this medicine is being administered?

Mr. GAINES. Senator, it was implicit, you should have made it explicit, in my remarks, that I think the new policies increase the likelihood of a more or less severe recession in the next year to 18 months. I think that just the unavailability of credit and/or the cost of credit will cause a number of, particularly small businesses to go under. It will have some impact on the unemployment rate, although I think we have some built-in safety factors there.

It will seriously impact business profits.

I have persuaded myself over the past several years that the first job we have before us is getting rid of inflation. In economic terms, there is nothing more serious that we should be directing ourselves to. If there is a way to make an omelet without cracking some eggs, and I am darned if I know what it is. In fact, Chairman Volcker has been quite explicit in this area himself, that the policies that they have launched upon will cause some slowing down in business activity.

I would prefer—in the first place, there is not a dog-gone thing we can do with fiscal policy because it is as close to being out of control as almost anything could be.

I would hope that we could, through quite separate programs, take some of the edge off that harsh monetary policy.

What I have in mind is, if we are concerned about unemployment, look at the unemployment benefits rather than trying to push the entire economy up. Go about it in a micro fashion.

In a nutshell, I do think that we are being thrown into a recession.

Senator JAVITS. I might inform you, just for your knowledge and information on the subject, that there is a $20 billion price tag attached to 8 percent unemployment annually. So that is why I asked you the question.

Congressman Reuss.

Representative REUSS. We are enormously appreciative of your contribution and would like to spend an hour conversing with you. But we are running a little late.

I would just ask one question. For several years now I have been supporting a proposal originally made by Governor Zolatas of the Bank of Greece, who has suggested that the United States could remove some of the dollars from the Euromarket, and make people feel better by issuing treasury securities for dollars, but denominated in whatever foreign currencies seemed most sensible. I think that both Mr. de Vries and Mr. Bell find themselves supportive of that general idea.

Is that true of you, Mr. Bell?

Mr. BELL. That is correct. That is what I called the new variants of the Carter bond.

Representative REUSS. Mr. de Vries, am I right?

Mr. DE VRIES. Isn't that basically the idea behind the substitution account?

Representative REUSS. No. We aren't talking about the substitution account. We are talking about, call them if you will, Carter bonds denominated in foreign currency.

Mr. DE VRIES. Yes. Except that I feel that we should do this alone. You see, Europeans always have great suggestions for us about what to do. Why should the U.S. Government issue DM denominated bonds for foreign central banks if the Germans are not willing to do the same? And the same applies to the other currencies. The Europeans and Japanese have to take more responsibilities. Mr. Zolatas made a very good suggestion, but we should do it together with other countries.

In this regard I would like to make an additional comment I haven't made yet. Many times the G-10 countries, the principal industrial countries pride themselves that they don't have any official money in the Euromarket. But, by making their own markets unavailable to the central banks, they force the central banks of other countries to put the money in the Euromarket.

So I could only be supportive of your suggestion if at the same time many other of the G-10 countries would do the same as the United States.

Representative REUSS. Thank you very much.

We will now hear from the three gentlemen representing industry, labor, and finance: Peter G. Peterson of Lehman Brothers-Kuhn Loeb; David J. Mahoney of Norton Simon; and Harry Van Arsdale of the New York Central Labor Council. You are all old friends of this subcommittee and we welcome you.

Mr. Peterson has a prepared statement, which will be printed in full in the record.

STATEMENT OF PETER G. PETERSON, CHAIRMAN, LEHMAN BROTHERS-KUHN LOEB, NEW YORK, N.Y.

Mr. PETERSON. I think we are late. Why don't I summarize, Congressman, a few points I wanted to make today.

Representative REUSS. That will be fine.

Mr. PETERSON. In addition to expressing general support for the Federal Reserve action, I take the opportunity, Congressman, in this statement to explore a little bit first of all who these various people are who seem to want very high interest rates, speaking for my community at least. Looking at the bottom line in a southerly direction in recent weeks, there are very few advocates there.

I then go on to point out what the alternatives might be to what Mr. Volcker and his colleagues have done. I conclude that most of the alternatives are either not very real, in the real world, or counterproductive.

I then try to point out how the nature of the problem—because you asked us to talk about trade, and perhaps it has changed since the days that I was working with you on some of these problems more directly.

I pointed out that whereas in the 1960's we tended to think principally about trade balances, and so forth, I think today with this enormous shift in externally held dollars, I think the important vortex is the value of the dollar as the stored asset.

I would point out that at the time of our 1970 moves on August 15 we were looking at externally held dollars in the range of $84 billion.

The numbers now reported are about net $600 billion. But I have been in some recent contact with some experts who tell me they are doing some additional studies. They find that very substantial amounts of these assets are not included and it looks as though it is at least possible that the actual numbers may be twice this number or perhaps even higher, let's say in excess of $1 trillion.

So these people, therefore, are very much concerned with the real rate of return on holding those dollars. That of course gives rise to some of the current moves, I suspect.

I then talk about the alternatives of letting the dollar run and its effects on our economy, and which I don't find really much conflict between what is in the domestic economic interest and the international interest.

Then I go on to make a point which I would like to spend just a couple of minutes on. Because I think in our euphoria over the very impressive moves of Mr. Volcker and his colleagues, I would not want us to think that this is most of the answer. I don't think he thinks so, either.

I think the evidence is overwhelming, Congressman, that our economy is becoming fat and flabby. It hasn't really realized how much our trade situation had deteriorated in manufacturing terms because it is so obfuscated by the enormity of the oil problem, until I went back and updated that study I once reviewed, you will remember, with you in early 1970 on the changing position of the United States.

There we find that the United States is moving from a $3 billion surplus to $30 billion deficit.

What is interesting to me is that the Japanese, who also have a very large oil problem, have coped with that problem by dramatically increasing their trade balance in manufactured goods by almost $64 billion, and West Germany's by $42 billion, at the same time that ours worsened, in spite of a major change in exchange rates. Our world share of manufacturers, and I think it is important to focus on that particular aspect because of our preoccupation with oil, has fallen in spite of these enormous exchange rate changes, from $18.4 to $15, while the others have increased their share. It looks as if this change has costs us at least $1 billion. In my statement I say the current account deficit, I don't find it at all necessary, it has probably cost us $20 billion or more in trade and balance-of-payments accounts.

When we look further in our trade balance and in our manufacturing structure, an area of major strength in the United States has always been the high technology area.

It interests me to look at what is happening in our trade on what you might call the frontiers, namely, with Japan and Germany.

Again, in spite of a rather extraordinary change in exchange rates, when theory indicated that would improve the picture, that technology in intensive projects, from Japan has worsened from about $2 billion to $13 billion. And that of West Germany has more than doubled.

I think it is very important for you gentlemen to not only focus on the monetary situation, not only to focus on the so-called productivity and investment area, but in particular to look at this whole question of the loss of our innovation trust. While I have focused here just on the trade aspects, wherever I look, whether it is expenditures for research and development or training of scientists and engineers, the draught of new technical companies—we used to have several hundred in the late 1960's, there are virtually none in the last 2 to 3 years. Numbers of patents—I think it would be worthwhile for you to look at what is happening in the technology-intensive area. Not just the aggregate.

For example, take chemicals and machinery, which have been a very important area of U.S. manufacturing strength, the patents granted rose in the period 1966 to 1976, patents granted to Japan rose 479 percent, and West Germany 70 percent; the United States declined 18 percent.

Of course we still have more patents. But the trends are not at all reassuring.

I say something about the German experience. I think we have a great deal to learn not only from their experience but their commitment.

Then finally I comment to you that in your sincere interest to look at the international economic picture, you not neglect not only these other moves to beef up our muscle, namely, our technological position, our investment position, what I call our "mego view" of exports—it always strikes, Congressman, very interesting that when Helmut Schmidt or some leader of a European country comes to this country, he is initimately aware of the major exports of this country, the big deals that are going on, and it is clearly a top commitment of

his government and his country. This has never been true of the United States.

Finally, a problem that is another mego subject and every time it is brought up everybody says we are crying wolf, I would recommend to your community that you take another look at this deficit problem of the non-OPEC LDC's. The number this year I am told is $45 billion to $55 billion. If there is no future OPEC increases, we would well be looking at $65 billion to $85 billion in 1980. I have done some very amateurish looks at a 5- to 10-year look at those numbers. It is several hundreds of billions of dollars.

I really think the time has come where we have to take some really different approaches to that problem, including some discussions of oil prices themselves, stable supply and reduction of demand, perhaps on some direct lending by oil-producing countries because we are now assuming a large part of the risks ourselves.

I know, Senator Javits, I go back to not too many years ago you were looking at some way of getting the oil-producing countries into this. It is a very complicated subject, as you know better than I.

I know we have tended to perhaps assume it is all taken care of. The further out, the more concerned I get with no further oil price increase. But with further oil price increases, I think it could become a very serious problem.

Thank you.

Representative REUSS. Thank you, Mr. Peterson.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF PETER G. PETERSON

I believe it was Lloyd George who once suggested that in crossing a chasm it is best not to take it in two steps.

We have been trying to cross the inflation chasm in small steps. Whatever you may have called our previous approaches—whether gradualism, marginalism, or incrementalism—it is clear they have not worked. We had reached the point where a large leap, even if an intuitive one, even if based on informed faith, had to be taken.

If there were a group for which there is less compassion than for politicians, it would probably be Wall Streeters. In any event clearly neither of our groups is the folk hero of our times * * * perhaps folk enemies is closer to it. Thus, when I tell you the effect of the Volcker moves on the bottom line of Wall Street is clearly in a southerly direction—whether on equity prices, bond prices, corporate financings, merges and acquisitions—I do not say it to arouse anyone's sympathy except my own perhaps—but rather to attempt a much needed boost in credibility. Most of us support what Paul Volcker is doing—and strongly so—in spite of what it may be doing to our current p & l's.

I sense there is some feeling that Paul Volcker may be doing some things for "international" economic reasons that may not be good things to do for "domestic" economic reasons. We seem to continue to have a bit of "ambivaýlence" as we used to say in Nebraska, about this whole business of "furreigners," particularly where money is concerned. Some of us who were involved were somewhat confused and amused when Mr. Nixon, in announcing the August 15. 1971 moves, referred to those "international speculators" but we concluded he knew how to create or at least identify a political folk enemy a lot better than the rest of us.

I really don't get it * * * the conflict that is, between domestic and international economic policy. Getting our inflation rate down is not only public enemy No. 1, as we see it, but as the world at large sees it. Sadly, they may see it more clearly and be more frightened by it than we are. Clearly, if foreign governments began a policy genuine competitive interest wars or competitive devaluations, we would need to look at the specifics, but at this point, I doubt it.

Nor do I get who all those speculators, or other dysphemisms we may create, are who want high interest rates. Our industry for one, it seems to me at least,

would be far better off if we had lower and more stable interest rates. And what Paul Volcker has initiated it seems to me is far more likely to get us lower interest rates in the future—and the not too distinct future—than the economic Disneyland we have been in for some time. Indeed, perhaps the main reason Mr. Volcker was able to get unanimity from his board was that the so-called "easy money," "low interest rate" group on the board concluded that high interest rates, high inflationary rates and high liquidity growth were indeed very close friends or close enemies depending upon how you looked at it and that, over any reasonable period, there really wasn't any reason for conflict. Thus, I would hope the support and the staying power for this program becomes bipartisan not only in the political but in the economic sense—and perhaps even ecumenical as well, because we need some religious fervor on the subject of inflation.

An old University of Chicago professor of mine used to say, if you have no alternative, you have no problem. To me, the alternative of our drifting downward, numbed by uncertainty about the future, indeed having lost our sense of the future—is no alternative at all.

Thus, history may well wonder not whether what Paul Volcker did was too much too soon but quite the opposite * * * in other words, what took them so long. Why didn't "they" realize sooner that the U.S. had a serious structural problem of excessive credit liquidity—not really the labor cost push—which fed increasingly higher and higher inflationary expectations? Why didn't "they" realize sooner, I expect historians will say, that indeed, when economics gets important enough, it indeed does become political and that our deteriorating economic position in the world lies behind a deteriorating political position in the world? Why didn't "they" realize sooner that there are fewer ways of guaranteeng oil price increases sooner and larger than an ever higher and uncertain inflationary expectation?

To the extent we have an international economic problem, how do we define it—or should I say, redefine it.

The decade of the sixties saw us defending our international economic problems largely in terms of balance of payments in general and balance of trade in particular. Thus, I am always surprised to remember that as recently as January 1968 I believe we had another balance of payments crisis, or perhaps I should say band-aid effort that involved capital controls on overseas investment—even returning planes from abroad so they can be repaired at home.

By the end of the seventies, however, the nature of the problem had been compounded extraordinarily by ballooning externally held dollar balances. By year-end 1971, according to the BIS, dollars held as assets of commercial banks in 10 OECD countries alone totaled $84 billion. By the end of the seventies these Eurodollar deposits abroad including those in the respective offshore branches, netted about $600 billion, yet these official numbers omit substantial amounts of the externally held dollar pool—for example, foreign banks not included above, the Bermuda and Netherland Antilles corporations, trust companies and the like. In fact, I am told that some recent expert studies suggest that the actual number could well be twice as high or even more, that is in excess of $1 trillion.

Whatever it turns out to be when our reporting techniques are both broadened and refined, the issue of the supply and demand for dollars, the dollar as a store of value, has become a dominant issue. Thus, while a current account deficit of five to ten billion dollars is an unwelcome one and, as I shall discuss later, an unnecessary one, of more concern to the trillion dollar (or more) club is the underlying value of their dollar assets. These holders have been experiencing negative returns—that is where the interest rate is less than the underlying inflation rate. Likewise, as someone recently observed, holders of dollars are watching them turn into sand whereas the holders of oil are enjoying a real return.

What is the alternative? Presumably, one is to "let the dollar run"—if indeed other countries would permit it. In this connection, even at these exchange rate levels, we see Europeans getting increasingly concerned as they see U.S. dramatically increase its penetration of the European petrochemical market with what they consider to be seriously under-valued dollars.

I suppose another theoretical alternative is to "manage" exchange rates and as part of that effort to "agree" on interest rates. In the real and fluid world economy in which we are living, I don't know how one would sustain such "agreements" if the underlying realities of past and expected inflationary rates won't support them. Alternatively, I see from time to time various Dr. Strangelove type scenarios involving exchange controls for example, limiting the out-

flow of investment dollars. (I hope we haven't forgotten some of the almost grotesque contradictions of the sixties' balance of payments programs—in a far simpler world.) I say Strange-Love because these scenarios typically greatly underestimate the potential for destructive response by others as well as an endlessly ingenious series of end runs by our people around the so-called investment guidelines.

So, let's get back to "letting the dollar run" and let's make the charitable assumption others don't respond. Let's talk about it's "double whammy" impact on our economy. The President's Economic Report estimates that for every 10 percent depreciation our cost of living rises by 1½ percent over 2 to 3 years, with one-half in the first year.

How can this happen, we might say? We used to be so insulated from foreign economies but today imports are about 20 percent of our production of goods; in 1970 it was but 9 percent. Interdependence, then, is much more than a new cliche.

Likewise, a deteriorating dollar provide OPEC countries one more incentive or perhaps reason to inflict one of three bad news possibilities: either raise oil prices, tighten supply or of course both.

To carry this "let the dollar run" scenario further, we can visualize a flight, if not to other currencies, to gold or to other commodities—which in turn is also highly inflationary. Thus, these so-called international moves by Paul Volcker confront directly our domestic public enemy number 1.

May I say that I hear talk about whether Paul Volcker will hang tough. Frankly, I have a good deal more confidence that Paul Volcker will hang tough than that the Congress and the Executive Branch will—and ultimately, the rest of us will. And, even if everyone holds firm, the "Volcker moves", however critical and even heroic, are not enough.

Our economy has become fat and flabby. It seems clear to me that we need a monetary diet to take a lot of our excess weight off. But we need more than that. We must strengthen our economic muscle.

I will not burden you, or depress you with one more melancholy recitation of our declining productivity, sinking savings rate, depressing rate of investment in new plant and equipment.

Let me highlight our performance on manufacturing exports generally and on technologically intensive manufactures in particular. Earlier, I said our current account deficit was both unwelcome and unnecessary. It is usually rationalized by some reference or I should say rationalization referring to our "oil" import problem—as though other countries did not have such a problem.

TRADE—EXPORTS

Let's review some trade history and focus on how West Germany and Japan have responded so that we don't become too persuaded by our own rationalization.

* * * In 1970, the U.S. had a $3 billion trade surplus; Japan had a $.4 billion surplus; and West Germany a $4 billion surplus. By 1978, Japan's foreign trade balance rose to nearly $19 billion; West Germany increased to over $21 billion; and the U.S. declined to almost a $30 billion deficit.

Let's consider the impact of fuels. Japan imports virtually all its oil and West Germany is a large importer. To pay for this larger fuel bill, Japan's manufactured goods balance rose by almost $64 billion (1978 over 1970) and West Germany's by $42 billion; the U.S.'s worsened by $5 billion.

* * * In share of the world exports of manufactures of the top 14 industrial countries, the U.S. declined from 1970 to 1978 from 18.4 percent to 15 percent, while Japan grew from 11.2 percent to 14.9 percent and West Germany edged forward from 19 percent to 19.8 percent. Sadly, the U.S. exports of manufactures have fallen in spite of an ongoing devaluation of major proportions; from year-end 1970 to year-end 1978, the German Deutsche mark appreciated 100 percent; the Japanese yen 84 percent against the dollar. Our loss in share of exports in those eight years has probably cost us at least a million jobs and at the current annual rate of over $20 billion in our trade and balance of payments accounts.

While the U.S. still has a significant positive world trade balance in what the Commerce Department calls "technology-intensive" manufactured products—over the last seven years (1971–1978) this deficit balance with Japan worsened from about $2 billion to about $13 billion and that with West Germany more than doubled.

Our loss of innovation thrust in our economy is seen in a variety of indices * * * in relative expenditures in r&d, in numbers of scientists and engineers, in numbers of patents. To take patents * * * in the decade 1966 to 1976, in the key U.S. export areas of chemicals and machinery, patents granted to Japan rose 479 percent, and West Germany 70 percent; the U.S. declined 18 percent.

Finally, let's look at the German view of inflation since this is a currently newsworthy subject, first, some background anecdote. Willy Brandt tells the melancholy story about his recollections as a child in the year 1923 when he would take baskets full of old Deutsche marks and deliver to orphanages for heating fuel; workers had to be paid twice a day so they could afford to buy their family's food during the lunch break—before prices rose again later in the day.

Helmut Schmidt refers to the "curious" American notion that there is a permanent trade-off between inflation and unemployment. Germans have learned from bitter historical experience that sustained substantial inflation causes high unemployment.

It is a sense of common purpose—like the collective fear of inflation—that we lack. We can only hope we do not have to suffer Germany's tragic experience before we learn their lesson. America today is inhibited by its own good fortune in understanding the grim consequences of inflation.

Let's take the case of Germany. Their wholesale price index has gone up substantially as follows:

	Percent
August 1978	1.2
August 1979	5.9

Of course, this is much lower than any other major industrialized country—in fact, less than half of the U.S., U.K., Canada, France and Italy.

By German standards, however, it is high, frighteningly high. This big increase in the rate of wholesale price increases is not yet fully reflected in Germany's consumer price increases, but this should not obscure their legitimate historical concern, and may I say, enviable concern. Perhaps all this is part of the politics of blame, but it is not clear why the Germans should pay the costs of our inflation.

Thus, while I believe the so-called Volcker moves were necessary, I certainly don't consider them sufficient, and I am sure he doesn't either, to relieve our international trade malaise. That will take aggressive muscle strengthening steps to make the future less uncertain, to shorten the time horizon of investment payback, to beef up the whole process of technological innovation, and to make us up from our continuing "MEGO" view (that is "My Eyes Glaze Over" view) of exports, and more exports. And, of course, an absolute fundamental, reduce energy imports.

Speaking of an eyes glazing over subject, I cannot resist the temptation to mention the ballooning debts and deficits of non-OPEC developing countries. I am not unaware of the "wolf crying" aspect of this—i.e., that the large part of this recycling has been handled and will be handled well by the commercial banks. As you know, the outlook for an aggregate current account deficit in 1979 of $45 to $55 billion, excluding official unrequited transfers, up about 40 percent from 1978. A big if, but if oil prices do not go up further in 1980, these LDC deficits will bulge to something in the range of $55 to $65 billion in 1980.

Now if you aggregate the compounding effect of these for another five years, and look at the underlying creditworthiness of some of these countries, the issue, in other words, is not simply recycling, the issue is "who is on the other side of this debt?" I cannot help but wonder whether we are not facing a potential number of such magnitude that other fundamentally different approaches will simply have to be considered * * * including agreement on oil prices themselves, on increased stable supply and reduced demand for oil, on direct lending by oil producing countries, and perhaps on some system of shared guarantees of these extraordinarily high levels of debt. This is too complex an additional subject for these hearings and I am an eminent non-expert in it but I commend it to you for the most serious scrutiny.

Thank you for this opportunity to express my views and support for the Federal Reserve Board's mid-October actions.

Representative REUSS. Mr. Mahoney.

STATEMENT OF DAVID J. MAHONEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NORTON SIMON, INC., NEW YORK, N.Y.

Mr. MAHONEY. Thank you. I come to you as chief executive of Norton Simon, Inc., a major international marketing company of consumer goods and services. I come to you not as a tax expert and certainly not as an economist, but with some concern for what is happening in the minds of the American consumers we have out there.

I am troubled by the erosion of consumer confidence, particularly in this country, which has been severely impacted by inflation, high interest rates, the declining dollar, speculation in gold and commodities, a falling stock market, and the energy crisis.

The consumer is reacting in disturbing ways. His real income is down this quarter yet total consumption is up—meaning that the deceptively strong economic activity we are now seeing really reflects buying in anticipation of inflation.

That is a very unhealthy picture. It is against this background that I fully endorse the new monetary policy of the Federal Reserve Board under Chairman Volcker. Controlling the supply of money rather than just controlling the cost of money is the first real commitment I see to an all-out attack on inflation which is our No. 1 problem. It goes to the heart of our and any other economic system in the free world.

I fully support the Volcker policy, but feel we need to take positive action in two other major areas as well.

First is a fundamental tax reform to stimulate the savings and investments which will allow us to increase productivity. We have lost our edge against our major trading partners. Unless U.S. productivity turns back up, we cannot expect to maintain or increase our real income, pay for the vital imports and bring our balance of payments, and with it the U.S. dollar, back on a solid footing.

I feel we must explore measures to:

One, stimulate personal savings through the elimination of double taxation of dividends.

Two, encourage business spending through increased investment tax credits and depreciation allowances that reflect replacement costs rather than historical costs. These of course are proposed in the Capital Cost Recovery Act, House bill 4646.

Three, we reduce permanently personal and corporate tax rates and perhaps even consider a value added tax.

Four, sharply reduce or eliminate tax on capital gains. It should not escape our notice that Japan, one of the fastest-growing industrial countries in the world does not have a capital gains tax.

Second, we cannot continue the massive budget deficits that seem to survive no matter what part of the economic cycle we are in and more alarming yet, seems to grow even as inflation boots the Government's tax take. Simply put, the Government is at the core of the problem of too many dollars chasing too few goods. Unless proper fiscal and monetary constraints are followed, we are going to see more of the proposition 13 type proposals and a real possibility of a constitutional amendment for a balanced budget, which we do not feel would be in the best interests of this country.

Our experts tell us that weakening of household incomes, heavier debt burdens, a change in State and Federal Government expenditure

policy away from stimulus, combined with the new Volcker policy make the 1980 recession virtually a certainty. Compared to 1979, 1980 will be a tough year. We agree with their forecast of somebody watching consumer behavior rather than the economics of the numbers.

From what I see in the foreign operations, I do not expect much economic stimulus from our major trading partners next year.

The 1979 oil price increase and resultant inflationary policies will lead to reduction in imports from the United States, further aggravating our problem. Japan and Germany cannot long continue to support the world economy.

I have deep concern over the absence of an effective and comprehensive U.S. energy policy and believe that our position from here on will be far more precarious. So far this year we have been able to slightly build our oil inventories while slightly cutting consumption, but with oil prices moving up out of sight there is a real question whether we will be able to afford oil imports at their present rate. The total world oil bill this year will be some $225 billion, up from about $150 billion last year. Our own oil imports will go from $43 billion last year to well over $90 billion in 1981. We must have an effective policy because we can't afford this type of bill very long.

The car rental system of our Avis subsidiary has some 235,000 units in more than 100 countries. From that practical vantage point, I can tell you that the 55 mile-an-hour speed limit that we have had for 6 years is about our major policy, and it is a far cry from a solution to our problems. It's not much to show compared to the strong actions taken in Europe.

In summary, I welcome the Volcker policy as a major step to bringing inflation under control. But, we need more. We must stimulate savings and investment through tax reform to increase productivity. We must prevent too many dollars chasing too few goods by putting some realistic and practical limits on Government spending. And we must have a sensible and effective energy policy. Time is running out. We need to move now.

Representative Reuss. Thank you, Mr. Mahoney.

[The prepared statement of Mr. Mahoney follows:]

PREPARED STATEMENT OF DAVID J. MAHONEY

As chairman and chief executive officer of Norton Simon, Inc., a major international marketing company of consumer goods and services, my principal concern is the consumer. I am troubled by the erosion of consumer confidence, particularly in this country, which has been severely impacted by inflation, high interest rates, the declining dollar, speculation in gold and commodities, a falling stock market and the energy crisis.

The consumer is reacting in disturbing ways. His real income is down this quarter yet total consumption up—meaning that the deceptively strong economic activity we are now seeing really reflects buying in anticipation of inflation.

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3. Reduce permanently personal and corporate tax rates and perhaps even consider a value added tax.

4. Sharply reduce or eliminate tax on capital gains. It should not escape our notice that Japan, one of the fastest-growing industrial countries in the world, does not have a capital gains tax.

Second, we cannot continue the massive budget deficits that seem to survive no matter what part of the economic cycle we are in and, more alarming yet, seems to grow even as inflation boosts the government's tax take. Simply put, the government is at the core of the problem of too many dollars chasing too few goods. Unless proper fiscal policies and constraints are followed, we are going to see more Proposition 13 type of proposals and the real possibility of a constitutional amendment for a balanced budget, which may not be in the best interests of our country.

Our experts tell me that weakening household incomes, heavy debt burdens, a change in state and Federal government expenditure policy away from stimulus, combined with the new Volcker policy, make a 1980 recession a certainty. Compared to 1979, 1980 will be a tough year. I agree with their forecast, although more from the vantage point of someone watching consumer behavior.

From what I see in our foreign operations, I do not expect much economic stimulus from our major trading partners next year. The 1979 oil price increase and resultant anti-inflationary policies will lead to reduction in their imports from the United States, further aggravating our problem. Japan and Germany cannot long continue to support the world economy.

I have deep concern over the absence of a comprehensive and effective U.S. energy policy and believe that our position from here on will be far more precarious. So far this year we have been able to build up our oil inventories while slightly cutting consumptions, but with oil prices moving out of sight there is a real question whether we will be able to afford imports at their present rate. The total world oil bill this year will be some $225 billion, up from about $150 billion last year. Our own oil imports will go from $43 billion last year to well over $90 billion in 1981. We must have an effective policy because we can't afford that type of bill very long.

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In summary, I welcome the Volcker policy as a major step to bringing inflation under control. But, we need more. We must stimulate savings and investment through tax reform to increase productivity. We must prevent too many dollars chasing too few goods by putting some realistic and practical limits on government spending. And we must have a sensible and effective energy policy. Time is running out. We need to move now.

Representative REUSS. Mr. Van Arsdale.

STATEMENT OF HARRY VAN ARSDALE, OFFICER, NEW YORK CENTRAL LABOR COUNCIL, NEW YORK, N.Y.

Mr. VAN ARSDALE. I don't come before you as an expert in finance. I am not even a student of finance.

I do represent the people who are themselves the victims of what has been going on for the last number of years. I know that you are familiar with the fact, but I would like you to pay closer attention to every

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increase that any group or any corporation finds necessary, is passed along. Whoever it is passes it along, passes that increase along until it reaches the people that I associate with and their families. There is no place for them to pass those increases along.

I am sure you are familiar with it in a general way. We have an education and cultural fund in one of our unions in the Central Labor Council, several of them, but one that I am familiar with. They have some 30 students every week of the year, except when there are religious holidays or national holidays.

Invariably, if I have occasion to speak with them, I ask them. They complain, they speak, they talk about the squeezes that they feel are in—the vise.

I say to them, "How many of you have sent a letter to your Congressman or your Senator?" Invariably, there is 1 out of 30, sometimes there are 2.

So I mention this to add to your realization that you don't get much reaction from these people that are the ones that produce the wealth in this country.

They really feel very much neglected. Many of our affiliated unions, the members, have no place else to turn so they invariably are showing their resentment by undertaking to defeat or to change their elected officials.

Their reaction to Mr. Volker's position that the American people should undertake to reduce their standards, if they understand correctly, if that is his position, their message to him is what does he think has been going on for the last 5 or more years? The American families and the American people in our experience in New York City and what we hear from our associates throughout the State is that their standards have been and are being reduced right along.

The question of solving the situation, the problem, as I understand it, is that there is too much money in the marketplace. So the way that is going to be solved is by shutting off the credit.

A lot of our affiliated unions view that as further unemployment on top of what they have already been burdened with in this city. It is not a very pleasant situation. They don't express themselves very kindly about that.

In discussing it among ourselves and trying to understand, and the fact that they are losing confidence in the people that have been in control of the situation, that they have had reason to have confidence in over the years, in fact they are losing confidence. But in those discussions, I don't have any idea how much money Mr. Volker's recommendation is going to take out of the marketplace. But with our limited experience, we thought it would be much better—inflation is a No. 1 problem. We can understand that. We can believe that.

How to find a solution is more difficult than knowing what the problem is. Mr. Volker's recommendation to reduce the standards of the American people comes somewhat as a surprise and a shock. We are told that there are 11 million illegal aliens in the country or undocumented aliens. We have sympathy for these people coming from countries where their standards are so much lower.

We are told that we have 1 million here. But we would like some people to understand what is happening to the American worker, what

is happening to the standards that it took them 25 or 30 years to establish, what is happening to our minority people.

In our Central Labor Council we have a Black Trade Union Leadership group. We have an Hispanic Labor Committee. It is their job to serve their people and to make known to us whatever ways we can be helpful.

They are people that just had an opportunity in recent years—to get on the first or the second rung of the economic ladder. They are subject to the competition for jobs from illegal aliens. The illegal aliens are not responsible for the situation, but somebody certainly is responsible for it. An illegal alien working for an employer that wishes to take advantage of his workers is the closest thing to a slave that you could possibly have in America. If you have 11 million of them in the country, which the Immigration Department reports, and if you have a million in New York City that really can't express themselves, they have no choice, they are being victimized to such an extent it is unbelievable, and they are not all in jobs of an unskilled nature. They are not all in jobs that nobody wants. That just isn't true. That is propaganda.

I know you don't have the time to hear all of this. But the suggestion that we came up with that we think ought to be given some consideration is that if the inflation is a No. 1 problem, a threat to all of us, why couldn't there be emergency legislation so that across the board every citizen would share equally, not have the burden passed along only to those at the working level. Why not pass emergency legislation that would set a percentage of every individual or every citizen's income, a percentage to be frozen, to be in something like we have in some of our unions, an annuity plan.

Money, if it was 10 percent or if it was a larger percent or if it was a smaller percent, and if that was frozen for the period that this situation exists and if it was clearly understood that that money couldn't be touched or used or find its way into the marketplace, we believe that that would represent a much larger sum of money than is going to be taken out of the marketplace by Mr. Volcker's recommendation.

We believe that at the end of the period the American people—that would be their money. That would be their estate. That would be something they would have.

The way it is, they are the victims. The money will come out of the marketplace. The interest rates are going up so high. The American worker knows that any corporation that has to borrow money to carry on their business has to pass that interest along, that higher interest. They have to pass it along.

It is going to destroy the construction business, which is one segment of our membership. No developer is going into development if the prime rate is 15 or more than 15 percent and he is going to have to pay 18 or 20 percent. He has no way of knowing at the conclusion of his work that he is even going to get paid for it.

We hear the stories continually from the employers in the construction industry that they can't get paid for the work that they have performed.

I think if a study of this was made, a lot of people would have great difficulty getting along on 5 percent or 10 percent or any percentage

less than their present income. But I think it would be more honest to face up to that, for every American to know that he is sharing equally. It would take the money out of the marketplace, but it would be their money when this serious situation has passed—it has to pass at some period.

In the meantime, they wouldn't be taken advantage of, as they feel they are.

Their feeling is that the cost of everything is going to increase. We are told that rentals in New York, which are extremely high now, are going to go through the roof because of the cost of energy and the cost of heating oil and all the other costs. They have continually been passed along to the people.

Then we are faced with the fact that the workers cannot have a proper adjustment. That was the thing that let the steam out of workers and their families, when they felt over a period of time that they were squeezed and overcharged for most of the things that are their necessities. They came to a time when they could negotiate, when they could present to their employers that they were faced with these burdens and that they expected their employers to in some way aid them to make an adjustment so that at the end of a period they would start to catch up, to get ready for the next period of increase that they would have to live through.

Now that is in many ways taken away from them. They don't have the opportunity for the kind of increase that they need to meet the cost of everything.

I would just like to say in closing that this city is facing a very serious situation. As the representative of these unions, I was asked to serve on a number of committees. I gave a great deal of attention to these committees, did the best we could, relayed to the membership and the members that this was not a fake situation in our city, that it was a very serious situation and we all will be affected if the city faced bankruptcy.

From my observation, the workers have responded. Not only have they accepted adjustments much less than they were entitled to and could have received, they have responded. The city unions have even made the money available.

I happened to sit in a meeting with the chief executive of the State and the representative of one of the organizations whose members felt that they had been taken advantage of to the point that they were not going to carry out their financial commitment.

Of course, I was there to reason out, to see if we could find a solution.

During the period we were discussing it, people on the outside we were told later, were contacting all the financial institutions to see if there was any other way to get the money to make up for this organization that had felt they were justified in not carrying out their commitment.

Evidently, that didn't succeed. At 3 p.m. there was no solution. We were told the bank would stay open until 4 o'clock. At 4 p.m. there was no solution. The bank agreed to stay open until 5 p.m. At a quarter to 5, at 15 minutes to 5, the union agreed to carry out their commitment, which involved a tremendous sum of money from their pension funds.

That was one of the experiences I had, and a number of others.

Now we are told in our city that this is a permanent way of life. The fact that the workers responded as they had, they are not going to be treated fairly, due to the fact that it is still continuing, it is ongoing, we are facing financial bankruptcy, after these workers have watched the way money has been spent during this period in many directions.

I just want to say to you that with a full understanding, the unions, from what I hear in their discussions, under the pressure of their members, are not going to be able to continue to accept the fact that the possible bankruptcy is now permanent and their workers are going to have to do without anything that could help them to catch up.

Everything indicates that the representatives of those unions, the elected officials in those unions, are going to be castigated. They are going to be held out to the public as the enemy. If there is a bankruptcy, history will show that they caused it.

I would say there is very little being done to forestall that. It is something that any responsible elected official of a union would like to avoid, would hate to see come about.

When you reach a point that you feel you have been victimized in so many different ways and that the people you represent have been victimized in so many different ways, it is hard to convince elected officials that there is no justification for their effort to get some degree of justice or to prove to the people that they represent that they are really not entirely neglecting their interests.

I know that this is a very serious problem you gentlemen are wrestling with. I don't think it is easy to find a solution. But I do wish that our people would be given serious consideration. I wish some of those that think unemployment is a statistic—we feel and have felt for a number of years that unemployment is a cancer on the economy of our Nation. We understand employers being reluctant to have full employment because they feel their workers would be too independent under that kind of a situation.

We would imagine there is enough ability in the country to devise ways and means that workers wouldn't individually or collectively take advantage or be allowed to take advantage of a full employment economy. But if the elected officials, if it was possible for them to have time, to spend more time with the families of the unemployed, to get to understand what unemployment really is as I understand it. It is not a statistic. It has wrecked thousands of families in this city, wrecked them.

We have a feeling that things can't continue as they are. The suggestion of the Federal Reserve Bank is, in our opinion, going to create additional unemployment. There are people who think when they see a few buildings going on in New York, and read some press releases. I will give you the figure of a group of 7,000 men, highly skilled men, that have given 5 years of their lives in previous years to learn their trade. The unemployment as of this morning is 692; 348 of these men are out working in distant parts of the country.

That means that they are working in most cases at lower standards. They have to support their families here, and they have to support themselves at very high cost, whatever part of the country they are employed in.

There are 232 that cannot accept a job in any other part of the country, so they are taking whatever kinds of jobs they can get.

There are 167 on furlough, which means that these men have taken an action to give up 8 weeks of their employment whenever they have a job they are required to go on furlough for 8 weeks to help their brother members have some work. That comes out to 1,439 out of 7,000.

I don't know if you have heard that kind of a statistic. These are very solid citizens. They are a very important part of our community. That is what they are faced with.

And this is something you can come and study, the records are kept for every day. A lot of people guess about how many people are out of work. In this industry, they have the day-to-day record of those that are out of work, those that are in jobs outside of our location, those that are in other occupations, and the number that are on furlough from their employment.

That is approximately 1,500 out of 7,000. That is over 20 percent of the 7,000. That has been going on for a number of years. The jobs that you see, the big jobs, people think thousands of men are working on those jobs. You can take a job going up 70 floors and it will have 30 electrical workers on it. It will have a couple of hundred building mechanics.

There is so little understanding and there is so little effort to have any understanding about these matters. If the unemployment, if there is not enough ability in our country to find a solution to an unemployment problem, it is a reflection on all of us.

Representative REUSS. Thank you, Mr. Van Arsdale.

Mr. VAN ARSDALE. If there are any questions that you care to ask, I might be able to give you more enlightenment in answering questions. As I said, I am not a financial expert and don't expect to be.

Representative REUSS. I would say, before calling on Senator Javits, that as far as I am concerned the purpose of these hearings is jobs and prices. The Federal Reserve is a mechanism for producing these. But you were talking about exactly what I wanted to hear.

Senator JAVITS. Thank you very much.

Gentlemen, I can't tell you how grateful I am. I believe the whole committee is also appreciative of this testimony. I think it is extremely valuable, the most important we could get from business, financial, and labor leaders of our city. You three are certainly highly representative.

Second, may I thank you for being willing to appear on the panel. We suddenly ran short of time. It is better for you and better for us to do what we did.

I have a few questions I would like to ask, starting with Harry Van Arsdale who, as we all know in New York City, heads a million-worker Central Labor Council representing the private sector of this city, an unparalleled representation as concentrated as this.

I noticed that you mentioned the restraints of the National Pay Board: How is that idea going down here in New York City?

Mr. VAN ARSDALE. There is a very effective way of enforcing that kind of a restriction. The employer sits there and says, "I'm sorry, we realize how much the inflation has cost all your people, but we are restrained, we can only give you this limited amount."

A lot of industries, they are not in the financial shape to give that amount. So the negotiations have been very difficult with employers that over the years have been cooperative with their workers. So many companies have been forced out of business. An employer can't be expected, if he or his family have put in 35 or 40 years in a business, nobody can expect that employer to be reasonable if they are facing extinction. And that is what so many of them are going through and so many of them have already reached it.

From my viewpoint, take the construction industry in New York that we were very proud of, I think it is practically, for all practical purposes, it has been destroyed Because it has been going on now for 6 years.

Senator JAVITS. This high mortgage money will do the rest?

Mr. VAN ARSDALE. Make it impossible.

Senator JAVITS. The other question I wanted to ask you is this: We are going to face in the Congress a decision about Chrysler, which is inherent in what you have been saying. That is a very, very big employer here and in many other places; what would be labor's view, in your opinion, as to what the United States ought to do about that?

Mr. VAN ARSDALE. It is one of those very, very difficult ones. Having the solution is a lot different from being familiar with the problem. I do not have any closeup on it.

Some of these things, it has been my experience, the Federal Government or an agency will act in the best of faith to do the right thing. Then after it occurs, you find people at work that turn it around. Lots of our labor legislation, as you would well know, has been turned around to the point where it is now used against workers instead of helping them to accomplish democracy in the industrial world.

I would say that whoever knows all the facts, if there is no other way, it would border on being criminal to let a company like that go out of business.

On the other hand, you are faced with the problem that if the Federal Government just gets to where you reward bankrupt companies, it will be more advantageous to go bankrupt than to be successful. That is the other side of the coin.

I don't really believe that our country in a case such as Chrysler, if there is some way to limit those that will follow in that direction. I don't see how they could come to any other conclusion except to keep those workers and their families provided for.

On the other hand, I fully realize that as soon as the Government money comes in, the problem will be solved, the money will start to be spent differently, it might possibly be spent differently than it otherwise would be.

Mr. JAVITS. Of course, I assure you that if we do it, we will exercise very tight controls.

Mr. VAN ARSDALE. It is very difficult, Senator, as you know. to do that.

Senator JAVITS. New York City is a good example. We gave help to New York City but under very tight and very effective controls. And those controls have been complied with.

Mr. VAN ARSDALE. One of the instances we have in our city is the efforts that were made to help our minority citizens with training programs and with other matters. The people in the neighborhoods de-

veloped the title, I had never heard it before, poverty pimps. That is because they on a day-to-day basis were close enough to what was going on by some of the people that maneuvered themselves into the handling of those funds. It is one of the very sad situations when a Government undertakes to be really helpful to the people and makes money available, and then you find the money going in other directions than that which it was intended to go.

Senator JAVITS. Of course, we have seen that in the welfare and antipoverty programs. But it is always a question of degree as to how bad it is.

I thank you very much for those views and for your general exposition of labor's position, which is very helpful.

I have just one or two questions of Mr. Mahoney and Mr. Peterson.

Mr. Mahoney, you do a good deal of investing abroad, don't you?

Mr. MAHONEY. Yes.

Senator JAVITS. That of course is very helpful for American business in terms of exports. What happens now, as you see it, considering the new program of restraint that we are on?

Mr. MAHONEY. Probably the diminution of it, Senator Javits, as it goes one. I think that some of the foreign countries are facing problems of their own, too, with the rising inflation. I think the United States has exported some of that to them, too.

But answering your question specifically, I think our involvement in money overseas will be reduced.

Senator JAVITS. Do you think that will have a direct effect on U.S. exports to which Mr. Peterson referred?

Mr. MAHONEY. I think it will from an international point of view. I am not sure it will from a Norton Simon point of view.

Senator JAVITS. You are a businessman. You run an enterprise. A number of your enterprises have research and development units. What is your comment on Peterson's point that we are suffering a great diminishing in respect of the innovation which is characteristic or has been for years characteristic of many expanding businesses and what do you think we ought to do about it?

Mr. MAHONEY. I would certainly support anything Mr. Peterson says factually numberswise. Over the years I have gained much respect for him. If the number is down, and I happen to know that it is, that is a part of the U.S. malaise, if that is the word to use, that we are not spending it.

More important, the R. & D. to me, because we are not in that same business in the same degree as electronic businesses are, is the fact that we are not depreciating our plants at the same rate when we are going to need to build them. So I don't know if Mr. Van Arsdale will have constituencies and the consumers in American are going to find down the road that many foreign countries are increasing their R. & D. rate to get out goods at the rate of 1½ to 2 times the United States.

If we depreciate a plant at $2 million it is going to cost us $15 million down the road and there isn't that money there, that is a problem.

It is also forcing American companies to go into debt because it is cheaper to go out and borrow the money and deduct it than to go into the equity market and get the money and pay double taxation.

Senator JAVITS. In other words, charge off the dividend?

Mr. MAHONEY. Oh, yes. You should also charge off the interest that you are paying on your debt. Also those of us who came up through a depression orientation, to keep borrowing money to keep out of debt is not very reassuring That is what American companies are forced to do.

I see it where we have an American industry now that we are not comparable. We have the manpower. We have the kind of people that can work in our plants that can do a heck of a job. But we do have to give them the tools, as was said back in 1940. I am not sure we are giving them those tools.

Senator JAVITS. In terms of modernization, we are very much behind the times?

Mr. MAHONEY. There is no question about it.

Senator JAVITS. Mr. Peterson, who do you believe we need to do in respect of these deficiencies? After all, you are in the investment business. Some of the suggestions made are for a faster writeoff of plant and equipment. Although I am necessarily confined in my support of accelerated depreciation to a strict 10–5–3 approach, I am committed to some form of more realistic writeoff, which reflects current replacement costs. In addition there is the idea that we ought to give some tax incentives for savings on the ground that capital is not moving into constructive purposes, such as investment. Could you give us your views on this general subject?

Mr. PETERSON. Generally, Senator Javits, quite beyond specific measures which I will comment on, I suspect that until you do something about the uncertainty factor in the future, you aren't really attacking what is the underlying problem.

I mentioned on the technological front that the formation of new technical companies, which I think you yourself have looked at, shortly before I got into this business, my recollection is that there used to be several hundred of these companies formed every year, out of which came to the Xeroxes, Polaroids, and Texas Instruments; and if you look at any numbers at all on jobs, they have extraordinary effect on jobs, trade balances, productivity, anti-inflation, and so forth.

People generally don't want to make long-term investments that carry an intrinsic amount of risk, particularly if the economic environment is extremely risky. So I think one of the first things you have to do is try to reduce the uncertainty factor.

Second, there is a whole series of things I think have to be done about both savings and investment. I am certain you are aware that in August and September the savings rate in the United States hit 4½ percent or something on that order. It is just a fraction of what it is in other countries. There are a whole set of reasons that ought to be looked at.

In that context, Senator, I would like to make a suggestion, if I may be presumptuous to make it. I think some group like the Joint Economic Committee may want to—may feel that the time has come to do a serious comparative study of the Japanese, the West Germans, and the U.S. economies and try to understand in a coherent way what is going on. It makes no difference what you look at, whether it is savings, investment, inflation, interest rates, productivity, trade balances, or patents. On the whole in front of what we call economic performance something is happening.

I have begun to update that study I did, as you are probably aware of, in 1971 when I went to the White House. And it is interesting. We seem to think there is some contradiction between inflation rates and unemployment and interest rates. The truth of the matter is the better the economy does in general, the better it does on all of those areas.

I would strongly recommend that a serious system study be done of those two economies in which you can look at the interactions between things.

On your specific question, we have to do more on savings. We have to reduce the time uncertainty of new plant and equipment.

On the technology front, Senator, I guess you are aware of this, but if you look at the costs of any technical innovation, what you will discover is that the R. & D. portion is only a small fraction of the total, about 10 percent, something of that order of magnitude. Vast other amounts are involved in starting up with that product.

The CED has recently done a study on technology that I commend to you. I am suggesting that perhaps you should take a look not only at new plant and equipment but something you can do to try to get pay-back on innovation projects faster than we are now getting.

On innovation, incidentally, I guess you know this, and you can go on by the hour, and we won't, on what is happening. I find the case of the video recorder a rather melancholy one. You know, we invented the video recorder out in California. We don't make one at the present time. That is true in an increasing number of areas.

Senator JAVITS. May I ask you this other question. What do you consider the effect of the antitrust laws, the foreign corrupt practices laws on our exports?

Mr. PETERSON. This is part, Senator, of a much broader problem. Other countries have decided that exports are such an essentially national priority that the general thrust of the policy seems to be, are to be, to encourage them. We seem to approach the problem in terms of setting certain barriers that have to be overcome, of which the regulations in this area are just one of a half dozen. I am not here to say they are more or less serious than a lot of others.

But if you look at the paperwork that an exporter in this country has to go through and the attitudes he perceives versus what happens abroad, I think again the Corrupt Practices Act has to be seen only as one of a half a dozen major barriers to exports in this country.

Senator JAVITS. Which they suffer under.

I was going to ask you, Mr. Van Arsdale, one other question. You mentioned illegal aliens and the sympathy of labor for them. They apparently are taking away, as you say, ongoing jobs which labor would gladly have. Yet you do feel, as I can well understand, a sympathy for oppressed people who have escaped here. What would you do about it?

Mr. VAN ARSDALE. One thing is that it is very difficult for us to believe that you could mobilize 11 million people from other parts of the world unless there was some tremendous effective and efficient organized effort being made to bring them into this country. Eleven million people. You have a tremendous job moving that many of your armed services during the world wars. Eleven million are in our country. We are told not by critics of the Immigration Department

but by the Immigration Department. It is unbelievable. It is very hard to believe.

Then we learn that some of them have paid thousands of dollars to reach this point and that they are supplied with very good counterfeits of all the documents that they are supposed to have to be here.

It seems to us like it must be a tremendous industry with tremendously able people with various kinds of influences that are able to bring this about. Could it come about accidentally?

The other difficulty is that if it was possible, if you had enough employment to take that 11 million people and give them full citizenship and each one of them had two relatives that they had follow in their footsteps, without an expanding economy, with what we have gone through for the recent years, it is almost unbelievable.

As far as the solution, I am no expert on finances. I am no expert on immigration. We ought to absorb all of those that it is possible for us to absorb. We certainly shouldn't allow the condition that exists at present to continue.

A good segment of our citizenship are starting to ask who is protecting them, who is protecting the American citizen in this country.

Another question that is very difficult that you might look into—I started in the depths of the depression. Nobody had anything. But if you had a dollar, you could buy something with it.

It is very difficult in this depression, as it exists among our workers in New York, to understand how the cost of everything keeps increasing. It seems the competition which was supposed to contribute a great deal to America has disappeared. Nobody has to enter into any illegal activities to overcome a competitor. You just buy the competitor. With the cost of things going up, every week the people come and talk about what some of the simplest things cost.

On the question of the immigration, we find that, like all other people, they come in different categories. Some of them demonstrate a desire for independence. They are quickly victimized as soon as they express a view that something ought to be done to have better standards—the employer can put in an anonymous call to the Immigration Department and they are taken away. That is an example for others. None of these problems are easy or they would have been solved long ago.

But our people have a right to feel that their Federal Government ought to contribute something to the solutions of these problems. It takes a long time to recognize there is a problem. Then there is no easy way to find the solution to it.

Senator JAVITS. Thank you, sir.

Representative REUSS. Thank you. Because it is late, I won't ask the many questions I have on my mind.

I would say that it is a happy coincidence that sees three outstanding leaders of finance, industry, and labor at the same table.

Germany and Japan have been much mentioned here, and properly, as countries that have seemed in the last generation to do a much better job with their economies than we have. They have found jobs and stable prices for their people. That is important.

There are those who say this is because they lost the war, and that has something to do with it. But it doesn't have everything to do with it.

I would suggest that one of the things that distinguishes the Japanese and German economic approaches from our own is that there they have what you would call the old-fashioned team spirit, the idea of planning and problem solving and cooperation.

One example is Japan. When 5 or 6 years ago it appeared that their textile industry was on the skids because Hong Kong, Korea, Taiwan, and Singapore could produce them cheaper, instead of fluttering around and doing nothing, or instead of doing the wrong thing, which would just have insured that Japanese prices went up and workers lost jobs, they put labor, industry, finance, and government together. They saw to it that when the textile plant in Kobi closed up, workers in that plant went across the street and got a better job in an up and coming consumer electronics plant.

Now, I can't help but think that if our Government would take a leaf out of the Japanese and German book, and under Government leadership, but with the input of you three or people like you, focus on the problems of this metropolitan area—that is a tenth of the Nation—with no small set of problems: small business, the change in economics, the problems of finance, interstate management, and illegal workers; I should think that such a team could come up with solutions for the Federal, State and local governments, the private sector, and labor.

Among other things, it might be that Peterson and Mahoney would maybe throw some cold water on a well-meaning solution presented by Mr. Van Arsdale; namely, forced savings. They might point out that that might merely intensify the recession into a depression if it were tried.

I would hope that Mr. Van Arsdale, in such a consortium, could talk his friends from industry and finance out of greatly increasing the budget deficit by going too fast with business-oriented tax deductions. They are good in theory. But if you start doing all that now, we would have a budget deficit that would really cause interest rates to make your hair curl.

So I think that the idea of playing down the antagonism in this country between business, labor, and government and wherever else man's hand is acting against every other man's hand, and getting on with planning and problem solving isn't all bad. If there is one thing I generate in my mind from this very dynamic discussion we have had, it is that people like yourself could contribute more to our country's problem solving if somehow we got it all organized, as the Germans and the Japanese seem to be able to do. With this hopeful thought I want to thank you, Senator Javits, for your 100-percent attendance record.

Senator JAVITS. I want to add that I am very devoted to the Labor-Management Committee idea. I hope this can be improved and developed. Provided it lays off the subject of collective bargaining, I think that can be a real answer to patriotic men and women like those who have been gracious enough to appear before us, Messrs. Van Arsdale, Mahoney, and Peterson.

Representative REUSS. Thank you. The subcommittee stands adjourned.

[Whereupon, at 12:55 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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