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THE 1979 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-SIXTH CONGRESS

FIRST SESSION

PART 1

JANUARY 23, 25, 29, AND 30, 1979

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THE 1979 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 23, 1979

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

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

Present: Senators Bentsen, Proxmire, Kennedy, McGovern, and Javits; and Representatives Brown and Heckler.

Also present: John R. Stark, executive director; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, Paul B. Manchester, Kent H. Hughes, Thomas F. Dernburg, George R. Tyler, Deborah Norelli Matz, and William D. Morgan, professional staff members; Mark Borchelt, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, Mark R. Polinski, and Robert H. Aten, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. Mr. Secretary, our economy is expanding rapidly. In the last quarter of 1978; we had a real growth rate of some 6.1 percent. We created 3 million new jobs last year. Yet, inflation remained as a very critical and emotional issue for our country, and refused to yield to any of the traditional answers.

We have almost rampant interest rates, voluntary wage and price guidelines, a relatively tight monetary policy, and yet the cost of living continues to rise at an unprecedented rate and despite a personal tax cut of almost \$13 billion by the Congress last year, inflation has outpaced the tax cut the people received in the tax bill.

Our dependency on oil imports since 1973 has continued to increase, and it has now reached almost 50 percent of total domestic oil use. We have come to depend far too much on oil from the Persian Gulf, and too little on some of the vast reservoirs that are much closer at hand, in Mexico, for example.

I don't want to belabor the point. We have made substantial progress in bringing commendable progress to the problem of solving our energy shortfall. But we still have a long way to go down a very dangerous road.

Mr. Secretary, this committee has had an unprecedented number of requests for membership on it this year, from both the House and the Senate. I think it reflects the feeling of the Congress that the economy is by far the No. 1 issue facing this Nation.

We have chosen you as our first witness to start these hearings on the economy so that we might explore with you the question of energy and its impact on inflation, and the security of this Nation.

Mr. Secretary, you may proceed.

STATEMENT OF HON. JAMES R. SCHLESINGER, SECRETARY OF ENERGY

Secretary SCHLESINGER. Thank you, Mr. Chairman.

Mr. Chairman, I do have a prepared statement which, with your permission, I shall insert into the record, and I will attempt briefly to summarize some of the major issues that confront us in the interactions between the economy and/or energy sector.

As you know, quite recently OPEC increased prices by 14.5 percent year-end over year-end. The effect of that will be to impact on the performance of the economy, and notably, to increase energy prices and through energy prices the cost of living.

When we trace through the effects of those crude oil increases, plus the increases on domestic crude oil, the result on gasoline prices—to take a dramatic example—will rise because of crude oil increases alone, by approximately 4 cents per gallon.

We face, also, a very tight international market in which spot prices are well above the nominal market prices of the OPEC nations. This will spill back into even higher prices for imported crude.

Presently in the short run, our conditions are dominated by what is occurring in Iran, and the effect of the shutdown of Iranian production on world oil markets. Since the end of December there have been essentially no exports of crude oil from Iran. Prior to the time Iran provided something on the order of 20 percent of the oil that flowed in international commerce, which represented approximately 10 percent of the free world's crude oil production.

So in the short term we have a problem that affects not only the United States but other countries as well.

I have not gone through the impacts of the curtailment of Iranian production and unless there is a desire on the part of the committee, Mr. Chairman, I will leave that to the question period.

Senator BENTSEN. Mr. Secretary, that will be covered I am sure during the period of questioning to follow. You don't have to have that in your presentation.

Secretary SCHLESINGER. Suffice it to say, Mr. Chairman, that we are drawing down inventories worldwide at the rate of approximately 2 million barrels a day in excess of what we normally do during this winter season.

Since world inventories are at a high level, we can afford to do that for a certain period of time.

We believe that we can get through the first quarter reasonably well; possibly through the second quarter, although our difficulties will increase. But unless Iran comes back onstream sometime in the second quarter, we face increasing difficulties through the rest of the year, and notably in next winter's season. Normally, after this initial period of drawdown at the start of a calendar year, there is a period starting in the spring in which there is restocking, a rebuilding of inventories. Unless Iran comes back onstream, that rebuilding of inventories will be less than it should be and as a consequence, next

winter we would be in trouble, given inventory levels and the expected demand which should be higher than it is this year.

Senator BENTSEN. Well, I would just interrupt at that point.

Secretary SCHLESINGER. Yes, sir.

Senator BENTSEN. This question concerns all of us. If you have that kind of a drawdown in inventories coupled with no current production, are we faced with the possibility of oil and gas rationing by this summer due to the Iranian shutdown?

Secretary SCHLESINGER. I think not, Mr. Chairman, though I would prefer not to be categorical on that at this time.

Senator BENTSEN. You do not rule that out as a possibility, however?

Secretary SCHLESINGER. We do not rule it out, but we think it is very unlikely, and it should be regarded as a last resort.

We have published recently in the Federal Register, our standby allocation regulations. To the extent that the voluntary response—in terms of enforcement of the 55-mile limit, the turnback of thermostats to 65 degrees during the winter, the elimination of unnecessary driving—does not work, we may have to have recourse to allocations later in the spring but I think that we can, under the worst of circumstances, avoid gasoline rationing.

Senator BENTSEN. Fine, Mr. Secretary, proceed.

Secretary SCHLESINGER. I think that that covers the short term problem.

As you know, Mr. Chairman, other OPEC countries have increased their production somewhat to offset the effects of the decline in Iranian production. How long those higher levels of production will last is also a question that we may have to face.

Without Iran, the world will continue in a supply squeeze and we face spot market prices well above the nominal prices of the OPEC nations.

Mr. Chairman, that brings us to the longer term conditions which reflect the elimination of Iran. Iran affects the longer term as well as the short term because we do not expect Iran to come back to the same level of production that was experienced prior to these recent difficulties in that country.

In the longer term, we have recognized, Mr. Chairman, that we face difficulties in increasing the world's oil output to match the growth of demand on a historical basis. Each time we review the availability of oil worldwide for 1985, we come to conclusions which are somewhat more grim than in the prior review.

For example, in the CIA study of early 1977 it was estimated that OPEC would produce something in the neighborhood of 44 million or 45 million barrels a day, if needed, in 1985.

Last year, our estimate was 37 million to 39 million barrels a day. Today, as a result of what has happened in Iran, and because of the projected investment in capacity by other countries, we anticipate that OPEC will be on the low side, 36 million to 37 million barrels a day.

As a consequence, in the 1980's we continue to face an inability of the world's oil suppliers to provide for the growth of demand at roughly the present price level in real terms. And unless we constrain demand, we will face either rapidly rising prices for oil, or a reduction worldwide in income, output and employment, as markets are cleared at those higher prices.

Those are the difficulties that we face in the longer term, Mr. Chairman.

The underlying question which this committee is interested in, and what all Americans are interested in, is: "What do we do about it?"

In the first place, we have resources other than oil in the United States that we have not completely tapped. The current supply of natural gas illustrates this point. The elimination of the dual market, Mr. Chairman, has resulted in the beginnings of a flow of gas that was surplus in Texas, in Oklahoma and, to some extent, in some of the other States, reflected in an article in this morning's business section of the New York Times.

It says, "Texas Surplus Gas Begins To Flow."

We have identified up to 1 trillion cubic feet of gas, a domestic bubble that can back out in the short term, approximately 500,000 barrels of oil a day of imports.

We want to make use of that gas so that we can reduce our oil requirements and the impact of our oil import bill on the balance of payments.

Further, we are interested in moving the Alaska natural gas pipeline. There is the possibility of 1 trillion cubic feet of deliverability from the North Slope.

The investment in that pipeline is desirable from the standpoint of the long-term energy economy of the United States.

Even if there is no more gas on the North Slope than is present in Prudhoe Bay, that pipeline turns out to be a bargain in the long term even though, for the first 5 or 6 years, the prices, given utility rate setting, will be somewhat higher than some of the alternatives.

In the long run, there is a net national benefit of about \$5 billion without the discovery of additional gas on the North Slope which, however, we expect to see.

Indeed, we would expect that pipeline to move gas for 50 years rather than for the 20-year amortization period.

That is a desirable thing.

Further, we are interested in pipeline gas from our neighbors, from Canada, from Mexico. As you know, Mr. Chairman, we are presently importing almost 1 trillion cubic feet a year from Canada and we hope that that flow continues, and we welcome Mexican gas.

We feel that that gas should be competitively priced so that we can back out residual fuel oil which represents five-sixths of the potential market for Mexican gas.

By making better use of natural gas, we can alleviate our own pressures on the international oil economy.

In the oil area, we are not moving as well as we might. Partly this is due to the surplus on the west coast which is a reflection of our own energy policies.

We have precluded the export of oil or the swapping of oil with those who can effectively use it in the Pacific at the same time that our procedures are blocking the construction of pipelines that can carry that oil from the west coast into the interior of the country.

Most notable is the case of the Sohio pipeline from Long Beach, Calif., to Midland, Tex., that has been held up by these kinds of procedures for 2 years.

California heavy oil can be better employed, can be better exploited than it is at the present time once we have resolved that surplus condition on the west coast.

In this connection, Mr. Chairman, I should have mentioned at the outset that these tight market conditions and the OPEC price increase have led to a deferral of the decision on the adjustment of the controlled prices for our domestic crude until we see better where the world's market is going.

We have on the street two rulemakings, one with regard to the so-called new oil, new reservoirs, that would provide incentive for additional discovery; and, at the same time, a rulemaking with regard to so-called marginal wells, particularly those in the lower-tier category, in order to maintain production at whatever level we can achieve.

Oil is, of course, another problem. We must remember that whatever we do, right now we are 75 percent dependent in this country on foreign oil and natural gas and whatever we do in terms of moving to alternative supplies, by the end of the century we will be 50 percent dependent on foreign oil and natural gas.

So, it is necessary to provide the necessary stimulus to production, particularly in the areas of coal and nuclear.

Mr. Chairman, we recognize, and I think all of us would desire, that we become less dependent upon foreign sources, particularly insecure foreign sources, but we have been unwilling to take those steps that would reduce our dependency on those foreign sources.

In the area of coal, we need to have a stabilization of the regulatory regime so that industry, as it decides whether or not to invest in coal-fired boilers, knows what the future will bear, and that it will not be faced periodically with changes in the regulatory requirements regarding coal, notably regulations in the environmental area.

Above all else, we need stability in regard to the regulatory regime. The tendency for industrial capital is to flee uncertainty; to the extent that we can provide greater stability, we can move coal more effectively.

Similarly in the nuclear area, we have in this country a great deal of ambivalence about nuclear power, but it will be a necessary part of our energy mix.

Right now it takes some 12 years to construct a nuclear plant, given the length of the regulatory requirements, given the planning process, given the length of the construction period.

Each year, Mr. Chairman, of delay in the construction period adds \$120 million to the cost of a nuclear plant or about 3 mils per kilowatt-hour.

By shortening that process, that is one way that we can help solve our energy problem, and also reduce the inflationary impact on the economy.

Inefficiency in the regulatory process has become one of the major elements in terms of permitting inefficiencies in production, and higher rates of inflation associated with declining rates of productivity, as you mentioned in your introductory remarks.

Finally, Mr. Chairman, I should mention conservation. I am happy to say that since the President's original presentation of the national energy plan that the arguments over conservation have tended to disappear.

The President asserted conservation was the cornerstone of our energy policy. There was a great deal of questioning on how much we could conserve.

In recent years we have brought down the rate of increase of energy requirements for growth of the GNP from 1.0 to 1 to 0.7 to 1, reflecting much higher efficiency in our energy use.

Industry has done a notably good job in that regard by reducing energy requirements per unit of output and their relative share in the use of energy nationwide.

Conservation has worked, and I think that there is a nationwide recognition of how effectively, indeed, it can work.

I should underscore that conservation is not a substitute for the provision of adequate supplies of energy to permit the growth of the economy, an increase in number of jobs, the growth of production and of productivity.

Whatever else we do, we must see that there are adequate energy supplies in the long term to permit the necessary economic growth.

Mr. Chairman, that is a brief summary of the position that we have taken.

We have short-run problems that, reflecting longer ones, demonstrate the inability of the world's producers to increase dramatically the supplies of oil, forcing us to turn elsewhere to meet our energy needs.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Secretary.

[The prepared statement of Secretary Schlesinger, together with attached charts, follows:]

PREPARED STATEMENT OF HON. JAMES R. SCHLESINGER

Mr. Chairman, I appreciate the opportunity to appear before you today to discuss a broad range of energy and economic issues.

In developing national energy policy, careful and continuing attention must be paid to the close interrelationship between energy and the economy. The burden placed on the economy by the continually large payments for imported oil has contributed to record trade deficits and inflation. The ties between energy supplies and the economy would be all too evident if the United States were to encounter another major supply interruption of the magnitude of the 1973-1974 embargo, which could lead to a large and precipitous drop in output and national income. Even the Iranian crisis has stretched taut the world's productive capacity, led to sharp increases in spot prices and provided a basis for higher than anticipated OPEC price increases.

The immediate concerns raised by the difficulties in Iran and recent OPEC price increases are only a small part of the energy problems that lie ahead. We would be lucky indeed to avoid other short-term threats to the security of our oil supply in the years ahead. Even if we are fortunate, the fundamental reality that oil supplies are eventually limited must be faced. By the mid to late 1980's, the Nation will face a condition in which ex-ante demand overtakes supply. Prices will then be driven up and/or markets balanced by a sudden reduction in income, output, and employment. We must plan now for the transition from oil to other fuels in anticipation of that day. Our action, and those of others, can alter this timing. Slower economic growth, a prescription offered by some, tends to delay the inevitable. Events such as those in Iran tend to bring it closer.

Let me address for a moment your particular concerns regarding U.S. oil supplies and requirements in light of the crisis in Iran. The recent events in Iran dramatically underscore our continuing vulnerability resulting from a growing dependence on increasingly expensive and insecure oil supplies. Overnight we have seen a 5 percent excess of productive capacity turn into a shortage.

The removal of Iranian production from world markets, coupled with increased production from other OPEC nations, is resulting in a worldwide drawdown of inventories of about 2 million barrels per day in excess of the normal drawdown at this time of year. This translates into an increase in stock drawdowns of approxi-

mately 500 thousands barrels per day in the United States. Current stock levels both worldwide and in the United States make such drawdowns manageable for the near-term. Increases in production from other OPEC nations have also helped. But until a major portion of Iranian production is restored—and it is unlikely to be restored to the full level of 6 million barrels per day—the consuming nations of the world are borrowing against the future.

Petroleum stocks are normally high approaching the winter to meet increased winter demand. Higher than normal drawdowns this winter will result in the need for a faster than normal stock buildup in the spring in order to be prepared to meet next summer's gasoline demand. If Iranian curtailments continue much beyond this spring, summer supplies will be particularly tight, and there will be little chance for rebuilding stocks during the fall in time to meet next winter's peak demand. Should stocks be insufficient to meet demand during next winter's heating season, prices could increase substantially.

The Administration has, therefore, asked every American to observe the 55 mile-per-hour speed limit, eliminate discretionary driving, turn thermostats down to 65 degrees, and take a number of other steps. Observance of these conservation measures could result in oil savings equal to the entire 500 thousand barrel per day shortfall caused by the shutoff of Iranian exports. This would take the pressure off current stock drawdowns, whatever the duration of the Iranian shutdown, and put the United States in a far better position to meet normal increases in demand this summer and next winter. Last week I wrote to Governors, Mayors, associations and companies urging support for additional voluntary conservation actions now in order to avoid mandatory measures later.

The Administration is also stepping up its efforts to maximize the use of the current natural gas surplus by urging that existing dual-fired facilities be switched from oil to gas. With a gas surplus of approximately 1 trillion cubic feet, the potential exists for displacing another 500 thousand barrels per day of imported oil.

If the Iranian curtailments continue beyond the spring of this year, and the response of the American public to voluntary conservation and fuel-switching is not satisfactory, other Governmental actions to reduce oil demand will have to be implemented. The list of potential actions, currently under review includes displacement of oil used in electric utilities by power from nuclear or coal-fired power plants, further switching from oil to natural gas and coal, possible temporary suspension of selected environmental requirements and deferral of Strategic Petroleum Reserve shipments.

Combined with stringent implementation of the oil to gas fuel switching program, these measures could save up to three-quarters of a million barrels per day. Unless a new supply interruption in addition to the Iranian crisis should occur, some combination of these measures, together with the voluntary program, should be sufficient to compensate for supply shortages and inventory drawdowns that would occur from a continuation of the Iranian curtailment for the rest of this year.

As a precaution, the Department will also submit gasoline rationing and mandatory conservation plans to the Congress. It should be emphasized that these measures are designed to deal with more substantial supply interruptions than those expected to arise from the Iranian situation.

The current tightening of the oil market due to the Iranian situation demonstrates the type of future events the United States must prepare for today. As the Members of this Committee are keenly aware, the OPEC nations recently announced a 14.5 percent increase in the price of crude oil. This increase will also be reflected in the price of the 2.5 million barrels per day of uncontrolled domestic production. Taking account of domestic inflation as well, gasoline prices will rise almost 4.0 cents per gallon in 1979 as a result of these foreign and domestic crude oil price increases. As a result of the Iranian curtailments, spot market prices are already running substantially above the announced OPEC price increase. Continuation of this situation could lead to even higher price increases over the course of the year.

In light of the significant economic effects of both price increases and supply shortfalls, the United States must take steps to reduce its consumption of oil. Many avenues are available to accomplish this goal.

One avenue is increased production and use of natural gas. The steady real increase in the price of new gas provided by the Natural Gas Policy Act, the protection against inflation, the more stable and predictable regulatory and financial environment, the deregulation of high cost gas (notably that below 15 thousand feet) and "the light at the end of the tunnel" for producers should—after a transition period—ensure a high rate of drilling activity in the lower-48 States.

We, consequently, expect that by 1985 annual lower-48 production will be at least 2 trillion cubic feet above that which would have pertained if the Natural Gas Policy Act had not been enacted. Thus, it is essential that producers have ready markets for this lower-48 production that will be the base of our future natural gas supply. For this reason, it is essential that the current surplus of up to a trillion cubic feet, made available to the interstate market upon enactment of the Natural Gas Policy Act, be absorbed to increase incentives for natural gas production as well as to decrease oil imports.

As a matter of national policy, when an industry or utility has a choice between burning oil or gas in existing facilities, that choice should be gas. Proposed regulations recently published under the Fuel Use Act and the Standby Petroleum Allocation Regulations incorporate this critical priority. This priority does not affect the Administration's commitment as outlined in the Fuel Use Act to the longer-range use of coal and renewable resources, as opposed to oil or gas, in new facilities or existing facilities which are coal capable.

If gas production from the lower-48 States can maintain or increase current gas use, then reasonably priced supplemental sources of gas should be used to further displace oil imports. These supplements should come on line according to a reasonable hierarchy based on their relative marginal attractiveness.

One highly appealing source of supplemental gas supplies is the Alaska Gas Pipeline. The pipeline represents an important investment in the Nation's energy future not only because it provides long-term supplies at reasonable prices, but also because it provides access to anticipated natural gas finds beyond Prudhoe Bay.

Other high priority sources of supplemental gas supplies are Canada and Mexico. We welcome such additional supplies—to the extent that they are reasonably reliable and are priced sufficiently attractively to maintain a market in the United States. We already receive a trillion cubic feet of imports from Canada, and with completion of the Alaska gas pipeline, this may increase substantially. Additionally, growing oil production in Mexico is making available substantial quantities of natural gas. A unique opportunity exists, given the mutual interests of our two countries, to negotiate gas sales that appropriately reflect the marginal value of the gas in both nations.

Domestically produced synthetic gas would be next in the hierarchy, although some uncertainties remain with regard to technical problems and costs. It is important to demonstrate the economic feasibility of high-Btu coal gasification, which could substantially increase the quantity of gas available to the U.S.

Finally, at the bottom of the hierarchy falls long haul, high cost, possibly insecure sources of LNG. We should not shut the door completely to LNG, but we should turn to it only if other, more attractive, lower cost sources of supply do not materialize.

Domestic oil production can also be enhanced. In this effort, it is essential that the logistical and institutional barriers to increased oil production be minimized. The greatest single opportunity for potential short-term increases in oil production involves the North Slope of Alaska. Increasing production above the current level of 1.2 million barrels per day, however, is difficult in view of the crude oil surplus on the West Coast. Refiners on the West Coast are unable to absorb some 400 to 500 thousand barrels per day in Alaska production, requiring expensive shipment of this oil to the Gulf of Mexico and the East Coast. If new markets could be opened for increased Alaska production, the United States could make better use of this valuable domestic resource, displace substantial additional quantities of foreign oil, and save billions of dollars in balance of payments outflows. The Administration is carefully reviewing the possibilities for action in this area.

The Department is also pursuing other methods for increasing oil production through proposed rulemakings on marginal wells and newly discovered oil. These regulatory changes could help increase discoveries and production from new reservoirs and maximize production from existing reservoirs.

A major issue that was not resolved during the last Congress is the development of a pricing formula for crude oil. The Administration remains committed, as a matter of energy policy, to moving toward replacement cost pricing for crude oil with equity for the Nation's consumers. Our current inflation problems, along with the OPEC price increase and the uncertainties resulting from the Iranian curtailments have required that we carefully review and weigh the schedule for meeting this goal. We look forward to further consultation and discussion with you and other Members of the Congress on this issue.

To meet the challenge of dwindling oil supplies, it is essential that the Nation make maximum use of its most abundant resource—coal. Increased coal use over the next decade will require prompt resolution of the uncertainties over environ-

mental standards. Technologies are available which allow the clean burning of coal. Scrubbers are immediately available and atmospheric fluidized bed combustors are the object of a major DOE commercialization effort. But even with effective technologies, the United States must assure a stable, dependable regulatory climate to provide the certainty needed to expand coal production and use.

To this point, concern over the newly enacted Fuel Use Act has also contributed to the uncertainties surrounding coal use. Recently proposed regulations now make clear the Department of Energy's intent to see coal used in major new industrial and utility facilities wherever possible. Where the choice for new facilities is oil, gas, or coal, coal will be the preferred fuel. Recent orders issued under existing authorities also make it clear that where gas, oil and coal can be burned in existing facilities, the Department of Energy (DOE) will press for the use of coal notwithstanding the preference for gas over oil.

I would like to take this opportunity to make a few remarks about conservation, a key energy policy area that is directly tied to the development of the Nation's economy. Conservation is a crucially important means for reducing the adverse effects of higher oil prices on the economy. Whether we face a potentially serious short-term problem like Iran, or the inevitable long-term transition to a less petroleum-dependent energy base, conservation remains the cornerstone of the National Energy Plan. Historically, growth in the national economy has closely tracked growth in energy demand. Until recently, this had led many people to believe that economic growth could not occur without a similar percentage rise in energy consumption. Conservation provides the key to breaking this historical relationship between economic growth and energy demand.

One of the most striking developments in recent years is the effect of conservation on the energy-economic growth equation. The National Energy Plan was premised on reducing the relationship of energy demand to GNP from an historic one-to-one ratio to an energy demand requirement of less than 70 percent of GNP growth. From 1975 to the present, the relationship between growth in energy demand and GNP has dropped from approximately 1.1 to .7, and we may all hope that this relationship can be reduced even more in the future. This significant development means that the Nation has put conservation into practice. In doing so, the United States has shown that we no longer must assume that our economic vitality is inevitably tied to lock-step increases in energy use. With that myth behind us, we can more clearly see the central role of conservation in our struggle to minimize oil consumption and shift to the use of more abundant energy resources.

Finally, I would like to comment on the actions the Department is currently undertaking to reduce inflation. All of the major actions to reduce oil imports will have an important positive effect on the Nation's effort to reduce the trade deficit, strengthen the dollar and control inflation. The Department is also intervening before the Interstate Commerce Commission to contest railroad rate increases for coal which DOE feels will inevitably result in higher utility bills and frustrate the Nation's efforts to reduce our dependence on foreign oil.

The Department is also vitally interested in steps to reduce the time needed to site and construct major energy facilities. It now takes from 12 to 14 years to site and construct a nuclear power plant. Each year of delay results in cost increases of up to \$120 million. The Department's nuclear siting legislation is designed to reduce the time required to no more than 6 or 7 years. Also, a group has been established under the Energy Coordinating Committee to help coordinate regulatory actions of various agencies in the construction of major energy facilities.

In conclusion, I would just observe that there are few subjects which affect every special interest and every aspect of a powerful Nation's activities like energy. Based on the experience of the last several years, building a consensus concerning our problems, not to mention agreeing upon solutions, is not an easy task. Enactment of the National Energy Act was an important beginning in building a national consensus that recognizes the limits of world oil supplies. The many issues raised by the national effort to meet this challenge are too numerous to mention in an overview statement. I trust many of those issues not yet touched upon will be discussed in the course of the questions that follow.

As these discussions progress today and in the future, I would hope we can build in the spirit of understanding and cooperation that finally helped enact last year's legislation. The tasks that lie ahead are monumental. Our sense of national purpose and urgency must be heightened. Honest disagreements as well as good faith compromises lie ahead. But with that approach, perhaps we can break the paralysis of inaction experienced in recent years.

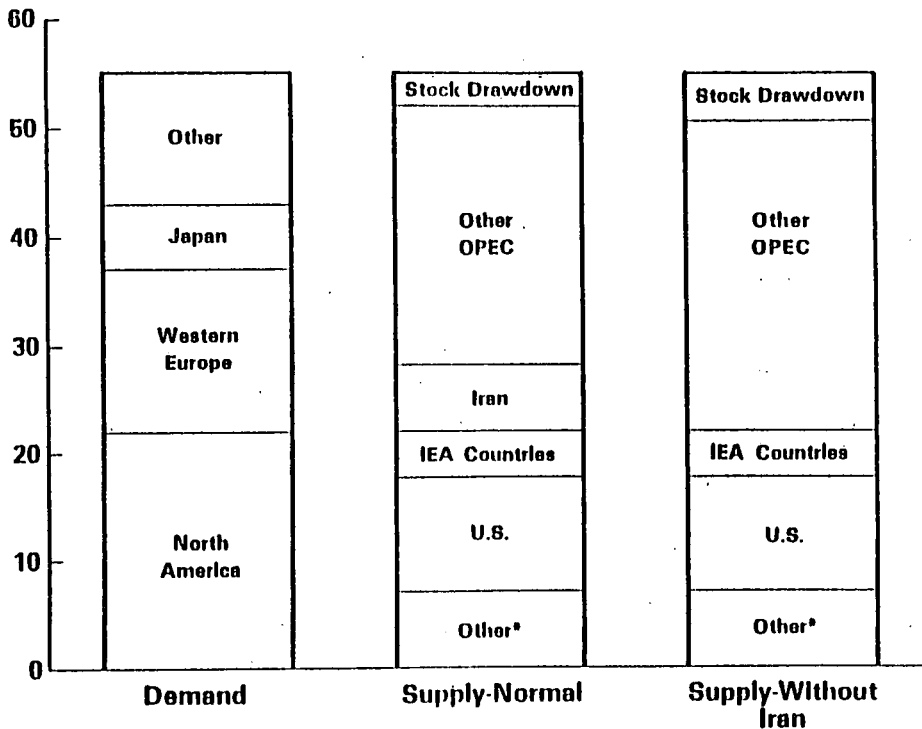
The truth is that there is much to do and not much time left in which to do it.

Thank you for this opportunity to appear before you today Mr. Chairman.

Free World Petroleum Demand/Supply

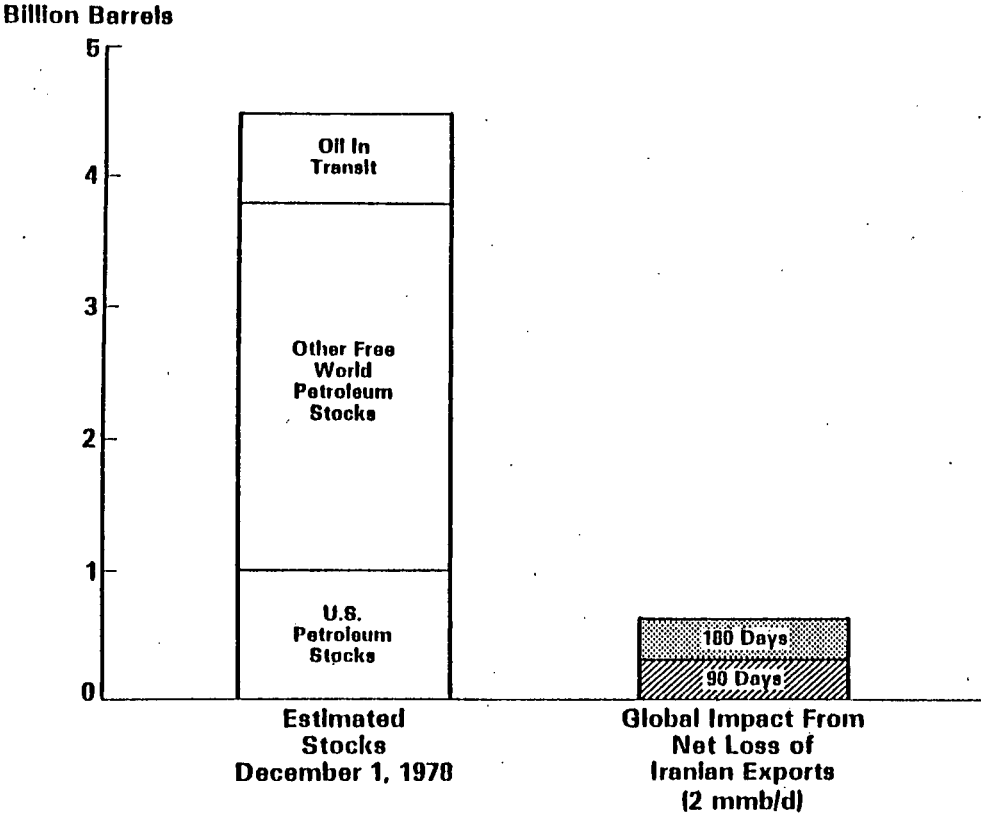
First Quarter, 1979

Million Barrels Per Day



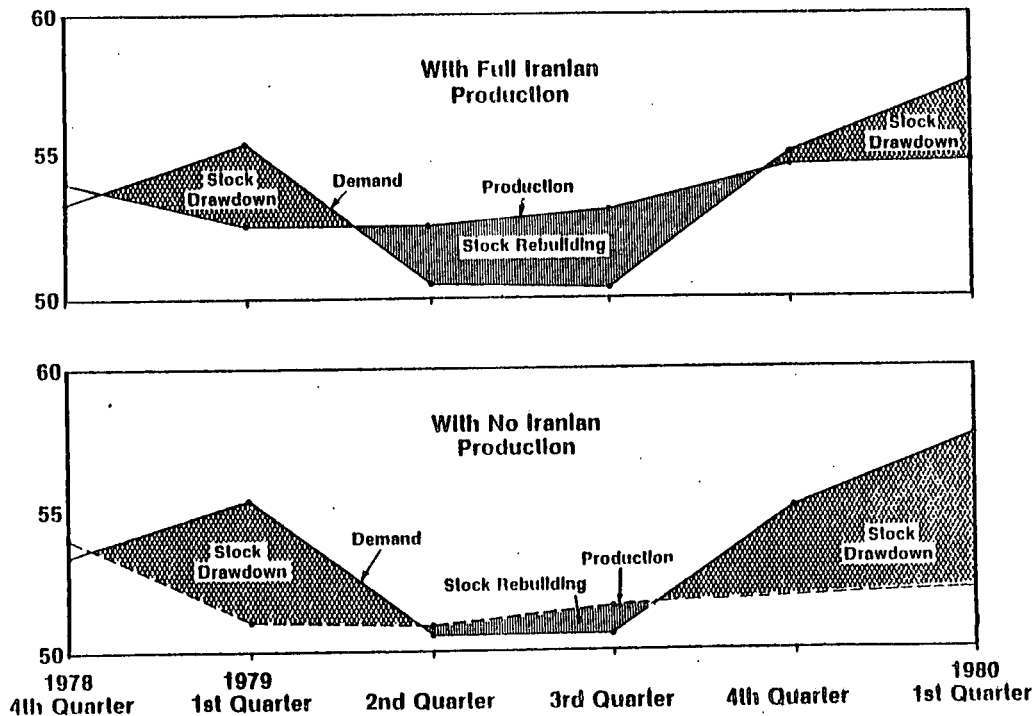
*Includes Soviet Block & China Net Exports

Free World Stock Situation



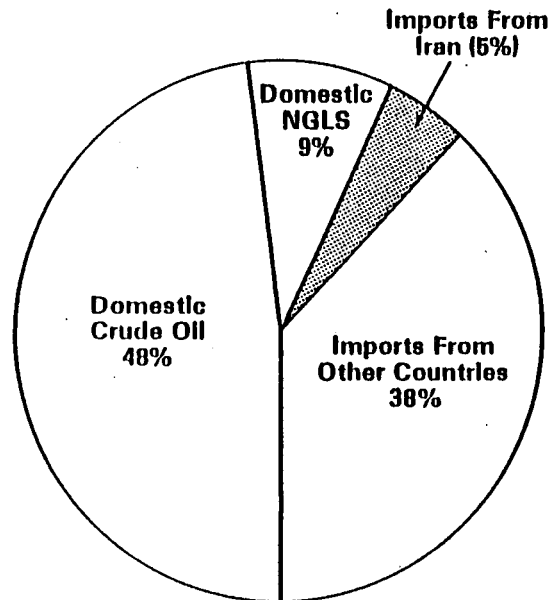
Free World Projected Petroleum Production and Demand

Millions of
Barrels/Daily

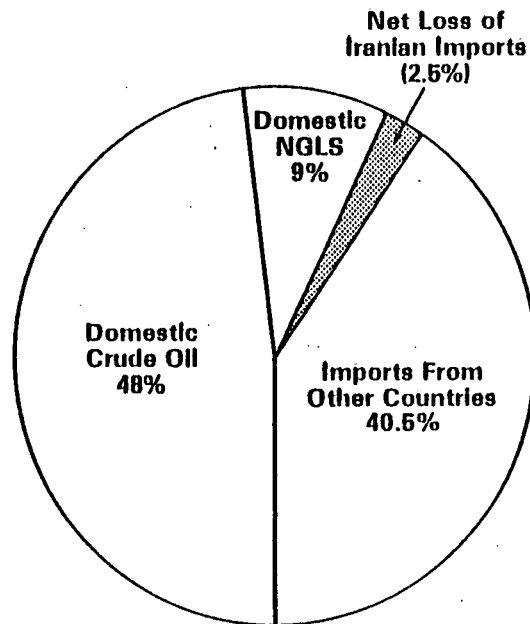


U.S. Petroleum Supply

46-126 0 - 79 - 2



Third Quarter 1978



Projection, Assuming
No Iranian Exports

U.S. Stock Situation

December 1978

Million of Barrels

1200

900

600

300

0

Natural Gas
Liquids

← Jet Fuel

Gasoline

Distillate

Residual Oil

Crude Oil

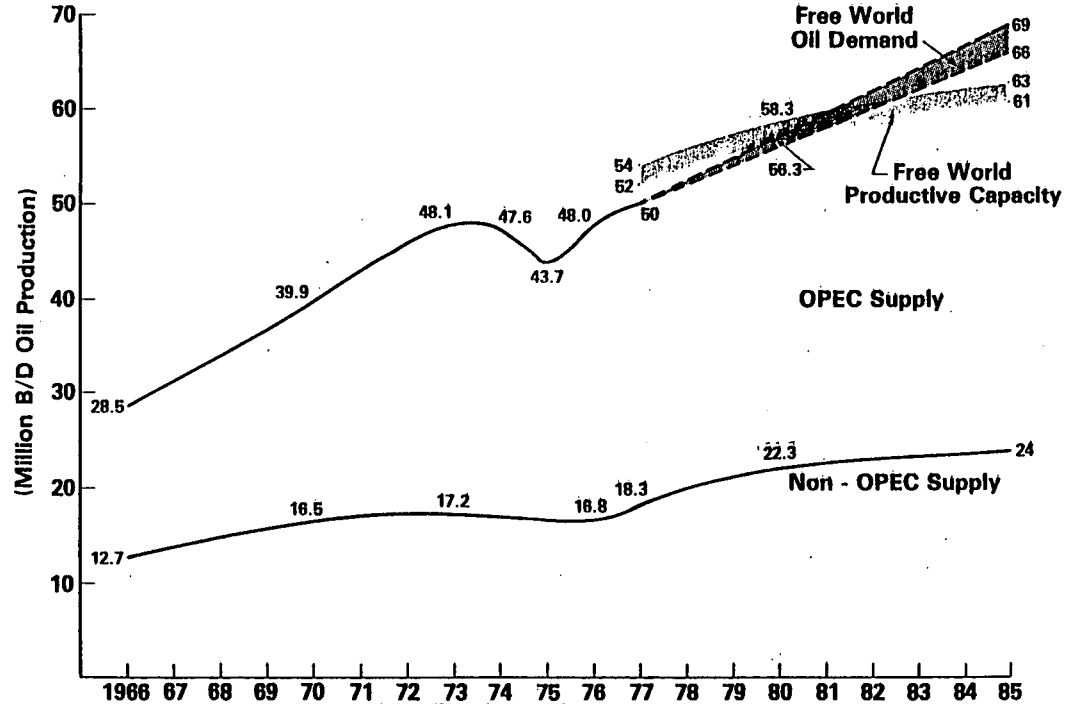
180 Days

90 Days

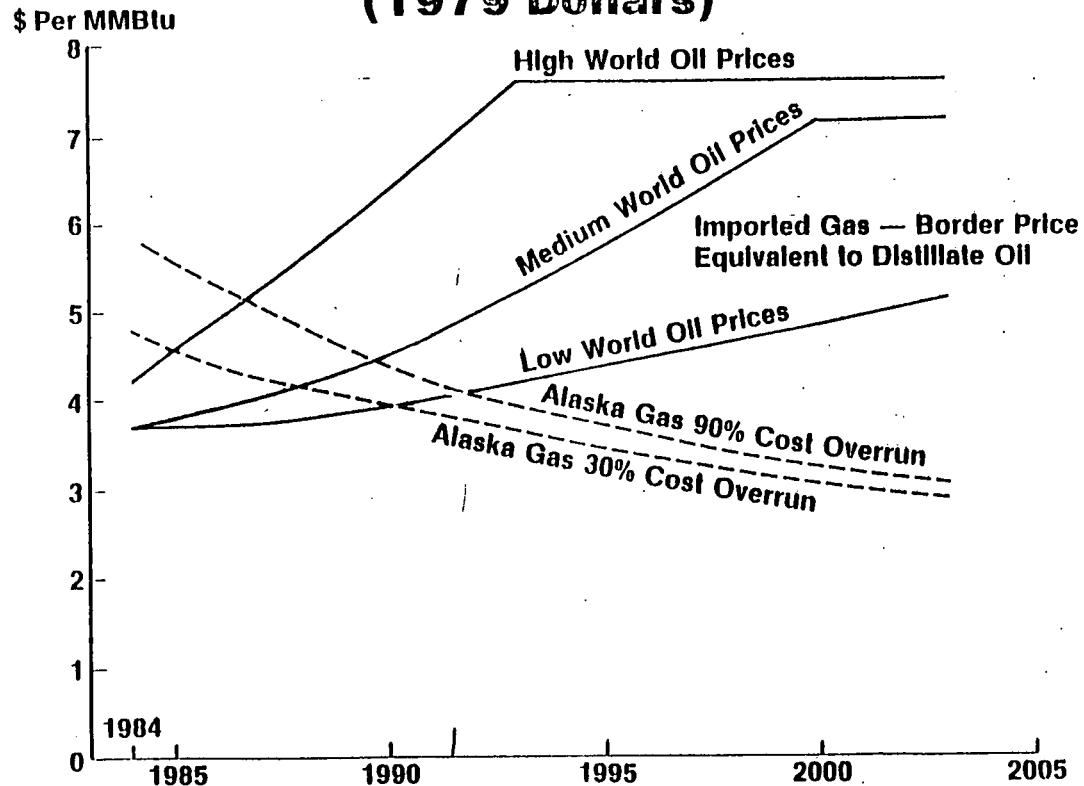
Gross U.S. Petroleum
Stocks

Impact of 500 mb/d
Shortfall of Imports

Free World Oil Demand and Supply 1966 - 1985



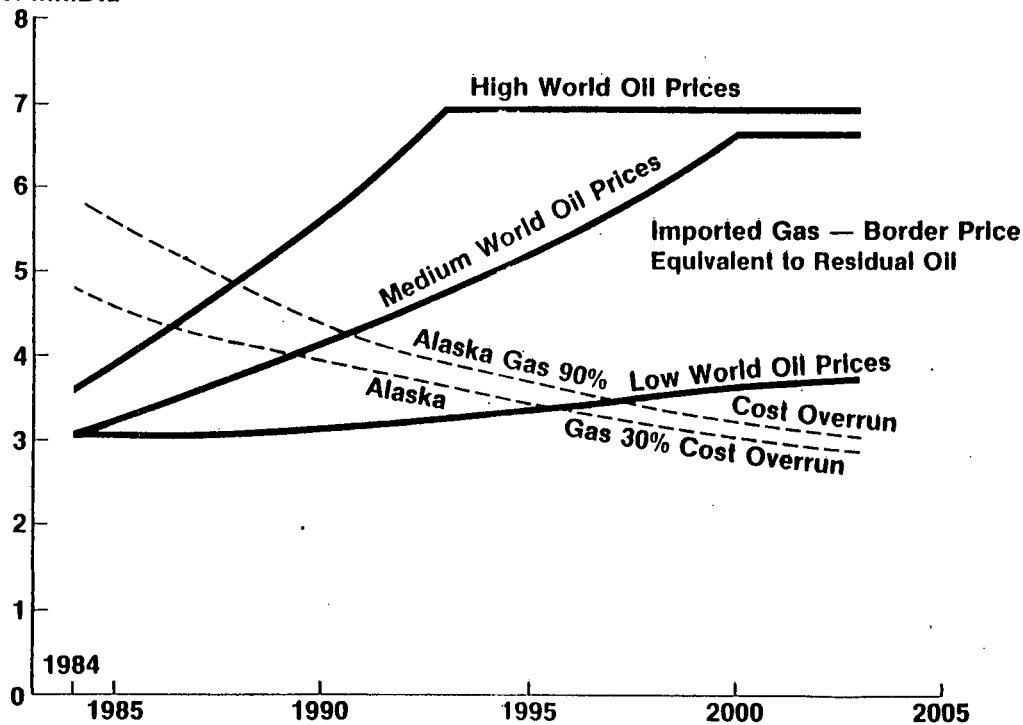
Comparative Natural Gas Prices (1979 Dollars)



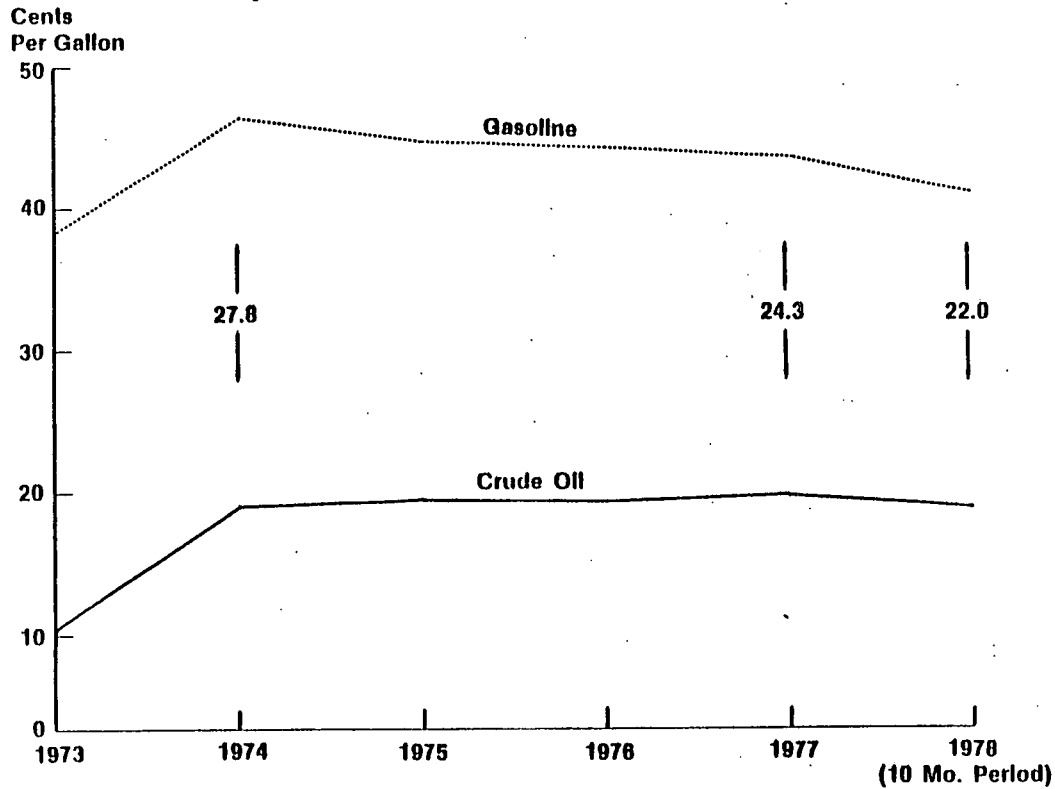
Comparative Natural Gas Prices

(1979 Dollars)

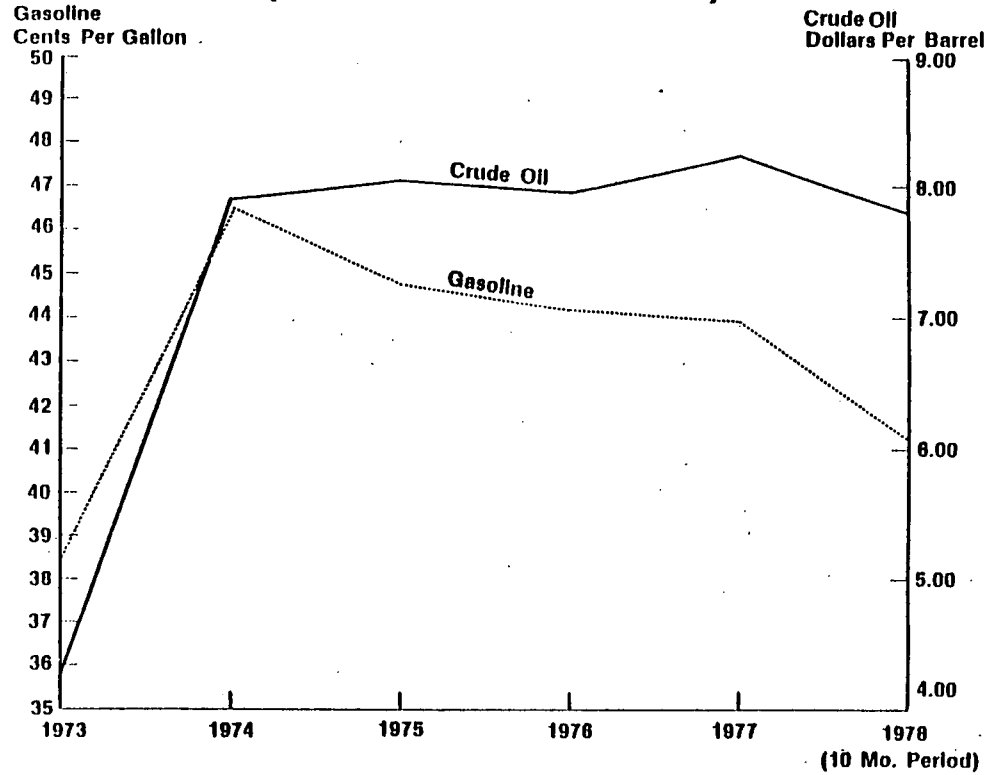
\$ Per MMBtu



Real Gasoline and Crude Oil Prices (Constant 1972 Dollars)



Real Gasoline and Crude Oil Prices (Constant 1972 Dollars)



Senator BENTSEN. Mr. Secretary, Congress has been very concerned about possible disruptions in the supply of oil from abroad. We therefore mandated that standby petroleum reserves and standby gas rationing systems be established.

We are far behind schedule on both systems.

Last year you said that we would have 250 million barrels of oil in our strategic petroleum reserve by the end of 1978. To my understanding, however, we only have approximately 70 million barrels now.

In addition, we have no standby gas rationing system yet in place, nor has one been submitted by the administration.

Tell me what happened?

Secretary SCHLESINGER. Mr. Chairman, let me take the less complex question first with regard to standby gasoline rationing.

As you know, we published a plan in the Federal Register last fall for public comments. I think that given the haste at the close of the session last fall, there was no eagerness to receive that on the Hill.

We will deliver that plan, as modified by public comments, to the Congress early in February, and the Congress will examine that plan for some 60 days.

With regard to the strategic petroleum reserve, when the administration examined that issue early in 1977, we desired to move that reserve ahead as quickly as possible.

We inquired of the FEA what level of reserve they had a 50-50 chance of making and we funded at that level. The response was, I think, about 220 million barrels.

We have just passed, as you indicated, the 70-million-barrel level. We are about 1 year behind in terms of reaching the target of 250 million barrels.

Quite recently we have been making our schedules; we have been moving 400,000 barrels a day approximately into the reserve, or approximately 10 million barrels a month.

However, we have been thrown somewhat off our stride of late, first, by force majeure resulting from the Iranian shutdown.

Second, there is a consideration whether we should divert some of our acquisitions to those refiners in the United States heavily dependent on foreign crude in order to avert a shutdown.

By this summer, aside from that issue, we will have 150 million barrels in reserve.

By next spring we will have the 250 million barrels, as I recall it.

Now, I should point out, as I did, Mr. Chairman, the question of our ambivalence on the west coast, about which we refused to have swap arrangements, yet we have procedures too complex to permit pipelines to go to the interior of the country.

We have had difficulties with regard to permitting for the strategic petroleum reserve. Despite the fact that we have had excellent cooperation from the permitting authorities, be it the Corps of Engineers or EPA or the Mine Safety Administration, each of these permits has taken time. Even at the Federal level, it took us 18 months, I believe, to get a permit to move brine from Brine Mound, Tex., into the Gulf of Mexico.

In Weets Island, we are engaged in negotiations with the Mine Safety Administration and as a result the Weets Island facility has slipped considerably.

It will come in about a year late.

We have had some difficulty with the authorities in the State of Louisiana with regard to the permitting process.

So, if we want to move these national projects rapidly, and we ought to be able to do that on the first 250 million barrels, we need to have a more dedicated effort with regard to permitting as well as to other issues.

The last 750 million barrels, Mr. Chairman, will require leeching operations in those salt domes and that is a complex technical operation.

We should have the 250 million barrels approximately a year after our desired date.

Senator BENTSEN. Is it true that we don't have equipment installed yet to pump that oil out of our reserves at the present time if we needed it?

Secretary SCHLESINGER. That is true. The removal system was scheduled to come in in late summer of 1979. We had a desire to move that oil into storage because we felt quite rightly that we could acquire it early at lower prices than later on.

The removal system is scheduled to come in in the summer of 1979. It should be available for next winter should we continue to have problems on inventory resulting from the Iranian situation.

We can develop a quick removal system of 200,000 to 300,000 barrels a day at an additional cost of about \$5 to \$10 million.

We do not believe that that is a necessary expenditure, however.

Senator BENTSEN. Mr. Secretary, mainland China is very much up front now, a hot topic included on the itineraries of Cabinet-level officials such as yourself.

Is China now energy self-sufficient? Can we look to exports of oil from China in the near future?

Secretary SCHLESINGER. Mr. Chairman, China is indeed energy self-sufficient. There are small exports of oil from China to Japan at the present moment.

I do not believe that the exportable surplus of China will increase in the near future.

In the more distant future, say 1985, it may increase depending on luck in the exploration and development process, and the speed with which foreign oil companies are able to negotiate with the Chinese Government.

The question is, in large part, uncertain because we do not know precisely where those resources lie.

Senator BENTSEN. Mr. Secretary, I am deeply concerned about our situation with Mexican gas.

You mentioned the Alaska Pipeline and I agree with you that the highest priority should be given to domestic production.

But we must not ignore Mexican gas. We should negotiate with them aggressively for their natural gas. As you well know, we have a surplus of gas today and, therefore, now is the time to talk, Mr. Secretary, I strongly feel that the time to negotiate with Mexico is when we have a surplus of gas; we will be in a much more difficult negotiating position when we are short of gas in this country. You can make a better deal at a time like this.

I also feel, having been born and reared on that border and having some understanding of the Mexican people, that they will retain full control over what they do with their natural resources. We must stand

in line with the rest of the nations of the world in a competitive position and offer them a competitive price for those resources. If we do not, you are going to find the Mexican Government committing that gas elsewhere, perhaps doing some of the wasteful things in Mexico that we did in years past in Texas when gas was plentiful and cheap. We can make good use of their excess gas. And they are not going to produce all the oil we would like to see them producing unless they have a sale for that excess but associated gas.

Can you tell me the status of the negotiations?

Secretary SCHLESINGER. Yes, sir. The negotiations were suspended pending the completion of the congressional debate on natural gas, and since the conclusion of that congressional debate there has been an effort on the part of both countries, I believe, to renew those negotiations.

The President will, of course, be visiting Mexico next month and this is a subject that will come up.

With regard to the Alaska natural gas, I think that we have a chart attached to my prepared statement that will demonstrate, and you have raised questions about this, that it is desirable to use domestic resources.

There is not a conflict, I should emphasize, between domestic resources and pipeline gas from—

Senator BENTSEN. I agree. I don't think it is an "either/or situation." I think we ought to proceed on all fronts to diversifying our energy supply and try to assure a long-term supply of energy for our country.

Secretary SCHLESINGER. Yes, and I think that that investment in the Alaska pipeline is a necessary ingredient that should not affect what we do on the Mexican border.

I think there has been some misunderstanding of that question.

The question of Mexican gas, I think, is driven by two considerations which we have discussed at some length with Mexican officials, and, of course, with Members of Congress and elsewhere.

First, as you know, we are importing approximately a trillion cubic feet of gas from Canada. The price on the Canadian border has followed closely the negotiations between the United States and the Canadian Government.

That price is the highest price for pipeline gas in the world. It is presently \$2.16. The price the Mexicans would have expressed a preference for is the price of distillate, which now comes through at approximately \$3 per million cubic feet.

The Canadians have indicated to us quietly but firmly that if the price on the southern border would go to \$3, that even though they recognize that it is not in their economic interest, because it would result in the shrinkage of sales, that they would be forced to follow suit.

The consequence of raising that price to obtain that price in Mexico would be to increase the price that we pay along the Canadian border by approximately \$800 million a year if we were to go all the way.

It would include a—

Senator BENTSEN. But don't you think those prices are going to go up on the Canadian border when that contract expires?

Secretary SCHLESINGER. As you know, Mr. Chairman, the Cana-

dians have indicated that they would follow the Btu equivalent of crude oil in their pricing.

They have not done so completely because they have discovered that their share of the American market has tended to shrink at that price, given the surpluses in the States, because they cannot effectively compete at that price.

The second point, Mr. Chairman, follows from that and that is five-sixths of the potential Mexican market in the United States is represented by backing out residual fuel oil.

The debate over the natural gas bill indicated that industry would not pay a higher price to back out residual fuel oil if that price were at the distillate level.

That came up in the incremental pricing section.

If, indeed, we are unable to obtain a competitive price for Mexican gas, they will not be able to make as large a market in the United States as would otherwise be the case.

At a residual fuel oil price, the market is essentially limitless. At a distillate fuel oil price, the market is exceedingly limited.

In my judgment—and I believe also the judgment of all who have looked at the energy conditions and the economics—it is no favor to the Mexicans to press for a price of distillate when the effect of that would be to constrain dramatically the market available to them in the United States.

In the long run, we should be eager to have Mexican gas when it is competitively priced and when it is available as a reliable source of supply.

Senator BENTSEN. I have one or two more questions.

But first I want to recognize the Senators as they have arrived to question you. We will do that because I think we ought to reward patience.

Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Secretary Schlesinger, we are delighted to have you. I very much appreciate your most thoughtful statement, and your responses to the chairman's questions indicated how very much on top of this whole situation you are.

Now, we have talked about the oil supply situation, first the short-run problem with Iran, and you say that oil inventories are now at a high level, and we are drawing down 2 million barrels a day.

Can you give us a little more on the arithmetic of that? You told us 2 million barrels a day, but you didn't tell us how big the inventories are and what level would be a danger point.

Secretary SCHLESINGER. Yes, Senator Proxmire.

About 2 weeks ago—I should be more precise—there were 3.8 billion barrels of oil in the inventory.

There were some 700 million barrels of oil in transit. It takes 30 or 40 days to transit—

Senator BENTSEN. Mr. Secretary, will you speak into the mike. We all want to hear what you have to say.

Secretary SCHLESINGER. It takes 30 or 40 days to transit from the Persian Gulf so oil has continued to flow in even though the shutoff occurred in December.

We still have about 3.8 billion barrels in storage in inventory, but the amount of oil in transit has diminished.

We are drawing down about 2 million barrels of oil per day. If one takes the impact of a 90-day cutoff, one can see in relation to the inventories that that is relatively limited. Even a 180-day cutoff, should full production be restored, is relatively limited in its impact in relation to the available inventories.

We are drawing down on stocks. We cannot do that endlessly.

To the extent that we do so, it reflects, I think, the anticipation of a restoration of production in Iran.

Senator PROXMIRE. Now, you said that on the assumption that the Iranian situation does not improve, and on the further assumption that we don't get the kind of response that we hope to get with voluntary programs you described, that we perhaps would not have to go to gas rationing—you say that is unlikely—but you say we might go to allocations.

What does that mean?

Isn't that kind of a private rationing?

Isn't that the nightmare experience we went through in 1973 when we stood in line at the gas stations all over the country and there was sort of a situation where we didn't have official rationing; we had something that was maybe even worse?

Secretary SCHLESINGER. Of course, that depends on one's judgment as to the efficacy of rationing, Senator Proxmire.

Generally speaking, we have been reluctant to institute rationing because we fear that unless there is a high patriotic fervor, the rationing systems tend to break down very quickly.

Allocation systems are more effective.

The base period that we would draw on is much higher than was the base period in 1973 and as a consequence, I do not believe that you would have a repetition of what you described.

Senator PROXMIRE. Well, would you have gasoline stations closing, for example, on Sundays?

Secretary SCHLESINGER. That is a possibility, Senator. Yes, indeed.

Senator PROXMIRE. Now, you made what I thought was a tremendously impressive presentation with that chart you had on Alaska, and gave an indication that by moving ahead with that pipeline we will be assuring ourselves in the long term, in the long run, by 6 or 8 years from now, of a much lower price than if we failed to move ahead promptly with it.

Would you describe what you mean by putting this pipeline in place?

Where is the policy decision now?

Is it a congressional decision or is it an administrative decision?

Secretary SCHLESINGER. It is both, Senator Proxmire.

In the first place, due to the congestion last fall, we were unable to send to the Hill, or the Hill was unwilling to receive—to be more precise—the reorganization plans that would place the responsibility of all of these agencies of the Federal Government in one Federal inspector by which means we would avoid some of the catastrophes that we experienced on the Alaska oil pipeline.

That reorganization plan will be presented to Senator Ribicoff and to the House shortly.

That is the congressional side of the action that will have to be taken, though it need not be taken immediately.

The immediate pressure point is certain regulatory decisions by the FERC regarding the gas price, regarding the adjustment of processing costs, and two or three similar items.

The FERC should complete this within 60 days and at that point we will test the market to see whether this pipeline is privately financeable.

Senator PROXMIRE. What action, if any, can we take up here in the Congress to encourage proceeding rapidly with that? It seems to me, in my part of the country—Wisconsin—and also in Senator Kennedy's and Senator Javits' part of the country, this is particularly significant to us. Is it not or am I misunderstanding?

Secretary SCHLESINGER. I think that it is particularly significant to you but also, of course, is significant to the entire Nation in terms of our secure energy supply.

I think that the expression of interest on the part of Members of the Senate and House to the FERC that these matters be resolved expeditiously, the indication to the financial market and to the producers that indeed the expectation is that they will get on with this pipeline, would be beneficial.

Senator PROXMIRE. Now, supposing we get a negative reaction from the market.

Is there any action that the Federal Government can consider any option that we have, any sort of guarantee or any sort of appropriation, even, that might make it feasible?

Secretary SCHLESINGER. I think that there are two aspects to that, Senator.

Of course, the Congress, in approving the President's recommendation, insisted, wrote in, that it should be privately financeable.

That is a decision that is, of course, reversible by the Congress. But the expectation has been for private financing.

I don't think it is necessary to provide an appropriation but certainly the Congress will not wish to reject out of hand the possibility of loan guarantees for the pipeline.

That would make it more readily financeable on a private basis.

It would permit certain adjustments of the ratesetting mechanism that would equalize the rates over a 20-year period or possibly a longer period and thus permit the early year cost of that pipeline gas to be lower than it would otherwise be.

Senator PROXMIRE. How large would that kind of guarantee have to be, roughly; what is the ballpark figure?

Secretary SCHLESINGER. I think that if it is guaranteed for the first period of pipeline operations, that that is the difficult period.

It should be a percentage guarantee of the cost of the pipeline.

Senator PROXMIRE. I am thinking of the potential liability to the Federal Government. How big would it be?

Would it be a \$2 billion, \$3 billion, \$4 billion guarantee? Would it be in that area? Bigger than that? Smaller?

Secretary SCHLESINGER. I think that one must look at the pipeline as several pipelines.

There would be no need, for example, for an American guarantee of a Canadian portion of that pipeline. The southern portion of the pipeline below the Canadian border that goes into Dwight, Ill., would not need to be guaranteed because that is easily financeable.

So, one is dealing only with the component from the North Slope down to the Alaska-Canadian border.

That is the sum you mentioned of \$2 or \$3 billion, which indeed might be in the right ballpark.

Senator PROXMIRE. Thank you.

Thank you very much, Mr. Chairman.

Chairman BENTSEN. Senator Kennedy, I think you were the second to arrive.

Senator KENNEDY. Thank you, Mr. Chairman.

I, too, want to join in welcoming the Secretary to the committee with his fine presentation.

Mr. Secretary, even though we are a region of the country that is a relatively low user of natural gas—we only heat about 12 percent of our homes in Massachusetts with gas, but it varies in different parts of New England—nonetheless, it is an extremely important source of home heating energy.

The people in my part of the country are quite puzzled about the administration's energy policy.

When they watched the debate in the Congress last year about scarce natural gas resources, then saw in recent years the continued escalation of energy costs, and then before the ink was dry on the National Energy Act, they read in the Washington Post and the national magazines of the natural gas sources in Texas and in other producing States causing a problem of overdeliverability and product bubble. And now they read reports of your New York speech, where you place a very high premium on the protection of the domestic industry at the expense of the consumer.

In your New York speech you say, for example, that Canada now provides almost 1 trillion cubic feet per year; that we would welcome additional supplies to the extent that they are reasonably reliable; and that the price is attractive to maintain a market in the United States and do not force the shutting in of domestic production. You say this last point is a vital but frequently ignored aspect of the problem:

We should be reluctant to contract for supplies even from our neighbors on a take-or-pay basis if that should be at the expense of the American producers, resulting in the shutting in of domestic capacity, diminishing domestic incentives for drilling.

Now, the consumers in my part of the country want to know what the administration's policy is.

Is high price a part of the problem, or is high price a part of the solution? It seems to me in your statements that high price is part of the solution and not the problem. I would just be interested in your response to that.

Secretary SCHLESINGER. Yes, Senator Kennedy.

I think that the answers to the questions that you have raised are all straightforward.

In the first place, we know, we have known for a long time, indeed, we emphasized that because of the dual market structure that we were trapping gas in surplus in the intrastate market that could flow once we created a single national market.

Senator KENNEDY. I know that is your position, but there are those that felt that with the various competitive pressures on the intrastate market and the other kind of debt financing for gas pipelines, that would have come onstream.

Secretary SCHLESINGER. I think that there is clear evidence that that gas, Senator, is beginning to flow as indicated in the article in

the New York Times this morning. Now, with regard to the more fundamental question that you raise about protection of American producers—

Senator KENNEDY. At what price, that is right.

Secretary SCHLESINGER. In the first place, we are not protecting American producers. We are preventing American producers from discrimination.

American producers are producing at lower prices than prospective foreign imports. The reason for our concern over a take-or-pay contract is that we would contract with foreign sources at higher prices and shut in lower priced American products.

Senator KENNEDY. But, Mr. Secretary—

Secretary SCHLESINGER. There is no protection of American industry. We are—

Senator KENNEDY. Mr. Secretary, everyone knows there is a rolling in process. You have just commented that with the pressures on Canadian gas that they are not—at least at this time—going for Btu equivalent because of the market pressures.

You are not giving market pressures an opportunity even for our neighboring countries. You are basing the price of natural gas on your chart here in order to bring in a natural gas pipeline that is going to cost approximately \$16 billion of American capital, as compared to the transportation of gas some 14 miles into the gas system in the southwest part of the country.

You show, by your own charts, that these lines are going to cross some time in 1992–93.

I say that natural gas policy, with the surplus that we have now, is based upon what the natural gas projection price is going to be in Alaska in 1992 or 1993. What that policy is, I think, is an unwarranted and unjustified burden on the American consumer. It is in my part of the country. I daresay that the pricing policy of the administration, based on what you anticipate is going to be the cost of gas coming in, will result in what the Congressional Research Service estimates at \$6.16 per mcf.

But, nonetheless, those who are developing natural gas policies do so in order, I believe, to justify the capital market for the Alaska pipeline.

Secretary SCHLESINGER. That happens to be erroneous, Senator.

Senator KENNEDY. Well, you straighten me out.

Secretary SCHLESINGER. In the first place, the issue of the Alaska natural gas pipeline is detachable from the general issue of American supply. That happens to be an important investment for the United States in the long run which, over the long run, will provide us, on average, with lower gas prices over the life of the pipeline even though the initial cost, you point out, would be higher.

That is a detachable issue.

The other part that you refer to implies, I think, that we should accept the price on the Mexican border of distillate. This surprises me, Senator, because in the past you have not been enthusiastic about pricing gas at distillate prices.

Senator KENNEDY. I wasn't enthusiastic about a lot of your policies on the regulations, either.

Secretary SCHLESINGER. That is correct, Senator.

So, this is a reversal of your prior position in that you are urging a price on the Mexican border 35-percent higher than is the price on

the Canadian border; almost 50-percent higher than the new gas price that you have objected to in the natural gas pricing bill; more than double the average price of gas in the United States; 4 times the price of gas flowing in interstate commerce; 10 to 12 times the price of gas that is charged in Mexico; and infinitely greater than the price of the 400 to 500 million cubic feet of gas that is being flared each day down in Mexico.

Senator KENNEDY. I am delighted to hear you state my position and then differ with it. That is not an accurate portrayal of my position. I basically reject it. I think that now we are setting the course of this country on gas policy which basically has spurned the opportunity for negotiations with the Mexicans on price; it has been really quite unimaginative in terms of contracting with the Canadians.

We all understand the distinction of the current price, but we also understand the importance of rolling in the price. You and I know, even though you talk about detachability, that unless the investors are going to be able to be assured of a very high return on Alaskan gas, they are not going to put the investment in. That ought to be plain to anyone in the investment market.

I daresay that the administration's policy is committing ourselves to unwarranted and unjustified cost increases.

Let me ask you on one—

Secretary SCHLESINGER. Let me, if I may—

Senator KENNEDY. Well—I would like to, if I could—we are running out of time.

Secretary SCHLESINGER. Well, I am coming back to that issue, Senator.

Senator KENNEDY. In the area of exclusions from the wage-and-price guidelines, you have excluded company price calculations under the wage-price guidelines. You say that sales by producers of goods and services included in the following categories are excluded. You have mineral products in exception of 138.

It says major group 13 and subgroup 138. The major group is oil and gas extraction; 138 deals with oil and gas field services.

In effect, what we are doing, as I understand it, is putting the limitations of the wage-price guidelines on the various cost activities in the oil and gasfields but we are not doing it on the pricing or the selling of the gas.

We ask every major corporation to show restraint in these areas in the battle on inflation, and I am interested in what activities the Department of Energy are taking with the oil and gas companies to try and bring about the same kinds of restraint that we are asking of General Motors or A.T. & T.

Secretary SCHLESINGER. Of course, the oil industry is quite complex, Senator.

For the extraction of oil and natural gas, the regulations, as issued by the Council on Wage and Price Stability, are as you have indicated.

On natural gas, we are following the legislative practices laid down last year by the Congress.

For oil, we are continuing to follow the escalation of prices at the rate of inflation as indicated under the EPCA, but when we get to the refinery gate, the same kinds of constraints will apply to refinery gate marketing as are applied to other industries.

Senator KENNEDY. My time is up, Mr. Chairman.

Secretary SCHLESINGER. Mr. Chairman, could I respond to the prior comments of Senator Kennedy?

Senator BENTSEN. Yes; if you would keep your answer very short, Mr. Secretary, as Senator Javits is patiently waiting.

Secretary SCHLESINGER. In the first place, Senator Kennedy, I should underscore that we have not spurned Mexican gas. We have repeatedly indicated that we are prepared to take whatever volume is surplus to Mexican needs at a price that is competitive.

In the second place, the asking price of \$3 is, as I have indicated, is 50-percent higher than the new gas price in the United States, 35 percent above the Canadian price.

The consequence of accepting that, if the Canadians do as they have suggested, would be to raise the prices to people in northwestern New England and all across the Canadian border to Washington State, by approximately 80 to 85 cents per million cubic feet and at a cost to the economy of approximately \$800 million.

Indeed, if you stretch that additional cost to the economy over the 1 billion cubic feet per day that the companies now say that they expect to get out of Mexico, then the net cost of that additional gas from Mexico would be approximately \$5.25 per million cubic feet because of the higher prices on the Canadian border.

That is no way to protect the American consumer in general; it certainly is no way to protect the consumer along the Canadian border.

Senator BENTSEN. Thank you very much, Mr. Secretary.

Senator JAVITS.

Senator JAVITS. Thank you, Mr. Chairman.

I join my colleagues in welcoming you, Mr. Secretary.

Secretary SCHLESINGER. Thank you, Senator.

Senator JAVITS. I enjoy your mettlesome answers to the questions.

Perhaps you will do the same for me.

Mr. Secretary, what do you think about the OPEC price increase of 14½ percent? How does it affect the people of the United States and our business?

Secretary SCHLESINGER. Senator Javits, the size of that price increase is unwelcome.

It will add about—just in crude oil costs with the increases in domestic prices—4 cents per gallon to the cost of gasoline.

It will increase the rate of inflation this year by about four-tenths of 1 percent, and next year about two-tenths of 1 percent.

Senator JAVITS. Now, as to this year, how much money in the aggregate is it going to cost the American consumer?

Secretary SCHLESINGER. At the anticipated level of import for this year, it will add \$4 billion to our balance-of-payments requirements.

Senator JAVITS. Now, Mr. Secretary, don't you think it is fair to compare that \$4 billion to the \$800 million you just talked about?

Secretary SCHLESINGER. No, sir.

Senator JAVITS. How do the two relate to each other?

Secretary SCHLESINGER. No, sir, I don't think—

Senator JAVITS. Why not?

Secretary SCHLESINGER. I don't think that is relevant because right now we have a gas surplus in the United States that we are attempting to persuade industry to absorb.

In the second place, if that gas began to flow, it would flow in late 1980 or early 1981. It does not bear on the present circumstance.

Senator JAVITS. Mr. Secretary, hasn't it been your feeling about our energy policy that we were caught flatfooted in 1974 by OPEC because we had not prepared some years ahead, and aren't we therefore making precisely the same mistake today if we follow your philosophy that it is today's price that determines our policy?

Secretary SCHLESINGER. No, sir. We are not suggesting that as an appropriate policy.

We are saying that in the competitive market whatever international oil prices may be, be they high or low, that external sources of gas in the American market should be priced at the British thermal unit equivalent of resid, not of distillate.

If prices go up, so be it.

Senator JAVITS. Mr. Secretary, is it a fact that if Mexico can export gas, it can produce 20 to 25 percent more oil?

Secretary SCHLESINGER. Indeed, if gas is not sold by Mexico and if it is not flared by Mexico, then the failure to find a market would impose a limit on oil production.

But, the production plans of the Mexicans have been drawn up on a somewhat different basis.

Senator JAVITS. Do your studies indicate the validity or invalidity of the Mexican claim that their reserves are twice as big as what they were contemplated to be, say, before this year?

Secretary SCHLESINGER. Through our sources, we have recognized, since the inception of this administration—and I think earlier than that—that the Mexican oil reserves prospectively were as great as those of Saudi Arabia.

Senator JAVITS. Isn't it a fact that we are only importing 400,000 barrels of oil a day from Mexico today?

Secretary SCHLESINGER. That is approximately correct. We are importing about 90 percent of Mexico's exports. We have repeatedly indicated that we are eager to be responsive to any Mexican initiative with regard to financing or technical assistance.

As the chairman indicated earlier, there is sensitivity over the national patrimony in Mexico, and that as a consequence, we did not want to seem to be in a position of pushing the Mexicans but we are prepared to be of whatever assistance we can in raising that level of production.

Senator JAVITS. Mr. Secretary, we have a way of saying among lawyers that it isn't what the facts are, it is what the judge thinks they are that really counts.

Isn't it a fact that we have very materially been poisoning the atmosphere between ourselves and the Mexicans by the adamant position that you have taken on Mexican gas?

Whatever you may say about the technicalities, "We will do it later; we offered them technical help," and so on.

In the meantime, the atmosphere is poisoned and the Mexicans give up on us because of this seeming position which we take that we cannot find some way of banking them. Even though their demands may be what we consider unreasonable, considering the greater issues that are at stake, especially, Mr. Secretary, breaking OPEC, if Mexico's reserves are as big as that of the Saudi Arabians, they are the greatest asset we have.

Second, there are millions of illegal aliens pouring across the border into this country because half of the Mexican people are not even in the money economy.

There is great disturbance and complaint in this country about that. Our relations with Mexico are very critical on that subject and materially are affected by what seems to them to be our arbitrary policy on their oil and gas reserves.

Those are my conclusions and you are perfectly at liberty to challenge them.

I would like to ask you this: As far as I know, this subject is not even on the President's agenda for Lopez Portilla in February.

As I understand it, the President is not even going to discuss oil and gas prices. Do you understand any differently?

Secretary SCHLESINGER. I believe that the subject of energy, indeed, is going to come up at those meetings. I think the President has indicated that he is not going to negotiate a contract as indeed he cannot under the law, and probably should not.

With regard to your more general comments, Senator Javits, I do not agree with your adjectives such as "adamant." We have taken a very flexible position with regard to this issue. It is not arbitrary. It has been carefully expressed to Mexican officials since January 1977. It should have been no surprise to them. Indeed, under the Natural Gas Act we are obligated to hold public hearings on these prices.

The FERC, in approving such sale, has to be assured that it is just and reasonable, that the prices and volume are justified, and those decisions by the FERC, or by the hearing board, cannot be based upon such concepts as the flow of illegal aliens.

It must be based on the requirements for energy. Now, it is no favor to Mexico to insist that they be given a price that is so high that they cannot effectively compete in the American market.

They will be excluded from a substantial share of the American market if indeed they price at distillate.

The reason for that is that distillate represents only one-sixth of the potential market.

We are eager to have not only Mexican gas, but Mexican oil, and irrespective of your questioning of our policies with regard to the pricing of gas, we have certainly been nothing but encouraging with regard to oil.

Whatever we say on that subject, we must recognize that the Mexicans have stated that they are concerned about the domestic impact of too rapid development in terms of its social implications. Those concerns have been reinforced by developments in Iran; they have indicated that they are prepared to go to something on the order of 2.2 million barrels a day by 1982.

The pace of development of these resources is not going to be—and perhaps we must all agree with regret—sufficient to break the OPEC cartel.

The only thing that will break the OPEC cartel is very substantial restraint in our use of oil internationally.

Senator JAVITS. Mr. Secretary, of course, these are things which I have heard you on before. Will you agree, however, that the matter of dealing with Mexico on oil and gas is a mix of foreign policy and the energy question.?

Secretary SCHLESINGER. Absolutely, sir.

Senator JAVITS. And therefore that it is not entirely within your department or within your attributions?

Secretary SCHLESINGER. That is correct. Indeed, in our discussions with the Mexicans that started in January of 1977, we worked very closely with the Department of State; our missions to Mexico included State Department officials as well as energy officials.

Senator JAVITS. May I through you express the hope and the expectation that the President will recognize the importance of this question and to affirm my own testimony as a witness that this situation, as I said when I began, is not what the facts are—it is what the judge thinks they are; and it is very materially prejudicing the relations between ourselves and Mexico, which are more critical than ever.

May I just ask one or two other questions, if I still have time?

One: We in the Northeast are very deeply concerned about the local aspect, the regional aspect, of the strategic reserve; and there seems to be even no provision for that at all, let alone any beginning of it.

Can you enlighten me on that?

Secretary SCHLESINGER. Yes, sir.

The intention reflected in the budget is that no consideration be given to a regional reserve, as opposed to the general national reserve located primarily in the Gulf States, until such time as there has been a chance for the Congress to review a use plan for that general regional reserve.

Senator JAVITS. So that we cannot—my time is up—expect any action on that unless Congress changes that?

Secretary SCHLESINGER. That's true.

Senator BENTSEN. I think Senator McGovern is next.

Senator MCGOVERN. Thank you, Mr. Chairman.

Mr. Secretary, I want to join with my colleagues in welcoming you as the first witness before the committee this year.

As you know, Mr. Secretary, the President's budget is being submitted for fiscal 1980, and has been described by him as an "austere" budget, and has been geared very heavily to the President's concern about inflation. I would like to ask some questions on the energy portion of that budget as it impacts on the problem of inflation.

First of all, as one looks at the energy budget of \$8.4 billion, I notice that in excess of \$3 billion of that is for defense activities, weapons of various kinds, naval reactors.

That represents a 12-percent increase in the defense portion of the energy budget, which, if my information is correct, goes beyond the increases in other parts of the budget.

It is true that the defense budget itself represents an add-on of some 3 percent above and beyond the inflationary increase, and this would be a 5-percent increase above the inflation rate.

How do you justify that kind of an increase in view of the guidelines that have been laid down by the President?

Secretary SCHLESINGER. There are two aspects. For research and development and weapons labs and testing, there is no increase of the sort that you have indicated.

In the production area, weapons production area, we have major new programs on the line: Poseidon retrofit, the production of the new warhead for the Minuteman III, the start of the development,

the completion of development on the warhead for the cruise missile, and the Trident warhead.

We have a very substantial increase as a result of a change in our strategic posture.

The largest element of the increase in the defense programs relates to the handling of radioactive wastes that have been in this country since 1945.

There is a \$400 million increase in that program for waste management. Senator McGovern, I think that you and many of your colleagues share the view that we must get on with the management, indeed, the final disposal of those radioactive wastes left over from the defense program.

We have delayed long enough. This is a good year to start.

Senator MCGOVERN. Since you brought that up, Mr. Secretary, I am working on an amendment to the energy authorization bill that would require a State to concur with the Energy Department before it was designated as a nuclear waste site.

It is my understanding that interim studies in the Department have indicated that there ought to be some kind of State approval before they are so designated.

Mr. Secretary, would you support giving the States the veto power with regard to the use of their State as a nuclear waste material disposal area?

Secretary SCHLESINGER. I think that that is unnecessary, Senator. We have already indicated to the States; and as a practical matter unless a State concurs, we would not be in a position to go ahead with such disposal projects.

There is a very tangled relationship. Under the Atomic Energy Act the Federal Government preempted some of these decisions, so before I could agree with the proposal—and I think the proposal is unnecessary—I will have to consult our lawyers.

Senator MCGOVERN. Do you support the general principle that there would have to be some sort of State concurrence before a State is designated as a site?

Secretary SCHLESINGER. Yes, sir, and we have informally indicated that to the various States, and I think, as a practical matter, the States can block such a facility.

Senator MCGOVERN. Returning to our earlier line of questioning, in 1973, when the first oil embargo hit, President Nixon said that we were going to have to move to greater energy independence.

His position made sense at the time. Since then, we have seen repeated price increases over which we have had no control; the OPEC's most recent one being close to 15 percent for the coming year.

Yet, as you know, we have not become more independent. Whereas 5 or 6 years ago we were importing a fourth of our oil, now it is up to about half of our oil consumption.

Doesn't that dictate in your mind an alternative energy strategy, where we move with much greater urgency in developing other sources of energy rather than relying as heavily as we have on oil?

How are we going to bring the inflationary impact of energy costs under control if we continue to be at the mercy of oil prices that are set by an agency over which we have no control?

Secretary SCHLESINGER. Senator, we agree with the objective as outlined. Indeed, conservation has been immensely successful if we look at the trends in energy use per unit of output in this country.

We have major investments in the technology of solar energy, and a substantial increase in this year's budget.

We trust that solar energy becomes cost effective, but until such time that it does, we are looking at potential costs in this area, for example, solar energy and other alternatives, of \$70,000 to \$80,000 investment per barrel equivalent.

That is not a way of bringing down energy costs, but your underlying strategy that we should go to whatever alternative energy source permits us to reduce the rate of inflation is one which we heartily embrace.

Senator McGOVERN. Well, I agree that there is some increase in the solar portion of the budget. I think it is roughly comparable to the increase in the defense part of the energy budget.

The problem is that you begin with such a small figure that when you increase it, you really haven't done very much in absolute terms.

Haven't you earmarked around \$650 million of the entire budget for solar energy purposes?

Secretary SCHLESINGER. I believe that if we include the tax expenditure, the expenditures are \$800 million, and that is a very significant figure, I think, for solar energy.

Senator McGOVERN. That tax expenditure figure is included in the overall estimates of the energy budget?

Secretary SCHLESINGER. Yes, sir. We do it both ways.

Senator McGOVERN. It strikes me, Mr. Secretary, that what you are proposing will, in the short run, be a very expensive strategy.

Looking down the road a piece, if we are going to continue to be so heavily dependent on the foreign oil, I don't see much hope for us getting out of this inflationary bind.

We can cut the Federal budget by a few billion dollars, but that is quickly neutralized by these very substantial and escalating energy prices; whereas, if we could begin to make some substantial progress on alternative sources of energy, not only solar power but biomass, windpower, hydroelectric, and other things, it seems to me that that not only holds out the hope for Project Independence at long last getting off the ground, but it also releases, over the long pull, us from some of these uncontrollable inflationary factors that we are confronted with now in OPEC.

Secretary SCHLESINGER. Once again, we share that objective. To the extent that we can move to alternative energy sources, well and good, but we must recognize, I think, that we will continue to be dependent upon foreign sources of supply for our oil and that even by the year 2000 that the amount of oil and gas we use in this country will be 50 percent of our energy budget.

Senator McGOVERN. Let me ask a related question, Mr. Secretary. I think second only to inflationary problems on the economic front, we have to be concerned about developing programs that are going to hold out the maximum prospects for jobs for our people.

We still have several million people looking for work. What do your studies indicate in the Department are the most labor-intensive types of energy development?

What would generate the largest number of jobs in the various forms of energy that are open to us?

Secretary SCHLESINGER. Conservation generates a very high proportion of jobs, notably in the building trades and in certain unskilled areas. Solar energy would also generate additional jobs.

The reason that oil and natural gas prices are relatively low is because it requires little labor to produce them.

Senator McGOVERN. Mr. Secretary, my time is up.

Senator Kennedy asked me to submit to you a number of questions which you may answer for the record.

There are some 14 questions about the Alaska Pipeline which have been made available to the press and the Senator would appreciate very much the committee receiving the answers to these questions on the pipeline within a week from today.

The remainder of the questions on other matters may fall within the same time frame. I would make those available to you.

Secretary SCHLESINGER. Thank you, sir.

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. JAMES R. SCHLESINGER TO ADDITIONAL WRITTEN QUESTIONS
POSED BY SENATOR KENNEDY

Question 1. Has Northwest Pipeline filed a detailed project costs statement with FERC? If not, on what basis has DOE made its estimate of the costs involved?

Answer. The Department has based its cost estimates for the Alaska pipeline upon the record in the proceeding before the Federal Power Commission and upon detailed information filed by the applicants during the President's consideration of the project pursuant to the Alaska Natural Gas Transportation System Act. The FPC record contains several thousand pages of detailed exhibits and testimony concerning the costs of pipeline construction. Consideration of that record and other filed data formed the basis for the cost overrun projections for the Alcan and El Paso systems that are contained in the President's Decision and Report to Congress on the Alaska Natural Gas Transportation System, September 1977. The overall cost overrun projection for the Alaska Highway project (then Alcan) was approximately 30 percent above the applicant's filed costs. That projection was based upon a separate analysis of each major segment of project.

The January 1979, Department of Energy Analysis also presented two additional cost overrun cases for illustrative purposes. Those cases represent projected costs approximately 60 percent and 90 percent above the applicant's original filed costs.

Question 2. Do the costs included in your calculations include all costs of gathering facilities? All new developmental wells?

Answer. The consumer costs section of the paper contains an illustrative field price for the gas of \$2.25 in 1979 dollars. That amount is more than sufficient to cover all incremental costs of natural gas sales from the Prudhoe Bay field. In fact, the FERC on February 2, 1979 issued a tentative order that would require the producers to absorb all costs of producing and processing the gas to pipeline quality within the base price of \$1.69 (1979 dollars) plus severance taxes, a total of approximately \$1.86.

The national economic benefit calculations also takes account of the incremental costs of gas sales compared with continued oil production. Large quantities of natural gas currently are being produced in association with the oil production. That gas is being partially processed, compressed to several thousand pounds per square inch, and reinjected into the formation. The gas-oil ratio will increase over time and additional gas handling and reinjection facilities will be needed even if gas is not sold. When sales of gas are commenced, the reinjection process will be reversed.

The incremental cost of gas production is very small in relation to the value of the gas. The January 1979, Department of Energy analysis uses the incremental cost estimates contained in the Van Poolen study of production options for the Prudhoe Bay field.

Question 3. Does it include the complete cost of that portion of the line necessary to deliver the gas to Dwight, Illinois, or only the price to the border? What is the estimated cost of this U.S. pipeline?

Answer. The cost estimates include the complete cost of the Northern Border pipeline system which will deliver the gas to Dwight, Illinois, and the cost of the Western leg portion of the line which will deliver gas into California. In the cost overrun case from the President's Decision and Report to Congress, the projected cost (including AFUDC) of the Northern Border system was approximately \$1.2 billion (1979 dollars). The projected cost of the Western leg, which consists of looping existing pipeline systems, was approximately \$750 million (1979 dollars).

Question 4. It is not clear in the transportation costs allocation for 2003 how the costs you estimate affect financing. Are these the costs now being presented to investors and how does the market view these returns?

Answer. The transportation costs for each year of the project reflect constant assumptions regarding the cost of equity and debt for the project. The equity returns are based upon the variable rate of return proposals currently before the FERC and the Canadian National Energy Board. The proposed allowed returns for the construction period range between 10 percent and 19.7 percent in the U.S. and 14.5 percent and 23.8 percent in Canada, depending upon the geographical location of the construction, and extent of cost overruns. The current proposed rates of returns for the operational phase are 13 percent for the U.S. and 14.5 percent for Canada.

In the United States, the actual rates of return for the equity investors will be much higher than the stated regulatory return. The Internal Revenue Code prohibits the FERC from taking account of the investment tax credit in setting the rates for the pipeline. The regulatory rate of return, therefore, does not take account of the value of the investment tax credit.

The FERC and the NEB have not made final determinations regarding the operation of the variable rate of return or the tariff. Also, no gas sales contracts have yet been signed. Therefore, it is not clear at this time how the market will view the equity returns.

The debt financing of the pipeline will be at the market rates prevailing at the time of financing. The cost estimates are based upon a debt cost of 10 percent; whether this is too high or too low cannot be determined at this time.

Question 5. Are these returns on investment consistent with the historic cost of operating pipelines? Are they consistent with rates of return and the rate base which pipelines have enjoyed in the United States?

Answer. The rates of return compare very favorably with the historic cost of operating pipelines. The pre-operational rates of return are considerably higher than the average allowed rates of return on equity for U.S. pipelines to reflect the additional risks associated with the pre-completion phase of the project. The proposed rate of return for the operational phase is near the average for U.S. pipelines because the risks of the project once construction is completed are not appreciably higher than for other pipeline projects.

The concept of a rate base determined by original cost less depreciation is consistent with U.S. Federal practice that has prevailed since the 1930's. It also is consistent with long-standing Canadian regulatory practice.

Question 6. You cite a transportation cost in the year 2003 ranging from \$.68 to \$.84. What value are you assuming for the pipeline at that point: salvage value, zero value, replacement value, current value, etc.?

Answer. The projected transportation costs for the year 2003 are based upon the depreciated rate base for that year. In the 30 percent cost overrun case, the 2003 rate base for all segments of the project is \$0.9 billion (1979 dollars). For the 90 percent cost overrun case, it is \$1.4 billion (1979 dollars).

Question 7. Do these figures assume inflation in operating costs of the pipeline and, if so, at what rate?

Answer. The estimated operating and maintenance expenses for the pipeline are assumed to remain constant in real terms, i.e., increase with inflation. The long run inflation rate assumed in the cost of service model is 5 percent.

Question 8. Footnote No. 1 indicates that project field costs of \$2.25 are "used for illustrative purposes only." While recognizing that a final determination cannot be made at this time, the Committee would appreciate the details of what is included in this price. Precisely what severance taxes and what allowances for conditioning? Are these *all* the costs that should be included in "field costs?"

Answer. The mid-1979 wellhead ceiling price for the Alaska gas under the Natural Gas Policy Act of 1978 would be approximately \$1.69. The Alaska severance tax varies with the rate of production, but averages approximately 10 percent. The total wellhead price would be \$1.86.

The allowance for conditioning costs within the \$2.25 thus would be \$.39. That amount alone would be sufficient to cover more than 50 percent of the current

estimates of all incremental gas production costs in the field. The FERC, of course, on February 2, 1979 issued a proposed order that would provide no separate allowance to the producers for conditioning costs.

Question 9. Please provide the Committee with the calculations by which you arrived at the price of distillate oil. Figures provided to the Committee from other sources are lower than your figures; thus, we would like to know how you arrived at the product price from the crude price used in your calculations.

Answer. The DOE integrated energy model projects that by 1985, the wholesale distillate prices in the New York area, including cargoes delivered to New York Harbor, will increase to more than \$3.50 per million btu in 1979 dollars, assuming no real world oil price increases beyond the currently scheduled 1979 OPEC increases.

Current prices in New York Harbor for domestic distillate oil are more than \$3.00 per million btu (\$.41 to \$.42 per gallon). These prices do not reflect subsequent OPEC increases but do reflect the substantial domestic subsidy of crude oil of approximately \$1.50 per barrel, or \$.25 per mmbtu. Spot distillate cargo prices have recently been reported as high as \$3.25 to \$3.30 per mmbtu (\$.44-.46 per gallon).

The 1977 Memorandum of Intentions between PEMEX and the U.S. pipeline companies regarding the purchase of Mexican gas refers to the "average of high" prices in New York Harbor. Therefore, in representing New York Harbor prices, at approximately \$3.50 in 1979 dollars in the low world oil price, the DOE analysis is conservative on the low side.

As the DOE analysis paper notes, the 1984 distillate equivalent price includes also an allowance for differential transportation costs. The Alaska pipeline cost includes delivery to major markets in California and the Midwest. Imported natural gas at border points, particularly on the Southern U.S. border is much more remote from the marginal natural gas markets. Therefore, to equate the two gas sources, a transportation cost of approximately \$.20 per mmbtu is assumed for the distillate equivalent prices. The \$.20 would cover incremental and operating expenses and additional capital costs for facilities to transport incremental gas supplies to the existing U.S. pipeline systems.

Question 10. Please give the Committee the assumptions made about costs to be borne by Canada in arriving at the United States cost. Include where appropriate the allocation of procurement expenses by both Canada and the United States.

Answer. The consumer cost in the U.S. for costs incurred on Canada will be determined by whether, and the extent to which, Canadian gas flows through the pipeline. If Canadian gas flows, the Agreement on Principles between the United States and Canada contains a complex cost allocation formula that allocates to the United States a portion of the costs of a Canadian lateral pipeline between Dawson and Whitehorse in the Yukon Territory. The amount of the U.S. share of costs of that lateral pipeline will be determined in relation to the extent of cost overruns on the main pipeline. Once in the main pipeline, Canadian gas would participate in the costs on a zoned, mcf-per-mile basis. The costs estimates in the DOE analysis are based upon an assumption that 1.2 bcf of Canadian gas from the McKenzie Delta will flow in the main pipeline system. Further details regarding the cost allocation system and its relationship to U.S. costs are set forth in the President's Decision and Report to Congress on the Alaska Natural Gas Pipeline System, September 1977, pp. 163-174.

If the Canadian gas never flows in the mainline system, there would be no sharing of mainline costs by Canada, but the tariff for U.S. consumers would be slightly lower than that set forth in the January 1979 DOE analysis due to lower capital costs and higher fuel efficiency.

From a national economic perspective, the Canadian tariff payments by U.S. consumers are treated as a real resource cost to the U.S. in their full amount in the year when incurred.

Question 11. Please indicate whether reinjection costs for natural gas in the North Slope were offset against project costs.

Answer. Reinjection costs were not offset against project costs. However, as noted in the answer to Question No. 2, many of the existing reinjection facilities will be used to produce, gather, treat, and compress the gas that is sold. These existing facilities of course are not treated as incremental real resource costs in the national economic benefit analysis.

Question 12. If a contract with Mexico were executed for \$2.60 and escalated at 7 percent, and if Mexico exported the maximum projected as available according to the Congressional Research Service study (e.g., 1.5 tcf in 1988), is it the

judgment of the Department that the Alaskan Gas Pipeline would still be necessary and economically feasible on the basis as in your paper?

Answer. If the Mexican gas were priced at \$2.60 (1979 dollars), and the price escalated at 7 percent per annum (assumed to be equal to the rate of inflation), it would be a very attractive supplemental source of gas supply. Imported pipeline gas at that price would be less costly than incremental LNG supplies and the overall cost would be slightly less than the Alaska North Slope gas for comparable volumes.

If an assured supply of 1.5 tcf per year of Mexican gas was available for 10-15 years at a fixed price and escalation factor and if currently projected U.S. supply and demand for gas are accurate, it is probable that construction of the Alaska pipeline could be deferred for a few years. However, the future of energy prices and availability, and the validity of projection models is sufficiently uncertain that the U.S. should, at this time, proceed with the project that will develop the certain energy resource on the Alaska North Slope. The potential for additional imports of reasonably priced natural gas from Canada or Mexico or the potential of future domestic supplies are not adequate substitutes for development of a long-term existing domestic energy supply such as the Alaska North Slope natural gas.

Question 13. Has the United States government made any attempt to insure through understandings with the Canadian government that any excess Canadian gas is sold through the lower portion of the Alaskan gas pipeline, rather than sold through conventional pipeline sales?

Answer. There have been ongoing discussions between Secretary Schlesinger and Deputy Prime Minister McEchan and other Canadian officials regarding the relationship between possible increased exports of Canadian gas and the Alaska Highway Pipeline project. The discussions have explored methods by which any increased Canadian supplies might be used to facilitate the financing and construction of the Alaska Highway project. The discussions are continuing at this time.

Question 14. You have given us the costs to consumers of the Alaska gas pipeline but you have not given us the costs to the taxpayers. Please indicate the expected cost to the treasury through the anticipated use of the investment tax credit, accelerated depreciation and drilling and production incentives for gas producers, using the same assumptions as in your paper.

Answer. The national economic benefit calculation recognizes income taxes as a cost in two respects. First, a 10 percent real discount rate is used, which is equivalent to a before-tax rate. Thus, to the extent that income taxes represent a surrogate for real resource costs, they are taken account of initially in the calculation of net benefits. The full capital costs of the project are treated as a resource cost. There is no deduction for the investment tax credit or other benefits.

Second, to present a conservative alternative case, the net present value of actual income taxes that will be paid by the pipeline company are deducted from the benefits to arrive at the comparative national economic benefits set forth the DOE Analysis. For example, in the 90 percent cost overrun case with low world oil prices, the \$5 billion advantage of the Alaska project over distillate-priced imported gas is net of approximately the \$950 million present value (\$3.6 billion aggregate undiscounted value) of actual income taxes that will be paid by the project.

No further explicit recognition of income taxes or income tax benefits need be made from a national perspective. If the Alaska project does not increase the aggregate level of investment in the national economy, it is not likely to increase to any significant degree the aggregate level of income taxes, tax credits, or deductions. The oil and gas producing industry under current tax laws has the ability to write off investment somewhat more quickly than industry generally, e.g., through intangible drilling costs deductions and expensing of dry holes.¹ But, the vast majority of investments that give rise to such accelerated write-off already have been made at the Prudhoe Bay field. The incremental investment for gas production is predominately capital investment that is subject to normal income tax treatment. Therefore, it is not believed that the construction of the pipeline project would generate significant incremental accelerated tax write-offs or credits that differ materially from those that would pertain to alternative capital investments.

¹ There is a theoretical possibility that a trivial amount of ANS gas would qualify for a depletion allowance. An independent producer could receive a 15 percent depletion allowance up to 6 mmcf of gas or oil equivalent, which would be allocated over all domestic production of that producer. IRC Section 613A.

To the extent that the Alaska project does give rise to a higher level of capital expenditures than otherwise would prevail in the economy, there would be incremental tax deductions or credits, but they would be more than offset by the incremental tax revenues that would be generated by the capital investment.

In regard to the actual tax consequences of the project, there are two principal components—the investment tax credit and accelerated depreciation. The investment tax credit would be 10 percent of something over 90 percent of the direct capital costs of the project. For the pipeline, the investment tax credit would be approximately \$500 million in the 30 percent cost overrun case and \$750 million in the 90 percent cost overrun case. The conditioning plant would generate an investment tax credit of approximately \$150 to \$175 million.

The project would also generate to accelerated depreciation. The gross amount of taxes paid over the life of the project would not vary between straight line depreciation and accelerated depreciation. However, the present value of the tax payments would be less with accelerated depreciation. Under the FERC regulations, the present value advantage or benefit is not retained by the company, it is flowed through to the gas consumers. From the perspective of the government, however, the accelerated depreciation compared with straight line depreciation would reduce the present value of the pipeline project's tax revenues by approximately \$250 million in the 30 percent cost overrun case² and \$375 million in the 90 percent cost overrun case. Accelerated depreciation for the gas conditioning plant would have a similar effect to the extent of approximately \$75 million.

VENEZUELA

Question 15. Have you explored the question of Venezuelan heavy oil?

Answer. DOE maintains close consultations with the Venezuelans to seek solutions to a wide range of energy problems. As you know, Deputy Secretary O'Leary has just returned from a visit to Caracas, where he discussed Venezuelan plans for heavy oil development and possible R&D cooperation in enhanced oil recovery techniques with Venezuelan officials as part of an overall cooperative energy program.

Question 16. What are your estimates of recoverable heavy oil reserves in Venezuela?

Answer. Estimates of heavy oil in place range from 750 billion to 3 trillion barrels. The bulk of the Orinoco Belt crude is less than 10° API, is very viscous, and has a high sulfur (4+ percent) and metal (vanadium and nickel) content. These characteristics present a variety of producing, transporting, and processing problems. Estimates of recovery rates range from 5 percent to 25 percent.

Question 17. What are your estimates of production costs?

Answer. Estimates of production costs range from \$7-11.50 a barrel, divided about equally between production and upgrading costs. These estimates include a 15 percent rate of return on investment but no taxes or royalties. Because of the high metal and sulfur content, large capital investments in processing installations and protection against damage to equipment and pipes are required. In view of the complex engineering problems and uncertainties inherent in new technologies, these cost estimates should be considered speculative.

Question 18. Why is this oil not being produced? What is the Department's policy toward its development being accelerated?

Answer. The physical and technical characteristics of Venezuelan heavy oil are substantially different from those associated with conventional crude oils and involve a wide range of new engineering problems and uncertain ultimate producing costs. Venezuela still has significant undeveloped resources of light, conventional crudes. The GOV has expressed interest in developing its heavy oil but must make a series of decisions involving technological approaches, investment mechanisms, and the other difficult questions associated with the development of new energy resources. In making these decisions the GOV will have to make difficult political decisions on the balance between indigenous resource development and foreign technological assistance. DOE and Venezuelan officials are consulting to determine areas where cooperative programs might be of mutual interest.

Question 19. Has the Department explored opportunities for channeling capital into this effort through the regional banks?

² PV of Sum of Years Digits of Depreciation—PV of Straight Line Depreciation×0.46
× Cost of Depreciable Asset, assuming 18-year life for tax purposes and 8 percent cost of long term debt to U.S. Government.

Answer. DOE believes the international financial institutions can make a major contribution to international energy development. We support the recent World Bank decision to increase its lending for oil exploration and development. The energy lending policies of the regional banks, in particular, the Inter-American Development Bank, should be reviewed to determine the appropriate role of energy lending, and, in particular, the optimal balance between lending for energy

and for basic human needs. The Department is currently consulting informally with staff of the Inter-American Development Bank on a proposal for expanding the IDB's commercial and political guaranty and insurance authority for Latin American mineral and energy projects.

Question 20. What about opportunities for increasing oil production in other Latin American countries like Guatemala, Argentina, Brazil and Peru. Does the Department have a policy that would enhance production in Latin America as a whole and wouldn't this have benefits in terms of the security of our imported oil supplies?

Answer. DOE considers that diversifying sources of U.S. oil imports, particularly from Latin America, could significantly enhance our energy security. DOE supports existing programs of expanded World Bank lending and OPIC provision of political risk insurance for oil exploration and development. We expect oil exploration and production in Latin America to increase between now and 1985. DOE is establishing a Foreign Energy Supply Assessment Program (FESAP) which will make in-depth geological and technical assessments of hydrocarbon resources in several countries, including Latin America. We expect these assessments will contribute to our understanding of the prospects and lead times for bringing on new supplies. Expansion of productive capacity in Latin America could:

Increase aggregate world oil and gas supplies as early as 1985, thereby limiting both the demand on existing suppliers and the probability and magnitude of oil price increases.

Further U.S. security interests (including nuclear non-proliferation objectives) by enhancing the political, economic, and energy position of other oil-importing countries.

Reduce the need for the U.S. to import from its existing suppliers to extend production beyond the levels these countries consider optimal.

Extend the period available for improving and installing the alternate technologies that will become increasingly important over the long run.

Improve the security of U.S. supply.

Senator McGOVERN. Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Senator McGovern.

Now Congresswoman Heckler, please.

Representative HECKLER. Mr. Secretary, coming again from the Northeast, we are very concerned about our energy policies and we feel that the burden upon the consumer there is probably the heaviest in our part of the country, and it has to be taken into account in terms of energy solutions.

Just recently the Washington Post ran an article on your discussion of Mexican gas in the meeting with Diaz Serano, director of the Mexican National Oil Co.

I understand from the Post that this was a very stormy meeting. At the meeting you told the Mexicans that the private commercial negotiations which had been successfully completed between U.S. companies and Pemex would be blocked by the U.S. Government. You say they are pricing themselves out of the market, but it is apparent that the Mexicans did have six buyers for their gas.

Was it a stormy meeting, and why was it a stormy meeting?

Secretary SCHLESINGER. Well, the question, I think, is: Was it a stormy meeting, and if so, why.

Representative HECKLER. Are you saying the Washington Post was incorrect in its analysis?

Secretary SCHLESINGER. I would say that the articles written in the Washington Post bear very little resemblance to reality. [Laughter.]

But I mention this in relation to the coverage of the speech I gave on gas policy in New York.

If one read the Wall Street Journal or the New York Times, which were quite accurate, they were far afield from the article that appeared in the Washington Post.

We welcome—and it was stated in the speech—natural gas from Mexico.

Representative HECKLER. You simply would not allow for the sale; is that correct?

Secretary SCHLESINGER. I don't know precisely what you are referring to in the article.

As I recall, the headline said "Dim on Natural Gas Sales From Mexico." That is totally wrong.

Representative HECKLER. But as I am told, you had announced to them that you would block this, that this was the position of your Department.

Secretary SCHLESINGER. As I have indicated earlier, Congresswoman Heckler, the discussions with the Mexicans started in January of 1977.

I indicated to the chairman earlier that if the committee would like it, I would be happy to meet with it with the appropriate Department of State officials to go over the negotiating record from the very inception of those discussions.

We have indicated that our problems were, first, that we did not want to tie the price of natural gas to the price of distillate in New York Harbor in an attempt to avoid raising natural gas prices in the United States.

Second, that we were concerned about any price, particularly before the gas flowed, that would upset the Canadian border price.

This was repeated; indeed, there were further negotiations with Mexicans during the summer of 1977.

Other proposals were put forward which the Mexicans accepted and then for some reason subsequently reversed themselves on.

In December they broke off discussions.

Representative HECKLER. Senator Bentsen, I think it would be useful for us to have a complete session on the Mexican gas negotiations, because, frankly speaking, there are so many questions that we could devote the whole session today to that subject alone. I would personally like to have the State Department here to testify and explain to this committee exactly what their rationale was.

It seems to me that their thinking is very out of date in terms of developing better relations with Mexico.

My main concern is with the problems and ramifications for the consumers of New England.

Nonetheless, if I were a Mexican, I think I would be quite outraged about the negotiations as I understand them.

So, to hear a clarification of exactly how they took place would be very enlightening, indeed.

Secretary SCHLESINGER. I want to say, Congresswoman Heckler, that I would not in any way accept the characterization of "treating Mexico as a banana republic."

Indeed, what we have done is to treat Mexico in precisely the same way that we bargained with the Canadians. There are Canadians who have certain national resentments about the United States but we have treated the border price at the Mexican border in precisely the same way as at the Canadian border.

We have conducted negotiations with regard to that price. In both cases, we are not prepared to simply submit to a monopoly price.

I should underscore that since the Canadians have emphasized that they would raise their prices immediately to whatever price was accepted on the Mexican border, that the impact on New England consumers would be devastating if we were to do as you apparently are suggesting.

Representative HECKLER. It is my understanding that the Canadians are prepared to raise their price at any rate.

Secretary SCHLESINGER. The Canadians have never suggested that the price of gas be at the Btu equivalent of distillate in New York Harbor.

Representative HECKLER. Well, we will discuss this, hopefully, at another time.

Mr. Secretary, I want to go to another subject concerning the whole aspect of the energy question because, in New England, where we are dependent to a ridiculous extent on imported oil, we are obviously concerned with price.

We are dependent on decisionmaking of OPEC.

In view of that, as well as the overwhelming evidence available to us—the Brazilian experience with racing car drivers' preference for gasohol and the extensive support in the State of Nebraska for gasohol—and the knowledge that this high octane fuel could lower emission standards and improve production and performance of most car engines, I wonder why we are dragging our feet on gasohol which could in some measure, considering our gasoline consumption, reduce our prices.

I know we are studying the issue, but how long will we study it and why are we so late when Brazil has already mandated the use of gasohol?

Secretary SCHLESINGER. The Brazilians, of course, are backing away from it because it represents a requirement on the agricultural sector that is detrimental to the food supply.

Let me underscore in this connection that the reason the gasohol is moving now is because of action taken by the Congress in the national energy plan in which the 4-cent-a-gallon tax was removed.

As we know, gasohol is somewhat more expensive. Alcohol used in gasoline is somewhat more expensive than the oil itself. But the removal of that tax by the Congress in the national energy plan is encouraging that movement.

Indeed, for the reasons that you have mentioned, the augmentation of octane ratings, gasohol looks like an effective substitute for leaded gasoline and I would think that it would move increasingly into the U.S. market.

Representative HECKLER. I would like to bring to your attention, Mr. Secretary, the fact that alcohol can be derived not only from expensive grain products but through a process being researched presently at Natick Laboratories in Massachusetts. This process of conversion uses waste materials: old newspapers, garbage, municipal and

industrial waste, and converts that waste into a usable resource which produces a methanol which can be used instead of alcohol in the 90/10 mixture. The process potentially offers us a way of dealing with the problem of waste disposal in not only the Northeast but other sections of the country; and, second, creating a gasohol mix that recovers from a waste product a product that can be utilized as a substance of value.

This process could answer the questions of expense, of the grain which is presently used from the farm belt and is the main source of the alcohol.

So, I hope that you, Mr. Secretary, will look favorably on these potential alternatives because the state of the art is advancing rapidly and I think, frankly speaking, if one looks at the gas mileage attained through the use of gasohol, the increase in cost is far outweighed by the higher performance and the better mileage which the car achieves.

Secretary SCHLESINGER. Those are well-taken points, Congresswoman Heckler.

I think that generally speaking as an augmentation disproportionate to the energy input, the augmentation of energy output through higher octane ratings makes this fairly attractive.

Representative HECKLER. No further questions, Mr. Chairman.

Senator BENTSEN. Thank you very much.

Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Secretary, the current loss of Iranian oil production amounts to 10 percent of the free world's supply, and 5 percent of the U.S. consumption. I understand about 42 percent of that or 40 percent has been picked up by increased Saudi production, at least for a short time. Nonetheless, we have a change in the pricing situation in the world.

Six months ago the price of the world market oil was below the OPEC set price.

Now that we have this world shortage, it is considerably above the OPEC set market price.

Now, you are currently Secretary of the Department of Energy; you have formerly been Secretary of Defense, formerly the head of the CIA.

I would just like to ask a couple of questions about all that from what is a rather unique background that you have.

First, it seems to me that our inability to take military action in the Iranian situation is apparent. Those are long supply lines to get us into that area.

Our diplomatic position has been somewhat fickle, to be kind.

First, we were for the Shah forever, then we decided that the Shah should go; all this within the last couple of weeks.

Now we support the Bakhtiar government and the new chairman of the Senate Foreign Relations Committee was on television the other day saying that he thought that that was premature and perhaps we ought to be supporting Mr. Khomeini.

It seems unlikely to me that the conflict between the religionists, represented by Mr. Khomeini, who thought the Shah was modernizing too fast, and the students, who feel that the Shah was modernizing too slowly, is going to terminate any time in the near future. That threatens us with the prospect that we will not have a restoration of the supply of free-world oil and U.S. oil from Iran for some time.

Now, with that background and with the problems that we have had, that I understand have been explored earlier by members of this committee with you this morning, referring to the strategic reserve getting established in this country—and I understand the new budget recommends a considerable slowing of the establishment of that strategic reserve which I find rather surprising—but what are you recommending to the President with reference to his single-handed authority on oil prices under the EPCA legislation as of the end of May?

Are you telling him that he ought to lift the domestic price of oil so we could encourage domestic production or are you telling him that we ought to hold down that price for domestic oil, with, of course, what has had the result of a deterioration of American production, so as to support his effort to beat back the fires of inflation?

Secretary SCHLESINGER. Let me not state what my own advice is, Congressman Brown, but let me try and answer your question which goes to the heart of the dilemma.

Representative BROWN. Is that privileged?

Your advice is privileged because of your relationship with the President?

Secretary SCHLESINGER. I think that the position of the Energy Department is reasonably well known and differs from that of other advisers.

Representative BROWN. If I knew clearly what it was, I wouldn't have asked the question, Mr. Secretary.

Secretary SCHLESINGER. The heart of the issue is the problem of anti-inflation policy as opposed to energy policy.

From the standpoint of energy policy, there are various areas in which increased prices, indeed the ultimate freeing up of this market, would be beneficial.

That, I think, has been reflected in the general views of this Department.

Representative BROWN. Is that what you have recommended to the President?

I hate to keep pressing the point, but I am not clear. You say everybody knows what you have recommended to him.

Secretary SCHLESINGER. The position of this Department has been in favor of moving to the replacement cost of energy, of eliminating controls, but the timing of that is the critical problem.

We have urged that at an early date, consistent with other responsibilities of other senior officials, particularly in the inflation area.

Representative BROWN. Your position, then, I gather, is to some extent in conflict and the President must ultimately make this resolution.

Is that fair?

Secretary SCHLESINGER. I think there is a disparity of views.

There are a range of views. Quite obviously, members of the administration who have particular responsibility for fighting inflation look with some apprehension upon substantial increases in the price of old oil, to a lesser extent of new oil.

Representative BROWN. The President could immediately raise the price to somewhere above the world price, in effect, immediately decontrolling the price of oil.

Secretary SCHLESINGER. You mean after June 1, Congressman?

Representative BROWN. Yes; he has that authority, doesn't the, under EPCA?

Secretary SCHLESINGER. After June 1?

Representative BROWN. Yes.

Secretary SCHLESINGER. Yes, sir.

Representative BROWN. Or he could do it on a gradual basis. He could recommend a step increase or recommend that we keep the controls where they are; isn't that correct?

Secretary SCHLESINGER. Yes, sir.

Representative BROWN. Now, have you selected in that range your position?

Secretary SCHLESINGER. I have.

Representative BROWN. And it is to do what: raise the price immediately, take it in steps, or leave it where it is?

Secretary SCHLESINGER. I think I could say this, that my general position has been in favor of a more rapid approach to world prices and more rapid movement toward decontrol, if that is obtainable. That has been the advice of some others.

I emphasize that we have dual objectives in this country, at least, and there is a disparity of views.

Representative BROWN. I paint a somewhat grim picture with which you have not taken exception with reference to Iranian oil.

Let me ask you, in view of that somewhat staggering policy about the Shah and Bakhtiar and Khomeini that seems to be emanating out of Washington, what is your feeling about where the Saudis may wind up? Are we likely to continue to share their production as generously as we have in the past? Are they likely to be as generous with us in terms of oil, or is there some danger that the Saudis may decide that, since they are unsure of whose side we are on in various places—Taiwan, People's Republic of China, the Shah, Bakhtiar, Khomeini—are they likely to be seeking a position that would see their oil distributed not only in the free world but perhaps also through other nations and into the Communist world?

Secretary SCHLESINGER. It is certainly conceivable, Congressman Brown, and let me make a general comment and then a specific comment.

My general comment is that in the face of the unrest, the disturbance, the concern throughout the Persian Gulf region, that clear, unequivocal indications of American strength and steadfastness are necessary to shore up all of the countries of that region other than Iran.

Representative BROWN. Is that why we sent the F-14's over and then announced that—

Secretary SCHLESINGER. The F-15's, you mean?

Representative BROWN. F-15; yes.

Secretary SCHLESINGER. I presume so.

Representative BROWN. And then announced that they were unarmed? [Laughter.]

Secretary SCHLESINGER. That was more equivocal than I would have preferred, Congressman.

Representative BROWN. Was it done by the same person or was that just confusion within the administration?

Secretary SCHLESINGER. I cannot answer who had the responsibility for that. I presume that it was a position taken by the Department of Defense.

Representative BROWN. So I gather what you are telling me is, we need to firm up our policy with reference to the Middle East and the oil situation in particular unless we are going to risk the loss of some of that Saudi production?

Secretary SCHLESINGER. It's not only a question of the energy issue, Congressman Brown; it's the geopolitical position of the Middle East. Unless these nations see firm and unequivocal western policies, the position that they have enjoyed and we have enjoyed since World War II could be dramatically shaken, and consequently, the geopolitical setback would be even more significant than the impact on energy.

That's the general comment.

With regard to the specific comment: The Saudis, as you know, have established an 8.5-million-barrel-a-day limit on production. They have, as you have indicated, as a result of concern about oil supply, permitted that to go above 8.5 million barrels a day in recent months, but they have not changed their general policy.

Representative BROWN. How long are they likely to keep that absorption of the Iranian loss going?

Secretary SCHLESINGER. We do not know the answer to that. They have been attempting to accommodate us and the other industrial nations—indeed the LDC's as well. Their desire—I think this is the heart of your question—to make what they regard as sacrifices to accommodate us will be influenced by their perception of our general strength and the long-term reliability of the support that they will receive from western nations.

Representative BROWN. And some—

Secretary SCHLESINGER. To the extent that they lose some of that, they may be less unwilling to turn elsewhere.

Representative BROWN. And regarding some of our other relationships, the Iranians were supplying oil to the Israelis, were they not?

Secretary SCHLESINGER. That is correct.

Representative BROWN. Are we prepared to pick up that slack from our—whatever it is—supply of oil in this country and supply the Israelis?

And, if we do, how is that likely to impact on the Saudi reaction to picking up the world's slack?

Secretary SCHLESINGER. The United States is obligated under the 1975 Sinai II Agreement that, if the Israelis are unable to obtain oil elsewhere in the world, to provide oil to Israel, approximately 70,000 barrels a day.

I think that to the extent that the United States demonstrates its continued determination to live up to its agreements, that that will not be taken by anybody around the world as a reason for turning away from the United States.

Representative BROWN. Are we prepared to ration to accomplish that, ration here?

Secretary SCHLESINGER. I don't think that 70,000 barrels a day would be significant enough to cause rationing. It's a very, very small part of our total consumption.

Representative BROWN. A final question from me, Mr. Secretary; my time is up, and I appreciate the chairman being very generous with me.

Let me ask: Are we going to pay the Mexicans, when we reach an agreement on natural gas supply from them, more than what we would be paying the Texans and Louisianans at the same time?

Secretary SCHLESINGER. Both the asking price by the Mexicans and the counteroffers by the United States are above the new gas price for our domestic producers. We went into this somewhat earlier, Congressman Brown; the point that I was making was our desire to use domestic production because of its lower cost. Senator Kennedy indicated that he felt we were having a protectionist policy, and my point was that we have the very opposite of a protectionist policy. We are not protecting high-cost domestic production; we are attempting to make use of lower cost domestic production before turning to higher cost external production.

Representative BROWN. Finally, if I may, Mr. Chairman, I would like to submit for the record to the Secretary a question that was prepared by Senator McClure, who was unable to be here. If I can submit that for the record and also for the Secretary, perhaps you would be kind enough to answer that and respond to Senator McClure.

Secretary SCHLESINGER. Yes.

Senator BENTSEN. I would like to ask you, Mr. Secretary, a question about the supply of unleaded gasoline. Unleaded gasoline has been in tight supply. We have had some spot shortages, and it sells from 5 to 7 cents a gallon more than leaded gasoline.

Alfred Kahn recently said that it might be necessary to put an additional tax on leaded gasoline. Are there any plans at all to do that?

Secretary SCHLESINGER. No, sir; there are no such plans. I think that there has been some discussion of removing the tax on unleaded gasoline as a way of bringing those into price balance.

Senator BENTSEN. To keep unleaded consumers from substituting leaded gasoline, right?

Secretary SCHLESINGER. Yes, but I have heard no suggestion of an increased tax on leaded gasoline.

Senator BENTSEN. I would like to ask you about a decision on an ICC case that affects San Antonio, Tex., which has major implications for the entire Nation. The Burlington Northern Railroad asked for an increase in transportation costs for coal that was approximately twice the price for transportation that they had originally told the city of San Antonio would be charged them. That original price played a very major role in their decision to convert to coal in trying to implement your coal conversion policies.

Your Department intervened in behalf of the city of San Antonio before the ICC for which I am most appreciative. But we lost.

Do you have any feeling of what that decision is going to do to your coal conversion programs in this country? Do you think any legislation is necessary to deal with this area?

Secretary SCHLESINGER. It would be premature to say, Mr. Chairman, whether legislation is necessary, but I think the situation should be carefully watched. Indeed, as you indicate, this Department did intervene with the ICC in regard to the rates charged by the Burlington Northern. There was some reduction from the request, although the rate does remain quite high.

We are involved in the generic proceedings on coal rates, Docket No. 357, of the ICC, which bears very closely on the question you raise. If we are to allow the increases—the prospective increase in coal demand in this country to be skimmed off in the form of rate increases in the transportation sector that makes coal uneconomical, then we would have not only struck a devastating blow against the coal conversion program, but we would have eliminated the traffic that the railroads hope to enjoy in the future.

That would be a case of killing the goose that laid the golden egg from the standpoint of the railroads while damaging the national interest in moving toward coal.

Senator BENTSEN. Mr. Secretary, you have heard almost unanimously from this committee a deep concern about possible negotiations with Mexico on natural gas.

I have lived on that border. It is part of my life. I feel, whether either nation likes it or not, that our futures are in part intertwined. There are 63 million Mexicans. If you extrapolate their present mortality rate and birth rate, that country's population will double in size in 19 years. And by 2025, without a break in that trend, you will see more Mexicans than Americans. The problem of spillover is apparent. It is terribly important to us consequently that we have a country, a neighbor there, that is economically and politically stable. It is in our mutual interest. So, the question of Mexican natural gas has very broad implications, far beyond issues of price.

Regarding the stalled negotiations on that gas, what happened at the Export-Import Bank when they were talking about financing the pipeline coming up through Mexico? That loan was denied. But all the U.S. negotiators did was turn around and get a consortium of banks, American banks and foreign banks, to lend the money they need.

I just don't see how the Eximbank's actions contributed in a positive manner to trying to work out a deal with Mexico. Would you explain that to me?

Secretary SCHLESINGER. Yes, sir. Let me do two things.

First, I endorse in their entirety the general comments that you have made. Second, with regard to the Export-Import Bank loan, from time to time we have encouraged the Eximbank to make—to grant credit to Mexico. The Eximbank cannot or could not, according to its procedures, issue a loan prior to the signing of a contract; a clear indication with regard to price. Consequently, the Eximbank never completed that loan.

That is a part of the procedural question. I would recommend Eximbank financing, Mr. Chairman, and this is one of the areas in which we as a nation are inhibited, but the Eximbank does not grant loans, front-end capital, as the World Bank is presently moving to do. The Eximbank is restricted only to granting loans if they will move American goods and services.

I think your point is well taken that there is room here for front-end money, particularly with PEMEX capital shortage, critical as it is. Other nations are not so restrictive in their lending policies. If the Congress were to review that, there may be the opportunity to broaden the charter of the Eximbank.

Senator BENTSEN. I think that is a good suggestion. I think Eximbank officials may have interpreted their policy rather narrowly in this

situation, because we are Mexico's No. 1 customer and they, in turn, are a top customer of ours. We have had a trade surplus generally with Mexico, and whatever they do that brings about progress in their country means a lot more sales of American products in Mexico.

So I would certainly encourage that kind of interpretation.

Mr. Secretary, I think from what you have heard and from the substantial number of members we have had in attendance during this hearing, that there is intense interest in what you have had to say. There have been some very strong and diverse opinions offered, and we appreciate the manner in which you have handled your testimony and in the way you have answered our questions.

Thank you very much. Just a moment—I beg your pardon. Congressman Brown.

Representative BROWN. Mr. Chairman, I am advised that Senator McClure wanted me to get that question on the record here. Is it possible for me to read the question and for the Secretary to respond?

Senator BENTSEN. Yes, of course.

Representative BROWN. Thank you, Mr. Chairman.

In 1970 we had the disruption of foreign oil supplies caused by a break in the Tapline in Syria. In 1973 and 1974 we had the Arab oil embargo resulting from the October 1973 Middle East War. And today we have the loss of Iranian oil due to internal political disruption in that country.

Throughout this entire period the Congress and the administration have had one consistent response: Discourage domestic energy production and encourage increased dependence on foreign imports. The 1975 Energy Policy and Conservation Act is perhaps the most striking example of this irrational response to a critical threat to our national survival. As you know, under this act the U.S. Government forces producers of domestic oil to subsidize importers of foreign oil. This degree of irrational behavior borders on the edge of a national death-wish, as viewed by both our allies and our enemies overseas.

In addition, we have the continuing administration opposition to the development of nuclear energy. Last year it was my understanding that this opposition had been somewhat modified, particularly with regard to the Clinch River breeder reactor project and related safety activities. As you know, the President agreed not to terminate Clinch River and to move ahead with the related safety work.

And yet, reading the President's budget, I see that the administration again proposes to terminate the Clinch River LMFBR project. I see also that the funding for safety research is to be reduced from the agreed upon figure of \$48 million to \$36 million and that agreed upon funding for phase 2 of the Safety Research Experiment Facility—SAREF—has been totally eliminated.

The question is: Does this represent an administration oversight by the Office of Management and Budget or does it mean that the President is renegeing on his agreement?

That is Senator McClure's question. Would you care to answer that? It would certainly make some of the other questions mild by comparison.

Senator BENTSEN. Mr. Secretary, do you think it is possible to keep the answer shorter than the question? [Laughter.]

Secretary SCHLESINGER. There are three aspects: First, I think that Senator McClure does point to some inconsistencies in our policies

over the last 7 years. We have not been of one mind nor have we been totally rational in adopting national policies to move toward lessened dependency.

Second, whether or not those harsh words about the EPCA are justified, I would not be prepared to say. I was not one of the authors of the act.

Third, with regard to the nuclear issue, as you know, the President did agree that he would not veto a Department of Energy authorization bill that contained \$540 million for its first fiscal year. He would approve \$513 or \$520 million—I forget the exact numbers—in subsequent years, if we could get the agreed on arrangements for the Clinch River breeder reactor. The phrase that was used was “discontinued,” “termination” sounding somewhat harsh. We are still prepared to fulfill those arrangements with regard to the breeder program.

I do not think that the President in any way has reneged on his position. Whether or not the Office of Management and Budget had a role to play in the budget levels, I think, is a question that perhaps answers itself.

Senator BENTSEN. Thank you very much, Mr. Secretary.

Secretary SCHLESINGER. Thank you very much, Mr. Chairman. Thank you, Congressman Brown.

Senator BENTSEN. The committee is recessed.

[Whereupon, at 11:58 a.m., the committee recessed, to reconvene at 10 a.m., Thursday, January 25, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, JANUARY 25, 1979

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

The committee met, pursuant to recess, at 10 a.m., in room 1318, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, McGovern, and McClure; and Representatives Long, Mitchell, Brown, Heckler, and Roussetot.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, Lloyd C. Atkinson, Kent H. Hughes, L. Douglas Lee, Deborah Norelli Matz, and William D. Morgan, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; and Robert H. Aten, Stephen J. Entin, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. It is 10 o'clock, and this hearing will start.

As we begin the second day of our annual hearings on the economy, the Joint Economic Committee will focus on the problems and the potential in the area of international trade.

We are privileged to have as our first witness the President's Special Trade Representative, Ambassador Robert Strauss, who is on the verge of completing one of the most complex, sensitive, and significant trade agreements ever negotiated—a treaty that is going to be reviewed in great detail by the Congress but has to be accepted or rejected by the Congress without amendment. Ambassador Strauss accepted a difficult assignment and, as usual, he has worked it out very well. We are pleased to have you here.

Following Ambassador Strauss to the witness table will be a distinguished panel composed of Mr. William Eberle, who has also served as a trade representative and who played such an important role in the enactment of the 1974 Trade Act. Mr. Eberle will be joined at the table by Prof. Robert Baldwin, professor of trade policy, University of Wisconsin; and Mr. Philip Trezise, a well-known trade authority.

Ambassador Strauss, depending on the arithmetic one prefers, our balance of trade deficit was somewhere between \$29 billion and \$35 billion last year. It was, in other words, equal to the budget deficit projected by the President for the coming year.

Our trade deficit with Japan was about \$12 billion, which has prompted the comment that the United States is still the land of opportunity if you happen to be a Japanese businessman.

In my opinion a trade deficit of that size is an intolerable, totally unacceptable deficit, and we just can't permit it to continue. That kind of a deficit erodes the value of our currency abroad, it causes inflation at home, and it destroys the financial system—it is a clear and present danger for the economic future.

Before you begin your testimony, I would like to make a couple of points, Mr. Ambassador.

We appreciate how hard you have worked for the Geneva agreements, but we also know that that is not some kind of a magical "fix" to all of our trade problems. I would hope, however, that you can tell the committee how, and to what extent, congressional approval of the treaty will improve our ability to compete on a basis of equity in the international marketplace, in other words, what we stand to gain on the MTN.

I also understand that you have been a long and a consistent proponent of free trade. Lately, however, some of us have begun to question whether that trade really flows equally in both directions. I don't seek to export a blame for the trade problems; I know that a lot of these trade wounds are self-inflicted; but I also know that we bear some pretty nasty scars on our backs and some of our partners in international trade, the same countries that clamor for access to our markets, have no qualms about finding ways to deny us export opportunities in their markets. I just don't want to see free trade become a one-way street and I know you don't either.

I would be interested in hearing your comments about enforcement mechanisms that exist in the treaties you have negotiated. Specifically, how do we guarantee—on a timely and effective basis—that our partners are adhering to the codes?

Finally, if we are unable to resolve our trade problems on a multilateral basis, it is obviously important that unilateral measures such as the surcharge protect us from unfair competition. I am concerned that we may be getting the short end of the stick with the Japanese and, if this is the case, I am one who is prepared to try to do something about it. I have asked the General Accounting Office to look into Japan's nontariff barriers to trade, and we are asking American industry for examples of discrimination.

If it develops that the Japanese are retaining nontariff barriers to American goods, then I think we should look very carefully at a surcharge or other barriers, and I think there are a lot of Members of Congress who feel the same way.

Ambassador Strauss, we look forward to your comments and welcome you to the Joint Economic Committee.

STATEMENT OF HON. ROBERT S. STRAUSS, AMBASSADOR, SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS

Ambassador STRAUSS. Thank you, Senator Bentsen.

I say to you and the other members of your committee that I propose to make an opening statement to cover my thoughts on your good questions. Following that, to the extent that my remarks have not

responded to your opening statement, then we will take your questions specifically.

First, let me thank you for holding these hearings and for permitting me to be here. As you know, I am not a trained economist, and any understanding I may have of economic events comes mostly from practical experience. In my recent work, however, I have had close association with some of our Nation's leading economists and, while they have taught me much, the only thing they have convinced me of, is that this is a time of tremendous confusion.

We are faced today with a high underlying rate of inflation which defies conventional economic logic. The prognosis from many economic forecasters is a pessimistic one. Yet the continued performance of our economy has been very strong. The fourth quarter of 1978 gross national product came in at an annual rate of growth of 6.1 percent, adjusted for inflation, easily topping the 2.6 percent of the third quarter and above most estimates. There is little indication of any impending softening in orders or sales. In particular, recent gains in employment have been substantial, and the labor market is becoming as tight as it was during the business upswing of 5 years ago.

I know that Chairman Schultze of the Council of Economic Advisers will discuss the economic outlook with you in some detail soon. He is a trained and competent economist, and this is his preserve. I think that when you have considered the evidence, you will agree that our economy is fundamentally solid and sound. Real wages and earnings are at record highs, and the dollar is steadying on international money markets.

This does not mean that we are satisfied. Along with the rest of the world, we are in a period of slow growth, although we are growing faster than many others, and at a better rate than many predicted last fall. Our trade deficit continues, as you commented, at an unacceptable level. Our export capability must be improved. All of this serves as a backdrop for our trade negotiations and makes our success in these talks even more crucial.

Let me describe to you in some detail now where we stand in international trade—not only through the multilateral trade negotiations in Geneva, but especially with respect to Japan.

As you know, President Carter reported to Congress on January 4 that we are in the final phase of negotiating the first major new set of trading rules in over 30 years. While the six preceding rounds of multilateral trade negotiations that have taken place since World War II dealt largely with multilateral and reciprocal reductions in industrial tariff barriers, the Tokyo round has been more ambitious. Besides a further reciprocal reduction in industrial tariffs, we have sought to conclude a major liberalization in agricultural trade barriers and others.

Most importantly, we have negotiated for the first time international codes of fair conduct in international trade in the areas of government procurement, product standards, customs valuation, subsidies and countervailing duties, import licensing, commercial counterfeiting, aircraft, and safeguards.

Finally, we have sought to develop internationally acceptable dispute settlement procedures for managing areas of trade conflict both inside and outside those areas covered by the codes.

We are close to a final agreement, but we are not yet there. Just as there remain questions on how those of you in Congress will come out, there are many voices in the European Community, for example, who feel they have given up too much for what they got.

Let me make it very clear that we are far from certain that the Council of Ministers of the European Community will approve what we are attempting to negotiate. We believe that they will; we feel strongly that they should.

On the tariff side, the package we are now talking about will represent duty reductions opening up billions of dollars worth of new export opportunities for U.S. manufactured goods and farm products. In agriculture alone, we estimate that there will be reductions in trade barriers covering trade worth about \$3 billion to this country.

When I took this job, Mr. Chairman, I appeared before you and other members of the Finance Committee, and I said that I intended to overperform and not overpromise. I am not going to start overpromising at this late date, but I do want to point out what some of the nontariff trade agreements can mean to our economy.

The proposed subsidies code represents the most extensive attempt ever made to subject actions designed to distort fair trade to uniform tests and the application of uniform penalties. The code will greatly streamline the cumbersome dispute settlement procedure in this area.

Similarly, through the safeguards code we will ease export opportunities by achieving better regulation of import restrictions applied by countries protecting their domestic producers. The Government procurement code will open up as much as \$25 billion a year in foreign government purchasing markets that are now closed to U.S. exports.

The standards code will force major movement by other nations toward the U.S. system of openness in drafting standard-setting procedures and reduction of the use of standards as hidden barriers to trade. In much the same way, the aircraft agreement will promote fairer as well as freer trade in this important U.S. export sector.

Now let me turn more specifically to the critical concern of our trade deficit with Japan. Mr. Chairman, yours has been one of the most articulate voices in Congress warning that the American people are not willing to accept ever-growing trade deficits with Japan.

I strongly agree with you, and this conviction has guided our trade negotiations with the Japanese. In past negotiations Japan has been permitted to stay on the sidelines, making few contributions and reaping the benefits of tariff cuts made by others. We did not let that happen this time. We mounted an all-out campaign to get Japan's tariffs down to levels about the same as ours, especially for key products, and we insisted that Japan assume full obligations in all the nontariff barrier codes.

What are the results? In the tariff area, Japan will reduce its tariffs to roughly the same level as our tariffs, both on an average basis and in key product areas. Overall, Japan will be cutting its tariffs on industrial imports from the United States by over 60 percent from the rates it has bound in GATT, with the cuts covering some 3,000 items.

The average Japanese tariff on industrial imports from the United States will be 2.3 percent, while our own tariff on imports from Japan will be just under 4 percent. After these cuts are fully put into effect, Japan will have one of the lowest tariff structures of any developed nation.

In addition to overall compatibility, we concentrated on getting Japan's tariffs down to our levels in product sectors of key export interest. As you will see, we have done so in such key sectors as computers, color film, and integrated circuits, for example.

In agriculture, the Japanese made concessions covering some 150 items and amounting to about \$1.5 billion in U.S. agricultural exports. A significant concession is a duty-free binding on soybeans, for example. In addition, high quality beef imports are going from 6,800 in 1977 to 30,800 tons by 1983. Japanese orange imports, on a fresh equivalent basis, taking into account the concession on concentrated orange juice, are going from 25,000 tons in 1977 to 136,000 tons in 1983.

In agricultural tariffs, of 21 concessions on fruits and vegetables, most are 50-percent cuts or greater, and only 6 are less than 40-percent cuts. Most of the fish concessions are cuts of 40 percent or more. For cottonseed oil and corn oil, the cuts are all 50 percent. For turkey and chicken, the cuts are at least 50 percent. While not covering all items, these are representative of the kinds of Japanese agricultural concessions we have negotiated.

Let me say this, Mr. Chairman, as an aside. If anyone expects me to say that we have received all that we wanted or even all that we are entitled to, that this is a 100-percent or A-plus negotiation, of course my answer would be "no." If anyone asks me on the other hand, Mr. Chairman, have we made significant progress, do the pluses far outweigh the minuses, my answer is a strong affirmative "yes."

While tariffs receive a great deal of attention because they are visible and easy to measure, what may have the greatest payoff over the longer term—especially with Japan—are the codes on nontariff barriers. Let me give you some specific examples.

1. GOVERNMENT PROCUREMENT

Up to now, foreign suppliers have found it virtually impossible to sell to Japan's Government because the procurement is negotiated behind closed doors. This code will force Japan and others to adopt a high degree of visibility of purchase opportunities so that foreign firms can compete. We are still pushing the Japanese for greater coverage.

2. STANDARDS

This code will insure that the Japanese no longer set standards that create unnecessary trade barriers. If we are dissatisfied, the code provides an international dispute settlement mechanism.

3. SAFEGUARDS

In the past, Japan has frequently agreed to restrain its exports to other markets, increasing the pressure to export to our market. This code will for the first time bring some discipline over voluntary export restraints, as well as providing for more open procedures on safeguard actions.

4. CUSTOMS VALUATION

Another major problem in exporting to Japan is the arbitrary behavior of Japanese customs officials in raising the appraised value of an export for duty purposes. The customs code will prevent this by carefully specifying valuation methods.

There are other advantages of each of these codes too numerous to mention here. You have already received detailed information on the provisions of each code; the Japanese have agreed to abide by these provisions in each case.

We are finally at the point where we can see some improvement in our trade figures with Japan. It is still too early to tell if all of our efforts over the past year are really paying off, but the data for the latest available 3 months of September-November 1978, is encouraging. In this period, U. S. exports to Japan were up 57 percent over the same months for the previous year. After averaging over \$1 billion a month from January to July, the deficit has come down to \$674 million. We are not out of the woods by a long shot, but the direction is right, for a change.

We have put more effort into improving our trade with Japan than with any other nation. We are opening some warped doors and making changes. Progress must be carefully monitored, and Congress should continue to keep the heat on.

Perhaps the easiest way to understand the importance of this agreement is to consider the consequences of failure or disapproval. In the absence of this substantial effort to discourage unfair Government intervention in trade, and to devise fairer rules and more workable dispute settlement mechanisms, it is likely that trade conflicts and distortions between nations will grow worse.

The stakes are enormous. Today we trade one-sixth of everything grown or made in this country on the world market. We are increasingly dependent on both exports and vital imports, not only of oil, but of industrial raw materials on which our domestic productive capacity as well as export capability is based.

It is easy to say that we are suffering from import competition and that the answer is to shut it off at the border. We must bear in mind that, if we take that course, we will also be cutting off at the same time about \$1 out of \$6 that our domestic investors and workers earn from exports.

We can promote—through these trade agreements—American enterprise, technology, and productivity to the benefit of all sectors of our economy. Or we can duck, stick our head in the sand, and hope that we don't see disaster when it hits us from behind.

Mr. Chairman, we must not make the easy mistake here of saying that the glass is one-third empty because of what these negotiations did not accomplish. There are many things that I could list that we did not agree on, but we need to concentrate on that part of the glass that is two-thirds full.

What we have been able to accomplish is greater than I dreamed possible when I first took this job. These accomplishments will not fill the book on trade; they are only the opening paragraphs of a book that charts a course and creates a climate which the Congress, the executive branch, and the private sector can add to, and implement, for many years to come.

The opportunities for orderly and fair trade which will flow from this agreement can result in the real gains from a renewed export thrust that our Nation so badly needs. At the very least, we will have removed a great number of the barriers which have prevented the free flow of trade in our past.

I think, Mr. Chairman, it might be well if I stopped here and took your questions.

Senator BENTSEN. All right. I ask that we observe the 5-minute rule and, as I have in the past, I will recognize those members in the order in which they arrived at the committee meeting, starting with the chairman.

Ambassador STRAUSS. Mr. Chairman, I see you are still conducting your business as you always have.

Senator BENTSEN. Let me say, Mr. Ambassador, there was not anything in that statement of yours I could not agree with enthusiastically, and I think you have made remarkable headway. I think we still have a long way to go. The New York Times reported today that Japan had a record trade surplus in 1978. That surplus of \$18.3 billion, on a customs-clearance basis, nearly doubled the 1977 level, and that is despite repeated pledges to reduce the trade balance. They always seem to have a large surplus. I understand they say they have a problem in trade with us, but that they just need a little more time.

Well, I can recall that their 1977 trade balance with us was about \$8 billion. The next year it went to \$12 billion, an increase of 50 percent.

Here are some of the games they are playing. They are smart, they are tough, they are able traders. I saw one the other day where they take care of part of this trade balance they report with us by doing the financing job on American airplanes that are sold by an American company to an American purchaser. They bought the plane, supposedly, in their name, but then leased to an American company so that it helps them reduce their trade surplus with us.

Look at this situation. I hear them say that one of the problems with the Japanese is that they just don't eat beef. Well, beef over there sells for about \$20 a pound, and they don't eat beef for the same reason we don't eat caviar—the price is just a bit high. Total imports of beef into Japan from all countries are the equivalent of about one thin hamburger patty per Japanese per year.

Now, in their recent concession, they have added a quarter-pounder. [Laughter.]

These are my concerns. You have made significant headway, but we are talking about a \$250 million gain and a \$12 billion problem.

I firmly believe that there has to be a redress of those imbalances and, if we don't get more significant concessions, then we can well see unilateral action taken here, and I don't want to see it taken. I think it is far better if we can work these things out on a reasonable basis.

Ambassador STRAUSS. Mr. Chairman, I certainly share those concerns with you as the members of this committee know. We did not, any of us, create the trade problems that we have right now, and we are trying to go about mending them.

As I clearly pointed out, the things we have negotiated in the Tokyo round are not going to take care of our trade problems; they are a step in the right direction; and I am not going to say anymore than that.

With respect to beef, of course that is true. When I got into this thing, it was six or seven times less—we increased it sixfold or sevenfold. You must keep in mind, as I know you do and members of this committee do, beef in this country is difficult to negotiate in any faster

fashion or rate than we have done. I am sorry that we started at too low a base.

Senator BENTSEN. Just look at price tags. Look at price tags in Japan and price tags here on comparable products. Why does a Toyota sell for the same price here as the Ford Pinto and the Pinto sell for twice as much there as it does here? I have not been able to get satisfactory answers to that, and it concerns me very much. There is a question of textiles, and I understand that you have made some headway on that.

Ambassador STRAUSS. Senator Bentsen, with respect to the textiles, you say you understand. I know that you probably are referring to the story that we are in negotiation with our textile people in the textile industry, both labor and management, and we are in the process of doing some negotiating with that industry. I have met with union and management people a great deal in the past 3 or 4 weeks.

We have a terribly difficult problem there. On the one hand, we have a sensitive industry, we have jobs that are at stake, we have people that must be kept employed and an industry that cannot be permitted to deteriorate.

On the other hand, we have the problem of consumer interests in this country and inflation, and we are trying to strike, I think, in a cooperative way with the industry, a balance. Whether we will be successful in doing so, I don't know. I think the approach we are making now is right. You recall the President issued a proclamation setting forth the course of the general, broad outlines of a domestic program, at the time he vetoed the legislation removing textiles from the MTN, and we are trying to implement that now in a sensitive and responsible way that would not be inflationary, but still protecting jobs here in this country.

Senator BENTSEN. Mr. Ambassador, my 5 minutes have expired. Congressman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

Mr. Ambassador, I feel that you are more than an able negotiator. Ambassador STRAUSS. Thank you, ma'am.

Representative HECKLER. And I feel that I agree with so much of what you have said; I find that in this Congress we are faced with developing a compatibility among opposites, between the environment and the economy, and free trade and jobs at home.

As you know, I come from a region of the country where the textile industry is of major significance. I have a great deal of interest in preserving our global marketplace, and I see the world as inter-related and interdependent. I see the pursuit of free trade as a goal for all nations.

At the same time, while I take that global outlook, as I look at the impact of our trade policies for the last several years on the textile industry and on the apparel industry, I would have to say that, if we were to rate it on a scorecard, the rating would be in terms of striking a fair balance, and that is exactly what I am interested in.

As you know, the textile industry has decreased probably 25 percent since 1967. In the apparel sector the decrease is even greater, and right now we are reaching the pitch of high anxiety, with good reason. At a recent public meeting in Fall River with Sol Chaikin, the head of the Ladies Garment Workers Union, one member of the union, a

lady garment worker, raised her hand and said, "I am not worried about wage and price controls; I am worried about working a 5-day week."

She is working a 2½-day week right now.

I feel that the impact of negotiations in the textile industry, and especially the apparel sector, will have to be taken very, very seriously. I remember when we discussed the sugar subsidy and the dependence of the United States on its own capacity to produce sugar was one of the arguments raised. Isn't there also a question of goods, and if one is to translate that into military terms, "to produce our uniforms," when we wipe out this industry? We are talking about survivability. We are wiping out skills that the country badly needs.

I think there is a great misunderstanding about the impact on the consumer of all of these things, because when imports started to flood the market the consumer was the initial winner, lower prices for a product from Hong Kong made the item much more attractive than the locally produced item. For many, many families with tight budgets, I can understand that, but the times have changed, and prices have changed.

I have two really almost identical, I think, ski caps here, and they look the same to me—perhaps some expert could see a difference. They are the same pattern, made in virtually the same way with the same materials. One made in Taiwan is sold to the wholesaler at \$6.50 a dozen. One made in the United States is sold to the wholesaler at \$15 a dozen; and the wholesaler sells both for \$36 a dozen. So the consumer no longer is the winner in this free trade or domestic production dispute.

My question to you is: While we would hope for an A-plus in our trade negotiations in terms of reaching fair balances with other countries of the world, how would you rate yourself in terms of the apparel industry and the knitted outerwear? What relief do you offer to them, because, frankly speaking, we are coming down to that. Considering the large segment of our America workers involved in this area, if we are going to turn our backs on their desire to earn their own livelihood in the name of perhaps negotiating a somewhat better international agreement, I question the justice of the course of that policy by the United States.

What do you offer us? What new approach would you offer these industries?

Ambassador STRAUSS. Congresswoman Heckler, let me respond to that very precise question in a precise way. With respect to the negotiations that we have had, bilateral negotiations under the multi-fiber arrangement, I think the industry will tell you we have been effective. In terms of accomplishing what they asked us to do, they set goals for us, we have achieved those goals. Now, Congresswoman Heckler, those goals that were set were not sufficient, were not precise enough, and through no fault of the industry or of our negotiators, the fact that it did not work as well as we thought it would or as they thought it would puts no blame on anyone. We are presently in the process of working with the textile industry to renegotiate the bilaterals, and within the last week we have completed, No. 1, the first negotiation with Japan in textiles. I can't make it public yet; it is still private; but let me say this to you: The Japanese negotiation was approved by the industry advisers, both business and labor.

Both sides sat in with us in those negotiations. They know the results. They have approved them. and we are now in the process of negotiating with Hong Kong, with Taiwan, with Korea, and with others. The Hong Kong negotiations will resume in February—I think it is on the 12th. We hope to achieve the same results there.

The negotiations that Senator Bentsen referred to that are taking place between my office—Mr. Chaikin, Mr. Findley, representatives of the mills, and others on the business side—we hope will achieve a balanced approach, one that really will take into account all of the sensitive areas of this Nation, and I think, indeed, we will be able to satisfy the very wise concerns that you have.

Representative HECKLER. Mr. Chairman, I understand that my time has expired.

Senator BENTSEN. Congressman Rousselot, you are next.

Representative ROUSSELOT. Thank you, Mr. Chairman.

Mr. Strauss, we are delighted to see you again, I, too, want to express my own appreciation to you for the hard-nosed approach that it appears you are taking in trying to work for the benefit of our country in these negotiations, and I know that it is not easy.

Ambassador STRAUSS. Thank you.

Representative ROUSSELOT. Can you describe a little further than you did the progress as it relates to citrus with Japan?

Ambassador STRAUSS. We have an increase in our orange quota from 15,000 metric tons in 1977 to 82,000 in 1983. In our grapefruit juice quota we went from 400 metric tons in 1977 to 6,000 in 1983.

Oranges, from 15,000 tons to 82,000 tons. In orange juice, 600 tons to 6,500 tons in that period of time, from the time I entered this job, until 1983. In grapefruit juice we go from 400 to 6,000 tons in 1983. We have got some midyear productions in grapefruit and lemons and limes and in lemon juice. And let me say this. I think our production will run in excess of 40 percent of the tariff reductions there.

Representative ROUSSELOT. And they will not engage in these other practices of other potential ways to increase the cost?

Ambassador STRAUSS. Congressman, what I am trying for—let me answer that in another way.

Representative ROUSSELOT. You mentioned the customs procedure.

Ambassador STRAUSS. Those things we are in the process of cleaning up.

Do we want these quotas over there? Of course not. We are trying to liberalize, we are moving toward an open market. We cannot liberalize that market overnight. Congressman, it is not my opinion, it is a fact; to do that they are going to have to get a better horse than me.

Representative ROUSSELOT. We thought you were a pretty good horse.

Ambassador STRAUSS. I tell you one thing, I never worked harder for a few bushels of oranges in my life. If there is anything left over there, somebody else is going to have to go get it now.

The citrus industry, you will be pleased to know, and Senator Bentsen will be pleased to know—we work closely with the citrus industry—is pleased, they are happy. Of course, they want more, they are entitled to more.

Representative ROUSSELOT. I have heard that.

Ambassador STRAUSS. Senator, in our own valley our citrus growers—I don't have to tell you—we just got a handwritten resolution of appreciation and signatures of several hundred growers on that.

Senator BENTSEN. I would be delighted to add my signature to it.

Ambassador STRAUSS. Thank you, Senator.

We don't have what they want; they don't have what they are entitled to. They have a lot more than they had 2 years ago.

Representative ROUSSELOT. Thank you. I was not being critical.

Ambassador STRAUSS. I know that. I am just trying to say I appreciate your question.

Representative ROUSSELOT. Now, another area, all within my 5 minutes of course. The Washington Post reports this morning—I know they are always accurate—that the trade negotiations with Europe have been jeopardized by sudden U.S. demand for concessions in paper products, and by a sudden decision to affect our agreement to abolish the American selling price system for some chemicals by raising our tariff on all chemicals. Now, have the negotiations in this area hit a snag?

Ambassador STRAUSS. Mr. Congressman, this is a very delicate subject, and I want to answer it with candor. We have not introduced anything new. We started out firm, we started out wanting a reasonable, fair arrangement. I started out with the conviction that we had not always been firm enough and we have hit snags—yes, there are snags there.

There are some of the European countries that feel that we have received more concessions than we have granted. I disagree with that. I think we have negotiated a fair and balanced package. It should be that way; it ought to work both ways. That is the position of this administration and it is the position I am going to stay with right now, and I hope we can convince them that we do need some additional concessions in certain areas; and obviously we are going to have to give something to get it. It is a negotiation; nothing is for free. There ain't nothing for nothing. I have found that out, Mr. Congressman.

Representative ROUSSELOT. Yes, I have, too. [Laughter.]

Ambassador STRAUSS. I like the idea that people think I negotiated well for this country; I take great pride in it; but everything we have got we have paid for; it has come out of the hide of somebody in this country.

Representative ROUSSELOT. Thank you, Mr. Chairman.

Senator BENTSEN. I am sorry we have the limitation of 5 minutes, but the Ambassador has to leave at 11 o'clock and we have such fine attendance at this hearing that I want to be sure that each member has a chance.

Representative ROUSSELOT. It is good to limit me to 5 minutes.

Senator BENTSEN. Congressman Mitchell.

Representative MITCHELL. It is good to see you again, Mr. Ambassador.

Ambassador STRAUSS. Thank you.

Representative MITCHELL. I suppose, as a strategy, we should try to improve our trade negotiations first; that is our most immediate problem. However, it seems to me that the future of the balance of trade and the future of our own economic growth lies in the development of markets in the lesser developed countries. That is the long-range strategy that we should be pursuing.

What steps, if any, are being taken or do you contemplate taking to cultivating that kind of economic interaction with some of the lesser developed countries, particularly the African nations which are so rich in many of the mineral resources for our own industrial growth and well-being?

Ambassador STRAUSS. Mr. Congressman, in the Tokyo Round there are 98 countries participating, and as we are putting in place the final touches on what I hope will be an approved agreement with the Japanese, the European Community and our American Congress—as we put that together—we are now moving far more aggressively with respect to the LDC's and we have tried to do it wisely.

We have said that there are some countries less developed than others and that as some reach a developed posture, they should be treated as developed and those who are far less developed than that should get more preferential treatment in other ways.

The first time I went to Europe we met with the other nations that are not the major nations in the trade negotiations, so we are making every effort to involve them, to find the commonality of interest so that we can do just as you suggest.

Representative MITCHELL. Well, that is encouraging.

I have time for another question.

I read somewhere that 5 percent of the American businesses—just 5 percent of them—provide 95 to 98 percent of all the export products in this country.

Ambassador STRAUSS. That is correct.

Representative MITCHELL. I think that reflects the exclusion, really, of small business from export-import areas.

More specifically, I am asking you what arrangements do you contemplate or what steps have you taken to facilitate the entry of small businesses into this whole export-import area.

Ambassador STRAUSS. Mr. Congressman, without telling you how hard I am working, I got up at 5 o'clock the other morning and went west to speak to 500 small business men and women and flew back that afternoon in time for some meetings here at 5 o'clock in the afternoon.

Now, I am not telling you that to show how hard I am working, but to show how high a priority I put on that.

You have touched on a very significant thing. The Du Ponts, the IBM's, the Fortune 500's have the means and the capital to acquire the skills to develop export markets; small business does not.

The first thing we have to do is provide capital for them to do it.

Second, under these rules we have to put a bit more certainty in where a man or woman can risk \$25,000, \$50,000, or \$75,000 to get into that business.

Third, we have to teach them how.

We don't know how in this country. Secretary Kreps of the Commerce Department is working very hard on that.

Representative MITCHELL. Pardon me, Mr. Ambassador. My time has nearly expired.

During your tenure, what specific successes have you achieved in the area of introducing small businesses into the export markets?

Ambassador STRAUSS. Mr. Congressman, I play a very rather insignificant role in direct relationship with small business because what I do is negotiate trade agreements—agreements between nations—and

I don't really have anything to do with the export thrust of our country.

What I have to do is negotiate the rules by which others will implement that—the Commerce Department and the other departments in this country's Government.

The reason I attend these small business meetings is that I like to be there and I like to tell the story and sell the medicine, if I can, of what exports mean to this country.

I have not done a darn thing, very frankly. If you go to the Eximbank, the Commerce Department and the others, they are making progress—not to satisfy me and not to satisfy you and President Carter and themselves, but we are working.

Representative MITCHELL. Thank you.

My time has expired.

Senator BENTSEN. Senator McGovern.

Senator MCGOVERN. Mr. Ambassador, I want to join with the chairman and other members of the committee in commending you on the fine effort you have made as our trade negotiator.

As I understand it, when the trade negotiations are completed, Congress will receive the final package and be voted up or down, but that there will be no opportunity for amendment; is that correct?

Ambassador STRAUSS. Thank goodness. That is correct, Senator McGovern. [Laughter.]

Can you imagine that I will be spending the rest of my life picking up two oranges here and something else there? Not me. [Laughter.]

Senator MCGOVERN. I just wanted to make sure we understood the ground rules.

Ambassador STRAUSS. One of the first things I read was the 1974 Trade Act that you voted on and I found that in there.

Senator MCGOVERN. Let me ask you this: For 30 years when we negotiated the International Wheat Agreement that has been handled as a separate treaty.

Ambassador STRAUSS. Yes, sir.

Senator MCGOVERN. It has traditionally been referred to the Foreign Relations Committee and then approved there. It requires a two-thirds vote before it goes into effect.

What are the present plans for handling the International Wheat Agreement?

Ambassador STRAUSS. My recommendation is very definitely it will be folded in with the MTN implementing legislation.

Although there has been no decision made, I am going to recommend that it does. I think it is a better way of treating it, but no decision has been made yet.

Senator MCGOVERN. You make that recommendation, I assume, Mr. Ambassador, with the understanding that the Senators from the wheat States who might find problems with the International Wheat Agreement could find this policy puts them in a position where, if they are opposed to the International Wheat Agreement, they have to vote against the whole package.

Ambassador STRAUSS. Senator McGovern, that is why I said no decision had been made.

I am going to come up here and work this Hill before I make a decision on that to find out what makes more sense and what would be more practical.

Let me say one thing to you, that we have got to be involved in drafting, for the next 3 months, the implementing legislation.

We are going to stalk the Halls of the Congress, as I have been doing over the past 2 years, to find out my areas of maneuverability.

I don't have any great strength as an economist or any great strength as an international tradesman.

If I have any strength here, it is knowing the temper and ability of the field and the sensitivity of the Hill.

Every step of the way for the last 2 years I have been doing that. As we prepare this implementing legislation, I will be sitting in your office and in other offices making that decision jointly and one in which we are all behind, so I tilt toward holding it in, I hope, trying to convince you.

Possibly being contrary will be the case.

Senator McGOVERN. On another matter that has not been touched on here today, but one which I think bears on the overall question of expanding the U.S. exports, we have a practice as you know, Mr. Ambassador, called the most-favored-nation practice. It is really a misnomer, in my judgment.

What it means, really, is that there are certain countries we don't discriminate against and we call those countries the most favored.

If you are not on the list, you are up against a discriminatory trade practice.

In some cases, it seems to me the results of that policy are not to make countries behave the way we think they ought to behave or change their ideology to conform to ours, but instead we are encouraging them to trade with other people.

I wonder if you have given any thought to whether or not that whole practice might be obsolete.

I can see where there might be certain countries that are so obnoxious where they would not want to trade with them at all but it seems to me if we are going to trade with countries and make a judgment that it is in our interest to do so, we ought not to encumber it with all these things.

Ambassador STRAUSS. Senator, I don't want to be cute in my answer, but it seems that in a democracy, everybody wants to be an expert on everything, particularly other folks' business.

That is the other folks' business and we have enough trouble with that.

I have some notions but I don't have any responsibility and it just would be unfair to the members of this committee and those whose job it is to deal with that.

Senator McGOVERN. I just want to underscore what Congressman Mitchell said with regard to developing countries. At the World Food Conference that I attended in 1974, a strong emphasis was placed on trying to develop more effective and workable trade relations with these underdeveloped countries.

There are potentially large markets out there and I think the point the Congressman made is well taken.

Ambassador STRAUSS. Senator McGOVERN, I understand. Let me say this to you: In my judgment, no nation has made any more effort, than we have made in the past 2 years in Geneva in this area and no individual has spent any more effort on it than has Mr. McDonald over there, who is my deputy.

In every report, we go into what is being done with the LDC's. We have a special group that is setting up meetings daily, weekly, or as often as we can, going over their problems.

I think as a matter of fact, our efforts over there—hopefully, will produce something.

I know they produce goodwill because I know we are trying.

Senator MCGOVERN. Thank you, Mr. Ambassador.

My time is up, Mr. Chairman.

Senator BENTSEN. Thank you, Senator McGovern.

Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Like everyone here, I do want to congratulate you, Mr. Ambassador. I have participated with you in negotiations over the last few years, and all I can say is that I am sure glad you are on our side.

Ambassador STRAUSS. Thank you.

What I am afraid of is that some of the people I am trading with are glad I am on this side.

Representative LONG. Does the scope of your responsibilities include recommendations to the President with respect to what might be done to establish some export incentives, and if so, what type import incentives have you recommended?

Ambassador STRAUSS. That is not my primary responsibility.

I sit in interagency meetings where we get into that subject.

The Commerce Department has an appropriation. It is not a large one but it is about \$25 million which they are spending on the export thrust.

There is going on right now an examination of export disincentives—not just incentives—to see what we are doing in that area. It is negative, rather than just throwing money away on creating incentives that may or may not work.

Representative LONG. At the field hearings that this committee—or rather one of our subcommittees—has conducted, I have been distressed not only by the lack of knowledge, but also by the lack of interest by businesses in getting involved in exporting. The lack of interest seems to be exhibited by medium-sized business and large business as well as by small business.

They never had to go for this market and they are actually a little bit scared of it.

Ambassador STRAUSS. That is correct.

Representative LONG. I think there is a major educational program that is going to have to take place if we are going to have any success at all in reversing the situation, since it has been in existence for such a long period of time.

Ambassador STRAUSS. I think that the Commerce Department has a modest program.

I think they are making some progress over there, as Secretary Kreps put it, and Assistant Secretary Mark Weil is working on that.

I think we are making progress.

Representative LONG. He appeared before our subcommittee and I think he is aggressively pushing the program.

Ambassador STRAUSS. Secretary Kreps gives good support.

Representative LONG. I will ask you one other question, if I may, Mr. Ambassador.

You stated in your statement that the Government procurement code is going to open up as much as \$25 billion a year in foreign government purchasing availability.

Ambassador STRAUSS. "Opportunities" is what I would call them.

Representative LONG. What about the reverse side of that coin? What about the dollar estimate on how the code is going to open up similar U.S. markets that are now closed to foreign sources?

Ambassador STRAUSS. Well, the truth of the matter is that there is not very much of that—less than half.

Our markets have been open. We are trying to see that we both play with the same rules and the rules are the ones we have been playing with.

Representative LONG. This would be to correct an inequity that has existed for a considerable period of time?

Ambassador STRAUSS. That is correct, Mr. Congressman.

Representative LONG. Thank you very much, Mr. Chairman.

Thank you, Mr. Ambassador.

Senator BENTSEN. Senator McClure.

Senator McCLURE. Thank you, Mr. Chairman.

I am tempted to go into the question that Congresswoman Heckler raised with respect to sugar because the sugar industry, at least the beet sugar industry, in the United States is about to close up. One of the major producers in the West has announced plans to get out of the industry completely. Their plants are on the block.

If their plans are carried out, then we will have about 100,000 acres of the best land in Idaho transferred from producing sugar to producing other crops that are now in surplus. I don't want to spend a lot of time on that because I think it is a particular problem and I hope we can work out a solution between the Congress and the administration,

I think it has an absolute priority and must be solved.

Ambassador STRAUSS. Yes, sir.

Senator McCLURE. The second question that I think we need to spend some time on is this question of the nontariff barriers. I look at the export of round logs to Japan and at the same time Japan refuses to allow entry of finished lumber products into their markets. That is an old problem. I have been working on it for 10 years with more than one administration.

We still have the same problem. They still want to have our raw material to process in their plants and we, in essence, then are providing the raw materials to furnish their jobs in their own markets, denying our own workers the opportunity for those jobs and at the same time creating a potential shortage of material in this country. We are now importing 20 percent of our softwood requirements in this country.

Rather than spend a lot of time on those, there are a couple of others that I want to address.

First of all, we talk about 2- or 3-percent changes in tariffs and yet we saw a 40-percent change in relative value of currencies. That is certainly a more massive economic shift than a small change in tariff and yet during the same period of time on that change between Japan and the United States, for example, it favored the United States by 40-percent readjustment.

The trade from Japan increased and became more favorable to them. That has to indicate that they have been more than slightly successful in their nontariff and tariff barriers to trade.

Ambassador STRAUSS. Senator McClure, that is a very perceptive observation that you made. I didn't intend to get into that today, but there are so many things that we could talk about here and I hope you and the chairman will focus on that, because there are no answers to this, but it raises a lot of questions.

You know, we heard about the J curve, how the trend goes for a while and then begins to take hold. Well, maybe in the last few months it has. It is running about 12 months late. They told me that that J curve was going to help me 12 months ago. It is still J-ing, but it is just now curving.

The change in currency goes to Senator Bentsen's concerns. You look at questions such as: Is a surtax going to do any good? You talk about 10 or 15 percent and the amount of time it might take to set in when we hear these discussions, Senator Bentsen and I have chatted about this on a personal basis informally. If you didn't get help from a 40 percent dollar devaluation vis-a-vis the year, why is a 15-percent surcharge going to help?

It comes back. It almost convinces me that I am on the right track in putting emphasis on these nontariff barriers.

That is the guts of the thing, Senator. The tariff things help a little here and a little there, but the guts of it is are you going to get the artificial barriers removed?

Senator McCLURE. Mr. Ambassador, I agree with that statement because obviously if nontariff barriers can offset whatever we got on the 40-percent currency revaluation, they can easily offset whatever you give in tariff reduction.

Ambassador STRAUSS. I agree. What I don't want to leave here is the impression that I am up here preaching that what we have done is going to solve all the problems—we are just not going to do it. We are going to begin to solve them and give an opportunity for the executive and private industry to move in and monitor and push. That is the way you solve these problems. It is a long drawn out process.

Senator McCLURE. Mr. Ambassador, there are a couple of things on our side that are barriers to our trade, too, that we have erected here addressed to—and I will not ask the question. I know my time is up.

One was the absolutely incredible illogic of trying to create some kind of control on proliferation of nuclear products that led us in the Congress with the help of the administration to pass a bill on nuclear licensing of nuclear exports that makes it impossible for Westinghouse to sell a U.S.-produced plant to the People's Republic of China at the same time that same plant can be furnished by the French to the People's Republic of China with Westinghouse licenses subject to approval of the U.S. Government.

While we won't approve the export, we will approve the license so that the French can supply the plant.

Second, it has been estimated by a study commissioned by EPA that environmental controls and costs add about 25 percent to the costs of our exports as compared to other countries. That figure may be arguable, but that was a study commissioned by them and they came to that conclusion. There are a number of people who are thinking in terms of trying to find a way to establish an environmental

tariff both to equalize the economics of trade and, second, to encourage people in foreign countries to take the steps of cleaning up the environment that we have found to be in our national interest and, I think, in the international interest.

We don't have time to really explore either of those policies at length here.

I thank the chairman and the committee for indulging me for a couple of extra minutes.

Senator BENTSEN. Thank you very much, Senator McClure.

A closing question, Mr. Ambassador.

With regard to the normalization of relations with the mainland of China, do you see that as a boon or a threat to our trade balance?

Ambassador STRAUSS. I think it will eventually prove to be a great boon to this country. I think we run a great risk of misleading the American public—the American business public particularly—to believe that overnight there is going to be 900 million people in China drinking Coca-Cola every day and buying every used car and truck and everything else we have to sell over there.

I think, according to the figures I saw, that they need about \$200 billion in the next 10 years to meet their capital requirements if they are really going to catch up with the industrialized countries of the world.

I think as we move into this, if we look wisely and prudently, it will be a major market for American business.

Senator BENTSEN. Thank you very much, Mr. Ambassador. We appreciate your attendance this morning. The members of this committee have a great interest in your work.

Ambassador STRAUSS. Thank you. I appreciate being given this opportunity.

Senator BENTSEN. We will now have the following members of the panel: William D. Eberle, former Special Trade Representative; Philip Trezise, acting program director, the Brookings Institution; and Robert Baldwin, professor of economics of the University of Wisconsin.

Will you gentlemen please come forward.

Bill Eberle, we are delighted to have you back and to have you here this morning. If you would like to proceed first, please do so.

STATEMENT OF WILLIAM D. EBERLE, FORMER SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS

Mr. EBERLE. At this time I would like to request that my prepared statement be made part of the record and I will cover the highlights and save you some time.

Senator BENTSEN. That will be done.

Mr. EBERLE. Mr. Chairman, I am delighted to be here, especially as the predecessor of your star witness this morning—it is nice to follow Ambassador Strauss.

It is important, I think, that you have recognized that the subject you are addressing—the American economy—is now so vitally tied to the international economy that our foreign economic policy is part of your annual hearings. This subject is important to every American worker, business executive, and policymaker. I don't have to put this

into focus any more than did the Ambassador but I would like to add a little more to the statistics so that you have a good feel for it.

Our exports and imports now approach 20 percent of our gross national product.

Senator BENTSEN. Would you say that again? We are getting a lot of background noise here. I want to be sure I hear it.

Mr. EBERLE. The imports and exports of the United States now approach 20 percent of the gross national product of the United States.

It used to be that our trade was primarily with Japan, the European Community, and Canada. No more. Today 40 percent of our exports go to the developing world. I might add here that I agree with Congressman Mitchell that the future of the U.S. economy is partially tied to the developing countries. The industrialized world will have a future growth rate of 3 to 5 percent. The growing developing world will have a growth rate of 4 to 10 percent. If we can share in sales to that part of the world, we will improve the growth rate in the United States. This is why I think it is so important that this year, 1979, we—in business and Government and the Congress—focus on these issues.

I understand you would like me to talk about three areas—the multi-lateral trade negotiations; what are the next steps in export policy; and our relationship with Japan. The policy decisions you make in these areas will affect the course of our economy for years to come. They will determine the volume and the direction of our trade, which sectors of our industry and agriculture are going to flourish or be cut back, and they will determine the kind of growth pattern the United States and the world will have.

Let me, first, focus on the Tokyo round. I am pleased to comment on the MTN since I have been a member of the President's Advisory Committee. In addition to that, I feel a responsibility to you in Congress because I was somewhat responsible for getting you into this a few years back.

While there is still much left to be negotiated, I can say to you that the broad thrust of the agreements that Ambassador Strauss and his team have negotiated carry many more pluses than minuses for the United States. Even though I must reserve final judgment, which we all must do, there is one very important thing we should all be able to agree on and that is that everyone must urge them on to complete the negotiations satisfactorily as quickly as possible.

Some real pluses go to the new rules on subsidies, which will be critically important for the future trading system. In his opening comments the chairman said we need equity. This code will bring equity. The Government Procurement Code. The Customs Evaluation Code. All of these are important, but what does this mean for Congress? Congress must vote up or down on these agreements, as you have indicated. If you do vote them down later on because you find them unsatisfactory, you will be creating great uncertainty internationally and domestically to business plans.

Although I will not suggest whether you should vote up or down at this time, I am recommending several things to you this morning. The first is that Congress should promptly act to waive the application of countervailing duties until these negotiations are completed.

The intent of the 1974 act was to allow duties to be waived until the end of 1978 to permit negotiations to be concluded. We did not meet the target, but we are close enough on the subsidies counter-vailing code that not to extend the waiver will jeopardize the entire negotiations. You will have a chance to evaluate the agreement when you vote up or down on the MTN results. I encourage you to proceed with the waiver extension promptly.

The second recommendation I would make is that you would refrain from legislating an exemption from any sector of industry or agriculture from the trade liberalization of the trade agreements. For the United States to take such action at this late date would do irreparable harm to our ability to conclude the negotiations and compromise the interests of some other segments of American industry or agriculture. Again, you will have plenty of time to review the agreements and I urge you to wait until you see what this package looks like before you take any action.

The third recommendation I have is that you look hard at the implementing legislation—for example the domestic laws that will carry out these agreements. This legislation will be the key to whether the agreements will succeed in the future or not. The implementing legislation will be part of the package that Ambassador Strauss and his team will be coming forward to discuss with you in the coming months.

This is an important matter. It is going to be a great opportunity to facilitate export growth—to build our trade on a sound basis. Let's get on with it.

Let me move to the export policy side. What are the next steps? I commend this administration for flagging export expansion as an important goal. I have to note, however, that when we talk about slower growth abroad, relatively higher inflation at home and oil import as the causes of our trade deficit, that is only half the equation.

The other half of the equation is exports. While our imports have continued to grow, the rate of growth of our exports has not kept pace. Indeed, it has declined. It has stagnated in our agricultural sector and the rate of growth in our industrial sector has declined in the past 4 years. As a result, our share of exports to the entire industrialized world has slipped.

This problem has been discussed in the business community, in the White House and in Congress—much of the focus has been on promoting exports, for subsidizing them and for help, as well, to "protect" domestic producers from imports.

The problem is too complicated for me to present in a short analysis a comprehensive cure, but let me talk about a few of the things that I think you ought to think about. We hear today that we ought to give the same kind of support and subsidies to American exports as some of our competitors abroad do. I think this is absolutely wrong.

I believe that it is the responsibility of the American businessman and the American farmer to see that we export. As you pointed out earlier, only 200 U.S. firms account for 80 percent of all exports today. I suggest there is a different role for our government to play.

First of all is the education of the small and medium business community. It should be made a higher priority, we do not have an adequate program today in the Commerce Department.

The Commerce Department could be reoriented to go out State by State to select the products, show them where the export markets are and get going. Talk does little good. We need action. This will be doing more than trying to compete on subsidies around the world, particularly when we are trying to balance the budget.

Second, eliminating the disincentives in current Government policies would make a good start. It is something under our control today.

Let me start out by pointing to the need to expedite export licenses. We do need some limits on high technology, but do you realize that every product that has any advanced technology must secure a license from the Commerce Department? I once chaired the interagency committee that makes the decisions and I can tell you that every product—and I am only talking about products now, not technology as such—goes through an interagency fight and every time they have to refight the same issues over again. It takes from 9 to 12 months, and it is an outrageous situation because in the meantime our competitors from France and Germany and Japan have the business in hand.

It seems to me that the Commerce Department could establish general guidelines on what technology products can be shared and then makes exceptions to that rather than refight every issue. Assistant Secretary of Commerce Frank Weil is very favorable to this and I urge you to think about how we can speed this up.

There is also regulatory spillover which is unbelievable. Today we have the OSHA, the CPSC, the FDA, all of whose requirements apply extra territorially, whether or not considerations to similar regulations are applied abroad. Twenty-five percent is probably a reasonable guess for increased costs to U.S. exporters.

Even if we require ourselves to do these things domestically, we should not say, in effect, that we don't want to export. Competition is the "name of the game" and our regulatory commissions ought to face this. The President should move on these problems.

We have environmental reviews on all applications for Eximbank financing. Can you imagine anything more ridiculous? If foreign customers want to buy it, it is a good project. Why hold it up? We are losing business on a daily basis because our Eximbank cannot permit this and our foreign government can.

The U.S. flagship requirements that prohibit Eximbank financing on foreign vessels is another example. I might point out two others. The Freedom of Information Act permits competitors access to proprietary information from bills of sales on exports, which discourages some companies from wanting to export. Also, there is a U.S. company that produces machinery, which wants to challenge the Japanese market and is going to do so, but because of U.S. tax laws, is going to do it out of Hong Kong.

These are the kinds of things that you can do something about. Let me conclude by saying: Isn't it about time that Congress makes exporting a more essential part of U.S. policy along with full employment? If it is good enough for Japan and Germany, is it not also good enough for us as national policy? Then our Departments will start to understand we mean business. It does not take long to do this.

I have two other suggestions. I think it is time that we repeal the Jackson-Vanik amendment and that we get on with granting the most-favored-nation treatment to both China and Russia.

I, like all of you, abhor and am concerned about human rights and discrimination, but restricting exports is not the way to do it. What we are really saying is, "Let somebody else do the business and we will stand on high moral grounds and not trade." Political leverage is where the real leverage comes, not in trade.

In sum, it is time that Congress face up, along with our administration, to eliminating the export disincentives.

While I do not believe we need subsidies in the business arena, but I do think we need aggressive government support in two areas.

The first area to which Ambassador Strauss alluded, is we must be out there every day combating unfair practices of foreign governments and firms. We must be sure we execute our own laws. Mr. Chairman, the business community has lost total confidence in the Treasury Department's ability to deal with countervailing and antidumping. Until Treasury restores that confidence, you are going to have everybody coming to Congress asking for protection. We put time limits into the 1974 Trade Act and Treasury has flouted that law consistently since.

It is not that they make good or bad decisions. They just don't make decisions and they drag their feet. I think it is time appropriate congressional oversight committees look into this and remedy the situation.

The second area concerns export subsidies. It is time the voluntary "gentleman's agreement" on export financing in the OECD became a mandatory international agreement which is enforceable. It may be covered in the pending MTN subsidy code—I don't know—but if it is not, you can push the administration to be more forceful.

Let me close by commenting on bilateral relations with Japan. These relations have special characteristics but they share many of the same general characteristics of our total trade problem. The trade balance is totally out of line, and we should have concern for it. But that concern, I would urge you, must be tempered by a perspective on the multi-lateral context because while the United States has a trade deficit with Japan, we have a trade surplus with Canada and Australia.

We must put pressure on both surplus and deficit countries to move toward balance. It is important that we bring the pressure within the OECD and our international financing institutions to see that this is done.

While we must wait until the end of the Tokyo round before determining what ought to be done next, there are several things that government and business can do in the meantime to ameliorate the problem with Japan.

First of all, our businesses have not vigorously attacked the problem of exporting to Japan. As a matter of fact, if you look at the trade statistics, you will find that our declining share of trade with Japan is in the very products where there are no barriers—food and machinery—where our share of the market has declined from 1969 to 1978. This is both a business problem and a Government problem. It is a business problem because we have not sufficiently aggressive exporters. It is a Government problem because in the case of nuclear reactors we were cut off from selling to Japan. In the case of food, we stopped our soybean exports. And with all respect to my good friends, Senator McClure, we have had a problem with logs: In the good years we

want to sell to Japan and in bad years we don't. We cannot be inconsistent.

Such inconsistency in U.S. Government policy has hurt efforts to do more export business with Japan. But the American business community has to do a better job too.

There are several areas in which the Government can be a great help and where we need to continue to keep the pressure on Japan. However, we must look at where Japan is today, and not let our pent-up frustrations over their heavily protectionist past policies motivate us. They have removed a great many barriers and they are now truly a part of the trading system. There are two areas where continued U.S. Government pressure is needed.

The first is in the area of certification of products. It takes months and even years. The very bureaus which are closely allied to Japanese businessmen are the ones that certify our products. They don't have self-certification. Our products must be certified by a Japanese bureaucrat in Japan whereas virtually all of their products exported here are self-certified under our system in the United States. It makes a big difference.

Second, we must continue to keep the pressure on them to restore a normal U.S. share of food imports which are controlled by the Government. This alone would increase our sales over \$1 billion if we got it back to just the same rate as in 1969.

Let me conclude by saying that we have some very important areas to move in. Your real responsibility is to take away the disincentives. American businessmen must then get out there aggressively and sell, which I think we can do. Thank you for letting me be here. You have a major challenge and I know you will rise to it.

Senator BENTSEN. Thank you very much. Mr. Eberle.

[The prepared statement of Mr. Eberle follows:]

PREPARED STATEMENT OF WILLIAM D. EBERLE

My name is William D. Eberle. It's a pleasure to be here this morning to take part in your hearings on the state of the American economy.

It wasn't so long ago, Mr. Chairman, that international economic policy issues were low priority concerns to the American people, the business community and our government. However, ballooning trade deficits, a declining dollar, dramatically rising oil prices, and the waning competitiveness of some American industries have made the arcane subject of international economics a topic of vital interest to workers, business executives and government policymakers.

The importance of our economic relations with the rest of the world to our own economic welfare has never been greater. And it's continually growing. About one out of every seven or eight manufacturing jobs in this country is dependent upon our ability to export. One out of every three acres of land under cultivation produces food or fiber for our export markets. We depend on foreign sources of supply for more than half our annual consumption of aluminum, tin, nickel, zinc, manganese and seven other critical industrial raw materials. Import competition has beneficial effects in stimulating domestic innovation and restraining inflation. In sum, international trade has very direct effect on the state of our economy with imports and exports now accounting for approximately 20 percent of our Gross National Product.

It used to be that our trade was dominated by transactions with Canada, Europe, and Japan. No more. U.S. exports to developing countries now approach 40 percent of our total. Furthermore, the United States exports more manufactured goods to LDCs than to Western Europe, Japan, and the Communist countries combined. The future vitality of our economy will be increasingly linked to the development prospects of the LDC's.

Because of its growing importance, trade policy has become highly politicized. The Congress has responded appropriately by seeking and achieving a bigger

role in the conduct of our foreign economic policy. This Congress must confront and resolve several extremely controversial trade issues.

Congress must decide whether to extend its authority to the President to waive the application of countervailing duties. It must evaluate and pass judgment on the results of the Multilateral Trade Negotiations. It must examine our export policies when it considers the Export Administration Act. Finally, it must confront inevitable pressures to restrict imports—pressures that will certainly grow in intensity if economic growth slows.

The policies you establish in resolving these and other trade issues will have very direct and large effects on the state of our economy and upon the daily lives of our citizens for years to come. These decisions will determine the volume and direction of our trade. They will influence which sectors of our industry and agriculture flourish through better access to export markets and which sectors will experience domestic adjustment, sometimes painful, to foreign competition. They may stimulate the development of new domestic products and more efficient production processes and they may cause older products to be replaced by cheaper or more innovative foreign substitutes. Finally, they will directly affect our ability to restrain inflation.

I will now try to touch on each of the three topics you have asked me to address this morning: the MTN, next steps in U.S. export policy, and our bilateral relationship with Japan.

CONCLUDING THE TOKYO ROUND

After more than five years of negotiations, the Tokyo Round is nearing a conclusion. The President has served notice of his intention to enter into trade agreements which the Congress must approve or reject. Mr. Chairman, I have followed these negotiations very closely as a member of the President's Advisory Committee and I do feel a sense of responsibility to Congress because of my role in working with you in writing the Trade Act of 1974 that got us started on this road.

While much of the work of the negotiators is completed, they are still meeting as we talk today to conclude unresolved and important issues—both with respect to the nontariff measure codes and the tariff negotiations. It's therefore impossible for me to give you a definitive evaluation of the result and recommend whether the agreements warrant your approval. I can say that substantial progress has been achieved in many areas of great importance to the United States.

The code on subsidies promises to bring new international discipline to bear on export and domestic subsidies on industrial and agricultural goods. Subsidies are among the most often cited foreign trade practices that inhibit U.S. exports.

The codes on government procurement and standards should combat foreign discrimination against U.S. exports and introduce greater openness in foreign government procedures to provide better access for U.S. goods.

The codes on customs valuation and licensing should remove some of the administrative impediments governments use to restrict trade.

I believe it is in our national economic interest to bring these negotiations to a successful conclusion. If our negotiators fail to conclude an agreement that meets with Congressional approval, the costs to our economy could be substantial. First, the failure of governments to reach an acceptable agreement will cast a shadow of uncertainty over business plans that may have a chilling effect upon investment and production decisions. Second, we will have lost a great opportunity to change the ground rules of international trade to conform to the present reality and create new mechanisms to deal with future disputes. Finally, domestic pressures here and abroad for merchantilistic trade policies might achieve a momentum that would be difficult to contain.

The Congress should therefore do what it can to encourage a rapid conclusion to the negotiations and begin itself to evaluate the results. I would like to make two recommendations to you on that score.

First, Congress should act immediately to extend the authority it has given the President to waive the application on countervailing duties to subsidized imports. This extension need only be for the time necessary to complete negotiations on the Subsidies Code and for the Congress to evaluate the result—perhaps until October. But it is essential that the extension be granted to defuse the political issue that the expiration of the waiver has created so that the MTN can be wrapped up.

The deadline set in the Trade Act for the completion of this aspect of the negotiations could not be met because of the recession of 1974-75 which effectively suspended bargaining and because this has been the most difficult and controversial issue tackled in the MTN. An agreement is now so close. I believe you should

extend the waiver and evaluate the agreements on their merits once negotiations are concluded.

Second, Congress must refrain from legislating an exemption for any industry from the trade liberalization that will result from this negotiation. For the United States to take such action now on behalf of any industry would be deemed an act of bad faith by our trading partners. It could do irreparable harm to our ability to successfully conclude the negotiations.

It's true that some domestic industries and certain farm products are challenged by stiff competition from abroad. But foreign manufacturers and foreign farmers in other sectors face equally tough competition from our own citizens. We can't expect to provide more business opportunities for our dynamic export-oriented growth sectors if we take unreasonable steps to restrict imports into the United States.

That brings me to the next topic you've asked me to address: export policy.

U.S. EXPORT POLICY: THE NEXT STEPS

To explain our trade deficits, economists have pointed to slower rates of economic growth abroad, relatively higher inflation here at home, and our increasing dependence on oil imports. These factors explain only half of the equation: the growth in U.S. imports. While imports continue to grow, the rate of growth for U.S. exports of manufactured goods has declined for the past four years. The rate of growth of U.S. agricultural exports has been stagnant for the last three years. As a result, the deficiencies or, indeed, the absence of any concerted U.S. export policy has been the subject of much discussion in recent months in the business community, in the Congress, and even at the White House.

This problem is too complex for me to present this morning a thorough analysis and a comprehensive prescription for a cure. But let me give some thoughts on the subject.

U.S. firms sometimes find themselves losing in competition with foreign firms that have substantial foreign government backing and assistance. The answer given in some quarters is that the U.S. government should emulate foreign governments in promoting and subsidizing U.S. exports. I believe this approach would be wrong. In our economic system, it is the responsibility of businessmen and farmers themselves to succeed in competition in the world market. The fact that only 200 U.S. firms account for 80 percent of U.S. manufactured exports shows the private sector has its work cut out.

The role of the U.S. Government in actively promoting exports must be limited. An illustration of a useful government function in such a limited role is providing more and better information to small and medium sized U.S. firms about business opportunities abroad and the technical assistance to exploit such opportunities. Undoubtedly, the funding priorities of the Department of Commerce can be re-oriented to direct more resources to this activity.

Rather than asking ourselves why our government doesn't do more to promote U.S. exports, a more appropriate question is why doesn't the government do less to hold back U.S. firms from competing abroad?

Expediting Export Licenses.—There clearly can be legitimate reasons to restrict exports such as protecting our national security. When restrictions are necessary, however, it's essential that our control system be efficiently administered. Unfortunately, that is now not the case. It's not unusual for the Commerce Department to take more than nine months to process export license applications. As a result, the United States is viewed as an unreliable supplier in many foreign markets. Sixty to ninety days is more than adequate time for the government to evaluate a license application.

Limiting Regulatory Spillover.—American firms also lose export opportunities because of the extraterritorial application of U.S. laws and regulations. The export-inhibiting spillover effects of regulations that promote other objectives must be taken into consideration in cost/benefit evaluations of these policies. Examples include:

- OSHA requirements, CPSC standards, and FDA requirements which are applied extraterritorially and preempt foreign government decisions;
- Environmental reviews which may limit export financing;
- Pesticide regulation which exceed foreign government standards;
- U.S. flagship requirements which prohibit Export-Import Bank financing for freight costs on foreign vessels, even when U.S. flagships are not available;
- Freedom of Information Act requirements that can result in government disclosure of proprietary business information valuable to foreign competitors.

U.S. tax policy has had some interesting trade spillover effects as well. In a recent article in *Foreign Affairs* ("Facing Up to the Trade Gap with Japan," Fall, 1978, pages 146-168), James Abegglen and Thomas Hout point to the case of a U.S. machinery manufacturer who chose Hong Kong rather than the United States as a base for exporting to Japan. The reason? U.S. tax laws. The result: lost U.S. exports.

Repeal of Jackson-Vanik.—In other areas much more fundamental action is required. Our policy of using exports as a tool to promote foreign policy objectives has failed the acid test of any policy: it does not work. And it should be stopped.

Americans who export are concerned about human rights and discrimination against other Americans—as concerned as any of us. And as a result of decisions based on these considerations they have lost business opportunities to foreign competitors and suffered the economic consequences. But their sacrifice has yielded no result.

The classic case is the Jackson-Vanik Amendment of 1974. The evidence suggests this amendment has not achieved its intended result—an increased rate of emigration of Jews from the Soviet Union. In the meantime, however, U.S. firms have lost business to their foreign competitors.

A similar situation exists with respect to China. President Nixon "opened the door" to China with the Shanghai communique of 1972 and the Japanese have been walking in and out with growing speed ever since, carrying contracts for millions of dollars worth of business. Now that we've established formal diplomatic relations, it's time to establish the appropriate environment for the conduct of full commercial relations as well. In sum, I think it's time that Congress granted most favored nation status and export credits to both the Soviet Union and China.

Aggressive Government Support.—Mr. Chairman, earlier I said it was not appropriate for the United States to deal with foreign competitors who do business with the backing and assistance of their governments by emulating them. But, there is nonetheless an important role for the U.S. government here. It is to vigorously combat—both through international negotiation and domestic measures—the unfair practices of foreign governments and firms. At this point, it looks as though the Multilateral Trade Negotiations will establish new international rules and mechanisms that will make this task easier. But the agreements we have negotiated are mere pieces of paper and will have no impact unless the domestic implementing legislation that is now being drafted is done effectively. In addition, our government must make a firm commitment to vigorously pursue the rights it has negotiated under these trade agreements on behalf of U.S. firms. In these two activities the Congress has a critical role to play—both in drafting the legislation and in overseeing its execution in the years ahead.

A final area where the U.S. Government has an important role to play is in seeking firm agreement with other countries to restrict competition among governments in granting export credits. Foreign government export credit subsidies, as much as any other single factor, shift business to European and Japanese firms and away from American firms. The existing international ("Gentlemen's") agreement on this topic negotiated earlier this year is purely voluntary and is not sufficiently comprehensive. These deficiencies must be remedied in new negotiations.

BILATERAL RELATIONS WITH JAPAN

While our trading relationship with Japan has several special characteristics, the problems which characterize it are not unique. To a large extent, they are magnified versions of problems that characterize our trading relationships generally. First, there is the deficit and then there are the related problems of American business initiatives to penetrate the market and the problems of restricted access for U.S. exports.

From 1973 to 1975, our bilateral trade deficit with Japan grew from just over \$1 billion to just under \$2 billion. It then jumped to \$5.4 billion and \$8 billion in 1976 and 1977 respectively. This year it's projected to be \$10-11 billion.

These alarming annual figures mask a development in 1978 that may indicate that our deficit with Japan may be peaking. The table that follows shows that U.S. monthly exports have grown slowly, though hardly dramatically, since April. Meanwhile, Japanese exports to the United States have leveled off with the result that our monthly bilateral trade deficit has declined gradually but steadily since last spring. I must emphasize this is not a dramatic shift in our economic relations with Japan, and even eight months' trade data is insufficient from which to draw any firm conclusions. But the shift bears watching nevertheless.

The fact that we have a deficit in our bilateral trade with Japan or with any country should not normally justify special attention or policy actions. Multilateral

balances may negate deficits or surpluses with individual countries. For example, Japan has trade deficits with both Canada and Australia; the United States has surplus trade balances with those countries. Nevertheless, the trade deficit with Japan is so large that it is a key component in the overall balance of payments deficit which the United States is currently running and it has been an important factor in the recent decline in the value of the dollar.

UNITED STATES/JAPAN TRADE BALANCE, JANUARY-NOVEMBER 1978

(Dollars in millions, seasonally adjusted)

	Exports	Imports	Balance
January.....	743	1,756	-1,013
February.....	869	2,000	-1,131
March.....	1,016	2,044	-1,028
April.....	970	2,242	-1,272
May.....	1,009	1,961	-952
June.....	1,046	2,059	-1,013
July.....	1,047	2,197	-1,150
August.....	1,092	2,015	-923
September.....	1,193	2,094	-901
October.....	1,249	2,087	-838
November.....	1,369	2,043	-674

Source: U.S. Department of Commerce.

We must, of course, recognize that countries have a natural propensity to be in surplus or deficit at different stages of their economic development. Nevertheless, even in a regime of floating exchange rates, we must insist that surplus countries as well as those in deficit assume equal responsibility for keeping the system in balance.

Both for these reasons and because of the fact that several dynamic developing countries (including South Korea, Taiwan, Hong Kong, Singapore) are emulating the Japanese economic development model and the problems we face with Japan today may characterize U.S. trading relationships with a number of these countries in the future, special attention to our deficit with Japan is warranted.

The U.S. side of the Equation.—It is customary for us to place responsibility for the deficit on Japan, and particularly on the government of Japan. There have been good reasons for this. However, we must also look to ourselves, both to the business community and our government, to explain a good part of the problem. I would like to explore that latter aspect of our relationship first and then return to the more familiar topic of what Japan can and must do.

As this Committee is aware, the U.S. share of world trade has declined steadily over the last decade, reflecting a general erosion of the U.S. competitive position. This has been true in Japan, as it has in other countries. The U.S. share of Japanese imports of both manufactured goods and many categories of raw materials and food has declined. This trend cannot be explained by the existence of Japanese trade barriers with which all our trading partners must also contend. And the answer to this problem must therefore be found at home, not in Tokyo.

Then there is the question of the level of initiatives by the American business community: are we trying hard enough to sell to the Japanese? Certainly the Japanese market presents difficult and special problems for foreign firms seeking to do business there. These have been well documented and while there may be good reasons for the current low profile of American business in Japan, the fact nevertheless remains that there are probably fewer American businessmen in Japan today who speak fluent Japanese than there are people in this room. How many Japanese businessmen fluent in English do you suppose are working in the United States at this moment? The success stories of companies like Coca Cola, Polaroid, Lipton, and Schick in Japan suggest other U.S. firms can succeed too. We cannot blame the Japanese for not buying from us if we have not made a determined effort to sell to them.

Past U.S. Government policy is also partially to blame for some of the problems in the United States-Japan trading relationship. As in the case of other countries, as I have pointed out, the credibility of the United States as a reliable supplier is in question in Japan. Japanese skepticism has a real foundation. Our abrogation of soybean contracts, our restrictions on exports on North Slope crude oil, and our long-time restraints on exports of logs go a long way toward explaining the motivation for Japan's diversification of its sources of supply for these materials and the eroding U.S. share of the Japanese market for them.

Japan's Role.—All this is not to say Japan is blameless. Japan's determined and very successful effort to exclude foreign products from its market for most of the post-World War II period has been a source of enormous frustration to American business. I'm confident that over the years all of the members of this Committee have been regaled with descriptions of Japan's restrictions, both formal and informal, on U.S. exports. It is ironic that Japan, the country that has gained so much from the liberalization of the trading system, has been so slow to accept that liberalization itself.

However, the judgments we make now and the future policies you set must be based on an accurate perception of the current situation and not motivated by pent up frustration over past Japanese practices. We can only go forward. I want to focus on the prospects for improving the current situation.

Largely motivated by strong pressures exerted by our own government over the past decade, Japan has already dismantled most of the formal barriers that inhibit U.S. exports. A number of formal restrictions still exist on products of great export interest to us. In addition, residual informal barriers are also substantial, as anyone who has even thought of conducting business with the Japanese Government or attempted to obtain Japanese government certification to health and safety standards for its products knows all too well. There are two ways to attack these problems.

One is through formal negotiation. Many of the problems U.S. exporters face in Japan have been the subject of bargaining at the Multilateral Trade Negotiations. I have high expectations here but we must await the conclusion of the MTN before we can render a judgment about the result. In addition, we must seek formal bilateral agreements with the government of Japan in specific problem areas to achieve a higher level of U.S. exports, such as with respect to food.

Second, the United States must continue to apply firm pressure upon the Government of Japan so that internal changes are made in bureaucratic practices and attitudes to erode the frustrating informal barriers to U.S. exports. This will be very important in areas such as standards certification and government procurement, notwithstanding any multilateral agreements in these areas. We must be vigilant to protect the rights we negotiate in any codes in these areas in the Multilateral Trade Negotiations.

CONCLUSION

Mr. Chairman, all these issues are important and the stakes for U.S. business in their successful resolution are very large. The 96th Congress does, indeed, have a major challenge facing it in managing the evolution of our foreign economic policy. It will need the leadership and guidance of the experts on this Committee to successfully meet that challenge and I appreciate the opportunity to have been able to give you my views today.

Senator BENTSEN. I think we will go through each of your statements before we have questions because of the time limitation.

Mr. Trezise, I know you have a particular knowledge of the Japanese economy and a great deal of experience in Japan.

STATEMENT OF PHILIP H. TREZISE, ACTING PROGRAM DIRECTOR, THE BROOKINGS INSTITUTION

Mr. TREZISE. I have submitted a prepared statement, Senator, and I will summarize very briefly what I have provided in my prepared statement.

On the MTN the outcome so far as we know it now seems to me to be substantially—indeed more than substantially—responsive to the mandate that Congress gave the Executive in the Trade Act of 1974. I think that both branches of the Government can take credit for this and can together, take some pride in what Ambassador Strauss has now put before you.

The so-called MTN agreements that have been negotiated seem to me to be a response to section 121 of the Trade Act a greater response than I would have expected. I think if they can be carried through, they will serve to modernize and strengthen the General Agreements

on Tariffs and Trade. This is long overdue. It can only help to move us toward the fairer and more open trading system which the Trade Act calls for.

The tariff bargain in the MTN, as I understand it, would cut existing duties by an average of 30 or 35 percent over the next decade. This is not a small reduction and I think, contrary to what many people say, it is a very important reduction. It will serve to move resources from less to more efficient uses in this country and around the world. Moreover, the fact that we are going to do this gradually means that the adjustment problems for individual firms and industries should not be very serious.

The agricultural package is, I think, less encouraging, but it does at least represent an effort to put some order into a sector of the world trading system that has been marked primarily by a progressive increase in intervention and governmental control.

The pending wheat agreement is quite innovative, particularly in its provision for buffer stocks. I think that it would have been more helpful had the wheat agreement been extended to coarse grains as well where we, of course, are the world's leading exporter.

Finally, on the whole package, I would remark that except for the tariffs, nothing in it is self-executing. Whether we make something of the agriculture package and the nontariff agreements depends upon how we and other trading nations perform. In our case it seems to me this is going to be a matter for both the Congress and the Executive—the Congress in its oversight responsibilities and the Executive in carrying forward the agreements we have made.

I don't see how we can realize the real hopes that are here unless both arms of the Government cooperate and act with a degree of forbearance on occasion as well.

Now, Mr. Chairman, I would say a few words about Japan. Let me say, first of all, that I think the present imbalance in Japan's external account is not very healthy for Japan and it is not very healthy for the world economy. It will be to the benefit of everybody that it should come down to more manageable numbers.

Now the explanation for the increase in the current account surplus of Japan is not quite so simple as is sometimes said. One explanation is that this is all a matter of protectionism. There is, of course, a bed-rock of protectionism in Japan, perhaps more substantial than in most other industrial economies. But I don't think we can explain away the increase in the surplus by protectionism because, as Bill Eberle has said a few minutes ago, protectionism, in fact, has been coming down. Tariffs have been reduced on two occasions in the last 6 years. Many of the quantitative restrictions have been either removed or liberalized and other nontariff barriers have been lowered or eliminated.

Thus it is difficult to accept the proposition that rising protectionism has led to a rising surplus. I don't think either that there is a general conspiracy against imports from Japan. There are barriers that are not official, led primarily by the language but also in the areas of custom and habit. If we can deal with the official barriers, if we can progressively bring those down, those that are based on law or on an official direction, then we can do all that is really humanly possible anyway. We cannot change the language and we cannot change the character of the Japanese people, and I don't think we need to.

I don't think either that there is an explanation to be found in Japanese export subsidies. The Treasury in 1976 made a comprehensive examination and investigation of 21 alleged subsidies that the Government of Japan was supposed to be operating. In the end they found that two were subject to countervail, and the amount of countervail was two-tenths of 1 percent in this case.

One of the subsidies was the deferral of taxes for small business exports, which is a low order of DISC, and the other was the provision of services for export promotion, not unlike what our Commerce Department does in the same field. So much then, for official subsidies.

What is more relevant, I think, was the official policy of Japan, particularly in 1976 and 1977, to restrain the rise in the exchange rate. I think this was an unfortunate and costly mistake for Japan and for the rest of the world, and it did contribute substantially to the growing external imbalance.

We need, however, here to look at the exchange rate in real terms rather than in the nominal terms that Senator McClure was suggesting.

Through 1977 the effective exchange rate in fact got back only to its 1973 level. Inflation in Japan was lower than for most of its trading partners so that the impact of the nominal change in the exchange rate was essentially zero.

Last year, pressures on the rate got so strong that the central bank could no longer contain them, and it did go up in real terms very substantially. Through October, it was up 21 percent, a very large amount. Now that we have had a recovery of the dollar, the real yen rate is 13-14 percent above its value of 1 year ago, still a very healthy increase. But we have had only a relatively brief time in which this change could work.

In addition to the exchange rate and even more fundamental has been the very sluggish economic recovery in Japan from the 1974-75 recession. Private investment, which used to be a principal force for growth, has slowed down very, very sharply in recent years. The result has been to keep imports low and to leave capacity for exports; in short, to generate all the conditions for a trade surplus.

This would not have been quite so much the case if Japan's main trading partners, especially the United States and Southeast Asia, had not been themselves operating at much more closely to their production potential.

So much for the diagnosis. The question is: Is this going to change? Well, there are some pretty good indications that it is changing. The sizable appreciation of the yen is beginning to work, I think. This has shown up in the volume of exports which has been declining ever since last March. Domestic demand is up. It was up last year 7 percent, which is considerably above the rate of growth of GNP.

Import volume has finally begun to rise, and I think that the OECD forecast that the current account surplus in 1979 will be reduced by half is probably a reasonable one, depending to some extent on the policies of the new government in Japan and a possible supplementary budget next fall.

Beyond 1979, Mr. Chairman, one can't obviously make very sensible predictions in any specific way. I would think, however, that Japan for the longer run—say, for the next decade—is probably going to have a surplus on current external account and that this will have to be

balanced by flows of capital, official and private, to the capital-needy parts of the world.

There is no way we can expect the world to make the kind of progress we hope for, with more output and rising incomes, unless capital is flowing from the capital-surplus countries to the capital-deficit countries. Japan is certainly going to be a capital-surplus country.

This flow will be facilitated if certain changes are made within Japan itself, and these I think will and must be made. In effect, what we should look forward to is Japan financing its own export surplus as, indeed, we did through most of the period since 1945.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much.

Mr. Baldwin, please proceed.

**STATEMENT OF ROBERT E. BALDWIN, PROFESSOR OF ECONOMICS,
UNIVERSITY OF WISCONSIN, MADISON**

I should like to comment on the international trade agreements covering nontariff trade matters that are currently in the final stages of negotiation in Geneva. As you know, the President, as required by the Trade Act of 1974, informed Congress on January 8 of his intention to enter into these agreements with other GATT members not less than 90 days from that date.

A final appraisal of these agreements cannot be made until the various gaps and bracketed language in the tentatively agreed-upon codes are removed and especially until one hears the answers by our trade negotiators to questions I hope the Congress will ask them concerning just what they expect from the agreements and why they accepted various provisions in them. However, on the basis of the information available thus far, I would conclude that on balance the new codes are in the interests of the United States and should be accepted and implemented by Congress.

I do, however, have some concerns about them. To start with, I doubt that what actually will come from the new codes is what many groups in industry, labor, and agriculture had hoped for and perhaps thought had been promised. Many leaders in these sectors firmly believe that most of the severe import competition and export difficulties faced by U.S. industry and agriculture is due to various nontariff measures adopted by foreign governments, and they hope these will be eliminated after the Tokyo Round of negotiations is concluded.

There is no doubt in my mind that many foreign governments do indeed use various nontariff devices to restrict imports and artificially promote exports much more than the U.S. Government does. But two points should be made.

First, foreign NTB's are not the main cause of the pressures for industrial adjustment that are being placed on the structure of U.S. production. These pressures are much more related to such basic economic factors as the worldwide spread of technology and rapid improvements in human and physical capital in other countries that are leading to faster development rates in many other areas.

Second, although the elimination of much of the type of Government intervention that U.S. business and labor leaders are concerned about would improve the U.S. trading position to an appreciable degree, there is, in my view, almost no chance for the kind of sweeping

modifications these leaders want. This has nothing to do with the ability of our negotiators but rests upon the rights of other governments to take social and economic actions that they believe are in the interests of their people. Their actions may have the effect of supplying foreign markets with higher cost foreign production rather than lower cost American goods, but this is usually a deliberate decision made for noneconomic reasons by these sovereign governments.

What especially concerns me in this connection is that the U.S. reaction to these facts of current international life will lead to a further push for protectionism in this country. An overselling of the results of the Kennedy Round negotiations was, I think, partly the reason for the strong protectionist pressures that emerged in this country in the late 1960's. So one must be realistic in his appraisal of what will come out of the Tokyo Round. And I was glad to hear Ambassador Strauss talk about that.

The new codes can eliminate some obviously unfair trade practices and might in the long run lead to fundamental improvements in the framework of international trade, but we should not expect too much in the future. If countries intended to dismantle most of their trade distorting measures, the negotiations would not have taken the form of new codes but of hard bargaining on the reduction of specific measures such as quotas or particular subsidies.

It is in relation to the longrun implications of the Tokyo Round negotiations where I have another concern. There is the danger that the negotiations will turn into being a step in the direction of what is called "managed" free trade.

This concept actually has considerable appeal among some American business and labor leaders. Basically it involves international planning aimed at sharing markets in an orderly manner and preventing so-called "excessive" expansions in capacity in several key product lines.

However, it runs against the spirit of U.S. antitrust legislation which is based on the belief that this kind of planning is likely to lead to price-increasing cartels and a reduction in the rate of economic progress. The United States is faced with very strong, new competitive pressures in the world, especially from the developing countries. But in my view we should and can pursue an active adjustment policy that humanly treats those who are adversely affected by economic change without at the same time preventing the kind of adjustments needed if we are to maintain adequate growth. And, it is this growth that is needed to expand the various social programs we desire.

One concern on this point relates to the International Steel Committee recently established under OECD auspices and possibly to the aircraft agreement being concluded, although there is not enough information on the latter agreement to make much of a judgment. The text of the mandate to the Steel Committee includes among its objectives the need to "avoid encouraging unjustifiable investments while recognizing legitimate development needs" and to "facilitate multilateral cooperation consistent with the need to maintain competition, to anticipate and, to the extent possible, prevent problems."

These phrases sound to me as the possible basis for output-restricting actions that are not in the longrun economic or political interests of the United States.

The mechanisms for dealing with the appointment of panels and dealing with their decisions is another aspect of the codes that bears on longrun prospects under the agreements. The key to improving the codes and turning them into meaningful behavior rules that expand world trade and promote international political stability is to build up gradually a body of forward-looking "case law" arising from specific disputes.

While the language establishing such panels varies from code to code—and indeed does not seem to be entirely consistent—preference is usually given to government officials as panel members. As I think past experience has indicated, government officials do not, in these circumstances, have the degree of independence needed for impartial, institution-building decisions. Some panel members in the past have had to make a decision concerning, say, a specific U.S. trade action and then the next week sit down and negotiate with the United States on a matter such as the amount of foreign aid his country will receive. This does not make for impartiality.

Even more important, however, is the so-called Committee of Signatories that each code has. These committees receive the report and recommendations of any panel established under the disputes settlement mechanism and then make appropriate recommendations themselves. This is the stage at which longrun progress in reducing NTS's must be made. All signatories to the various codes are members of these committees. However, the tradition of the GATT is that matters are not decided by voting but by general consensus. This has meant that if one of the major trading powers such as the United States, the European Community, or Japan opposes a particular action, it is not implemented. Thus, what I fear will happen both in the short term and long term is that many of the NTB cases raised by the United States and the developing countries, especially, will not result in significant changes because of what is, in effect, the veto power of other large countries who do not share our views.

Again, it is a fact of international life that you cannot force other large countries to do what they do not wish to do. However, it seems to me that by pushing for greater authority for the GATT Secretariat in dispute settlement matters, there was a greater possibility for promoting in the long run not only U.S. interests but those of the world economy generally than has actually been achieved under the agreed-upon disputes settlement provisions. But, one would want to ask our negotiators about their efforts in this regard before reaching firm conclusions.

Now let me turn briefly to some of the specific codes. The key ones from our economic interest are the ones covering subsidies and countervailing duties and government procurement policy. There are appreciable market opportunities available for U.S. firms if foreign subsidies can be made less trade-distorting and if foreign governments will in their purchasing policies reduce their hidden preferences for domestic producers.

Our leverage in trying to secure better control over subsidies has been the possibility of introducing an injury clause into our countervailing duties law. All other major countries have such a provision as does the original GATT code on this matter. While one can in theory argue that all subsidies that distort trade are bad from a global view-

point, it is sensible from a selfish viewpoint to accept an injury clause, since, if there is no material injury to any domestic industry, it seems foolish not to give domestic consumers the benefits of the willingness of foreign citizens to pay part of the costs of the goods they consume. We also have left open another route for dealing with subsidies that does not require material injury to be established. This so-called "serious prejudice" route hopefully will be useful in dealing with subsidies that take away U.S. export markets.

That can be a very powerful device, say, for dealing with the Japanese problem.

In return for accepting an injury clause the United States has obtained GATT provisions that make it more difficult to provide hidden export subsidies. The door has also been opened for trying to mitigate the trade-distorting effects of domestic subsidies. This, in my view, is the most important part of all the agreements. Unfortunately, in the short run I do not see much progress in this area. The European Community has resisted the U.S. initiative in this area and since the tentative section on domestic subsidies was drafted by the Community, I doubt if many changes will be made in Community subsidy policy, which I think is quite restrictive as far as U.S. trade is concerned.

The best prospects for change rest on the likelihood that the EC will itself come to appreciate the high costs and adjustment-interfering nature of domestic subsidies and move towards less distorting means of providing social and economic assistance. But, as I have also said, I would have liked to see a better mechanism for facilitating such a change than seems to exist in this and the other codes.

The government procurement code is very much in the interests of the United States, since nonmilitary purchasing by governments and government-owned or controlled firms is much more extensive than in this country. It appears that its applicability will be considerably more narrow than the United States had hoped, but it is a very worthwhile start.

There is insufficient time to make more than passing comments upon the other codes. The one on safeguards is the least complete so little can be said about it. One regret is that there is not more emphasis on adjustment as a prerequisite to trade-restricting assistance, but this also applies to our own trade law. The codes on standards, licensing customs valuations, and commercial counterfeiting will help to eliminate blatant trade-distorting practices in these areas and bring about more uniform procedures.

The final code on which I wish to comment deals with the reform of the GATT. One section of this code deals with improving the general disputes settlement and surveillance procedures of GATT. Again, as with the specific codes, I think we need to learn more from our negotiators how they expect undue "big power" pressure to be avoided under these procedures, and how an increasing degree of adherence to non-trade-distorting practices can be secured from these reforms.

Another important part of this code deals with differential and special treatment in favor of developing countries coupled with their gradual assumption of greater GATT responsibilities. It is the developing countries toward which the United States will be devoting an increasing amount of economic and political attention in the future, and it is essential that we lay the foundations for more harmonious relations with these nations.

As they continue to compete more successfully for markets in the industrial countries, we must take advantage of the growing export markets they provide rather than adopting inward-looking protectionist policies. Otherwise we are likely to be faced with a growing degree of political hostility that endangers the foundations of world peace the United States has worked so hard to build over the last 40 years.

The part of the GATT reform code dealing with the developing nations is somewhat helpful in promoting better relations, but I would not be overly optimistic concerning the implementation of the broad objectives set forth. What the developing countries really want and need is an easing of the quantitative restrictions that the industrial countries, including the United States, have introduced on imports of such goods as textiles, shoes, TV sets, and steel. But this cannot be achieved until both the developed and the developing nations devise effective industrial adaptation policies that do not impose adjustment costs on affected industries that are too high and too rapid to be politically acceptable.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Professor Baldwin.
Congresswoman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

I would like to thank the members of the panel.

Mr. Eberle, I would like to have you pursue your earlier comments on the lack of business confidence in the countervailing and anti-dumping remedies because this is the experience that I have often heard recounted, that the remedies presently are so burdensome that it takes thousands and thousands of dollars to fight the case and then get it through the bureaucracy. There are innumerable steps which only the richest corporations can survive, and only they can possibly pursue what should have been available for any business.

Now, what my question is: Should there be a change in the law? Because, obviously, I have a lack of confidence in it, and the business community, as I listen to people, has a lack of confidence. Furthermore, the implementation of these provisions is less an automatic working of the law than it is the will of the administration. And I don't mean that in a political sense. I say, isn't there a way that we can tighten this procedure and develop business confidence in it so that fair competition can be the modus operandi of the marketplace?

Mr. EBERLE. I am not sure what the best solution to it is. But the problems goes back all through the 1960's where Treasury simply never made any decisions. Many of the same people are there even though the law changed. The law changed in 1974. Treasury has been required to speed things up, but they have simply ignored the law.

Part of Treasury's rationale that I used to hear was they didn't have enough people to do the job. My guess is that because it can be a disturbing element in our foreign policy, that the operation is not independent enough of the pressures from the other agencies and from the Secretary of the Treasury. It leads me to believe that, although there should be some foreign policy check, obviously, with the President, there needs to be more independence in the decisionmaking and speed. Really it is the question of timing that is probably more important.

Even if the decision came down against business, I think they would be happier just to have the decision on a timely basis because then they know what they have to do. Both the shoe and the textile industries thought they were going to get some decision and relief and never got it, and now in many cases it is too late.

Representative HECKLER. Therefore, what are you suggesting?

Mr. EBERLE. I guess I am suggesting that when you look at the implementation of the new code that you find some way of giving independence to the Government decisionmaker that will handle this.

Representative HECKLER. Yes, sir.

Mr. EBERLE. I know it can be done. I don't care whether it is in or out of Treasury so long as there is more independence and there is a faster answer.

If they don't have a finding pro or con, perhaps it ought to go in favor of the business automatically—that is, if they don't make a decision.

Representative HECKLER. The time frame should be in the plan one way or the other.

Mr. EBERLE. It is like the up or down vote you will make on the trade agreements. It is certain. You are going to act and make a decision.

On a certain day there ought to be a decision, and if they don't do it, then the allegation ought to be presumed to be true.

Representative HECKLER. In terms of that, I think that is a very practical piece of advice in the sense of setting perhaps a time frame that would be fair and pinning it down so that the decision can be made, because then at least business could make its plans with that sense of reality instead of this expectation of a favorable response.

In terms of our expertise in the import area, obviously, certain firms—those magic 200—are experts but really I find an enormous interest in developing export expertise in small companies in my area. Yet when I attend these seminars, I must say I think I am not a business person, but I do think all of us know that the advice which is given is fairly limited.

Now, isn't there a way of presenting a more sophisticated insight into this so that small- or medium-sized firms could be brought up to snuff in a sophisticated way and then decide whether they make the extra investment in promoting a product for export?

Mr. EBERLE. My judgment is there are two basic problems. One is the cost problem to smaller firms to equip themselves to understand it all, and second, is the lack of understanding of small firms as to how big that market is out there. It seems to me that one of the best things that could be done is to approach this on a State-by-State basis. For example, there is a proposal before the regional governments of Washington, Idaho, and Oregon to do exactly that, which is to study regional products with export potential, and identify the markets. The idea is to have an independent firm determine that, and then go into the market in cooperation with two or three companies to demonstrate that they are right in their recommendations. I think that kind of project proves that it can work with small-medium-sized companies is what will have to be done.

It is not good enough to send 300 people from the Commerce Department to cheer and give awards. That is not going to do us very much good.

Representative HECKLER. I see.

I thank you very much.

I just would like to say, Mr. Chairman—and I know my time has expired—I think that we are trying to avoid this heavy-handed, and in some sense, protectionist policy by seeking a fairer policy.

I personally am interested in innovative trade groups, but when we have lost jobs to other countries, we are not dealing with innovation there; we are dealing with labor costs.

When I look at this Government which has increased the social security costs and the regulatory costs of every business and the cost of doing business on every single operator and if we, at the same time, will then allow the small employee who is working for \$4 an hour in a factory to be wiped out simply because we are interrelated, there is something very unjust about this.

Representative LONG. [presiding]. Thank you.

Congressman Roussetot.

Representative ROUSSELOT. Thank you, Congressman Long.

Mr. Trezise, you seem to indicate, as I listened to your statement, that the objective of the United States is to increase exports and achieve a trade surplus.

Well, why not revalue the dollar just as Japan has revalued the yen?

Mr. TREZISE. We have done a pretty good job of devaluing the dollar, I think, since 1975, when in fact the dollar was overvalued very substantially.

Since then, it seems to me, there has been a little trouble about the extent of the decline in the value of the dollar, so much so that I find my friends in the Treasury rather sensitive now if you suggest that maybe the other currencies could appreciate a bit more and help our trade and external deficit problem.

My own preference is to see what the foreign exchange market will do, within limits anyway. But I recognize that this can be overdone. There are other factors other than the trade and current account surpluses that affect the exchange market and I am not exactly in favor of wholly unrestricted movements in exchange rates. But it is one way to adjust surpluses and deficits.

Representative ROUSSELOT. Do either one of you want to comment on that?

Mr. BALDWIN. I might make the point that, of course, the dollar is affected by much more than trade in goods. We have a tremendous volume of investment dollars overseas that are particularly subject to speculative reactions. This speculation led, a few months ago, to a dramatic depreciation of the dollar. Sometimes the speculative pressures are so strong that they dominate the exchange rate forces coming from our trade account.

Representative ROUSSELOT. Mr. Eberle.

Mr. EBERLE. With the volume of imports that we have and with its ramifications for the lack of confidence in the dollar, this has a tremendous impact around the world. I also think we have to focus on our domestic policies.

Representative ROUSSELOT. So devaluation is inflationary?

Mr. EBERLE. Absolutely.

Representative ROUSSELOT. Professor Baldwin, you heard Mr. Eberle, a former negotiator on our behalf, mention and put strong emphasis on the problem of regulatory burden that is imposed on

exports and he listed, as you indicated, too—he called it “limiting regulatory spillover” and gave us quite a list of things that needed to be done to modify that, to change that burden.

What about that regulatory burden? Do you want to comment on it?

Mr. BALDWIN. I agree with him.

Representative ROUSSELOT. With his list?

Mr. BALDWIN. With his statement about these regulations.

Representative ROUSSELOT. He listed the OSHA requirement, CPSC standards, FDA requirements, environmental reviews which limited export financing. You don't find yourself in disagreement?

Mr. BALDWIN. No; I would suggest that a committee be set up in Government, if there is not already one, to go systematically through all our regulations and try to ascertain their impact on exports and try to determine whether they can't be framed to still do what they are designed to do domestically but without having an adverse effect on exports.

One hears, in story after story, from businessmen it is the redtape we have imposed upon ourselves that is a great burden on our exports.

Representative ROUSSELOT. He mentioned also the U.S. flagship requirements that prohibited Export-Import Bank financing of freight costs. So you agree with that whole list?

Mr. BALDWIN. I do, indeed, and I am sure there are many others in the service areas.

Representative ROUSSELOT. Thank you.

Mr. Eberle, you mentioned in your testimony the case of the U.S. manufacturer who chose to locate in Hong Kong rather than in the United States as a base for exporting to Japan, and the reason was because of the U.S. tax laws. What specific tax laws do you believe need to be changed to prevent this situation from happening again?

Mr. EBERLE. There is a range. The particular one—

Representative ROUSSELOT. Maybe you want to submit them in writing.

Mr. EBERLE. I would like to give it to you in specifics.

Representative ROUSSELOT. Good. Now the question is can you get Congress to listen?

Mr. EBERLE. You are listening.

Representative ROUSSELOT. So you will submit it?

Mr. EBERLE. I will submit it to you.

Representative ROUSSELOT. That will be helpful.

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

* * *. One area in which the U.S. government might play a useful role is in the review of tax laws that can make it difficult for an aggressive U.S. company to cut price into Japan. The issue here is transfer price between U.S. parent and overseas sales subsidiary and the degree to which price cutting from the parent is viewed as an effort to displace income to a different tax jurisdiction. The Internal Revenue Service can hinder U.S. companies from repaying the Japanese in kind and price cutting into the Japanese competitors' home market.

A case in point is a U.S. machinery manufacturer, a dominant and low-cost world producer. A major Japanese company entered its product area, and by aggressive sales of small-size products took a major share of the Southeast Asian and West European markets. By the time the U.S. producer awoke to the threat, its share in many markets was second to the Japanese company's. The threat is now being met by the U.S. company. But the most effective strategy is to attack the Japanese company in the Japanese market. The Japanese firm's sales there

are large, the U.S. company's negligible. Sharp price cutting into Japan could cut off the cash flow that is supporting the Japanese company's worldwide attack. The U.S. company intends to do so, but because of U.S. tax laws has chosen to go into production in Hong Kong as a supply base for attacking the Japanese market.

Source: Abegglen, James C. and Hout, Thomas M., "Facing Up to the Trade Gap With Japan," *Foreign Affairs*, Fall, 1978, pages 161-162.

Representative ROUSSELOT. Anyone else want to comment on that.

Mr. TREZISE. No.

Representative ROUSSELOT. Mr. Baldwin.

Mr. BALDWIN. No, I don't have any particular expertise there.

Representative ROUSSELOT. My time has expired.

Representative LONG. Congressman Brown.

Representative BROWN. Thank you, Congressman Long.

Mr. Eberle, and to all of you, I guess, I would like to pose sort of a general and long question.

We are all aware, I think of the rising protectionist sentiments in the country and, as I understand from my brief review of your testimony, all of you express or imply opposition to it, but it seems to me it is more complicated than that. I have a specific problem in my district that I can understand because I have a newspaper business and I have been through all this before in the committee about the problems that my newspaper business faces, but I want to relate it now to the steel industry, because that focuses on an area where we are having export problems and import problems.

A steel mill in my area has been having trouble over the last few years and the Government blames that on labor and management, implied at least by the wage/price guidelines. Is there a way that we could make the point about the impact of what inflation does to the ability to compete?

Do you know of any studies that would give me the effect of inflation on the inability of U.S. manufacturers to compete, and how the job losses are multiplied throughout the community when a firm closes down?

Now let me give you a couple of the impacts here that the Government has. The Government has been blaming labor and management. I have been blaming the Government, and labor and management have been quiescent to some extent in the Government program. Let me give you the problem.

Old equipment begins to wear out; the company has to replace the equipment; the company has had its profits taxed away at a certain rate; but when you go to buy the equipment, the equipment costs more than three times than when it was originally installed, or perhaps four times or two times, but at any rate a great deal more and, of course, that replacement cost under the principles of accounting should have been deducted from profits, but it was not.

The higher phantom profit because of inflation was there and it was taxed because inadequate depreciation was taken away. As a result of that we have not had any steel mills built from the ground up in the United States in I don't know how long.

Then we legislate in air and water quality standards, which is an enforced expenditure that the steel mill has to undertake, that does not relate in any way to productivity. In other words, we mandate them to do that and to put it in the price of their product or depreciate it at the inadequate depreciation rate.

Then we mandate things like occupational safety and health. And there is another thing I guess I ought to throw in. Inflation requires the worker in that mill to ask for more income just to keep even after taxes because of our increased tax bite on inflated earnings, and so raises the wage cost of the steel mill.

Now all of that is a follow-on of inflation. Part of what I said is a result of our environmental concerns at the Federal level and some other concerns, safety and health and so forth.

Do you know of any studies that give us the effect of the rate of inflation on these things, like depreciation, and jobs, and how can we make it clear that inflation is part of what is destroying our ability to compete abroad?

Mr. EBERLE. Congressman, I know of only one precise study. The Conference Board has done a study on inflation, on investment.

Representative BROWN. Who has done it?

Mr. EBERLE. The Conference Board in New York. I will see if I can find it.

Representative BROWN. But that is just the depreciation aspect?

Mr. EBERLE. Yes.

The Salomon Brothers have done another. I don't know if anyone has done all that you have asked for, but I know there are a number around.

Representative BROWN. I used to work in the chamber of commerce. They used to say you could get a new manufacturing plant, multiply the jobs in the community by six times, because the cocktail waitresses and the cab drivers and the home builders and all those people would have to be employed because you had this new plant. That is what I am looking for.

Mr. EBERLE. There are several studies on the multiplier effect of a new industry or an improved industry.

Representative BROWN. I am not asking that. We have all of that. I want to know what the depressing effect of the rate of inflation is.

Mr. Trezise.

Mr. TREZISE. Yes. We do have one paper at Brookings which I will be happy to send you, which does that just a little more broadly than you suggest, but it would cover the inflationary question.

There is no doubt, it seems to me, that inflation is the biggest domestic problem we have in our foreign trade. It could not be otherwise.

There are some complications, of course, because the exchange rate has been moving, too, so the corrective force of the exchange rate has somewhat modified the impact of inflation, but obviously not enough.

Representative BROWN. So, floating currencies are a necessity when we have inflation going at the rate it is?

Mr. TREZISE. I am afraid that is right. Bill Eberle says the depreciating dollar is inflationary. Well, it is depreciating because we have been inflating so much. I think the President's new emphasis on dealing with inflation is not only justified but well overdue.

I don't see how in the community we can have constantly increasing rates of inflation without doing damage to the whole structure of our system.

Representative BROWN. If you can provide me the Brookings information and Mr. Eberle will get the Conference Board study to me, and maybe the Joint Economic Committee can study this effect.

Mr. BALDWIN. I don't believe you can get one figure. I think there are components around by which you could put together what you want.

Part of it is a macroeconomic problem that has generated inflation. This will be partly offset in the exchange rate and depreciate and thus restore part of the competitive powers that you lose, but it won't be entirely restored; it will have a differential effect on industry, partly because of their different capital intensities.

There have also been some studies done on the impact on, say, the United States compared with the advantages of these various environmental controls and so forth.

I could get you some information on that.

Representative BROWN. That is kind of a regulation thing that is a separate issue.

Some of that has been done from the Joint Economic Committee but I want to suggest that you do a study on our ability to export.

I was startled in the President's remarks the other night and then I am amazed at your contradiction of him, Mr. Eberle, because he said in his speech that we now are exporting agricultural products at a record rate, and in your remarks you said, "The rate of growth of U.S. agricultural exports has been stagnant for the last 3 years."

Can you clarify your contradiction of the President for me so that perhaps he won't feel badly about it?

Mr. EBERLE. Far be it from me to contradict the President. I would only suggest that if you take the inflation factor out, that you will find that the big increase has been one of value, not in units.

Representative BROWN. The President was talking about inflated dollars and not about increased exports.

Mr. EBERLE. I don't know what he was talking about.

Representative ROUSSELOT. You don't know what he was talking about?

Mr. EBERLE. I don't know what numbers he used.

I think, if you look at the units, we are on a stagnating basis on the side.

Representative BROWN. I have two more questions, Congressman Long, if I may ask them.

Representative LONG. Go ahead.

Representative BROWN. You mentioned it and we have just had a discussion of it, also, which embraced the handicap regulations placed upon exporters, but it seems to me that as is always the case—and this is where I was getting to with my first question—that inflation and regulation falls heavier on small- and medium-sized businesses.

You don't seem to see a lot of little businesses getting into the export market out in the world. It seems that it is always the biggest companies in whatever the field is.

There are some areas of export where the businesses may not be as large as General Motors or something, but in the field it is usually the largest company that is the major exporter.

My question is whether or not there is a way to encourage small- and medium-sized businesses to get into the field or is that a hopeless situation as long as we have the regulations that we have from the Government and also the inflation rate that we have currently?

Mr. EBERLE. I responded this way: It is not hopeless. First of all, the conditions have changed. The exporting has grown from about 4 percent of the GNP to two times that. Many businesses must look to exports for the first time if they are going to grow and expand. There is an automatic incentive.

Representative BROWN. Of which the biggest company can take the best advantage.

Mr. EBERLE. That is correct. But small companies can do it too. There is a small candy company in Tacoma, which has 45 percent of its business overseas and it did it because its president had a desire to create an export market and worked at it. So it can be done. But we have the largest common market in the world in our 50 States and it is a lot easier to sell here than it is abroad.

Smaller companies need help to be shown that they can be successful overseas, and to find ways in which it can be done. There are many ways it can be done, but it has to be done on a pragmatic basis.

Representative BROWN. Do either of you want to make a comment?

Mr. BALDWIN. I think it is enormously expensive and risky to go into overseas markets and for most business it is just not feasible.

We can have many of these promotional programs and I don't think they are going to have a great deal of effect.

If you really want to have an effect, I think you would need to have a very aggressive type of export promotion policy by the Government. We should learn from the developing countries on this point.

These nations have whole government divisions set up for export promotion. They go out and find the markets, that is, they assume the risk of exploring for markets, then come back to small businessmen and say, "We found the market for you; now, go and fill it."

Representative BROWN. So, you think more could be done?

Mr. EBERLE. Definitely.

Representative BROWN. It is an educational procedure?

Mr. EBERLE. Yes.

Representative BROWN. Are the banks doing their part?

Mr. BALDWIN. I think, in general, yes.

Representative BROWN. Let me turn that around just a minute. I come from a town of 12,000. We have two banks in town. We have at least one business in town which is in the business of overseas export, but I asked one of my bankers if he is encouraging that and he said:

Are you kidding. With what the Comptroller of the Currency is laying on me with regulations, I have time and funds to encourage the little businesses in this town to get into the export market.

And he just laughed me out of the room.

Is he irrational?

Mr. EBERLE. Congressman Brown, I would suggest that he call up the Eximbank which maintains an open-window discount, a very large percentage of that paper, which I believe is 90 percent, is available to support him.

Representative BROWN. Is it an 800 number?

Mr. EBERLE. It has been several years since I was employed in Washington.

I don't know.

Representative BROWN. Do you have any comments?

Mr. TREZISE. I don't know how you get the small business to export. I suspect a whole range of things, some of which you touched on.

Small businesses are simply not equipped to be exporters and perhaps we need to persuade somebody to set up trading companies as in Japan. Japan's trading companies do draw in goods from a lot of small businesses which would not in and of themselves be able to export; they simply would not have the capability. I don't know whether that is a general answer or not, but it might in some cases be the way. Indeed, that is the way we export our grain, through the grain companies. No farmer could be an exporter of grain; he would not have the capital and skills.

Representative BROWN. You have made the connection that I was working toward, and that is that the smaller the unit in the United States, the smaller the unit of production, the more difficult it is, and the smaller the finance source the more difficult it is, and I think we need some special attention.

Now, let me try my radical question on you.

Some years ago, in order to establish monetary policy in this country, we established the Federal Reserve Board as an independent operation in the banking community to try to stabilize that element of our economy.

Are we approaching the time when we ought to have—independent of the President, of the Congress—an independent agency to promote and set tariffs and assure the distribution of American products abroad?

If I had had more time, I would have laid a longer predicate to my question, but I want to remind you of our experience a few years ago where the Japanese bought a lot of soybeans and we said that we were not sure we are going to deliver them because the price was high, the labor unions were interfering, and a lot of other things were interfering.

Is the timing for us to consider that radical idea now appropriate or do you think it is a likely decision that we should make some time in the future?

Do you understand what I am suggesting?

Is it a new idea or an old idea?

Mr. EBERLE. I certainly feel that now is not the correct time.

I think we can do a much better job to clean up the disincentives that are in Government before you create a new bureaucracy to add on top of all the problems we now have.

So, I would urge that you focus to do the disincentives first while an effort is made at developing export markets for small business.

Representative BROWN. What disincentives are you talking about?

Mr. EBERLE. My testimony listed a whole range of disincentives from taxes to regulations.

Representative BROWN. You are talking about the——

Mr. EBERLE. Purely domestic.

Representative BROWN [continuing]. Impediments that we impose on ourselves?

Mr. EBERLE. And adding a whole new bureaucracy on top of that before you clean it up seems to me to be a serious mistake.

Mr. TREZISE. I agree with Mr. Eberle. I don't think this is the time for a new agency.

More than that, you mentioned the soybean embargo which was a terribly unfortunate mistake but I don't believe we could have any agency so independent of the President of the United States that it would not be possible to make that mistake over again.

This was, after all, a decision that was made at very high levels in the Government and for reasons that I am sure at the moment were quite persuasive and compelling.

I thought at the time it was a disaster and I think it has been, but I don't think you could create an agency so remote, so independent that it would not be found to do things like that in the stress of circumstances.

Representative BROWN. Well, domestic, political, and economic circumstances and that is what I am trying to avoid.

Mr. TREZISE. We were running a price control system at that time.

Representative BROWN. But I am trying to get our foreign trade away from that and see if we cannot develop a consistent and aggressive trade policy that would help sugar and rice in Congressman Long's area of the country, and soybeans and steel in my area, and movie stars and orange juice and oranges in Congressman Rousselot's area.

Representative ROUSSELOT. We are already exporting movie stars.

Mr. BALDWIN. I think that trade is tied in so closely with our foreign policy that it would not be possible to separate those two.

We do find that at many times it seems commercial relations are sacrificed for broad and vague foreign policy interests and often that frustrates us but I think it is something that, on balance, we have to accept.

Let's go for reducing nontariff barriers through the new trade negotiations, trying to increase our export in this way as well as for improving our domestic controls and regulations and trying to before we move on to some of these more radical proposals.

That would be my suggestion.

Representative BROWN. Thank you, Congressman Long.

Representative LONG. Gentlemen, we have a number of additional written questions. If it is agreeable, we would like to submit these questions to you. If you would be good enough to give us those, your views on these questions, we would be most appreciative.

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. ROBERT S. STRAUSS TO ADDITIONAL WRITTEN QUESTIONS
POSED BY SENATOR BENTSEN

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., February 26, 1979.

HON. ROBERT S. STRAUSS,
Special Representative for Trade Negotiations,
Washington, D.C.

DEAR AMBASSADOR STRAUSS: On behalf of the Members of the Joint Economic Committee, I would like to thank you for testifying before us as part of our annual review of the American economy. Your testimony will be of substantial assistance to the Committee. And beyond your testimony, we are all appreciative of your months of toiling in the trade vineyard.

Unfortunately, time prevented us from asking some important questions. With your heavy schedule in mind, I will limit these additional questions to just one subject—the matter of a surcharge on Japanese imports.

Last July, Congressman Vanik and four other Members of the Subcommittee on Trade of the House Ways and Means Committee urged the President to consider imposing a surcharge on Japanese imports as the only effective way to deal with the mounting U.S. trade deficit and the rapid depreciation of the dollar. In your response to Congressman Vanik, you recommended against a unilateral surcharge, but noted that Section 122 of the Trade Act of 1974 would be a "legitimate option . . ." under different circumstances.

First, I am concerned about whether or not a unilateral surcharge would be consistent with existing GATT rules.

Second, to what extent could businesses in one country avoid the impact of a six-month surcharge (the usual limit contemplated by the Trade Act) by tightening profit margins and other measures?

Third, in discussing the use of a surcharge against one or more countries, the Trade Act of 1974 (Sec. 122(d)(3)) states that "After such time when there enters into force for the United States new rules regarding the application of surcharges as part of a reform of internationally agreed balance-of-payments adjustment procedures, the exemption allowing discrete rather than across-the-board surcharges authority . . . shall be applied consistently with such new international rules." How will the proposed multilateral trade agreement affect the surcharge against only one country provision of the Trade Act of 1974?

Fourth, in talking with a variety of Japanese officials as well as a number of scholars specializing in the Japanese economy, there has been a general preference expressed in favor of yen appreciation as opposed to an across-the-board surcharge on Japanese imports. The preference appears to be based on several grounds—Japan is no longer singled out for unilateral action; appreciation allows more gradual (and therefore less painful) domestic adjustment; and appreciation, of course, would affect all Japanese international economic transactions rather than only visible trade with the United States. In general terms, would you express a similar preference for currency appreciation as opposed to the application of a surcharge? Given the administration's existing commitment to support the dollar, to what extent would yen appreciation be an acceptable eventuality?

Fifth, in treating bilateral economic relations with Japan, the emphasis has been on Japanese practices that increase her exports and limit her imports. Much less attention has been focused on the remaining Japanese exchange and capital controls. How extensive are these controls? To what extent have changes in such controls been part of our bilateral negotiations with Japan? What impact would you expect a lifting of Japanese controls would have on our overall trade deficit and in what period of time?

Finally, in the case of Japan or other surplus countries, what type of bargaining response can we expect from the threat of application or the application of a unilateral surcharge on their exports to the United States?

Thank you again for your fine testimony and for adjusting your extremely busy schedule so that you could join us.

Sincerely,

LLOYD BENTSEN,
Chairman, Joint Economic Committee.

THE SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS,
Washington, D.C., May 25, 1979.

Hon. LLOYD BENTSEN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BENTSEN: Attached are answers to the questions you asked me to reply to for the record of your hearings.

I appreciate the opportunity to testify before your Joint Economic Committee. Please call me if I can be of additional assistance.

Sincerely,

ROBERT S. STRAUSS.

Attachments.

Question 1. Is a unilateral surcharge consistent with GATT rules?

Answer. The GATT provisions on trade measures for balance-of-payments purposes allow quantitative restrictions to be imposed. However, under the

"Framework Agreement" reached in the Multilateral Trade Negotiations, it was agreed by GATT members that, when it is necessary to restrict imports as a balance-of-payments measure, the restrictions should be applied in a manner to limit the trade distorting effect as much as possible. As surcharges are generally recognized as the least trade-distorting restriction, we believe that import surcharges would arguably be most consistent with the spirit of the new GATT "Framework Agreement", although signatories have reserved their GATT rights.

As for the unilateral aspect, the Framework Agreement does permit unilateral actions, but they would be subject to review by GATT members under established procedures.

Question 2. To what extent could business in one country avoid the impact of a six month surcharge (the usual limit contemplated by the Trade Act) by tightening profit margins and other measures?

Answer. The question cannot be answered with precision. It depends on many factors including the size of the surcharge, the size of profit margins (had they been squeezed earlier by exchange rate changes or competitive conditions in the market place?) demand elasticities, and future expectations (about business activity, possible renewal of the surcharge, exchange rate changes).

Question 3. In discussing the use of a surcharge against one or more countries, the Trade Act of 1974 (Sec. 122(d)) states that "After such time when there enters into force for the United States new rules regarding the application of surcharges as part of a reform of internationally agreed balance-of-payments adjustment procedures, the exemption allowing discrete rather than across-the-board surcharges authority . . . shall be applied consistently with such new international rules." How will the proposed multilateral trade agreement affect the surcharge against only one country provision of the Trade Act of 1974?

Answer. The Multilateral Trade Agreement has no effect on Section 122 of the Trade Act. We have not yet negotiated new international rules as contemplated by that section of law.

Question 4(a). In talking with a variety of Japanese officials as well as a number of scholars specializing in the Japanese economy, there has been a general preference expressed in favor of yen appreciation as opposed to an across-the-board surcharge on Japanese imports. The preference appears to be based on several grounds—Japan is no longer singled out for unilateral action; appreciation allows more gradual (and therefore less painful) domestic adjustment; and appreciation, of course, would affect all Japanese international economic transactions rather than only visible trade with the United States. In general terms, would you express a similar preference for currency appreciation as opposed to the application of a surcharge?

Answer. In general terms, balance of payments adjustment is better promoted by currency adjustments in response to underlying economic conditions—backed up by appropriate domestic policies, especially fiscal and monetary policy, as well as liberalization of trade barriers by the surplus country—than by trade restrictions such as a surcharge.

Question 4(b). Given the administration's existing commitment in support of the dollar, to what extent would yen appreciation be an acceptable eventuality?

Answer. A restoration of balance in Japan's balance of payments accounts does not necessarily mean continued yen appreciation. As indicated in the previous reply, domestic policies are an important part of balance of payments adjustment. In the case of Japan, we have encouraged the Government of Japan to reduce Japan's trade barriers to achieve basic equity in our trading relations, and expand domestic demand to attract imports and shift the use of Japanese resources from export production to domestic production.

These measures appear to be having some success as Japan's current account surplus has been falling rapidly in the last few months without further yen appreciation.

Question 5(a). In treating bilateral economic relations with Japan, the emphasis has been on Japanese practices that increase her exports and limit her imports. Much less attention has been focused on the remaining Japanese exchange and capital controls. How extensive are these controls?

Answer. In the past, Japan's foreign exchange and capital controls have been pervasive. Since the late 1960's Japan has taken a series of steps liberalizing the controls. At present, the Government of Japan is in the process of overhauling the entire control system on the principle that all transactions should be free (uncontrolled) unless specifically prohibited. Examples of the types of controls that are being reviewed follow:

For most import purchases, a declaration must be filed if made under the "standard method" of settlement. The "standard method" requires that import payment be made no more than one year after customs clearance. Limits also apply to repayments. For a few goods, and payment outside the "standard method", prior approval must be obtained.

Payments for invisibles are subject to verification by foreign exchange banks. Foreign investments generally must be approved by the Government of Japan or notified. Foreign ownership, up to 100 percent, is permitted for virtually all industries, but prior approval is generally required.

Subject to prior approval, which is generally automatic, capital may be transferred abroad and foreign investments may be made by Japanese residents.

Question 5(b). To what extent have changes in such controls been part of our bilateral negotiations with Japan?

Answer. We have included these issues in our negotiations. In the Strauss-Ushiba Joint Statement of January 1978, Japan agreed to:

1. Relaxing the rules for the "standard method" of settlement.

2. Conducting a sweeping review of its foreign exchange control system and planning a new system based on the principle that all transactions should be free unless specifically prohibited. As a forerunner of the new system, certain immediate measures of liberalization are to be announced soon.

Following this agreement, the rules for the "standard method" of settlement were liberalized in April 1978 by extending the time limit for import prepayment and for deferred payment on capital and consumer goods to one year (from four months). Legislation to revamp the foreign exchange control system is being submitted to Japan's Diet.

In addition, we have been discussing with Japan ways to provide U.S. banks with reciprocal marketing opportunities.

Question 5(c). What impact would you expect a lifting of Japanese controls would have on our overall trade deficit and what period of time?

Answer. We do not have such an estimate. We do believe that our businessmen can prosper in an open, market-oriented international payments system. We believe a lifting or liberalization of Japan's controls would increase opportunities for U.S. business activity in Japan.

Question 6. In the case of Japan or other surplus countries, what type of bargaining response can we expect from the threat of application or the application of unilateral surcharge of their exports to the United States?

Answer. It would be inappropriate for the Administration to speculate on the response of another country to a "threat" by the United States. Japan, however, is certainly aware of discussion in the United States about the possibility of a surcharge on Japanese goods. Many of the recent decisions Japan has made to reduce trade barriers and take appropriate measures to reduce its current account surplus have been made in light of that knowledge.

RESPONSE OF PHILIP H. TREZISE TO ADDITIONAL WRITTEN QUESTIONS POSED BY
SENATOR BENTSEN

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., February 28, 1979.

Mr. PHILIP H. TREZISE,
*Acting Program Director,
The Brookings Institution,
Washington, D.C.*

DEAR MR. TREZISE: On behalf of the Members of the Joint Economic Committee, I would like to thank you for testifying before us as part of our annual review of America's economic problems and prospects. Your testimony will be of substantial assistance to the Committee.

Unfortunately, time prevented us from asking some important questions. Would you please answer the following questions at your convenience so that we can further benefit from your thinking on international economic problems.

1. In your testimony before the Committee, you noted that the real appreciation relative to the dollar did not begin until sometime in 1978. Despite the Administration's adoption of a dollar support plan in late 1978 and the subsequent appreciation of the dollar, there was still substantial real yen appreciation relative to 1977. How long will it take for yen appreciation to be felt in our *dollar* denomin-

ated trade deficit? To what extent will the workings of yen appreciation through a J curve effect be slowed by non-tariff, Japanese barriers to trade?

2. Over the past two years, a number of the witnesses before the Joint Economic Committee have noted that the United States has been losing its export share in Japan. What is the explanation for this loss?

Thank you again for your fine testimony.

Sincerely,

LLOYD BENTSEN,
Chairman, Joint Economic Committee.

THE BROOKINGS INSTITUTION,
Washington, D.C., March 13, 1979.

HON. LLOYD BENTSEN,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR SENATOR: You have asked me several questions which were not covered at the hearing of the Joint Economic Committee on January 25.

Question 1. How long will it take for yen appreciation to be felt in our dollar denominated trade deficit?

Answer. As you know, an unqualified answer to this question is bound to be somewhat misleading. Studies of exchange rate changes in the past suggest that the negative of J-curve effects on trade account work themselves out in six quarters, after which the positive impact comes on strongly, overwhelming the earlier results. But the effect on trade flows of a change in currency values also depends on the state of economic activity: that is, an appreciating currency should be accompanied by stimulative policies, a falling currency by restrictive policies. Ideally, the countries concerned should act appropriately and together. If these conditions are not satisfied, the impact of a given change in currency values will be slower, smaller, and possibly will not occur.

In 1978, it appears, domestic demand in Japan grew quite fast, at about 7 percent, while the U.S. economy slackened somewhat from 1977 but still seems to have been operating close to its potential. I believe that the decline in Japanese export volume and the growth of import volume after the first quarter was associated with the yen rate appreciation, the rise in Japanese domestic demand, and perhaps to some degree the lower rate of growth in the United States. It seems a reasonable proposition that with continuing growth of domestic demand in Japan, a still strong yen, and with the expected slowdown here, Japan's current account surplus, expressed in dollar terms, should register a significant decline in 1979. The OECD projection is for a fall of almost one-half, on a calendar year basis. The Japanese government foresees a reduction for the 1979 fiscal year, April-March, of about the same magnitude. Both estimates are based on expectations about the yen rate and about levels of economic activity in Japan.

Both estimates were made, however, before the recent events in world oil markets. I do not know how to predict what the reactions will be if oil prices should rise by much more than the original OPEC announced increase for the year. On the one hand, Japan's oil import bill will go up more than that of any other industrial nation, which will tend to shrink the surplus. On the other, it is recalled that in 1974 the Japanese government, like most others, responded with sharply restrictive policies which brought on a recession, from which the economy recovered slowly and incompletely. I do not suppose that will be the case this time—nor can I foresee what the United States, Canada, and Western Europe will do—but the uncertainties in the present situation are very considerable.

Question 2. To what extent will the workings of yen appreciation be slowed by non-tariff Japanese barriers to trade.

Answer. Non-tariff or, for that matter, tariff barriers are a limitation on the expansion of imports that the yen's appreciation should induce. Japan's imports are relatively price-inelastic anyway, because so large a share consists of food, fuel, and raw materials; trade barriers contribute further to the low elasticity of import demand. It is pertinent in this connection that imports of semi-manufactures and manufactures, which would be expected to be most responsive to price changes, rose by 36 percent in the first eleven months of 1978 over the same period of 1977. Also, while the data I have at hand are sketchy, they do show a distinctly positive relationship between the increase in volume of manufactured goods imports and the extent of the decrease in import prices. In the area of semi-manufacturers and manufactures, at any rate, I would expect that yen appreciation, on a real terms basis, will foster a rising level of imports into Japan.

Relaxation of non-tariff barriers of course will aid this process, but I do not know how to quantify the outcome.

Question 3. Over the past two years, a number of witnesses before the Joint Economic Committee have noted that the United States has been losing its export share in Japan. What is the explanation for this loss?

Answer. On an aggregate basis, the United States apparently has gained rather than lost market share since 1976. The figures are as follows:

	Japan's total imports (Dollars in millions)	Growth rate percent	Shares percent			
			United States	European Community	Southeast Asia	Communist countries
1976.....	64,798.9	19.3	18.2	5.6	20.7	4.4
1977.....	70,808.7	21.1	17.5	5.9	21.3	4.7
1978 (11 mos.).....	71,568.1		18.6	7.6	21.7	4.9

¹ 1976-77, December to December.

² 1977-78, November to November.

As you will note, the United States gain in market share, 1976-78, was relatively less than that of the European Community, Southeast Asia, and the non-market countries. I am not sure, however, that much importance should be attached to these short run shifts. Japan's imports of crude oil account for 38 percent or so of total imports. Even a modest change in this category will affect both the grand total and the shares of non-oil exporters. In any case, it would be risky to postulate a trend on the strength of data for only three years.

The U.S. share of Japan's food imports jumped from 31.7 percent in 1977 (November-November) to 35.2 percent, and this obviously accounted for the gain in overall market share. In manufactures, taken broadly to include chemicals, refined metals, and textile fabrics, etc., the U.S. share fell from 33.1 percent in 1976 to 30.2 percent in 1977, while the European Community's share rose from 22.9 to 26.4 percent. Here are the comparisons:

JAPAN'S IMPORTS OF MANUFACTURES, 1976-78

	Total (dollars in millions)	Shares (percent)			
		United States	European Community	Southeast Asia	Communist countries
1976.....	11,717.2	33.1	22.9	20.7	4.7
1977.....	12,829.5	31.5	24.9	19.7	5.1
1978 (11 mos.).....	15,731.6	30.22	26.4	20.3	5.3

Looking at particular categories, the European Community registered a higher market share in almost all instances. In clothing, for example, it increased its share from 14.9 percent in 1976 to 17.3 percent in 1978, while the dominant supplier, Southeast Asia, dropped from 68.3 percent to 63.8 percent. The United States share declined in all categories except clothing and, a more important case, electric machinery.

A summary of the import picture by main categories for 1976-1978 is shown in the appended table.

As I have said, these data are too limited to be used to support longer run projections. At the same time, they do not argue for complacency. Structurally, one would suppose, the United States should be a major supplier of foods and some raw and semi-finished materials to Japan. There is nothing wrong with our being an exporter of, say, feedgrains, which in fact come from one of world's most efficient and technologically advanced industries. But we should be a vigorous competitor in most categories of manufactures as well. If we do not improve on the export record of recent years in these categories as our domestic economic activity slows down, it will be a pretty clear signal that something is going badly and needs to be corrected.

I hope that these comments will be helpful.

Sincerely,

PHILIP H. TREZISE.

Enclosure.

JAPAN'S IMPORTS, 1976-78

	Grand total	Food	Crude materials	Mineral fuels	Chemicals	Processed metals	Textiles (intermediate goods)	Non-electric machinery	Electric machinery	Transport equipment	Textile products	Household equipment	Domestic electric equipment	Passenger cars	Toys and musical instruments	Manufactured goods total
1976 January-December (millions).....	64,798.9	10,281.9	11,756.1	28,287.3	2,602.2	1,733.5	778.7	1,960.3	1,212.3	594.0	920.5	65.8	94.5	222.1	285.2	11,717.2
1977 January-December (millions).....	70,803.7	11,339.3	12,575.5	31,148.7	2,938.9	1,980.6	727.1	2,234.9	1,235.2	436.9	1,005.2	78.3	92.6	285.2	301.6	12,829.5
1978 January-November (millions).....	71,568.1	11,323.7	12,239.5	28,370.9	3,336.4	2,411.6	1,131.1	2,257.1	1,455.8	958.9	1,308.1	91.8	94.7	362.6	394.2	15,731.6
Growth rate (per cent):																
1976-77 December-December.....	9.3	10.3	6.9	10.1	12.9	14.3	-6.6	14.0	1.9	-26.4	9.2	18.9	-2.0	28.4	5.8	9.5
1977-78 November-November.....	11.1	8.9	6.3	.4	24.7	32.6	78.7	14.6	30.8	143.0	40.5	28.4	12.2	39.5	44.1	35.9
Share of imports from (per cent):																
United States:																
1976.....	18.2	31.6	19.6	5.1	40.9	8.0	5.6	53.6	50.9	47.1	3.9	18.1	30.8	38.8	44.5	33.1
1977.....	17.5	31.7	19.6	4.3	38.7	4.9	5.7	50.8	51.6	57.9	4.4	15.2	28.9	34.8	40.8	31.5
1978.....	18.6	35.2	21.9	2.9	37.8	7.8	4.9	49.5	56.6	43.2	4.6	15.1	28.5	24.0	42.8	30.2
European Community:																
1976.....	5.6	4.0	.9	.2	29.1	5.6	21.7	29.5	15.7	22.5	14.9	33.7	15.9	56.7	21.1	22.9
1977.....	5.9	4.1	.9	.1	29.3	4.9	26.9	32.1	21.2	25.5	17.4	40.6	15.6	61.5	21.1	24.9
1978.....	7.6	4.9	1.1	.1	30.5	6.2	20.5	35.2	19.0	42.8	17.3	41.9	19.2	73.5	18.9	26.4
Southeast Asia:																
1976.....	20.7	22.7	25.9	17.7	7.5	18.6	54.3	3.6	28.1	8.1	68.3	14.7	51.0	-----	28.2	20.7
1977.....	21.3	21.7	25.5	19.9	9.1	19.5	48.8	3.7	21.9	7.9	63.9	13.5	53.2	-----	32.3	19.7
1978.....	21.7	20.4	26.9	20.9	8.6	17.4	56.3	3.3	18.9	3.5	63.8	17.5	49.3	-----	31.7	20.3
Communist countries:																
1976.....	4.4	3.8	7.1	3.4	3.3	13.4	11.6	.7	.2	.4	9.4	6.7	-.04	-----	.8	4.7
1977.....	4.7	3.8	8.6	3.3	3.1	14.3	12.1	.7	.2	1.8	10.6	5.9	-.03	-----	.7	5.1
1978.....	4.9	4.3	8.3	3.4	2.8	14.7	13.4	.4	.1	.6	10.6	6.3	-.03	-----	.7	5.3

Source: The Summary Report: Trade of Japan, Japan Tariff Association.

Representative LONG. Does anyone have any additional questions?
[No response.] Thank you, gentlemen, for being with us, and for the effort you have put into preparing your testimony.

The committee stands recessed.

[Whereupon, at 12:26 p.m., the committee recessed, to reconvene at 10 a.m., Monday, January 29, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, JANUARY 29, 1979

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

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, McGovern, Javits, and McClure; and Representatives Reuss, Hamilton, and Brown.

Also present: John R. Stark, executive director; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, Paul B. Manchester, and M. Catherine Miller, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, Mark R. Policinski, and Peter Turza, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

Mr. Schultz, it is certainly a pleasure to have you back to discuss and comment on the President's Economic Report, and as Chairman of the Council of Economic Advisers, you certainly played a major role in the formulation of it, and we really look forward to your testimony. I think you have done an excellent job under some trying conditions.

I want to particularly commend you for the sense of realism and financial responsibility that you brought to the Economic Report. I hope I am not in a minority.

Mr. SCHULTZE. I surely hope not.

Senator BENTSEN. I think for too long there has been a problem of the Government having a tendency to overpromise people, to say it will deliver more than it can deliver. To the attempt to bridge this gap between promise and performance, I attribute some of our problems of inflation. It places a heavy tax burden on the American people and has inhibited growth and stability in our economy.

I think your appraisal is an honest appraisal and because of that it is going to be controversial, because it doesn't give you any simple, painless, quick fix for inflation. There are also broad differences of opinion on how that pain ought to be apportioned.

Compared with the other analyses I have seen, you seem relatively optimistic about our rate of growth.

The CBO, for instance, last week, projected a \$41 billion budget deficit, and primarily due to a slower growth than you assume.

Last week Chairman Miller also suggested that your inflation predictions were on the low side. Frankly, I hesitate to take a position between economists arguing like this, but I am sure rooting for you on your projections. Mr. Schultze, because, if the others are right, I think we are in for some awfully tough sledding this year.

There is another point I would like to make.

It appears that fiscal restraint in this budget is coming more from the tax side than from the spending side, and in real terms spending is just about the same as last year, but the tax burden will have increased substantially by \$7 to \$8 billion.

One thing that gives me real concern in the information that you have provided, and one I have been talking about a long time here, is the question of the loss of productivity in this country.

As I recall the figures, between about 1950 and 1965, we had about a 2.5-percent increase in productivity. From 1965 to 1973 you had approximately 2 percent. From 1973 to the present, you have got down to about 1 percent, and this last year eight-tenths of 1 percent.

Anytime you do that, and that pie is not expanding as rapidly as it has been, and there is constriction of lack of expansion, what it really means is that you are not going to satisfy a lot of the hopes and dreams and expectations of people, and I think in turn it can lead to great social conflict in this country and great economic unrest. And, as you pull up the drawbridge on millions of low-income people and deny them the opportunities of achieving what they had dreamed for—there are lots of reasons for that that are given; one of them, of course, is the lack of investment back into the modernization of the manufacturing capacity of this country. That is one of the major ones.

Another is that you have a lot of unskilled people coming into the work force to an extent that we have not had before.

I think what you are going to have to see, Mr. Schultze, is a major change in the economic approaches of this country and the taxing purposes of this country.

For a long time we have encouraged consumption. I think we have to find ways to encourage saving, and not just saving, because that would give us just a real depression, but attempt a two-pronged attack, investment into the productive capacity of this country, if we are going to turn this thing around, and not to have it be just a society that is encouraging consumption, and to become competitive in this world.

Do you have any comments, Congressman Reuss or Senator McGovern?

Representative REUSS. No.

Senator MCGOVERN. No.

Senator BENTSEN. Please proceed, Mr. Schultze.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY DAVID MUNRO, SENIOR STAFF ECONOMIST

Mr. SCHULTZE. Thank you, Mr. Chairman, Congressman Reuss, and Senator McGovern.

I have a prepared statement which I trust can be submitted for

the record, and I will read it in substantially abbreviated form to leave more time for questions and, I trust, answers.

Mr. Chairman, when this administration took office 2 years ago our economy was recovering from the deepest recession of the postwar storing a high-level economy.

When idle resources are drawn down to small margins, as they have been in this recovery, the economy must then make the transition to slower but sustainable rates of growth. Otherwise, excess demand pressures would be created, inflation would accelerate, and further economic progress would be endangered.

As a consequence, to accomplish this need of transition, fiscal and monetary policy have to shift toward restraint. The need for that restraint at the present time has been made more urgent by several factors.

Even during the recession and early stages of the current recovery, the underlying rate of inflation never dropped below 6 to 6.5 percent.

That stubborn rate of inflation increased sharply in 1978.

A significant decline in productivity growth occurred last year that contributed to heightened inflation and lowered the rate of economic growth consistent with the avoidance of excessive demand.

The necessary transition began in 1978. Firm but measured restraint must continue to prevent economic overheating, to give the President's voluntary wage and price standards a chance to succeed, and to insure that future growth will be moderate and sustainable.

The 1980 budget strongly supports that fight against inflation.

Fiscal and monetary restraint alone could not reduce inflation while still preserving the economic gains we have made during this recovery. The President's anti-inflation program, therefore, combines firm restraint over aggregate demand with a voluntary program of pay and price standards designed to brake the inherited momentum of the price-wage spiral. Both elements of that program are essential. The pay and price standards could not work in an overheated economy—and so restraint is needed. Restraint alone could not brake the stubborn momentum of the price-wage spiral, unless applied in extreme measure over a long period, at huge cost to the economy. And so the wage and price standards are needed.

The course we have chosen—combining voluntary standards with restraint in budgetary policies and in the day-to-day conduct of government—is the only practical course available. Avoiding extreme solutions to our economic problems offers the best chance to achieve successfully the difficult transition to sustainable growth and reduced inflation.

As I indicated earlier, Mr. Chairman, the margin of unemployed labor and capital resources that existed when this administration took office has been reduced substantially over the past 2 years. Present rates of capacity use are not as high as in previous periods of accelerating inflation, but the amount of unused capacity no longer is large. Similarly, by late 1978 the rate of unemployment had declined to the top of the range within which there is an increasing risk of accelerating inflation. We are not at this time experiencing excess demand in our economy, but we must slow the pace of economic growth to avoid overheating in the period ahead.

Since there are still pockets of substantial structural unemployment in our country, the overall unemployment rate remains unacceptably high. Further reductions, however, must depend primarily on a concerted attack on the sources of structural joblessness. Efforts to reduce such unemployment through traditional macroeconomic policies would run the serious risk of worsened inflationary pressures.

Unlike earlier years in this recovery, when the underlying inflation rate stayed around 6 to 6.5 percent, 1978, as you know, witnessed a widespread acceleration of prices and costs. Compensation per hour in the fourth quarter of 1978 was almost 10 percent higher than a year earlier, in contrast to the average yearly increase of 8.5 percent during the preceding 3 years. Price increases in 1978 were larger than in earlier years for virtually all categories of goods and services. Both consumer and producer prices rose at an annual rate of 9 percent last year.

The acceleration of price increases stemmed from a variety of sources. Food prices rose 11.5 percent. The depreciation of the dollar contributed, and mortgage interest rates also contributed.

Apart from these special developments, however, there was an increase in the underlying inflation rate. Wage increases speeded up and productivity growth slowed, leading to a broad acceleration in the rise of costs.

The faster pace of wage gains began in late 1977 and continued in early 1978. Although some moderation occurred in the second half of the year, the hourly earnings index rose 8.2 percent over the year as a whole, compared with 7.5 percent in 1976 and 1977.

Inflation undermines the competitiveness of our industries abroad and adversely affects the value of the dollar. Our prestige as a Nation, and our ability to support expanding world trade, depend materially on our ability to bring inflation under control.

Inflation also injures our social and political institutions. A democratic society prides itself on maintaining conditions in which its citizens have a sense of command over their own destiny. When the purchasing power of the dollar—the yardstick with which we do our economic calculations—is subject to large and unpredictable shrinkage, an important element of command over our own future slips away. It is small wonder that trust in Government and in social institutions is simultaneously eroded.

Mr. Chairman, given these conditions, reducing inflation must be the primary objective of the Federal Government at this time. We cannot expect to solve our inflation problem overnight. Inflation has been building for more than a decade, and it will take time and patience to reverse its momentum. For this reason, macroeconomic policies must pursue a course that can be sustained economically and politically as long as it takes to get the job done.

We will not pursue policies that wring inflation out of the economic system by sharp increases in unemployment and large losses in output. That would be unfair and ineffective. Twice in the past decade, inflation has accelerated and a recession has followed. Because prices and wages have become relatively insensitive to economic slack, the recessions did not make a significant long-term contribution to reducing inflation. The recessions of both 1969–70 and 1974–75 provided only limited and temporary relief from pressures on costs and prices.

Stop-and-go economic policies that lead to swings between boom and bust undermine business and consumer confidence, slow the pace of investment, and involve massive social costs. They do not cure inflation. What is needed, we think, and what this administration has adopted, is a durable set of economic policies designed to address our long-term inflation problem with a long-term remedy.

Let's look at the overall economic policies to fight inflation that are involved.

The key element in the President's anti-inflation program is a restrained budgetary policy. Federal spending in the 1980 budget has been kept under tight control. In total, Federal spending will rise by less than 8 percent from 1979 to 1980, compared with an average annual increase of 12 percent during the previous 6 years. Adjusted for inflation, the rise in real Federal spending in 1980 will be less than 1 percent. Restraint in spending will make it possible to reduce the share of the Nation's output accounted for by Federal spending to about 21 percent in fiscal 1980.

Those constraints on Federal spending, combined with the revenues yielded by a moderately growing economy, will reduce the budget deficit to \$29 billion in fiscal 1980.

Spending restraint in the 1980 budget has been severe. Adjusted fully for inflation, an extension into 1980 of the services and programs in the 1979 budget would have required outlays of some \$544 billion. In fact, the President's budget recommends outlays of \$531.6 billion, more than \$12 billion below that \$544 billion level.

Budget reductions of that magnitude have required the President to make many difficult choices. This budget has not been cut indiscriminately. It has been evaluated program by program, to enable us to continue to meet the Nation's needs within the boundaries of fiscal responsibility. Where needs and priorities were high the President has maintained—and in some cases expanded—program levels.

Now, I know that people will differ among themselves and with the administration on the ranking of needs and priorities. Debate and discussion of these matters can only be welcomed. But this budget reflects, I believe, a fair and reasoned set of choices in an overall situation in which it must be tightened.

Let me turn to the other major element in the anti-inflation program.

Overall economic policies can create an appropriate environment for unwinding inflation. But after 10 years of inflation, the momentum of price and wage increases is too strong to be dealt with effectively by monetary and fiscal measures alone. The administration has, therefore, set forth voluntary standards for pay and price increases in 1979.

Since these standards have been discussed extensively in the press, in the Economic Report of the President, and elsewhere, I will not elaborate on them here. However, there are several points that I would like to make.

The pay and price standards take account of the widely differing circumstances and institutional arrangements that characterize the various sectors of the economy. We are not monitoring each and every price and wage decision—that would obviously be impossible. But the standards are meant to serve as guidelines on wage and price decisions for everyone—businesses, large and small; State and local governments; educational institutions and those providing professional services.

I am encouraged by the acceptance of the standards to date. The Council on Wage and Price Stability has been receiving between 1,000 and 2,000 letters and phone calls daily, principally from businesses of every size, and from every industry, asking how they can comply with the standards. And although many labor organizations continue to respond with caution, the prospects for widespread cooperation appear to be improving steadily. We were particularly encouraged by the wage settlement in the petroleum industry early this month that met the pay standard.

Public opinion polls report that a large majority of workers express a willingness to accept a lower wage increase if it will lead to lower inflation. You can't make any distinction in the polls between union and nonunion members. They both report the same thing, but one obstacle to cooperation with the standards, however, is the fear of individual workers that if they cooperate, others may not, and hence they would suffer a loss in real income. The President's real wage insurance proposal is designed to alleviate this concern.

Given this program, Mr. Chairman, let me turn to the economic outlook as I see it.

Our economy entered the new year in a position of strength. Growth in 1978 was both strong and balanced, and the \$19 billion tax cut that took effect on January 1 will help to sustain consumer and business spending during the coming year.

These factors are likely to slow growth, but I expect the slowdown to be moderate. Real GNP should rise by about 2.2 percent over the four quarters of this year, well below the 1978 pace, but only a little below the economy's potential. Labor force growth will remain strong, and most new workers will find jobs.

I recognize that many forecasters anticipate a recession this year. Some commentators predict a recession in 1979 simply because the current economic recovery will shortly be entering its fifth year and historically the average length of recoveries has been less than 5 years. But as the president of the Federal Reserve Bank of New York pointed out recently, recoveries don't die of old age but from imbalances and excesses.

Such problems have not developed on a wide scale during this recovery. Inventories have been kept lean, overbuilding of shopping centers, apartments, and office buildings has been avoided. Corporate financial statements are in relatively good condition, and liquidity remains adequate to support continued expansion. Aside from a few limited examples, capacity is sufficient to meet expected needs.

The Government is exerting measured restraint to insure that excess demand does not emerge. But restraint is not being applied so severely as to generate an economic downturn. We cannot fine tune the economy, and we do not intend to try. But current fiscal and monetary policies are designed to follow a prudent middle course that will permit continued, moderate growth and yet provide the restraint needed to fight inflation.

The most important contribution to maintaining a satisfactory growth rate this year is the prospect that the rate of inflation will moderate. The combination of Government restraint and widespread cooperation with the President's pay and price standards should make possible a significant winding down in inflationary pressures during the course of the year. From the fourth quarter of 1978 to the final quarter

of 1979, consumer prices are forecast to rise by about 7.5 percent, and the annual rate of inflation is expected to be below 7 percent in the final quarter of the year.

Special factors will keep prices rising early in the year. Food prices, particularly meat prices, will rise significantly. The OPEC oil price increase will also affect prices, and the delayed effects of the depreciation of the dollar last year will continue to be felt.

As these factors wane, and as the pay and price standards begin to take hold, the rate of inflation should slow significantly. In 1980 the effects of policies of restraint and the pay and price standards should result in a further slowing of the inflation rate. We expect the rate of consumer price inflation over the 12 months of 1980 to be below 6.5 percent.

I might note, Mr. Chairman, that if one looks at the major published economic forecasts, our forecasts are about the middle of the pack. There are some higher than us and some lower, but we are about in the middle.

The administration has given top priority to the inflation problem because we believe that moderating inflation is essential to making progress toward our longer term economic goals.

This year, as a result of the passage of the Full Employment and Balanced Growth Act of 1978, special attention has been given to the longer range concerns of economic policy.

The Humphrey-Hawkins Act requires the administration to set forth economic goals for the future. This year's Economic Report of the President contains a discussion of the economic performance necessary to achieve the 1983 goals of 4-percent overall unemployment and 3-percent inflation that were stipulated in the Humphrey-Hawkins Act.

We have looked at long term economic growth in that context. As you think about it, it turns out you have to answer two sets of questions, about the feasibilities and problems that those goals set forth.

The first question is, Can economic output grow fast enough to achieve that kind of unemployment goal by 1983, while at the same time moving toward a balanced budget in the Federal budget, as indicated in the act.

Second, can we reduce unemployment to 4 percent by 1983 while avoiding an increase in inflation and, indeed, reducing it significantly?

Our analysis of the Economic Report concludes that maintaining the requisite growth of real GNP and moving to achieving a balanced budget over the period do not appear to be inherently conflicting aims. Private investment would have to grow sharply and exceed private saving by an amount equal to roughly 1 percent of GNP. But this is within the boundaries of historical precedent.

The principal obstacle to achieving the goals of the Humphrey-Hawkins Act will stem from the difficulty of lowering unemployment significantly further while simultaneously reducing inflation. Although our economy was operating at a level somewhat below its potential in 1978, intensified pressures on wage rates and prices have already appeared. Continuation of inflation at a high rate would seriously jeopardize the prospects for maintaining a strong economy and so imperil our ability to achieve the unemployment goals of the Humphrey-Hawkins Act.

The current structure of labor markets makes it especially hard to reach 4-percent unemployment and at the same time reduce inflation substantially. Unemployment varies widely across demographic groups. Measures to address the structural sources of unemployment have been an ingredient of Government economic policies for more than 15 years, but differential unemployment rates among groups in the labor force are greater today than they were 10 years ago. Until these differentials are reduced, substantial further reductions in the overall unemployment rate will be very likely to create additional inflationary pressures.

The sources of structural unemployment problems have been reviewed frequently. We do spend a good bit of time in the report examining those various sources. Essentially what we know is that any number of policies have to be in place to deal with that problem. Toward that end, we are now pursuing several strategies.

Efforts are being made to target public service employment toward those most in need. In 1979, the administration will propose a welfare reform program that will include efforts to use public service jobs and training programs to combat structural unemployment. The special employment programs established for youths under the Youth Employment and Demonstration Projects Act and other legislation will continue to pay particular attention to the needs of the disadvantaged. In the President's 1980 budget these youth programs are continued and supported at high levels of funding.

In 1979, and 1980 new resources also will be devoted to promoting employment opportunities for the disadvantaged through job opportunities in the private sector. The 1978 CETA legislation authorized a special private sector employment and training initiative that will finance new job training slots in private business and, in addition, the targeted employment tax credit, which was enacted last year, provides businesses a special tax incentive to hire disadvantaged persons, particularly youths between the ages of 18 and 24.

These programs can reduce the labor market shortages and inflationary pressures that otherwise would be associated with achieving lower overall rates of unemployment. At the present time, however, we cannot be sure, Mr. Chairman, that continuing or even greatly expanding these programs would make possible an overall 4-percent unemployment rate without accelerating inflation. Much work needs to be done to improve existing employment programs and to discover new approaches to structural problems if the goals of the act are to be realized.

In conclusion, our Nation faces new and difficult economic realities that require adaptations in economic policies. A decade old inflation persists. We must make progress in regaining price stability if our hopes for achieving sustained economic growth and prosperity are to be realized. We cannot avoid the hard choices that this effort will entail. Budgetary stringency is essential. Sacrifices will have to be made. Cooperation will be required from private citizens in every walk of life to make the anti-inflation program successful.

Progress can be made toward reducing inflation in 1979 without putting the economy through the wringer of recession. It can be done, and it must be done, to lay the foundation for a strong economy. As we are successful in sustaining reasonable growth with lower in-

flation, we will create the kind of economic climate in which the growth in productivity and living standards is most likely to improve.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Schultze.

[The prepared statement of Mr. Schultze follows:]

PREPARED STATEMENT OF HON. CHARLES L. SCHULTZE

I am pleased to appear before the Joint Economic Committee this morning to discuss the President's economic and budgetary program for 1979 and 1980.

When this Administration took office two years ago, our economy was still recovering from the deepest recession of the postwar period. In the past two years, we have made major progress toward restoring a high level economy.

When idle resources are drawn down to small margins, as they have been in this recovery, the economy must then make the transition to slower but sustainable rates of growth. Otherwise, excess demand pressures would be created, inflation would accelerate, and further economic progress would be endangered. To accomplish the needed transition, fiscal and monetary policy must shift toward restraint.

The need for restraint at the present time has been made more urgent by several factors:

Even during the recession and early stages of the current recovery, the underlying rate of inflation never dropped below 6 to 6½ percent.

That stubborn rate of inflation increased sharply in 1978.

A significant decline in productivity growth occurred last year that contributed to heightened inflation and lowered the rate of economic growth consistent with the avoidance of excess demand.

The necessary transition began in 1978. Firm but measured restraint must continue to prevent economic overheating, to give the President's voluntary wage and price standards a chance to succeed, and to ensure that future growth will be moderate and sustainable.

The President has sent to the Congress a very stringent budget for 1980. It is a compassionate budget that responds to the nation's most vital needs within an overall framework of substantially reduced growth in expenditures and a declining Federal deficit. The budget strongly supports the fight against inflation.

Fiscal and monetary restraint alone could not reduce inflation while still preserving the economic gains we have made during this recovery. The President's anti-inflation program, therefore, combines firm restraint over aggregate demand with a voluntary program of pay and price standards designed to brake the inherited momentum of the price-wage spiral. Both elements of the program are essential. The pay and price standards could not work in an overheated economy—and so restraint is needed. Restraint alone could not brake the stubborn momentum of the price-wage spiral, unless applied in extreme measure over a long period, at huge cost to the economy. And so the wage and price standards are needed.

The course we have chosen—combining voluntary standards with restraint in budgetary policies and in the day-to-day conduct of government—is the only practical course available. Avoiding extreme solutions to our economic problems offers the best chance to achieve successfully the difficult transition to sustainable growth and reduced inflation.

ECONOMIC PROGRESS IN 1978

The year 1978 was one of considerable further progress for our economy and our people. Real GNP rose by 4¼ percent. During the course of the year:

Employment rose by 3.3 million, bringing to over 7 million the number of new jobs created in the past two years.

The unemployment rate dropped to 5.8 percent by the final quarter of 1978, down from 7.8 percent in the fourth quarter of 1976.

Employment among minorities grew strongly and the rate of unemployment among minorities and youths declined, although it still remained at very high levels.

Industrial production rose 7.7 percent, and by the fourth quarter 86 percent of the nation's industrial capacity was in use, well above the 81 percent utilization rate at the end of 1976.

Profits rose more than 10 percent, and business investment in real terms increased by 8¼ percent.

The margin of unemployed labor and capital resources that existed when this Administration took office has been reduced substantially over the past 2 years. Present rates of capacity use are not as high as in previous periods of accelerating inflation, but the amount of unused capacity no longer is large. Similarly, by late 1978 the rate of unemployment had declined to the top of the range within which there is an increasing risk of accelerating inflation. We are not at this time experiencing excess demand in our economy, but we must slow the pace of economic growth to avoid overheating in the period ahead.

Since there are still pockets of substantial structural unemployment in our country, the overall unemployment rate remains unacceptably high. Further reductions, however, must depend primarily on a concerted attack on the sources of structural joblessness. Efforts to reduce such unemployment through traditional macroeconomic policies would run the serious risk of worsened inflationary pressures.

The acceleration of inflation

Unlike earlier years in this recovery, when the underlying inflation rate stayed around 6 to 6½ percent, 1978 witnessed a widespread acceleration of prices and costs. Compensation per hour in the fourth quarter of 1978 was almost 10 percent higher than a year earlier, in contrast to the average yearly increase of 8½ percent during the preceding three years. Price increases in 1978 were larger than in earlier years for virtually all categories of goods and services. Both consumer and producer prices rose at an annual rate of 9 percent last year.

The acceleration of price increases stemmed from a variety of sources. Food prices rose sharply because supplies of red meat were even more limited than had been expected and adverse weather damaged fruit and vegetable crops. The substantial depreciation of the dollar in international exchange markets was accompanied by higher prices of imports and of competing domestic products. Mortgage interest rates also rose substantially.

Apart from these special developments, however, there was an increase in the underlying inflation rate. Wage increases speeded up and productivity growth slowed, leading to a broad acceleration in the rise of costs.

The faster pace of wage gains began in late 1977 and continued in early 1978. Although some moderation occurred in the second half of the year, the hourly earnings index rose 8.2 percent over the year as a whole, compared with 7½ percent in 1976 and 1977.

As wage increases were moving up, productivity growth was declining. During the four quarters of 1978, productivity rose by less than 1 percent, compared with the 2 percent rise expected at the beginning of the year. This weak growth of productivity speeded up the rise in production costs and put additional upward pressure on prices. It also added indirectly to inflation by increasing demands for labor. Studies by the staff of the Council of Economic Advisers suggest that the speed of the increase in employment and the swiftness of the decline in unemployment contributed importantly to increased wage inflation in late 1977 and early 1978.

Accumulating evidence suggests strongly that the longer-term trend of productivity increase in our economy is significantly lower today than in earlier periods. Between 1948 and 1965, productivity growth in the private nonfarm sector averaged 2.6 percent per year. Between 1965 and 1973, this rate declined to 2.0 percent. Since 1973 productivity has grown at an average pace of 0.8 percent per year. In late 1973 and during 1974, productivity dropped precipitously. During the first two years of the economic recovery, productivity increased strongly and preliminary statistics for 1977 suggested continuing improvement. Revised data for 1977, however, showed a disappointing increase for that year, and preliminary data indicate a further decline in productivity growth to less than 1 percent during 1978.

A wide variety of factors have contributed to the long-term decline in productivity growth. Low rates of capital formation relative to the increase in the labor force have been a major contributing factor, as have the effects of increased government regulations. A full catalogue of the sources of slower productivity growth, and especially its performance in the past year, is not possible. What is clear, however, is that lagging productivity growth has complicated our inflation problem and increased the urgency of dealing with it effectively.

The urgency of the inflation problem

The effects of inflation are well-known, but they bear repeating. Inflation injures everyone. It means that paychecks do not go as far as they once did, and that savings accumulated for retirement or a child's education become inadequate.

The poor and the elderly are especially hard hit. The prices they pay for food, shelter, and transportation rise rapidly, while their incomes often increase slowly, if at all.

Inflation also poses the greatest single threat to the prospects for achieving full employment and greater prosperity for our people. Inflation drives up interest rates. It undermines the confidence of businesses in the future and upsets plans for investment. Consumers lose confidence in their own prospects as a result of inflation.

Inflation also undermines the competitiveness of our industries abroad and adversely affects the value of the dollar. Our prestige as a nation, and our ability to support expanding world trade, depend materially on our ability to bring inflation under control.

Inflation also injures our social and political institutions. A democratic society prides itself on maintaining conditions in which its citizens have a sense of command over their own destiny. When the purchasing power of the dollar—the yardstick with which we do our economic calculations—is subject to large and unpredictable shrinkage, an important element of command over our own future slips away. It is small wonder that trust in government and in social institutions is simultaneously eroded.

For all these reasons, reducing inflation must be the primary objective of the Federal government at this time. We cannot expect to solve our inflation problem overnight. Inflation has been building for more than a decade, and it will take time and patience to reverse its momentum. For this reason, macroeconomic policies must pursue a course that can be sustained economically and politically as long as it takes to get the job done.

We will not pursue policies that wring inflation out of the economic system by sharp increases in unemployment and large losses in output. That would be unfair and ineffective. Twice in the past decade, inflation has accelerated and a recession has followed. Because prices and wages have become relatively insensitive to economic slack, the recessions did not make a significant long-term contribution to reducing inflation. The recessions of both 1969–70 and 1974–75 provided only limited and temporary relief from pressures on costs and prices.

Stop-and-go economic policies that lead to swings between boom and bust undermine business and consumer confidence, slow the pace of investment, and involve massive social costs. They do not cure inflation. What is needed, and what this Administration has adopted, is a durable set of economic policies designed to address our long-term inflation problem with a long-term remedy.

Macroeconomic policies to fight inflation

The key element in the President's anti-inflation program is a restrained budgetary policy. Federal spending in the 1980 budget has been kept under tight control. In total, Federal spending will rise by less than 8 percent from 1979 to 1980, compared with an average annual increase of 12 percent during the previous six years. Adjusted for inflation, the rise in real Federal outlays in 1980 will be less than 1 percent. Restraint in spending will make it possible to reduce the share of the nation's output accounted for by Federal spending to about 21 percent in fiscal 1980. We will have achieved that goal one year ahead of the Administration's original schedule.

Constraints on Federal spending, combined with the revenues yielded by a moderately growing economy, will reduce the budget deficit to \$29 billion in fiscal 1980, less than half the absolute level in the year that President Carter ran for office, and only one-quarter as large in relationship to the size of our economy.

Spending restraint in the 1980 budget has been severe. Adjusted fully for inflation, an extension into 1980 of the services and programs in the 1979 budget would have required outlays of \$544 billion. The President's budget recommends outlays of \$531.6 billion, more than \$12 billion below that level.

Budget reductions of that magnitude have required the President to make many difficult choices. This budget has not been cut indiscriminately. It has been evaluated, program by program, to enable us to continue to meet the nation's needs within the boundaries of fiscal responsibility. Where needs and priorities were high the President has maintained—and in some cases expanded—program levels. I realize that people will differ among themselves and with the Administration of the ranking of needs and priorities. Debate and discussion of these matters can only be welcomed. But this budget reflects, I believe, a fair and reasoned set of choices.

Fiscal discipline is being complemented by firm but careful restraint in monetary policy. During 1978, interest rates increased significantly and the growth rates

of the monetary aggregates slowed late in the year. In the past, periods of credit tightness have severely reduced the funds available to support housing. Often, a collapse of housing has been instrumental in tipping the economy into recession.

Recent innovations in financial markets have reduced substantially these abrupt and often damaging effects of monetary restraint. During 1978, depository institutions were authorized to issue new savings certificates bearing interest rates tied to those on 6-month Treasury bills. These new certificates have kept flows of funds into thrift institutions, and mortgage credit supplies, at a relatively high level. As a result, the restraining effects of rising interest rates are occurring more gradually and are spread more evenly across the economy. Prudently applied, monetary restraint can now be used more successfully to combat inflation while still fostering a healthy and stable economy.

Pay and price standards

Overall economic policies can create an appropriate environment for unwinding inflation. But after ten years of inflation, the momentum of price and wage increases is too strong to be dealt with effectively by monetary and fiscal measures alone. The Administration has therefore set forth voluntary standards for pay and price increases in 1979.

Since these standards have been discussed extensively in the press, in the Economic Report of the President, and elsewhere, I will not elaborate on them here. However, there are several points that I would like to make.

First, the pay and price standards take account of the widely differing circumstances and institutional arrangements that characterize the various sectors of the economy. We are not monitoring each and every price and wage decision—that would obviously be impossible. But the standards are meant to serve as guidelines on wage and price decisions for everyone—businesses, large and small; State and local governments; educational institutions and those providing professional services.

Second, I am encouraged by the acceptance of the standards to date. The Council on Wage and Price Stability has been receiving between 1,000 and 2,000 letters and phone calls daily, principally from businesses of every size, and from every industry, asking how they can comply with the standards. And although many labor organizations continue to respond with caution, the prospects for widespread cooperation appear to be improving steadily. We were particularly encouraged by the wage settlement in the petroleum industry early this month that met the pay standard.

Real wage insurance

Public opinion polls report that a large majority of workers express a willingness to accept a lower wage increase if it will lead to lower inflation. One obstacle to cooperation with the standards, however, is the fear of individual workers that if they cooperate, others may not, and hence they would suffer a loss in real income. The President's real wage insurance proposal is designed to alleviate this concern.

Under this proposal, employee groups that meet the 7 percent pay limitation would receive a tax credit if the consumer price index increased by more than 7 percent. The rate of the credit would be equal to the difference between the actual increase in the consumer price index and 7 percent, up to a limit of 3 percentage points, or 10 percent inflation. This rate will be applied to each employee's wages up to a maximum of \$20,000. Employee groups that are exempt from the pay standard will qualify for real wage insurance only if their average pay increase is 7 percent or less.

The cost of this program—which we estimate at \$2.5 billion for fiscal 1980—depends primarily on the degree of participation in the program and the rate of inflation. Lower compliance by employee groups would raise the expected inflation rate, but reduce the number of workers eligible for the credit. In this sense, the potential budgetary impact of the insurance program is self-limiting.

As its name implies, real wage insurance offers important protection to workers against the major risks of complying with the President's program. It does not offer cash to "buy out" higher pay increases, and it is emphatically not an effort to make inflation easier to live with or to index the tax system. Indeed it is just the opposite. It provides some protection against inflation specifically to those who have done something to reduce inflation. The Administration urges that members of the Congress give this important program a sympathetic and open-minded hearing and enact it expeditiously.

The economic outlook

Our economy entered the new year in a position of strength. Growth in 1978 was both strong and balanced, and the \$19 billion tax cut that took effect on January 1 will help to sustain consumer and business spending during the coming year. However, growth will slow during the course of this year for two reasons.

First, the effects of the increase in interest rates last year will be felt increasingly during 1979. Indicators of business capital investment suggest that the high cost of borrowing may already be having a moderate deterring effect on capital outlays. Moreover, high interest rates have begun in recent months to reduce savings flows to thrift institutions.

With mortgage interest rates already at record levels, it is likely that the rate of housing starts will decline moderately this year.

Second, the personal saving rate was low during 1978. In the last three months of 1978, Americans saved less than 5 percent of their incomes, compared with a historical average of around 6 percent. Last year, consumers continued to purchase durable goods in large quantities and to increase their outstanding debts. They are therefore likely to show greater caution in their borrowing and spending during 1979.

These factors are likely to slow growth, but I expect the slowdown to be moderate. Real GNP should rise by about $2\frac{1}{4}$ percent over the four quarters of this year, well below the 1978 pace, but only a little below the economy's potential. Labor force growth will remain strong, and most new workers will find jobs.

I recognize that many forecasters anticipate a recession this year. Some commentators predict a recession in 1979 simply because the current economic recovery will shortly be entering its fifth year and historically the average length of recoveries has been less than five years. But as the President of the Federal Reserve Bank of New York pointed out recently, recoveries don't die of old age but from imbalances and excesses. Such problems have not developed on a wide scale during this recovery. Inventories have been kept lean.

Overbuilding of shopping centers, apartments, and office buildings has been avoided. Corporate financial statements are in relatively good condition, and liquidity remains adequate to support continued expansion. Aside from a few limited examples, capacity is sufficient to meet expected needs. The government is exerting measured restraint to ensure that excess demand does not emerge. But restraint is not being applied so severely as to generate an economic downturn. We cannot fine tune the economy, and we do not intend to try. But current fiscal and monetary policies are designed to follow a prudent middle course that will permit continued, moderate growth as we fight inflation.

The most important contribution to maintaining a satisfactory growth rate this year is the prospect that the rate of inflation will moderate. The combination of government restraint and widespread cooperation with the President's pay and price standards should make possible a significant winding down in inflationary pressures during the course of the year. From the fourth quarter of 1978 to the final quarter of 1979, consumer prices are forecast to rise by about $7\frac{1}{2}$ percent, and the annual rate of inflation is expected to be below 7 percent in the final quarter of the year.

Special factors will keep prices rising early in the year. Food prices, particularly meat prices, will rise significantly. The OPEC oil price increase will also affect prices, and the delayed effects of the depreciation of the dollar last year will continue to be felt.

As these factors wane, and as the pay and price standards begin to take hold, the rate of inflation should slow significantly. In 1980, the effects of policies of restraint and the pay and price standards should result in a further slowing of the inflation rate; we expect the rate of consumer price inflation over the 12 months of 1980 to be below $6\frac{1}{2}$ percent.

The long-term economic outlook

This Administration has given top priority to the inflation problem because we believe that moderating inflation is essential to making progress toward our longer-term economic goals. This year, as a result of the passage of the Full Employment and Balanced Growth Act of 1978, special attention has been given to the longer-range concerns of economic policy.

The Humphrey-Hawkins Act requires the Administration to set forth economic goals for the future. This year's Economic Report of the President contains a discussion of the economic performance necessary to achieve the 1983 goals of

4 percent overall unemployment and 3 percent inflation that were stipulated in the Humphrey-Hawkins Act.

By any criterion these are very ambitious goals. Achieving them simultaneously would demand not only a performance by the American economy that is virtually unprecedented in peacetime history, but also government programs that can deal effectively with some of our most intransigent problems, particularly inflation and structural unemployment.

The discussion in the Economic Report begins by evaluating the likelihood that the nation's output can grow rapidly enough between now and 1983 to achieve the unemployment goals of the act while still moving toward a balanced Federal budget. The analysis concludes that maintaining the requisite growth rate of real GNP and achieving a balanced budget do not appear to be inherently conflicting aims. Private investment would have to grow very strongly and exceed private saving by an amount equal to roughly 1 percent of GNP. But this is within the boundaries of historical precedent.

If Federal spending is held under tight control over the next five years, opportunities will develop for tax cuts to help stimulate growth in the private sector within the context of a Federal budget that continues to move toward balance. The appropriate timing and magnitude of those tax cuts, however, cannot be determined now. Our ability to foresee economic problems over a 5-year period and to design appropriate policies to deal with them is extremely limited.

It would be a serious mistake to commit ourselves now to future changes in fiscal policy that might be entirely inappropriate at the time they occurred. It would be equally unwise to adopt some mechanical formula that linked Federal spending to forecasts of GNP or that provided automatic changes in tax rates with changes in the rate of inflation. Such formulas fail the test of fiscal responsibility. They also limit the scope of the Congress and the President to adopt sensible and needed changes in budgetary policies in the future. And they are very likely to result in perverse effects on the economy—for example, fixing in law the share of Federal spending in GNP would tend to raise demand when inflation increased and restrict demand when the economy weakened.

There is simply no substitute for the difficult process of matching our overall budgetary policies to the economic requirements of the nation as they develop.

The principal obstacle to achieving the goals of the Humphrey-Hawkins Act will stem from the difficulty of lowering unemployment significantly further while simultaneously reducing inflation. Although our economy was operating at a level somewhat below its potential in 1978, intensified pressures on wage rates and prices have already appeared. Continuation of inflation at a high rate would seriously jeopardize the prospects for maintaining a strong economy and so imperil our ability to achieve the unemployment goals of the Humphrey-Hawkins Act.

The current structure of labor markets makes it especially hard to reach 4 percent unemployment and at the same time reduce inflation substantially. Unemployment varies widely across demographic groups. Measures to address the structural sources of unemployment have been an ingredient of government economic policies for more than 15 years, but differential unemployment rates among groups in the labor force are greater today than they were ten years ago. Until these differentials are reduced, substantial further reductions in the unemployment rate will be very likely to create additional inflationary pressures.

The sources of structural unemployment problems have been reviewed frequently. One major factor underlying the widening of unemployment rate differentials has been the fact that groups with relatively high unemployment rates, such as youths and women, are now a much larger share of the labor force. Teenagers and young adults tend to change jobs more frequently than older workers as they try new occupations and search for long-term careers; women, particularly during their childbearing years, tend to move into and out of the labor market more frequently than men.

Major structural obstacles also confront many groups of workers—especially, but not exclusively, minorities. Many potential imbalances in labor supply and demand disappear as workers move from sectors offering relatively poor employment prospects to sectors offering better opportunities. But this process may be blocked by the difficulty of acquiring skills, wage rigidities that discourage employers from hiring less productive workers, and various sorts of discrimination.

These characteristics of the labor market make it very hard to reduce the overall rate of unemployment substantially below the present level through expansion of aggregate demand without encountering labor shortages. As the overall unemployment rate declines, demand for skilled, prime-age workers exceeds supply of those workers, and puts upward pressure on their wages, even though unemployment among minorities, teenagers and women may remain unacceptably high.

The inflationary pressures in a tight labor market carry over into the rest of the economy, contributing to general inflation.

Achievement of substantially lower rates of overall unemployment in a non-inflationary environment will therefore hinge on whether governmental policies can effectively reduce the structural sources of unemployment. Toward that end, the Administration is pursuing several strategies. Strong efforts are being made to target public service employment more directly on those most in need.

In 1979, the Administration will propose a welfare reform program that will include efforts to use public service jobs and training programs to combat structural unemployment. The special employment programs established for youths under the Youth Employment and Demonstration Projects Act and other legislation will continue to pay particular attention to the needs of the disadvantaged. In the President's 1980 budget, these youth programs are continued and supported at high levels of funding.

In 1979 and 1980, new resources also will be devoted to promoting employment opportunities for the disadvantaged through job opportunities in the private sector. The 1978 CETA legislation authorized a special private sector employment and training initiative that will finance new job training slots in private business, and a \$400 million supplemental appropriation has been included in the 1979 budget for that purpose. In addition, the targeted employment tax credit, which was enacted last year, provides businesses a special tax incentive to hire disadvantaged persons, particularly youths between the ages of 18 and 24.

These programs can reduce the labor market shortages and inflationary pressures that otherwise would be associated with achieving lower overall rates of unemployment. At the present time, however, we cannot be sure that continuing or even greatly expanding these programs would make possible an overall 4 percent unemployment rate without accelerating inflation. Much work needs to be done to improve existing employment programs and to discover new approaches to structural problems if the goals of the act are to be realized.

Conclusion

In summary, our nation faces new and difficult economic realities that require adaptations in economic policies. A decade-old inflation persists. We must make progress in regaining price stability if our hopes for achieving sustained economic growth and prosperity are to be realized. We cannot avoid the hard choices that this effort will entail. Budgetary stringency is essential; sacrifices will have to be made. Cooperation will be required from private citizens in every walk of life to make the anti-inflation program successful.

We also have to realize that the nation's productivity is not growing as rapidly as it once did. Our demands for increases in real incomes and in real standards of living will have to take that reality into account, and that is true no matter what the source of our income—wages and salaries, profits, interest, rent, or government transfer payments. Our national resources must be husbanded more carefully. We cannot do everything at once.

Progress can be made toward reducing inflation in 1979 without putting the economy through the wringer of recession. It can be done, and it must be done, to lay the foundation for a strong economy. As we are successful in sustaining reasonable growth with lower inflation, we will create the kind of economic climate in which the growth in productivity and living standards is most likely to improve.

Senator BENTSEN. We will have 5 minutes on the questioning by each member in order that everyone have a chance to ask his questions of Mr. Schultze and then, of course, we will go around for a second round for whomever wants it.

We will recognize the members in the order in which they arrived at the committee meeting.

Mr. Schultze, since I arrived first [laughter], I will start with my questions.

I note in your annual report that you talk about the GNP deflator and its decrease from 8.5 percent in 1978 to 7.5 percent in 1979 and hopefully down to 6.5 in 1980, as a result of tightening of pay and price standards.

Does that mean that you are contemplating a tightening of the current price and wage standards in 1980?

Mr. SCHULTZE. Well, no decision has been made, but my own judgment is that there will very probably be a necessity for this in 1980, although no specific decision has been made to do this.

In order to achieve the purpose that we are after, we not only need a budget which—

Senator BENTSEN. Probably you won't be able to do it without tightening up those wage and price standards by 1980.

Mr. SCHULTZE. Probably, but, again, it obviously depends on the circumstances and how we do in 1979.

There is no use in my trying to make a final decision, but I think that is quite possible.

Senator BENTSEN. I commented very early, and you commented at length, on the problems of productivity. This committee, I think, is perfectly positioned to undertake an extensive investigation of this problem. We are not going to get out of this problem, probably, any faster than the rate at which we went into it.

Part of our job is to look at the significance of those long-term trends in the country, and the staff is undertaking a study. We would be delighted to have your contribution to that study, because I know you share our deep concern over it.

Now, in your discussion of monetary policy, could you elaborate on question of more restrictive monetary and credit policies?

What do you mean by that? Relative to what? Does this mean higher interest rates, or do you think they have peaked, or do you see a dramatic shift in interest rates forthcoming?

Mr. SCHULTZE. Let me make several points with respect to that.

Until very recently, and by very recently I mean in the last year or so, in the past, as inflation rose and monetary policy was tightened up to deal with it, the major impact of monetary policy came not principally because of the impact of higher interest rates or mortgage rates and people's willingness to buy homes; it came because higher market rates contrasted with the low rates paid on passbook savings, and that pulled huge amounts of funds, in effect out of the thrift institutions, mutual savings banks, savings and loan associations, and the like, leading to a rationing of funds in the housing industry, leading to a virtual collapse in the housing industry.

Most of the recessions in the postwar era have come about because of the impact on housing.

In 1978, the creation or development of money market certificates made it possible for savings and loan associations and other thrift institutions to become more competitive in the market as short-term rates changed.

It was intended to moderate, not eliminate but moderate, the monetary impact on housing, but spread it—

Senator BENTSEN. We haven't had the disintermediation problem that we saw in 1973 and 1974.

Mr. SCHULTZE. Right.

I don't want to suggest that there has been no impact. If you look at the flow of funds into thrift institutions in the last year, they have been declining, but not as abruptly as in the past.

I think the second point is that you can look toward significant moderation in interest rates as we get significant moderation in inflation.

The two go together.

I think that—

Senator BENTSEN. Do you have any timespans on those?

Mr. SCHULTZE. No, sir.

Let me simply—when I say, “no, sir,” let me go on to point out that both the administration and the Chairman of the Federal Reserve Board, Mr. Miller, share the same objective to provide the kind of firm and careful restraint to try to get us through this transition period through relatively high periods of growth without overdoing it.

The specific monetary actions from week to week or month to month, however, are in the province of the independent Federal Reserve Board, and I am not going to predict monthly changes.

It is our forecast, however, that in the early months of 1979, the rates of inflation are not likely to see a lot of moderation because of increases built in there, but as we move into 1979 further, we should see the rate of inflation moderate and it is then possible to have the possibility of monetary restraint with the possibility of lower nominal interest rates.

Senator BENTSEN. Don't these interest rates have to take effect and take a bite on the plans of young persons thinking of buying homes, not that they are worried about the amounts of mortgage 25 or 30 years from now, but they are worried about the amount of monthly payment, when the interest rate gets up around 10.5, 11, or 12 percent, the monthly rate gets up to a point where many of them can't cut it.

Don't you think that is true?

Mr. SCHULTZE. Indeed, Mr. Chairman, there are risks in that.

For example, our own forecast for the economy does include a moderate decline in residential construction during the year—not a collapse, but a moderate decline—to a range of perhaps 1¼ million housing starts by the end of the year. We think that is part of the constraint needed.

The long-term prospects for housing are good.

The demographics are going in the right direction, but as part of the overall restraint, there would be a modest decline in the housing industry. in 1979, we think

Senator BENTSEN. Mr. Schultze, my 5 minutes weren't long enough, but I am sure the ones who just arrived think it was too long.

Congressman REUSS, would you please go ahead.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Schultze, unemployment, now at 5.9 percent, will rise to 6.2 percent in 1979?

Mr. SCHULTZE. That is correct.

Representative REUSS. I read, from a Washington Post story yesterday, about the view of you and your colleagues. The Post says:

Schultze and his CEA colleagues say that the Humphrey-Hawkins full employment goal can be achieved in only one way in a noninflationary environment: With jobs programs designed specifically for blacks, teenagers, women.

In other words, everyone except prime aged, skilled white males.

That is fine, but why didn't you do that? Why are you sitting by and allowing the overall unemployment rate to go up from an inexcusable 5.9 percent to an outrageous 6.2 percent, when the additional unemployment will fall largely on blacks, teenagers, and women, the

groups which you say it should be the policy of the Government to treat directly, so you don't run into inflation.

I agreed with what you said, but why don't you do what you said?

Mr. SCHULTZE. Congressman Reuss, we are.

We have moved in that direction. Let me note that when this administration took office there were 330,000 public service jobs and an unemployment rate of almost 8 percent.

We moved in very quickly with some countercyclical public service jobs.

Then, over the intervening period, we have moved to substantially beef up title II, the structural unemployment part, and as the unemployment rate has moved down from 8 percent to about 6 percent, we have reduced the countercyclical part and increased the structural part.

We have very substantially increased the funds available for the youth employment and training program. I think we have virtually doubled it.

Next, this budget does include not just in the public service area or the governmental training program area funds—very substantial amounts compared to what was the case 2 years ago, or 3 years ago.

We have introduced, admittedly on a modest scale, to see how it will go, two things: A private employment initiative in which, through the expenditure side of the budget, the Labor Department will be working with local groups to place the disadvantaged in private firms and in on-the-job training and work experience and, second, a work employment tax program.

The funds have been expanded substantially.

There is a limit, however, to how fast we can move with these various ventures. We have to gain experience; these programs have not been around for a long time.

We need to do it in a careful, targeted way to get precisely what we want, not to have it substituted.

I don't think we have all the answers. We clearly don't in order to get the unemployment rate among the structurally unemployed down now.

We are moving to try to find what the answers are and experiment with different ways of doing it.

Representative REUSS. With your overall unemployment rate going up this year, as projected, from 5.9 percent to 6.2 percent, what do you figure that will do to the unemployment rate for black teenage women?

Mr. SCHULTZE. I think that will depend in part upon how the private initiative, particularly some of the private initiative programs, work, where we have two new programs coming in directed toward those groups. You are right, about the overall unemployment rate, if it does edge up to 6.2 percent, we will have more of a problem.

Representative REUSS. Well, if they use up all their budgetary money, what will be the effect on the unemployment rate for black teenage women?

Mr. SCHULTZE. As I said, I can't tell because I don't know how successful those new programs are going to be in bringing people who are structurally unemployed in those groups into employment.

If it is very successful, then we should be able to get some shift in the unemployment in the direction we want.

Representative REUSS. If I had been running this, I would have found whatever moneys were needed to avoid increases in structural

unemployment, and within the budget's projected \$29 billion deficit.

For example, the budget includes \$2.3 billion for State revenue sharing. Certainly, we would be much better off taking care of the unemployed than writing blank checks to States.

Or I could have found \$2.5 billion in your wage insurance. It is a better social contract with workers, I suggest, than the proposed wage insurance.

Or I certainly could have found \$3 billion in the defense expenditure programs, shifting that to the relief of structural unemployment would have added more to the security of our country than more weaponry.

Mr. SCHULTZE. But, Congressman Reuss, it isn't only a question of finding more money. From 1976 to 1980, the budget for CETA has approximately doubled.

Within that budget, we are moving as fast as we think we can toward getting the right targeting.

Representative REUSS. I will stipulate that CETA is a dud, but you have more promising programs.

Mr. SCHULTZE. But the way to make sure they are not duds is to proceed carefully before dumping \$5 or \$6 billion in them.

The CETA program now runs up about \$11 billion a year, I think. I don't have the figure in my head. We have moved substantially to try to tighten up every target.

It has been a major effort, but I don't think the way to do it is to say, "Can we find the money?" We can find the money one way or the other, but I don't think that is the answer.

Representative REUSS. I just wanted to record my dissent.

Thank you, Mr. Chairman.

Senator BENTSEN. Senator McGovern.

Senator MCGOVERN. In the President's just released Economic Report, he says, "We will not try to wring inflation out of our economic system by pursuing policies designed to bring about a recession."

Further down the page he says, "Stop-and-go policies do not work."

Aren't these statements in effect offset by the President's own fiscal and monetary policies?

In other words, aren't we really going back to the old policy of raising interest rates and unemployment and slowing growth, policies that may very well provoke a recession, without really getting at the cause of the inflation?

Mr. SCHULTZE. Senator, not at all. We have an economy which is recovering from a recession. The rate of growth in 1977 was 5.5 percent.

The rate of growth in 1978 was 4.25 percent. Obviously, as we recover, we have to moderate that rate of growth so that we don't go through the roof and run into inflationary pressure.

What we are seeking is not to cure inflation by turning the economy into a recession. What we are facing is the simple reality that when an economy recovers, you have to slow down the growth so it doesn't go through the ceiling.

This is what this budget is all about. It does require restraint. Monetary restraint is required.

I would have you note, for the reasons I indicated earlier in the colloquy with the chairman, that I think there have been major

improvements in the way the monetary policy works, so it doesn't just clobber housing.

We need restraints, but there is no question that we simply can't blink our eyes at the fact that we have to move from an economy of recovery to an economy of sustained but much slower growth.

Senator McGOVERN. You don't see a danger of that leading to a recession this year?

Mr. SCHULTZE. Of course I see a danger. The danger is that it is never as easy as rolling off a log to make a transition from a recovery period to a long-term growth period, but I think that the danger of having budgetary and monetary policies which kept the economy going up very steeply would have been much greater.

This can be done, and we can get through. I think we will get through.

Senator McGOVERN. You stated in your prepared statement, "The key element in the President's anti-inflation program is a restrained budgetary policy."

Is that the chief cause of inflation today in the Federal budget?

I presume that means the nonmilitary portion of the budget, since you are increasing the military budget even faster than the inflationary rate.

Is it fair to say that the nonmilitary portion of the Federal budget is the key cause of today's inflation?

Mr. SCHULTZE. No; it is not, Senator. That is, in fact, precisely what we want to avoid—budgetary policies which were not a key cause of inflation in the last 3 or 4 years and which we want to make sure don't become a key cause.

In fact, in a given period, that budget hasn't been a cause of inflation, which doesn't mean one can have any old budgetary policies in the future.

If we don't slow it, it would be.

Senator McGOVERN. So that explains why the key element in the anti-inflationary policy is restraining the nonmilitary portion of the budget?

Mr. SCHULTZE. There are two key elements. I don't think the word "key" should be used as the keystone in an arch.

There are two—

Senator McGOVERN. You indicated that a majority of workers favor staying within the wage-price guidelines if that brings some relief from inflation.

Don't those same polls show that by an even larger percentage the people favor wage and price controls?

Mr. SCHULTZE. Let me first make it clear about the polls. The question was not asked specifically in terms of the standards, "Would you be willing to accept a lower rate of money wage increase if it helped bring down inflation?"

The answer is yes.

I think you are right. I have seen polls in which people give a majority for wage and price controls. My own judgment is that if that happened, exactly what would occur is what occurred in 1971.

It would last about 9 months, maybe a year, and then because there isn't any set of bureaucrats who can manipulate 5 million price structures, the pressure to dismantle it would be irresistible and it would be dismantled.

So, I think you are right.

Senator McGOVERN. My time is up.

Senator BENTSEN. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

I spent the weekend in a couple of public town meetings in my district in southern Indiana, and one thing that impressed me was a number of older people coming in objecting strongly to the President's proposal to reduce social security benefits.

I know those proposals are fairly modest in size, but they certainly have these people, at least, mightily stirred up.

What impressed me about them was not so much their anger as their anxiety, and, really, their fear for the future about what these proposals may mean.

I am not speaking here of people who are at the bottom rung of the economic ladder, but higher than that. They really are deeply concerned about those proposals, and they argue that the Government is breaking its contract, and they fear what is ahead in the future beyond these proposals that the President has made.

Now, what do you say to those people? What are we getting into with regard to the social security system specifically and other pension systems as well, and what can we say to these people which will give them some major hope for the future?

Mr. SCHULTZE. Congressman Hamilton, several things.

In the first place, there are a number of different thrusts to the President's social security proposals. One of them has to do with reforming the disability system, which has been growing absolutely by leaps and bounds.

Basically, Congress itself—I believe Ways and Means and I think Finance; I am not sure—examined it carefully last year and made recommendations on the subject.

One of the major elements in the reform of the disability side is to try to insure that the disability program does not provide benefits larger than the prior earnings of the beneficiary, and then where there are significant social needs at the low-income level, that they be picked up by the SSI program.

Similarly, in the social security area itself, before we had a much better developed program for assistance through SSI, through college scholarships, and the others, we had built into the social security system a number of welfarelike benefits, which at the time probably made sense, because we didn't have anything else.

The thrust of most of these reforms is to try to make the social security system somewhat more an earnings-related, insurance-related type program and somewhat less a welfare program, because now we do have programs to handle this.

For example, a minimum benefit is an exceedingly inefficient way to provide assistance to those at very low-income levels.

Among other things, what it tends to do is to provide minimum benefits to Government employees, who retire and have a very good pension and get minimums from the social security system.

Representative HAMILTON. Is the President's program the opening shot of a battle to take away the marginal benefits of the social security systems?

Mr. SCHULTZE. I don't think you can say that, Congressman Hamilton.

What this was, was a look at the system. You may recall one of the problems, and I don't know how much the pressure is now, but some time ago there was a great pressure on the part of State and local government employees to opt out of the system.

Why? Because there were enough minimum benefits and welfare benefits in that people were afraid it wasn't a good buy for the middle-income earner.

Representative HAMILTON. What do you say to the people who say there is a contract in effect between people in the Government and certain benefits which are built into the law, and they were in the system and anticipated receiving the benefits, and now you are changing them?

Mr. SCHULTZE. It seems to me if one argues the contract theory in that sense, one could never reform the system at all.

Let me give you an example.

Two years ago, Congress moved to make a major reform to the so-called uncoupling problem, because it double counted during inflation.

It would have had disastrous consequences by the turn of the century. Now, Congress has moved to reform that. If one acts on the contract theory, you couldn't have done it. It would have been impossible to make any move like that.

So, it seems to me one has to look at this in broad terms as a social contract, but not such that every minute point of the system cannot be touched.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator BENTSEN. I would say, Mr. Schultze, we have had excellent attendance at all of these meetings, and I think it shows deep concern on the part of the members to the questions you are addressing.

Senator McClure.

Senator McCLURE. Let me go on with the comment relating to what Congressman Hamilton was concerned about in the social security field.

I believe it is correct to state that if we could get our growth rate up by just under 1 percent per year and sustain it, we could afford the benefits we have promised without raising the tax rates, and if we don't get the growth rate up, then we will have to raise the tax rates from 12 to 18 percent, or raise the retirement age to 68 for new workers, or cut benefits in some manner.

I make that comment, and I suspect that you agree that it is correct, that if we could get the growth rate up, we won't have to take the more Draconian measures with respect to social security.

Mr. SCHULTZE. Senator, over the longer term, the rate of growth in productivity, particularly if you look down the years, is very important in terms of financing burdens of social security.

That is exactly right.

If productivity grows very slowly, then prices tend to grow almost as fast as wages and the impact on the social security system is severe.

If productivity grows rapidly, then benefits that are indexed grow much less rapidly than wages which pay the payroll tax and the burden on the system is much less.

So, as a general proposition over the years that is correct, expressed in terms of productivity.

Senator McClure. That leads into what is my greatest concern. I don't think we will ever get to a balanced budget unless we change economic directions.

We cannot do what we have been doing in recent years, rushing to put out the fires of inflation, while the fire of unemployment grows hotter, and then turning around and running to put out the fire of unemployment at the expense of allowing the fire of inflation to rage.

There has to be something to break that cycle, and I have not seen it under recent administrations, Republican or Democrat, and I don't see it under this one.

In your prepared statement, you have painted a rather grim picture of productivity.

Over the past 5 years, since 1973, productivity has grown by only eight-tenths of 1 percent per year. This compares with a long-run historical average of 2.5 percent growth per year.

That has to increase the rate of inflation. It must reduce our economic growth. It has got to put a terrible drag on our standard of living in the long run.

The basic premise upon which we have built various programs, such as, welfare, social security, railroad retirement, Government retirement, military retirement, all these things, is average historic rates of growth. These programs were rational at the time they were initiated if we stayed within those projections, but now we face the possibility that these projections will not come to pass.

Unless we can point to increased rates of productivity in the future, we simply will not achieve the necessary growth to pay for these programs.

We heard Congressman Reuss a few minutes ago talking about the three-tenths of 1 percent in the rate of unemployment as being a totally unacceptable course, and I suspect as unemployment edges up, as I expect it will, there will be more and more concern expressed about unemployment and less and less, relatively, about inflation.

Then we get into the 1980 Presidential election year with the economy relatively sluggish, with the recession late this year or early next year. Unemployment will rise. The administration, seeking the political base it must have, will then rush to put out the fires of unemployment by reflating the economy very rapidly.

Mr. Schultze, the thing that troubles me about your statement and the President's budget is that there are a lot of short-term, quick-fixes in it, but no proposals for long-term productivity growth.

We have got to take some measures to increase productivity. I would certainly appreciate your comments.

Mr. SCHULTZE. In the first place, Senator, not merely 1978, but the longer term growth obviously poses all kinds of problems for our economy.

Second, there are no magic buttons to push to get productivity up.

There are a number of elements required and you can't put numbers on them. One is investment. You may recall that in the last session the tax cut which the Congress enacted had about \$7 billion of cuts directed in one way or the other toward investment-related requirements.

The administration would actually have had about the same proportion. We would have preferred to come in different ways, but at any rate, it was about \$7.5 billion.

Investment has, by the way, begun to grow again at a fairly good clip.

It was about 9 percent in real terms in 1977, and about 8 percent, I think, in 1978.

That is important; it is hopeful, but it takes time.

Research and development is important. Again, in the last two budgets for the first time, adjusted for inflation, Federal support for research has turned around and has begun to increase. That is important.

We can't put a number on it.

I think it is important in a way that I am convinced is correct, although I can't measure it. All over the world the rate of investment and the rate of productivity growth has fallen off in the 1970's.

I think one of the reasons for this is that in 1973, 1974, and 1975, not just the United States but the world as a whole, went through a major trial, double-digit inflation, and the worst recession since the Great Depression, all at once.

Confidence in the future was struck a really hard blow. It has recovered some, but not fully. Growing productivity means doing things differently.

It means taking more risks.

One of the major elements to get there is an economic policy that tends to promise less stop and go and more stable, sustained growth, trying to get your hands around inflation and gradually bring it down.

Bringing more stability into the system will be very helpful in the interim; until productivity does grow, our ambitions have to be more limited than what they could have been in terms of what wages can do and in all terms of our economy.

I think some of that is in motion, but no one can predict to you the exact day, hour, time, or year when it will take over.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Schultze, I am positioned between microphones. I hope you can hear me.

I was startled in the President's message to the Congress last evening to find out that farm sales abroad were at record levels.

I venture to say that there isn't a farmer in Ohio and perhaps much of anyplace else, and I guess they are on their way to town to tell us, who would share that comment of the President's.

The only thing I could figure out to justify it—I didn't want to attack the statement as untrue—was that he is dealing with inflated prices and, of course, all administrations, when they prepare the glowing reports of how well the economy is doing, pull the inflation into it.

For instance, I think that you tend to do what others have done.

I think you show spending falling as a percentage of GNP from 22.6 percent in the year 1978 to 20.7 percent in 1982.

The other side of that is, of course, that the taxes on individuals are rising to 19.7 percent of GNP in 1978 and 21.6 percent of GNP in 1982.

So, in effect, what is happening is that we are getting eaten up by inflation at both ends. I had a colloquy with Mr. Miller of the Federal Reserve Board about how \$15 billion more has been paid into the Federal Treasury because businesses around the country still pay

more in taxes because their profits are overstated because the replacement cost of their equipment is underdepreciated because of inflation.

That is about a \$30 billion overstatement in taxes and about \$15 billion overpayment of taxes and, of course, that means that that is money that you do not have in your till. To replace your equipment, you go out and borrow, and that exacerbates the investment problem that Senator McClure has been discussing.

Would it be possible for us ever to have all these figures presented in such a way that we didn't try to make the best of a bad situation, that we would report it more clearly?

I have to make a McKinley Day speech tonight—this is his birthday [laughter]—and, of course, no one wants to go back to the era of McKinley, but I would point out to you that the real GNP in President McKinley's days in office was growing at about 6 percent, and the real per capita income was growing at 4.5 percent.

Ours is growing at a lesser rate, and our per capita income is growing at about 2 percent. We really aren't as well off now as in those days when the Federal budget was one-thousandth of what it is now.

Maybe we are doing something that is not right, and I would like to discuss that with you in the half-minute remaining [laughter] or let you discuss it with me.

Is there any way that we can get really effective cuts in what the Federal Government is spending rather than talk about the cosmetics of an inflated dollar?

Mr. SCHULTZE. I am not sure what you mean by the cosmetics of the inflated dollar.

When spending goes down, the inflation is in the denominator and in the numerator.

Representative BROWN. But taxes go up. You are not saving anybody anything. You are actually taking more from them.

Mr. SCHULTZE. We had coming into effect in January of this year a \$29 billion tax cut addressed to that problem.

Representative BROWN. Say how much it was again.

Mr. SCHULTZE. \$29 billion.

Representative BROWN. What about social security increases?

Mr. SCHULTZE. I want to come to that. If one looks at tax rates, you are quite right, the average effective tax rate does tend to climb as inflation pushes people into higher brackets.

Consistently Congress, every year or so, or at 2- or 3-year intervals, tends to reduce that.

Representative BROWN. Why don't we do it by formula?

Mr. SCHULTZE. Let me go on for a moment. The share of taxes on personal income has not risen over time. It rises and then is cut.

Where the share has been rising is in social security taxes, to pay for the increased benefits.

Representative BROWN. And State and local taxes, which are mandated by the Federal Government, because of the Federal programs the Government presents them as matching programs and says, "If you don't spend this money, you don't get the goodies out of Uncle Sam."

Isn't that true?

Mr. SCHULTZE. Except if one takes away the growth—what the Federal Government has provided is considerably more than what

the States are asked to pay. In many cases, the Federal cost share is 80 percent, 90 percent, and in some cases 100 percent.

Let me go to the mechanical formula. There are problems with that. In the first place you give up the automatic flexibility of the tax system.

As time goes on, it is desirable, necessary and appropriate to reduce Federal taxes to take account of the impact of inflation, but to put it into a mechanical formula means that the Congress is setting fiscal policy into the future rather than being able to adjust taxes when that is needed and by the amount needed to deal with the economy.

Next, if one wants to look down the road in providing, for example, more investment incentives, it seems to me Congress should look at the taxes and maybe give a greater proportional share of cuts to that sector.

Representative BROWN. We seem not to have done too well in either one of those. We seem not to have done too well by retaining that flexibility.

My time is up, but let me conclude with this comment: We have what we call uncontrollables in spending to the point where the budget is supposedly impossible to cut.

Now, if Congress provides that taxes automatically increase through inflation and spending is supposedly uncontrollable, then it seems to me that people who spend the money have the best of both worlds.

Congress supposedly can't cut the expenditures, and the taxes pay for the expenditures.

I would like to see us try something automatic, either in spending or in the taxing so that the automatic part could work on the side of the individual taxpayer rather than on the side of the person who spends the money and collects it.

Senator BENTSEN. Mr. Schultze, the member's time has expired.

Your time has not expired and you may have equal time to respond.

Do you want to comment, Mr. Schultze?

Mr. SCHULTZE. Several quick points, if I might, Mr. Chairman.

First, let's go back to the period of 1960 to 1965.

In that period, or between that period and 1979, the share of total Federal taxes in GNP has gone up 1.6 percentage points from 18.3 to 19.9.

During that same period, the share taken by social security taxes has gone up by 2.9 percent, and all other taxes have come down. If one remembers, Congress has tended to cut income taxes, and properly so, as growth and inflation pushes individuals into higher brackets, but the large growth in social security benefits has grown more than proportionately with our economy.

Second, the Congressman from Ohio raises a good question about how we deal with our taxes in a period in which changes in the economy tend to change the tax rate. But the dangers of trying to get a mechanical formula seem to me to be very great.

For example, there are two bills now before Congress that would fix the share of Federal spending and fix tax reductions by law for a number of years into the future.

Let's look at the one which fixes expenditures as a percentage of GNP. Therefore, that would make it possible to cut taxes automatically.

In 1980, that particular proposal would fix the Federal spending share at 21 percent of GNP. It would be locked into law that Federal spending in 1980, and, again, in 1981, would be what the Congressional Budget Office forecasts for GNP times a percentage.

Now, we happened to look at the range of economic forecasts among the major economic forecasting institutions for 1980, and the range is so large—these are the major ones—that if you applied 21 percent to the top forecast and 21 percent to the bottom forecast as a measure of Federal spending, the difference is \$18 billion.

So, when you try to lock in Federal spending as a fraction of GNP, the Congress would have taken all its discretion over spending and turned it over to whoever the technician is who is estimating GNP.

It is a judgment about forecasts, not about spending. I think it is very dangerous. The way to handle that is with the good sense, debate, and the dialog between the administration, the Congress, and the public rather than trying to lock it into a formula.

Senator BENTSEN. Mr. Schultze, we come back again to the question of productivity.

There are many things that have contributed to the decline in productivity. You are talking about investment to modernize the manufacturing capacity of the country. Normally, others who have testified before us talk about three possibilities, taxwise, and those are corporate tax reduction, investment tax credit, or accelerated depreciation.

Talking about modernizing the industrial capacity of the country, where do you think you would get the most, from which of those three?

Mr. SCHULTZE. I am not sure. I would say, choosing among them, virtually all the economic studies, for what they are worth, indicate that tax cuts are directly related to changes in investment.

Senator BENTSEN. That was Bill Miller's testimony before this committee, too, and before the Finance Committee.

Are there other questions?

Let's go down the list.

Congressman REUSS.

Representative REUSS. First of all, I would like to congratulate the Council on an extraordinarily good report, particularly in the many pages it has on Humphrey-Hawkins and its international aspects.

Having said that, in your prepared statement, you say, and I quote: "We cannot fine tune the economy, and we do not intend to try."

Well, I think you have got to fine tune the economy, and you should intend to try in this day of international dollars, with all its sinking problems, and the course we need to steer between inflation and unemployment, which you rightly, I think, concede, is unamenable to traditional monetary and macro means.

Mr. SCHULTZE. Let me see if I can undo the quibble, Congressman Reuss, because I think we don't really disagree.

If you mean that in setting fiscal policy, we ought to look for a reasoned objective that we want the economy to perform, and try to aim our fiscal policy toward it, that is what we ought to do, and that is what we have done. I don't call that fine tuning.

What is fine tuning is, every quarter, looking at the statistics, if things are a little worse than you thought, you go ahead and try to

boost the economy and so forth. The fine tuning I don't like is when you try to change your mind, or however you want, every quarter.

Representative REUSS. If you define fine tuning as constant oscillation, then we must all approve of that.

I would add to the area and content of good fine tuning, that which we all like, the relationship between fiscal and monetary policy.

Turning to another quibble in your prepared statement, where you are relatively happily tuned about the future, you say, "Overbuilding of shopping centers, apartments, and office buildings has been avoided."

Well, I would say that the overbuilding of apartments has been avoided. It has been one of the most colossal successes in history. [Laughter.] There haven't been any apartments built, and that has been one of the problems. So I wouldn't want the word to get out among the troops in the executive branch that avoiding apartment building should be a prime object of international policy.

I am sure you didn't mean it that way, and that is why I called it a sort of a quibble. [Pause.] As between fiscal and monetary policy, in view of the needs expressed by many of my colleagues here this morning for more capital investment and more research and development, aren't we better off with a quite tight fiscal policy and a monetary policy which is a little less tight than wholly tight, because by reason of the tight fiscal policy, it doesn't need to be all that tight?

In other words, aren't lower interest rates designed to increase investment, increase productivity, and, thus, combat inflation in the long run?

Mr. SCHULTZE. It all depends on "compared to what?"

Fiscal policy has become significantly more tight. The monetary policy that would have been required had fiscal policy not have done that would have been substantially greater. In that sense, you are quite right. I think one has to look at it in terms of real interest rates.

My own judgment, and this is one of the reasons why pushing down the rate of inflation rate, is because it then makes possible the kind of interest rates that gets in the direction you want.

I am not sure how feasible that will be until we get the rate of inflation down. There is obviously a mix between the two. I think the mix is in fairly good balance. Nothing in this world is perfect, but I think it is in balance.

Representative REUSS. You say in your prepared statement that the tax cut that took effect on January 1 will help to sustain consumer spending. You say, "and business," but I leave that out.

That is part of the game plan, is it, to sustain consumer spending?

If so, it runs counter to the gospel according to the committee chairman, that what we need to do in this country is to have a little less exuberant consumer spending and a little more exuberant investment spending.

So, why do we want to increase consumer spending?

Mr. SCHULTZE. Again, in all things, there has to be some sort of balance. I don't want to speak for the chairman. He can speak for himself. But I presume that when one speaks about investment incentives and the need for investment, one doesn't probably mean that you ought to let individual income tax rates climb for the next 10 years, and put all potential tax credit into investment. There is a balance.

I note this in last year's tax proposal, where there was a larger proportion relegated to investment tax credit than is normally the case. One has to tip the balance, but not completely go overboard.

Representative REUSS. Then you approved that portion of the tax cut with respect to consumers?

Mr. SCHULTZE. Individual tax cuts?

Yes. Any cut is an increase of money and purchasing power in consumers' pockets, but that has an impact on the economy. You have to look at it both ways.

Representative REUSS. Thank you.

Senator BENTSEN. Senator McGovern.

Senator MCGOVERN. Just one question.

Mr. Schultze, the reason I asked you earlier about your statement that the key element in the President's policies is the budget restraints that I have been concerned about what seems to me to be a developing situation where we are beginning to assume that if we just control the Federal budget, inflation is going to disappear, it is almost as though that were the only cause of inflation.

We begin to identify people who are concerned about inflation and those who aren't almost entirely on the basis of how large a Federal budget they want, particularly when it relates to nonmilitary government.

I am wondering, as a professional economist, if you would talk for a couple of minutes about what you see as the basic cause of this inflation that has afflicted the country over a considerable period of time.

Mr. SCHULTZE. I would be glad to, Senator. I am trying to think how to get it into 3 minutes.

Maybe I can do it very briefly.

We have had 10 to 12 years of high inflation. It has averaged 6½ percent. Essentially, it came, I think, from three kinds of things. We had two major episodes in which we got a real inflationary kick.

In the 1960's—it depends when you want to start it—in 1966, 1967, 1968, and perhaps 1969, when we financed the Vietnam war with no tax increase, and had a good old fashioned boom on resources and a jump in inflation.

Then, again, in 1973-74, we had a little bit of overheating, but also really got hit by crop shortages all over the world, driving up farm prices and by OPEC, quadrupling the price of oil. That really hit us. We had two major inflationary episodes, both of which, particularly the first one, were part of the Government overheating the economy.

So we slammed on the brakes, and inflation didn't recede very well. So whatever starts it, and it can be from overheating, or outside events like food, like in 1973 and 1974, the traditional medicine of slamming on the brakes, while it has some effect, does not stop it.

You have prices chasing wages and wages chasing prices, and expectations. When nothing is overheating the economy, as in 1976, 1977, and 1978, you still get the inflation going. So what you want to do is prevent the initiating set of factors—don't overheat the economy.

If we did that in 1979 and 1980, we would get it.

Second, we need price standards to help unwind this momentum.

You will note in my prepared statement, and I thought I took great pains to point out this is a balanced approach. I stated:

Fiscal and monetary restraint alone could not reduce inflation while still preserving the economic gains we have made during this recovery. The President's anti-inflation program, therefore, combines firm restraint over aggregate demand with a voluntary program of pay and price standards designed to brake the inherited momentum of the price-wage spiral. Both elements of the program are essential. The pay and price standards could not work in an overheated economy—and so restraint is needed. Restraint alone could not brake the stubborn momentum of the price-wage spiral, unless applied in extreme measure over a long period, at huge cost to the economy. And so the wage and price standards are needed.

We don't get overheating, and the main thing is to brake the momentum that keeps you going even when you don't have excess demand.

That is more than 2 minutes.

Senator McGOVERN. My time is up.

Senator BENTSEN. Congressman Hamilton.

Representative HAMILTON. One of the more popular games in town now is drafting "balance the budget" amendments.

I think the President spoke out against that the other day. Why don't you put on the record for us here what is wrong with those amendments, even those that include some flexibility for national emergency exceptions and all that?

Mr. SCHULTZE. There are a number of things I think are wrong with it. I was careful over the weekend to make some calculations that I probably cannot find now. But let me simply note the obvious point, that it makes very good sense to move toward and to balance the budget as the economy moves toward high unemployment.

It is absurd, and I will use the word again, absurd to try to balance the budget in an economy that for a combination of reasons is moving into a recession.

Let's take 1975, and I hope I can remember these numbers, and I will correct them for the record, that if in 1975, we had had an amendment, and didn't have an emergency proviso, initially, we would have had to reduce the budget spending by \$45 billion, or raise taxes by \$45 billion as we moved into the early phases of that recession. But, that wouldn't have been enough.

Even though that would have balanced the budget on the first round, it would have driven the economy down further, and we would have had to have had further cuts, amounting, I think, to some \$70 billion, with an unemployment rate of 11 to 12 percent, instead of the 8 to 9 percent we actually got.

Balancing the budget is very important under conditions in which you are trying to combat inflation. Balancing it in the middle of a recession is another story.

Every State, I think, has in its constitution a budget balancing provision, but that hasn't prevented them from running modest deficits, at least, under some circumstances.

If you look at other nations which have balancing provisions, what do they do? The great game becomes, "Why do you classify as investment what you could classify as operating?"

Then you get emergencies, and the emergencies get easier and easier to declare. In my own judgment, there is no substitute for an attempt at reasoned use of fiscal and budgetary policy to meet the needs of the Nation.

We haven't always done very well at it, but we cannot get around having done it badly in the past by trying to work some formula into

law, or even worse, in the Constitution—quite apart from the problems of a constitutional convention. Once you get it started, Lord knows what you would get out of that.

Representative HAMILTON. In exchange with other members, I got the impression that you had less confidence in CETA as a program dealing with the structural sources of unemployment, and, perhaps, more confidence in other measures, such as those you mention in your prepared statement; namely, private sector employment, training initiatives, and the \$400 million provided in the budget targeted to employment tax credit—is that right?

Is your thinking with regard to how to get at those structural sources of unemployment shifting more in that direction and away from CETA?

Mr. SCHULTZE. I don't think it is so much away from CETA at all. I think what we have are very substantial resources invested in CETA now.

Representative HAMILTON. You still consider CETA an important effective part—

Mr. SCHULTZE. Yes. I suppose what I am trying to say in a crude form is that if one wants to reduce structural unemployment, CETA is vital, but we cannot say that we should double the amount.

I think CETA is a very important part of this. Improvements are being made. More improvements will have to be made, but I would also like to give a try at the private sector part. CETA is a very important part of this, but it isn't the only part.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator BENTSEN. Senator McClure.

Senator McCLURE. Thank you, Mr. Chairman.

Let me digress for a moment.

It seems to me your last answer betrays the myopia that has occurred with CETA for the past several years, because CETA can be a private sector program as well. There is an amendment in the law which I got the committee to make to that very effect.

The fact that it is not has resulted from the mind fix of the program sponsors over the years without an attempt even to look outside of the public sector effects of CETA as it was originally written.

I just hope you go back and try to get some of the administration thinking on CETA focused on the private sector.

Mr. SCHULTZE. May I respond?

I accept the rebuke. You are quite right. One of the elements of the private sector program is within CETA, and I don't want to leave the impression that one cannot use CETA in that direction.

You are quite right, Senator.

Senator McCLURE. I appreciate that. It is there, it isn't being used, and I think it could be used.

Mr. Schultze, I know every administration tries to paint a picture rosier than it is, and an administration that has been in just 2 years is going to point to all the good things that have happened within the last 2 years and all the bad things that have happened, that either happened before that, or their roots before that, so that is not new to this administration, and it isn't peculiar to the State of Georgia, but I think it is part of the political process.

But if I read your figures and the analysis of the budget correctly and what you project for the future, it doesn't fit with the reality of

what we see in our economy. What we see in our economy does not fit with what President Carter said in the state of the Union message, when he said that incomes were rising.

That really covers up the true situation. The Government's own figures on real inflation adjustments, spendable earnings after taxes, show that workers on the average have 3 percent less than last year, and are no better off than in 1965.

We have slipped back to 1965 earnings, and what is more, we are still slipping. By the projections I see, in the budget analysis and in your own statements, Federal spending in real terms will grow at 3.7 percent a year, but taxes in real terms will be up more than 7 percent per year.

It would seem to me that it is obvious that the real spendable income of the average American will continue to decline in real terms. That is simply by way of saying that if the reductions in the expenditures were greater than are proposed, we might be able to lower taxes and increase real spendable earnings.

Mr. SCHULTZE. Again, let me note several things.

First, the series you were using to describe earnings, is real weekly earnings. There has been a steady downward trend in the number of hours worked per week in this economy, about a half a percent a year.

That is partly because of longer vacations, partly because of more part-time workers are in the economy. You have to be very careful in using that series.

Real income per capita has been rising, but since productivity growth has slowed down, much slower than in the past.

If one looks in the long-term future, into 1981, 1982, and 1983, and calculates the ratio of taxes to GNP or taxes to income, that ratio will rise, and as the President has indicated any number of times, one of his objectives is to slow and hold the rate of growth in Federal spending to reduce the share of Federal spending in GNP so that as appropriate, depending on the economic circumstances, you can continue to reduce taxes.

The other thing I have complained about, if you will, this morning, is that I don't think that ought to be done by a mechanical formula, but the strategy is clearly there.

Senator McCLURE. In other words, you hope we can change that by enactments of Congress and the initiatives of the administration in the future, but it requires future action which is not programed?

Mr. SCHULTZE. Right, because of the inflation problem we are facing now, we need to bring that under control.

Senator McCLURE. Isn't the real objection to indexing tax rates is that it is easier to cut taxes than it is to increase them, and if we index the rates now, we might have to in the future increase some in order to reduce others?

Mr. SCHULTZE. Increase others, or face an inflationary burst and need to hold the economy down, one or the other or both.

Senator McCLURE. The Congress could exercise discretion without an index system, except that they are playing not with money, or taxes, already levied, and, therefore, being able to reduce them, but they would also have to inflict pain at the same time.

Mr. SCHULTZE. First, it takes time, and, second, it is much more difficult, and as I say, you have in effect given away some of the automatic stabilizing features of the system.

Senator McClure. One final question, if I may, Mr. Chairman.

Senator Bentsen had earlier outlined some possible alternatives that might stimulate investment productivity.

One of the things that was not covered in his list of three things was a method by which we might encourage savings in order to encourage the formation of capital which would then be more freely and readily available for investment.

We have the most highly consumptive society in the world. One of the reasons we have that highly consumptive society is that our taxing and spending system, and particularly the taxing system, encourage spending. They reward spending and debt, and penalize saving and investment.

Would it be a useful thing to make the tax system either reversed, or more neutral in the individual's choice of whether he should save money or spend it?

Mr. SCHULTZE. Senator McClure, my own judgment would be that as you look down the years at the opportunities in reducing taxes and at the need to increase investment, one should pay most attention, certainly initially, toward incentives to stimulate investment.

I believe the savings are there if the investment demands were there.

Ultimately, as you go down the road, I don't know, but it seems to me that the investment—

Senator McClure. I assume your conclusion is that the high interest rates everyday are inflation-related?

Mr. SCHULTZE. Principally, that is correct.

Senator McClure. They are a measure of inflation or the expectation of inflation, rather than any imbalance between supply and demand in investment capital?

Mr. SCHULTZE. I think essentially, and I might want to quibble around the edges of that, but it is principally inflation, correct.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Schultze, I want to go back to an area of agreement on the question that Congressman Hamilton asked you.

In your prepared statement you have the sentence:

As the overall unemployment rate declines, demand for skilled, prime-age workers exceeds supply of those workers, and puts upward pressure on their wages, even though unemployment among minorities, teenagers and women may remain unacceptably high.

That seems to me a pretty good argument for increases in training in the private sector that would enhance the skills of minorities, teenagers and women in productive jobs in the private sector.

The major exceptions to the CETA intention of providing jobs in the public sector seem to me to be title VII and the targeted jobs program, which has a low budget in 1979 compared to the whole CETA budget in 1979.

When you said earlier that you want to make modifications into the CETA programs, do you read into that that you intend to move more into the private sector for job creation? Because it would seem to deal with both of these problems.

Mr. SCHULTZE. I understand that. We now have just underway two important programs in the private sector, one on the tax side and one of the expenditure side, and I think we have to see how those work out

before we move ahead, but it seems in the long run we do have to have private placement of the disadvantaged.

Let me note significant parts—

Representative BROWN. When you say, "placement," you mean training as well?

Mr. SCHULTZE. What I meant is that you look to the private sector to absorb the structural unemployment.

Let me also note, even though I cannot give numbers, the important part of the youth moneys in CETA do go toward experience and training programs in which the private sector is closely related.

I cannot give you a breakdown on that, but part of the money in that program is in that general direction.

Representative BROWN. I had the occasion the other day to talk to a young man who had been trained in the CETA program as a fireman, and, unfortunately, they ran out of positions before they hired him.

He asked me where he would go to get a fireman's job. He was trained for a public job, and unless he went to a private firm that had a need for a fireman, the opportunities were limited.

Let me be somewhat more contentious. I agree with you that we need to look to investment, and it seems to me that investment comes from increased savings, and I have a bill in, and I think Senator McClure has a similar bill in the Senate, to encourage, by a tax credit, the increase in savings by private Americans.

It would move us toward the individual savings rates of the Germans, which is three times as high as ours on an individual basis, or the Japanese, which is something like five times ours.

You talk a good game, but when we talk about cutting taxes, and social-security taxes, and the administration is opposed to rolling that back, and the administration is opposed to a general cut in income taxes, at least as proposed by some of those on our side of the aisle. In the depreciation area that I discussed with you, there is legislation put in by Representative Stockman to do something about that problem. I understand that administration opposes that. The instant write-off of pollution control equipment; to reduce that, and also to compensate for health and safety spending, I am told the administration opposed that.

Senator Javits had a proposal last year to cut corporate tax rates by 40 percent. The administration opposes that. Representative Steiger and Representative Archer proposed a cut in capital gains taxes and that was opposed by the administration. Also, you abandoned your support of reducing that tax on dividends.

I am concerned about what the formula is that the administration will support, because that seems to me to cover a rather broad range, depreciation, capital gains, personal income taxes, savings, and so forth.

What is the area that the administration is going to support that will encourage savings and investment and reward rather than tax the money that goes into that.

The talk is good, but the results don't seem to be terribly impressive.
Mr. SCHULTZE. Let's expand on this.

The administration proposed last year a deeper cut in corporate taxes than the Congress would accept.

The administration proposed a reduction in the capital gains tax structure and the Congress turned that down.

The administration proposed last year an investment-related package which was larger than it ever was in terms of the split in the tax cut. In the immediate year ahead, we are facing the problem of the strained budget, and bringing inflation under control. As I indicated, over the years, as will clearly be the case, we should move toward further tax reductions. There are any number of options out of which one can pick the ones between the administration and the Congress after we debate the ones that we think are the most effective for increasing investment.

The mere fact of increasing the whole range of things, if you added up the budgetary costs of the whole range of things, the costs are incredible. As we go down the pike in future years, there will be others. This year is not the time for it, but there will be a time.

Representative BROWN. Someday, but not now?

Mr. SCHULTZE. That is correct, just as we said on expenditures.

Senator BENTSEN. Senator Javits.

Senator JAVITS. Thank you.

Mr. Chairman, I apologize for being so late, but I had to go to New York to join in a tribute to my political colleague, Nelson Rockefeller. But I did rush back to have a word with you, Mr. Schultze.

I understand you had an interesting exchange with Senator McClure on productivity, which you know has been a concern of mine.

I am interested in a study made by the New York Stock Exchange entitled "Reaching a Higher Standard of Living," because it exposes a thesis on which I would like you to comment, but knowing me as you do, you will appreciate my saying that I really don't require your comment off the top of your head.

I think this requires study and thought, and if you agree, please tell me, and we will wait until you can think it out.

The theory is this: The administration said when it published the Economic Report, that if productivity remains in the cellar, as it is now in the United States, it is likely that the Nation's standard of living is likely to improve only very slowly for some years.

Now, the real thesis of the stock exchange study is that not only will productivity not improve, it will deteriorate, notwithstanding that we may remain flat and stagnant. That is the theme.

That is what I would like the comment on. I think it is important.

I will put this study in, Mr. Chairman. It is quite extensive, but I really think it is quite worthwhile.

Senator BENTSEN. I have a copy of it, and I quite agree.

Senator JAVITS. May I put it in the record?

Senator BENTSEN. Yes.

[The study follows:]

REACHING A HIGHER STANDARD OF LIVING

THE New York Stock
Exchange

OFFICE OF ECONOMIC RESEARCH

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PREFACE

Why has the New York Stock Exchange undertaken a study of the economic forces that have powered America's standard of living? It is because we share in the national concern over the lackluster performance of our economy. Closer to home, both equity investments and the securities industry do best when real economic growth is strong and inflation is under control.

We hope that our analysis contributes to a better understanding of the reasons for inflation and below-trend economic growth during the seventies, and that our suggestions prove useful in the formulation of policies to get our economy onto a low-inflation, higher-growth track.

For a decade, the real buying power of wages has remained virtually flat — apart from cyclical ups and downs — despite large increases in money wages. Higher wages have simply been gobbled up by higher prices. According to the U.S. Bureau of Labor Statistics, private nonagricultural workers' pre-tax earnings averaged \$190 per week in 1977, compared with just over \$100 in 1967. But *real* earnings, after adjusting for inflation, were only \$2.50 per week higher than in 1967—an insignificant $\frac{1}{4}$ of 1% average annual gain in buying power over the decade.

Even in periods of recession there has been little relief from severe price inflation. It used to be assumed that inflation and recession were mutually exclusive but, in recent years, that has changed. We have seen in 1969-1970 and 1974-1975, for example, how inflation can persist when unemployment is rising and the economy stalls.

A decade of inflation has undermined most Americans' traditional confidence in the basic strength of our economy. Available explanations do not satisfactorily describe the causes of the acceleration of inflation in the face of decelerating real growth—or why living standards have not improved in recent years.

Substantial improvement in real wages and the living standards they support is impossible without substantial gains in productivity. The formula is simple. Wage increases not supported by productivity gains are translated into higher prices which leave the wage earner back where he started. Thus, a study of the basic economic forces that raise living standards is necessarily a study of productivity. If we fail to improve productivity, our economy may be further bedevilled by inflation, sluggish or nonexistent real growth, and a loss of competitiveness in international markets.

Unfortunately, the long-entrenched Keynesian economics has left productivity out of economic analysis for several generations. Keynes was concerned with creating jobs. In the midst of the Great Depression, nonproductive make-work jobs, even digging holes and filling them up again, could be justified as better than none. Today, however, the challenge is to find ways to place job seekers in jobs which provide an adequate supply of goods and services, produced as efficiently as possible. Productivity has come of age.

To enlist the broad cooperation required to lift productivity growth, it is necessary to dispel the widely held notion that equates productivity with faster assembly lines and greater human exertion. One need not look too far back in economic history to appreciate the fact that productivity gains have come about largely from more modern plant and equipment, more efficient production processes, and better management. The historic increases in both leisure time and purchasing power of workers are testaments to the benefits of productivity.

We believe that our study can contribute toward a solution to the riddle of persistent inflation. We have developed a theory of how declining productivity gains can send inflation spiraling upward despite slow economic growth and how accelerating productivity gains can help unwind inflation. Naturally, this is not meant to imply that productivity gains alone can eliminate inflation. Indeed, only if monetary and fiscal policies are effective can productivity help in conquering inflation.

Since productivity improvements depend heavily on utilizing more modern plant and equipment and incorporating new technology into new productive facilities, a major remedy for sluggish productivity gains should be obvious: an upsurge in capital formation to finance new plant and equipment and technological improvements. Suggestions for stimulating capital formation and other ways of improving productivity are discussed in the closing chapter of this study.

The study was completed under the supervision of Dr. William C. Freund, Senior Vice President and Chief Economist of the Exchange. New estimates by Professor John W. Kendrick of George Washington University of the factors underlying the productivity slowdown in recent years appear for the first time in this study. We deeply appreciate his contribution. We also gratefully acknowledge the important contributions of Ira Gelb and Mel Colchamiro, NYSE staff economists; the helpful overall suggestions of Dr. Edward F. Denison of the Brookings Institution; of Dr. Lawrence R. Klein of the University of Pennsylvania; and the guidance on selected parts by Dr. Albert Rees of the National Bureau of Economic Research and Professor Richard E. Quandt of Princeton University. We also acknowledge the considerable assistance of a number of prominent business economists. Of course, the Exchange assumes full responsibility for any errors or omissions.



William M. Batten, Chairman
New York Stock Exchange

SUMMARY AND CONCLUSIONS

"When I use a word it means just what I choose it to mean—neither more nor less" (Humpty Dumpty to Alice in "Through the Looking Glass")

Unfortunately, the true meaning of productivity and productivity advances is sometimes misunderstood. Too often those terms conjure up images of sweatshops and speeded-up assembly lines. The truth of the matter is that greater physical effort is but a tiny part of what makes productivity increase. Productivity increases when:

- People are better trained, educated and motivated;
- People have better working environments;
- People are in better health;
- People have more efficient machinery and equipment to work with;
- People develop new products and technology;
- People shift from working in less efficient industries to working in more efficient industries;
- People manage more effectively.

In short, productivity increases primarily when people work smarter and more efficiently.

Productivity growth is important to all Americans because it is a key factor in determining improvements in living standards. It fuels economic expansion, provides for vigorous long-run growth in jobs, and, in a way little understood, restrains inflation.

Productivity gains have dropped nearly in half during the past decade, contributing both to an escalation of inflation and a slower rate of economic growth.

The decline in productivity is a long-run problem which cannot be overcome by short-run solutions. Current inflation took time to wind up and it will take time to decelerate. Productivity can play a key role in that process, as this study shows.

Productivity and Economic Growth

There are but two sources of long-run real economic growth, labor input and productivity:

<p style="text-align: center;">Labor input (man-hours) + Productivity _____ = Real Economic Growth</p>
--

A realistic goal for the decade of the 1980s is a real economic growth rate of 4% per year; any higher rate would fuel inflation. But a 4% growth rate can be achieved only if productivity grows 3% per year, since man-hours will increase no more than 1% per year:

If man-hours grow	1%
Productivity must grow	<u>3</u>
To achieve desired growth of	4%

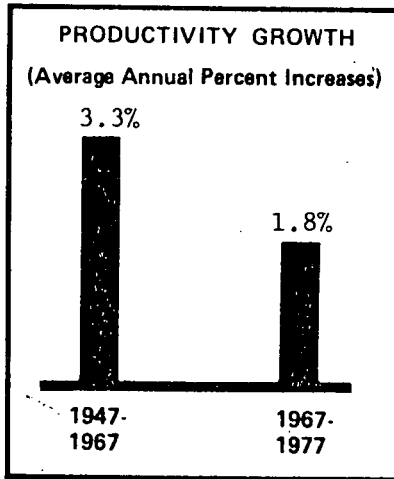
If the 4% annual growth rate is achieved by the end of the 1980s:

- 16 million additional jobs can be created.
- Real per capita income will grow by 48% and reach \$10,500 (1977 dollars).
- Average family income will rise by 32% and reach \$27,000 (1977 dollars).

In short, a 4% real growth rate in the 1980s will raise America's living standards substantially.

Unfortunately, productivity growth has declined to only 1.8% per year in the last decade, or about half of what it was in the two decades earlier.

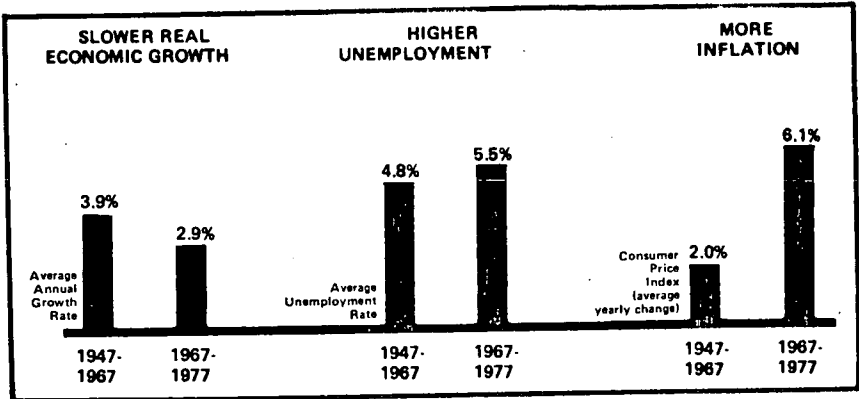
CHART 1



The decline in productivity has contributed to slower real economic growth, higher un-

employment and more inflation, as can be seen below.

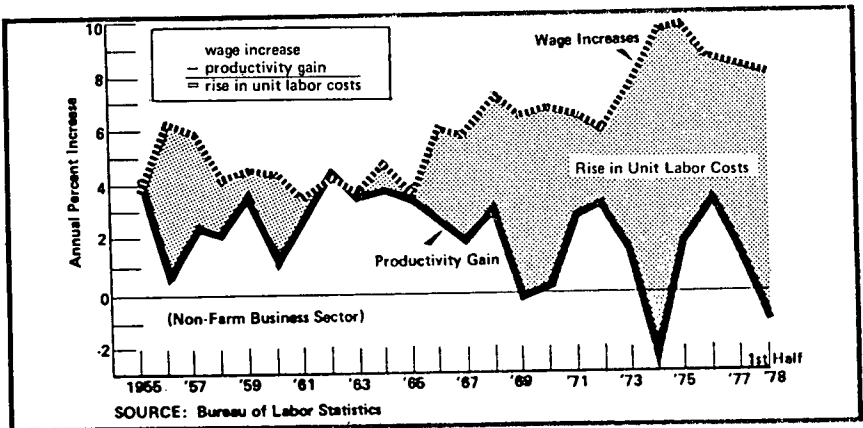
CHART 2



Productivity and Inflation

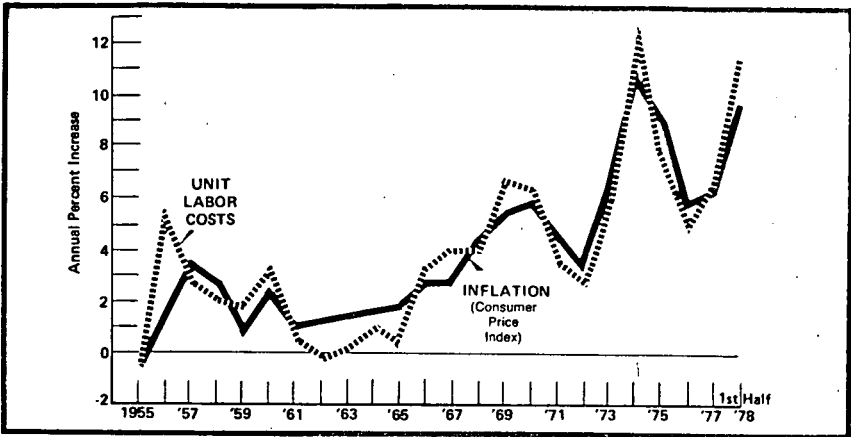
Though prudent monetary and fiscal policy remain critical weapons against inflation and cannot be supplanted by alternative policies, productivity growth remains a strong influence on the rate of price increases. Productivity gains offset wage increases and thereby help check unit labor cost rises. . . .

CHART 3



... and unit labor cost increases are a key factor in determining inflation.

CHART 4



Moreover, as this New York Stock Exchange study shows, productivity gains often have unrecognized "multiplier" effects on inflation and, as a result, are a more potent weapon against inflation than is generally assumed:

- Declining productivity growth can accelerate inflation over time.
- Rising productivity growth can help unwind inflation over time.

For example, a 1% increase in productivity growth can produce a decrease of several percentage points in the rate of inflation over time.

Sources of the Productivity Slowdown

New data prepared by Professor John W. Kendrick indicating the sources of the recent slowdown in productivity gains appear for the first time in this study. The primary factors are:

- A slowdown in capital spending for
 - research and development programs
 - new plant and equipment.
- Increased negative impact of government regulation.
- Increased impediments to capital and labor mobility.
- Slower output growth.

Policies to Promote a Higher Standard of Living

It is essential to reverse this slowdown if we are to come close to achieving the key national objectives of:

- Promoting a higher standard of living.
- Creating a sufficient number of jobs.
- Restraining price inflation.

The following set of economic goals would help achieve these objectives:

- Increase annual real growth in GNP to 4%. To achieve this will require
- Raising annual productivity growth to 3%. This, in turn, depends primarily on
- Increasing the GNP share of business investment by at least 2 percentage points—from 10% to 12%.

These goals can be achieved if labor, management and government all give urgent priority to increasing productivity growth. To this end, the following policies should be considered:

- Develop a national commitment to productivity improvement.
- Adopt measures to encourage saving and risk-taking.
- Implement programs to increase business capital spending.
- Create incentives to spur research and development.
- Relax unnecessary government regulation and other restrictive practices which add to business costs and inflation.
- Improve education and training; put greater emphasis on on-the-job training.
- Establish policies to better match job vacancies and job seekers.
- Promote economic stability.

A coordinated national effort to boost productivity growth to at least 3% per annum would go a long way toward unwinding inflation, raising living standards, and creating jobs. It would also make American goods more competitive internationally and help strengthen the dollar. These are objectives in which every American has a stake.

PRODUCTIVITY AND ECONOMIC GROWTH

Introduction

"I believe in materialism. I believe in all the proceeds of a healthy materialism—good cooking, dry houses, dry feet, sewers, drain pipes, hot water, baths, electric lights, automobiles, good roads, bright streets, long vacations, new ideas, fast horses, swift conversation, theatres, operas, orchestras, bands—I believe in them all for everybody. The man who dies without knowing these things may be as exquisite as a saint, and as rich as a poet; but it is in spite of, not because of, his deprivation."¹

Francis Hackett wrote these words in the beginning of this century. At the time, the United States was already embarked on the greatest advance in material well-being that the world had ever seen. Advances since World War II have been particularly dramatic. For example:

- Real per capita income almost doubled between 1947 and 1977.²
- The number of U.S. job holders increased by 59% between 1947 and 1977, to a total of over 90 million.
- The average American's life expectancy has increased by five years since 1950.
- The percentage of U.S. families with incomes below the poverty level was almost halved between 1959 and 1976, declining from 18% to under 10%.
- The percentage of U.S. households with at least one room air conditioner more than tripled, from 17% in 1960 to 55% in 1977.
- 98% of U.S. households have television sets today, compared with only 9% in 1950; 79% have color T.V., compared with 4% a decade ago.

If the U.S. is to continue to benefit from the proceeds of materialism, then our economy must grow. We do not mean to imply that economic growth has no undesirable side effects. One has seen a decline in the quality of the environment. The Environmental Quality Index—developed by the National Wildlife Federation—indicates that the overall quality of the environment worsened by some 10% between 1969 and 1977. Yet, paradoxically, future economic growth is necessary if we are to have sufficient economic resources to eliminate the effects of past pollution while maintaining our high living standard.

¹ Francis Hackett, *Ireland*, cited by Paul A. Samuelson, *Economics*, tenth edition, 1976, page 759.

² Real per capita income (personal income in 1977 dollars, divided by population) rose from \$3,740 in 1947 to \$7,053 in 1977.

The Meaning of Productivity

Productivity has been the overwhelming force behind advances in our material well-being. Essentially, productivity measures how much is produced, on average, per hour worked; it relates the amount of output—in terms of goods and services—to the number of hours of labor input. But speeding up the assembly-line is not the only way to promote productivity. In fact, if people become bored, or tired, or dissatisfied with working conditions, a faster assembly-line may promote inefficiency and reduce, rather than increase, their output. Many other factors are involved. Productivity increases when:

- People are better trained, educated and motivated;
- People have better working environments;
- People are in better health;
- People have more efficient machinery and equipment to work with;
- People develop new products and technology;
- People shift from working in less efficient industries to working in more efficient industries;
- People manage more effectively.

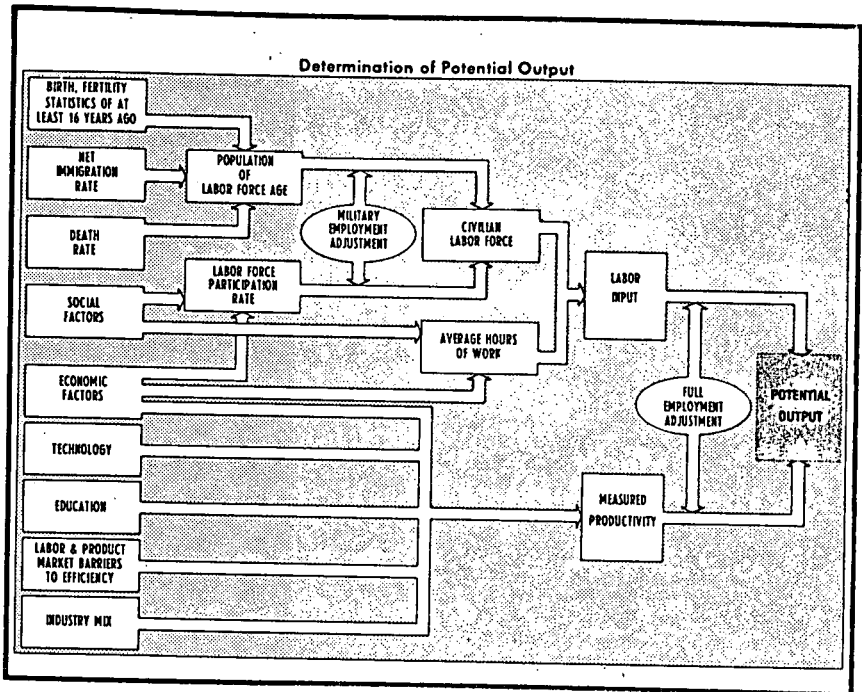
In short, productivity increases not only when people work harder—but when they work smarter and more efficiently. People produce more when they have better tools, better production techniques and are better-organized and managed.

Sources of Output

Simply put, man-hours worked, and the degree of efficiency with which they are combined with other productive factors, determine the volume of output. Many factors affect the number of man-hours including, for example, population size and characteristics, labor force participation rates, labor-leisure preferences, and a host of social factors. Technology, education levels, labor market efficiencies and the quantity and quality of production facilities all help determine productivity levels and growth.

The schematic diagram below, prepared by the Federal Reserve Bank of St. Louis, depicts the key factors determining labor input (man-hours) and productivity. As the diagram shows, the interaction of labor input and productivity of that labor are the ultimate sources of growth.

CHART 5



Source: Roger W. Spencer, "Population, the Labor Force, and Potential Output: Implications for the St. Louis Model," *Federal Reserve Bank of St. Louis Review*, February 1971, page 18.

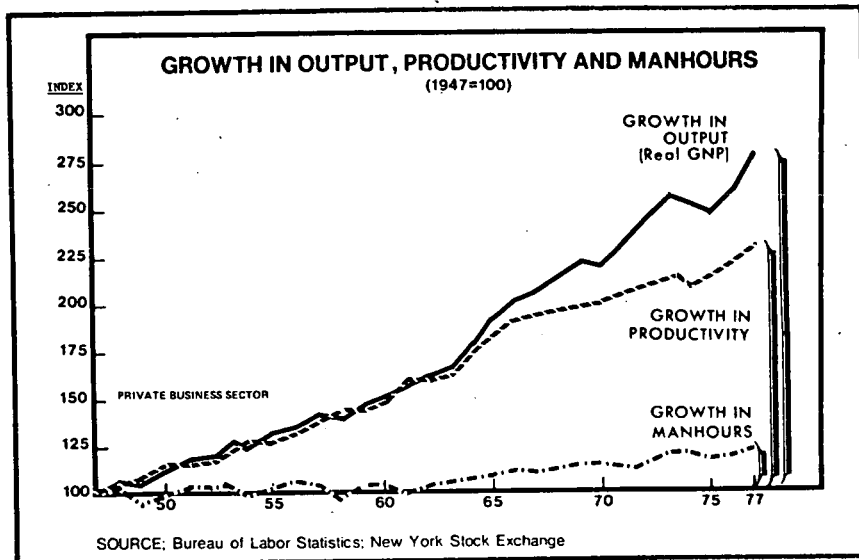
The following simple equation summarizes the factors that determine the total output of the economy and provides a framework for estimating the relative importance of the two basic components of growth—man-hours and productivity:

$$\text{Total Output} = \text{Man-hours} \times \text{Average output Per Man-hour (Productivity)}$$

Man-hours are determined by the level of employment, the length of the average workweek and the average number of weeks worked each year.

The crucial role that productivity has played in the growth of our economy since the end of World War II can be seen by comparing the trends in the Labor Department indexes of real output, hours worked and productivity. Between 1947 and 1977, real output increased at an

CHART 6



SOURCE: Bureau of Labor Statistics; New York Stock Exchange

average annual rate of 3.5%. Over the same period productivity grew 2.8% per year,³ while man-hours advanced by only 0.7% per year.

Wide disparities in rates of productivity growth exist among industries. While an industry-by-industry analysis of productivity is beyond the scope of the present study, the chart presented in Appendix I illustrates some significant differences.

Recent Trends in Productivity and Output

Through the late 1960s, productivity in the United States accounted for almost 8/10 of each percentage point of output growth⁴ while man-hours accounted for but 2/10. More

3. It should be noted that the Labor Department output per man-hour measure used here measures the contribution of all factors of production (including labor, capital and natural resources) in raising output per-hour worked.

4. These estimates are very close to those of Dr. Edward Denison. His study of the sources of growth in the U.S. economy indicates that total factor productivity as used here has accounted for approximately ¾ of the growth in national income between the years 1929-1969.

See Edward F. Denison, *Accounting for United States Economic Growth 1929-1969*, The Brookings Institution, 1974, pages 124-149 especially Table 9-5 on page 128. Data in Table 9-5, if regrouped to approximate the overall productivity measure used here, confirms the Exchange's findings.

recently, however, the proportions of output growth attributable to productivity have declined substantially (see Appendix II).

This shift has occurred because productivity gains have slowed while gains in man-hours have accelerated. The following table shows how the output slowdown during 1967-1977 is directly related to the drop in productivity gains; the increase in man-hours merely prevented a more precipitous decline in output.

TABLE 1

Man-hours, Productivity and Output (Private Business Sector) ⁵					
	<u>Man-hours</u>		<u>Productivity</u>		<u>Output</u>
	—Average Annual Percent Increases—				
1947-1967	0.4%	+	3.3%	=	3.7%
1947-1957	0.2	+	3.3	=	3.5
1957-1967	0.6	+	3.3	=	3.9
1967-1977	1.2	+	1.8	=	3.0

Source: Bureau of Labor Statistics.

U.S. productivity growth has lagged behind that of other industrialized countries. The next table shows that output per man-hour in manufacturing increased more slowly in the United States than in any of the 11 other major industrialized nations during 1960-1976. In part, this reflects the fact that other countries' productivity *levels* remain well below U.S. levels, so there is greater room for improvement. Nevertheless, the fact remains that U.S. productivity gains have fallen sharply since the 1960s.⁶ Productivity growth in six countries accelerated after 1966, while the 45% decline in the U.S. was far greater than in any of the other countries. It would be one thing if the poor U.S. track record were just part of a world-wide slowdown. It is quite another when we lag seriously behind the rest of the world.

⁵ Changes in man-hours plus changes in productivity equal changes in output.

More precisely, man-hours *multiplied* by productivity equals output. Little accuracy is sacrificed by adding rates of change here, because of the small magnitude of the percent changes.

⁶ A full discussion of the sources of this decline begins on page 14.

TABLE 2

Productivity in Manufacturing, 1960-76 (Average Annual Percent Change)				% Change 1966-76 vs. 1960-66
Country	1960-76	1960-66	1966-76	1960-66
United States	2.9%	4.0%	2.2%	-45%
United Kingdom	3.3	3.7	3.1	-16
Canada	3.8	4.3	3.5	-19
Switzerland	4.3	2.9	5.1	+76
France	5.7	5.5	5.8	+ 5
Sweden	5.7	6.5	5.2	-20
Italy	5.8	6.7	5.3	-21
Germany	5.9	6.0	5.8	- 3
Netherlands*	6.7	5.6	7.4	+32
Belgium*	6.8	5.0	8.1	+62
Denmark	7.0	5.4	8.0	+48
Japan	8.9	8.8	8.9	+ 1

*1960-1975.
 Note: Data for 1976 are preliminary estimates.
 Source: U.S. Department of Labor, Bureau of Labor Statistics.

Economic Growth, Productivity and Jobs in the 1980s

The prospect for continuing sluggish productivity gains does not augur well for U.S. economic growth in the 1980s.

Output grew rapidly during 1967-1977 only because man-hours increased at an extraordinary pace. After increasing 0.4% per year during 1947-1967, man-hour increases accelerated to 1.2% per year during 1967-1977. If man-hours had grown only as fast as in the 1947-1967 period, output would have been 6% lower than it actually was. Between 1980 and 1990, growth in total man-hours is unlikely to exceed 1% per year for two reasons. First, the number of new entrants into the labor force is expected to decrease; second, the slow long-run downward trend in the length of the average workweek is likely to continue.⁷ Given the impending slowdown in additions to man-hours, productivity gains will have to exceed

⁷ Average workweek, total private nonagricultural sector:

1947 = 40.3 hours	1967 = 38.0 hours
1957 = 38.8	1977 = 36.1

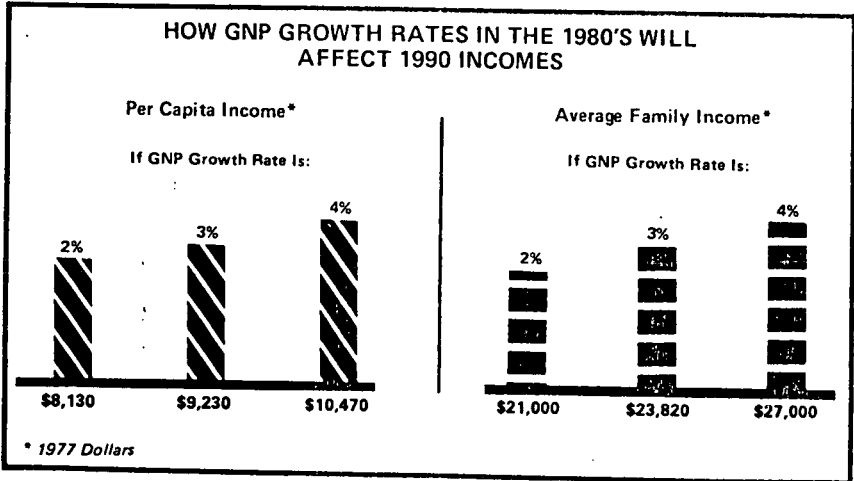
those of the past 10 years *merely to equal the sluggish output growth of the past decade*. If output is to regain the 4% annual 1957-1967 rate of increase, then productivity must increase much more quickly.⁸ The arithmetic is as follows:

If man-hours are expected to increase by	+	then productivity will have to increase by	=	for output to increase by
1%	+	2%	=	3%
1%	+	3%	=	4%

A 1% annual change in output may not seem like very much; but, over a period of years, it means a significant difference in living standards. Had real GNP growth continued at 4% per year during 1968-1977, for example, real GNP would have risen to \$2,120 billion (in 1977 dollars)—12% and \$233 billion higher than the actual 1977 level. Per capita income would have been almost \$9,800 (in 1977 dollars) in 1977, or roughly \$1,100 more for every man, woman and child in America.

A 4% real growth rate in the future would also mean substantial increases in *real* per capita and household incomes. Real per capita income (in 1977 dollars) would rise from \$7,050 in 1977 to \$10,460 by 1990, a jump of 48%. Real household income (in 1977 dollars) would rise from \$20,470 in 1977 to \$27,000 in 1990, a gain of 32%.

CHART 7



* * * *

These numbers tell us how Americans can benefit from additions to the output of goods and services—both in terms of job opportunities and Francis Hackett's "healthy materialism"—if productivity improves and real growth in the 1980s is strong. But if productivity growth continues to lag, what will be the impact on the quality of life in America?

- Long-run additions to the output of goods and services will remain sluggish.
- Inflation will be fueled.
- Job creation will slow, making it more difficult for those who have traditionally been hard hit by economic recessions and slowdowns — teenagers, women, minorities — to participate successfully in the work force. It is an unfortunate fact of economic life that these workers are the first to be fired and the last to be rehired.
- Fewer new job opportunities and a low growth rate would make alleviation of social problems more difficult. With less new output to be distributed, each economic group would have to strive harder to better its position. Tensions between competing economic groups would be aggravated as each group's expectations could be realized only at the expense of other groups.
- By inflating costs, sluggish productivity will make U.S. goods less competitive in world markets, adversely affecting the nation's trade balance and the international value of the dollar. Foreign travel and foreign goods will be much more expensive, further cranking the upward spiral of domestic inflation.

In short, when gains in productivity and output growth decline—or worse, disappear—the quality of American life suffers. The impact ranges from individual economic hardship to heightened social tensions. As each group fights to maintain its piece of the economic pie, the latent tensions in society surface. Thus, a slow or no-growth economy tends to foster a more divisive and contentious society.

If we are to improve, rather than diminish, the over-all quality of life in America, the nation must pledge its collective will to the goal of balanced, non-inflationary economic growth.

⁸ A 4% growth rate fueled by a 3% rise in productivity and a 1% rise in man-hours can produce a substantial increase in jobs in the coming decade if aggregate demand is strong enough to accommodate them. Man-hours and productivity gains are, after all, *supply* variables and define what *may* be, not *will* be, attained. The extent of the increase is demonstrated by the following relationship:

$$\% \text{ Change in Employment} = \% \text{ Change in Man-hours} - \% \text{ Change In Workweek}$$

Assuming a 0.3% annual decline in the length of the average workweek, in line with the 1947-1977 experience in the private nonagricultural sector, the change in employment can be estimated as follows:

$$\begin{aligned} \% \Delta \text{ Empl.} &= \% \Delta \text{ man-hours} - \% \Delta \text{ workweek} \\ \% \Delta \text{ Empl.} &= 1\% - (-0.3\%) \\ \% \Delta \text{ Empl.} &= 1.3\% \end{aligned}$$

Thus, employment can increase by 1.3% per year on average and could mean 16 million additional jobs by 1990—or an average unemployment rate of 5.0% over the decade of the 1980s. (Year-by-year changes are shown in Appendix II.) This assumes the BLS projected increases in the labor force (1.3% per year 1978-1984 and 0.9% per year 1985-1990).

SOURCES OF THE PRODUCTIVITY SLOWDOWN

(The material in this section draws from a detailed paper specially prepared for this study by Professor John W. Kendrick, of George Washington University, which is available on request.⁹)

The rate of productivity growth has slowed perceptibly over the past decade, especially in the last five years. Professor John W. Kendrick has developed data tracing the sources of this slowdown.¹⁰ These data cover three periods: 1948-1966, 1966-1973, and 1973-1977. The data for 1973-1977 appear for the first time in this study.

Professor Kendrick's data indicate that over-all productivity growth slowed from an average annual rate of 2.7% during 1948-1966 to 1.6% during 1966-1973 and to 0.7% during 1973-1977. This decline—from 2.7% to 0.7%—was caused primarily by slowdowns in the rate of technological progress, reduced capital and labor mobility, and by declines in economic growth associated with the 1974-1975 recession. These and other factors are summarized in the chart on page 15 and the table on page 19*.

It should be noted that the data analyzed by Professor Kendrick represent total factor productivity; that is, the efficiency of labor and capital inputs. The way these inputs are combined provides the link between factor productivity and the more-familiar labor productivity concept. This appears at the end of this section.

Sources of the Productivity Slowdown

Technological Progress — The most important source of productivity growth is the application of new technology to the production of goods and services. More than half of the net productivity growth during 1948-1977 is attributable to technological advances.

Technological progress historically has been fueled by capital outlays for formal research and development (R&D) programs. These expenditures had steadily increased to 3.0% of GNP by the mid-1960s, but subsequently declined, to 2.2% of GNP, by 1977.¹¹ As a result, the growth of the real stock of technological knowledge has decelerated in the past decade.

The purchase of new capital equipment also significantly affects technological progress. Since capital goods produced each year embody the latest technological advances, capital

⁹ Address requests to: Dr. William C. Freund, Office of Economic Research, New York Stock Exchange, Inc., 11 Wall Street, New York, New York 10005.

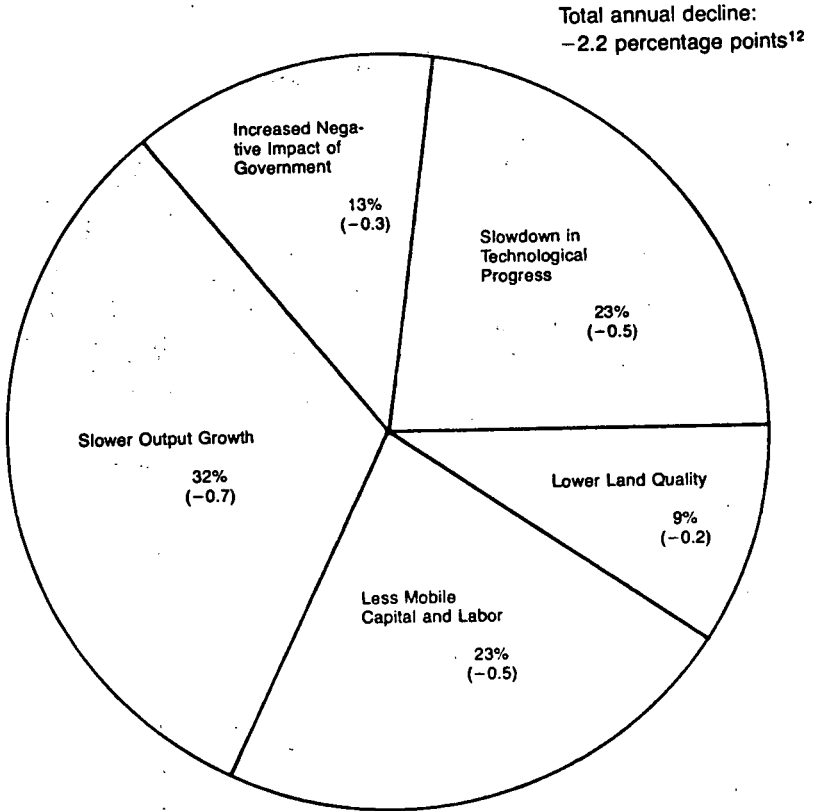
¹⁰ The estimates are confined to the U.S. domestic business economy, which accounts for about 85% of GNP, since output and productivity measures are not available for the public and household sectors.

* Professor Kendrick's more detailed table appears in Appendix III.

¹¹ Nonetheless, real R&D expenditures (1972 dollars) have risen from \$20 billion in 1960 to \$26 billion in 1970 and to \$29 billion in 1977.

CHART 8

**FACTORS CONTRIBUTING TO THE DECLINE IN
AVERAGE ANNUAL PRODUCTIVITY GROWTH
1973-1977 vs. 1948-1966**



¹² The actual decline in total factor productivity was 2.0% per year—from 2.7% in 1948-1966 to 0.7% in 1973-1977. This reflects the netting of the declines shown above against a modest 0.2 percentage point gain due to accelerated increases in labor quality plus "other" factors.

TABLE 3

Sources of Productivity Growth 1948-1977
(U.S. Domestic Business Economy)

	1948-1966 1966-1973 1973-1977 ^p			Change Between Periods	
	(a)	(b)	(c)	1966-1973 vs 1948-1966 (a)-(b)	1973-1977 vs 1948-1966 (a)-(c)
	(Percentage Point Contribution to Growth Rate)			(Percentage Point Contribution to Change in Growth Rate)	
Technological Progress	1.4%	1.1%	0.8%	-0.3%	-0.5%
+ Changes in Labor Quality	0.6	0.4	0.7	-0.2	+0.1
+ Changes in Quality of Land	0.0	-0.1	-0.2	-0.1	-0.2
+ Capital and Labor Mobility	0.8	0.7	0.3	-0.1	-0.5
+ Changes in Output Growth	0.4	0.2	-0.3	-0.2	-0.7
+ Net Government Impact	0.0	-0.1	-0.3	-0.1	-0.3
+ Other N.E.C.	-0.5	-0.6	-0.4	-0.1	+0.1
	Average Annual Rate of Growth			Change in Average Annual Rate of Growth	
= Total Factor Productivity	2.7%	1.6%	0.7%	-1.1	-2.0

p = preliminary

N.E.C. = Not Elsewhere Classified.

Source: Professor John W. Kendrick, George Washington University.

spending tends to spread cost-reducing technology throughout the economy, reflected in a lowering of the average age of capital goods employed in the U.S. economy. Between 1948 and 1966, the average age of the capital stock decreased by about three years. However, during 1966-1973, the decline slowed to one year and between 1973 and 1977 there was virtually no change.

Informal inventive and innovative activity, including a myriad of small technological improvements devised by plant managers and workers, also help improve total technological knowledge. Professor Kendrick's data indicate no significant falloff in this area.

The cumulative changes in the various forms of technical progress — highlighted by the slowdown in R&D spending and capital formation — resulted in a very significant 0.5 percentage point decline in the average annual rate of productivity growth during 1973-1977, relative to 1948-1966. In other words, slower technological progress accounted for approximately 25% of the slowdown in productivity growth.

Changes in Labor Quality — This major category was the only one to increase its contribution to productivity growth in 1973-1977 (0.7 percentage points per year) versus 1948-1966 (0.6 points per year), as can be seen in table 3 on page 16. Three factors — education and training; health and safety; and the age-sex composition of the labor force — determine such changes in labor force quality.

Education and training is by far the most important determinant of labor force quality. In fact, Professor Kendrick's data indicate that education and training accounted for all of the upgrading of labor quality during both 1948-1966 and 1973-1977.

The average health and safety of workers has continued to improve slightly, resulting in reductions in time lost due to illness and accident, and increases in potential working life. These improvements have annually contributed a constant 0.1 percentage point to productivity growth over the full 1948-1977 period.

Changes in the age-sex composition of the labor force became a significant negative factor by the mid-1960s, when the proportion of youth in the labor force increased (reflecting the baby boom after World War II), and accelerating numbers of women began entering the labor force. Since these groups have traditionally been less experienced and less well trained, their increased representation in the labor force temporarily reduced the over-all efficiency of labor, offsetting increased productivity in other areas. Thus, changes in the age-sex composition of the labor force are estimated to have reduced productivity by 0.4 percentage points during 1966-1973, compared with only 0.1 percentage point during 1948-1966. By 1973-1977, the earlier entrants to the labor force had gained experience and training on the job while the influx of additional teenagers slowed. Thus, the age-sex composition in the latter period is virtually neutral with respect to productivity and is no longer a significant factor explaining its decline.

Labor and Capital Mobility—Productivity is affected by how quickly and efficiently labor and capital are reallocated among industries and geographic areas in response to continually changing supply and demand conditions. Inefficient allocations usually result from restrictive practices of firms and unions, government regulations, lack of knowledge of where opportunities may exist, and the sheer costs of movement.

Productivity improved significantly during 1948-1966, when less productive farm labor shifted to more productive non-farm jobs. However, farm-to-urban labor shifts have become a less significant source of productivity gains as the over-all proportion of farm labor in the economy has declined. With only 5% of the work force remaining in agriculture, productivity gains from a further shift are virtually exhausted.

There have also been relative shifts of capital (including land) from uses with below-average rates of return to more productive uses. A recent study, using real capital estimates for over 50 industry groups, found that relative shifts added 0.4 percentage points to growth during 1948-1966, and somewhat more after 1966.¹³ However, Professor Kendrick estimates that this source actually had a negative impact on productivity after 1973. In total, capital and labor mobility account for 25% of the over-all decline in productivity gains between the 1948-1966 and 1973-1977 periods.

Slowed Output Growth—The recession of 1974-1975 sharply depressed output, significantly contributing to the decline of productivity gains. Productivity growth also declined because of the loss of economies of scale as capacity utilization rates dropped. On an annual average basis, these factors slowed productivity by 0.3 percentage points during 1973-1977, compared with a *gain* of 0.4 percentage points during 1948-1966. Over-all, output-related factors accounted for more than one-third of the decline in productivity gains during 1973-1977.

Changes in Land Quality—Since the mid-1960s, productivity growth has decelerated in agriculture, while productivity actually declined in mining. The decline was due in part to capital expenditures for safety and other regulations. It also reflected some decline in the average quality of natural resources. These factors led to an average annual 0.2 percentage point reduction in productivity during 1973-1977 relative to 1948-1966.

Net Government Impact—The proliferation of government rules and regulations has increased business costs and more than offset the positive contribution to productivity from such governmental infrastructure expenditures as roads. Incrementally, capital expenditures for compliance with environmental and occupational safety and health regulations reduced productivity growth by 0.3 percentage points during 1973-1977. Because any improvements in the natural and working environments associated with this spending cannot be measured, these expenditures necessarily lower measured productivity.

¹³ See Frank M. Gollop and Dale W. Jorgenson, "U.S. Productivity Growth by Industry, 1947-1973," in *New Directions in Productivity Measurement*. (University of Chicago Press for the National Bureau of Economic Research, in press).

The Role of Capital In Labor Productivity

As noted earlier, Professor Kendrick's data explained the sources of *total* factor productivity, that is, the efficiency of both capital and labor inputs. This measure of productivity can be related to the more customary measurement—output per man-hour—by examining the role capital plays in raising the productivity of labor inputs.

The usual measure of productivity—output per man-hour—measures more than the actual performance of workers. It also reflects changes in all the various factors which help make labor more productive. Although capital works side-by-side with labor to raise output per man-hour, the role of capital is not identified in the customary Bureau of Labor Statistics productivity data.

In general, the more capital associated with each man-hour of labor input (the so-called capital/labor ratio), the greater output will be. A man using a steam shovel can dig and displace more dirt per hour than if he used an ordinary garden spade and still more than if he used only his hands.

Thus, to assess adequately the role of capital in raising output per man-hour we must have some notion of the degree to which capital and labor are combined in the productive processes. Professor Kendrick calls changes in this combination "capital/labor substitution" or the "rate of substitution of capital for labor." A higher rate means more capital associated with each hour of labor input and vice-versa. Professor Kendrick has estimated that capital substitution improved labor productivity by 0.8 percentage points during 1948-1966. During 1966-1973, however, growth of the capital/labor ratio declined as the result of the bulge in man-hours associated with the post-World War II baby boom, boosting labor productivity by only 0.5 percentage points. As the increase in man-hours subsided, capital substitution increased labor productivity by 0.7 percentage points during 1973-1977.¹⁴

The two basic factors which contribute to labor productivity—the efficiency of labor and capital and the mix of labor and capital inputs—are summarized below.

TABLE 4

	1948-1966	1966-1973	1973-1977
	(Average Annual Percent Change)		
Factor Productivity (Efficiency of Labor and Capital)	2.7%	1.6%	0.7%
Capital/Labor Substitution (Mix of Capital to Labor Inputs)	<u>0.8</u>	<u>0.5</u>	<u>0.7</u>
Output Per Man-hour (Labor Productivity)	3.5%	2.1%	1.4%

¹⁴ The improvement in the capital/labor substitution ratio in 1973-1977 reflects greater efficiency per unit of capital. In absolute terms, the amount of capital per person in the labor force declined between 1974-75 and 1977.

* * * * *

Clearly, capital plays a crucial role in raising labor productivity. Through R&D spending it provides the wellspring for technological progress; capital spending for new plant and equipment spreads cost-reducing technology throughout the economy and in combination with labor inputs, makes labor more productive.

The data also show that many of the factors which fueled productivity growth in the past—the shift of less productive farm labor to more productive non-farm jobs, the high degree of capital and labor mobility, the higher quality of land and the less unfavorable net impact of government regulation on business—cannot be expected to provide the push for higher rates of productivity growth in the coming decade.

Future gains in productivity will have to come from continued improvement in the age-sex composition of the labor force, in the quality of labor and, above all, from capital spending for research and development programs and for new plant and equipment. Naturally not much can be done to influence the age-sex composition of the labor force. But in areas of labor quality and, especially, capital spending among others, policymakers can indeed have a powerful constructive impact on productivity and American living standards.

EFFECTS OF PRODUCTIVITY ON THE INFLATION PROCESS

Some Fundamentals of Inflation

America's continuing problem with inflation reflects a disparity between ambitious social goals and relatively limited economic resources. We have sought to achieve many desirable objectives, including high levels of employment, a high degree of family security, an abundance of social services, and real economic growth. But even a country as richly endowed as the United States cannot stretch its economic resources to meet all desirable goals. Ultimately, inflationary pressures develop, and real benefits begin to evaporate.

Choices must be made and priorities set. The achievement of larger social purposes requires higher tax revenues in one form or another. Either society decides to tax itself or the hidden tax of inflation serves to limit competing claims. Once inflation gets started, it feeds on itself, and the upward spiral is difficult to stop.

Economics texts generally distinguish between "demand-pull" and "cost-push" inflation. Demand-pull refers to price rises resulting from demands which strain available supplies, while cost-push inflation results from rigidities in the markets for both labor and products which allow wages and prices to be pushed up even in an economy operating below full employment. However, categorizing the causes of inflation is in many ways artificial, since demand-pull and cost-push often interact and reinforce each other.¹⁵

Although it is impossible to define a single cause of, or a single remedy for, inflation, productivity gains can be a powerful tool in reducing inflation, no matter what its cause. However, productivity growth cannot supplant responsible monetary and fiscal policies. Prudent government spending and taxing policies contribute importantly to price stabilization. Judicious monetary policies can hold down cost-push inflation by avoiding the excessive increases in the money supply required to finance the push in wages and prices. In other words, cost-push inflation can proceed only so long as expansion of the money supply permits it. Often, however, monetary authorities fear that a tighter money policy would jeopardize the short-term maintenance of high employment. The problem here is that monetary policy that validates the cost-push process can set the stage for longer-run economic instability and inflation.

The presence of cost-push factors sometimes leads to calls for wage and price controls. To the extent that inflation results from claims on resources that are not adequately dealt with by monetary and fiscal policies, controls treat symptoms rather than causes. To the extent that a productivity slowdown fuels inflation, controls again do not come to grips with causes. A program of wage and price restraint will have a chance for success only if accompanied by prudent fiscal and monetary policies and by vigorous efforts to increase productivity growth.

¹⁵ For a discussion of the interaction of these two sources of inflation over the past decade, see Appendix IV.

Unfortunately, productivity has been largely neglected as a vehicle for reducing inflation. Productivity is an important element in the cost-push equation since it serves as a direct offset against wage-induced price rises. Two major reasons seem to be responsible for the neglect of productivity:

- The conventional analysis of productivity's role in holding down unit labor costs seems, at first blush, to offer little promise of significantly reducing inflation. If, for example, productivity were to rise by one percentage point, the initial impact on unit labor costs would be a decrease of only one percentage point, hardly an exciting prospect.
- Gains in productivity come relatively slowly and over a period of time. They provide no quick fix for controlling inflation.

How Productivity Fights Inflation

In the arsenal of weapons against inflation, gains in productivity are more potent than is generally assumed. The primary role that gains in productivity play is well understood: An increase in productivity brings an increase in aggregate supply, which holds down unit labor costs. This, in turn, brings downward pressure on the average price of goods. *But to a degree not widely recognized, increases in productivity can have "multiplier" effects on moderating inflation.* A one-unit increase in the longer-run growth of productivity can produce a more-than-one-unit decrease in the rate of inflation over a period of time.

This magnified effect of productivity gains is due to the workings of the so-called "wage-price spiral." An increase in wage-rates can push up prices; and the increase in prices can, in turn, operate to push up costs and, as a result, prices. The increase in prices once again operates to push up wage-rates which act to push up prices again — and so the spiral continues. But whenever an increase in productivity growth occurs, it will act as a more-than-one-time brake on the spiral.

Let us assume that the increase in productivity growth occurs at a point where wages are acting to push up prices. On the first round, the increase in productivity growth will moderate the wage-induced rise in prices. On the second round, by holding down the initial price-increase, the earlier productivity gain can moderate subsequent wage increases; likewise, the resulting price increase would be more moderate—and so on through each round of the spiral.

To understand more fully the role of productivity in the inflation process, one must first look at a few details of wage negotiations.¹⁶

The Wage Bargain

It is widely acknowledged that wage increases are generally composed of two main parts:

- *An increase to compensate labor for past inflation.* Indeed, with some two-thirds of negotiated wage contracts that cover 1,000 or more workers tied to cost-of-living clauses, the adjustment to past inflation tends to be built in. Moreover, contracts frequently also reflect anticipated inflation over the contract life.
- *An adjustment for labor's entitlement to perceived past productivity gains.* Workers expect their real incomes to rise and their real purchasing power to improve. Since long-run improvements in real wage rates can only come from rising productivity, this element of the wage contract generally reflects labor's and management's perceptions about average long-run productivity gains.

One observer of the economic scene recently commented on these two components of current wage settlements: "... strong unions habitually settle for nothing less than 3% (productivity offset) plus the rate of inflation ..."¹⁷ Another observed:

"These [large] unions all have contracts similar to the one pioneered by the auto workers in 1970—3% annual wage increase plus essentially full adjustment for increases in the cost of living. When increases in the cost of fringe benefits are included, these contracts produce compensation cost increases in real terms of 3% or slightly more per year. When these contracts were first negotiated, it was believed that real wage increases of about 3% were in line with the economy's ability to provide higher real wages through productivity growth. In fact, however, the 3% figure was overly optimistic . . . since 1970 productivity has been only 1.4% per year."¹⁸

The institutionalization of the long-outdated 3% productivity standard was recently remarked upon by Barry Bosworth, Director of the U.S. Council on Wage and Price Stability. He noted that:

"... many labor contracts currently call for cost of living plus a productivity improvement. The only trouble is that this formula dates from the world of the 1950s and 1960s, when we had 3 percent annual productivity increases. This economy hasn't had a 3 percent annual productivity growth in a decade."¹⁹

¹⁶ Naturally, not all wage increases are set through formal collective bargaining. Nonetheless, agreements reached in union negotiations tend to have powerful spillover effects and set patterns for the entire labor market.

¹⁷ Sam Nakagama, "Economic Perspectives," Kidder, Peabody & Co., July 28, 1978.

¹⁸ Morgan Guaranty Survey, October 1978, pages 5-6.

¹⁹ A Conversation with the Honorable Barry Bosworth, American Enterprise Institute for Public Policy Research, 1978, page 29.

Wage Increases and Productivity

Productivity gains are a direct offset to wage increases. If we assume in one case no productivity gain and in the second a 3% productivity increase, the difference in unit labor costs is 3%.

	<u>Case 1</u>	<u>Case 2</u>
Wages rise	8%	8%
Productivity increases	<u>0%</u>	<u>3%</u>
Unit labor costs will rise	<u>8%</u>	<u>5%</u>

Since labor costs are a dominant component of total business costs, it follows that in Case 1, inflation will be roughly 8%, and in Case 2, about 5%.²⁰

The following table shows that the relevant statistics bear out these illustrations and that:

- As discussed earlier, productivity improvements played a vital role in containing unit labor costs between 1955 and 1967. Thereafter, as productivity gains slackened, unit labor costs began spiraling upward.
- The rise in labor costs has gone hand-in-hand with inflation. While inflation has not always coincided exactly with rising unit labor costs, the two statistics have tracked each other quite closely.

Table 5

**Changes in Wages, Productivity, and Unit Labor Costs
in Non-Farm Business and Consumer Prices, 1955-1977**

	Compensation Per Hour Worked	minus	Output Per Hour Worked (Productivity)	equals	Unit Labor Costs	Consumer Price Index (Inflation)
	----- Annual Percent Changes -----					
1955	3.7%		4.1%		-0.4%	-0.4
1957	5.9		2.2		3.7	3.6
1959	4.4		3.7		0.7	0.8
1961	3.5		2.8		0.7	1.0
1963	3.7		3.5		0.2	1.2
1965	3.4		3.3		0.2	1.7
1967	5.8		1.9		3.9	2.9
1969	6.5		-0.2		6.7	5.4
1971	6.6		2.9		3.5	4.3
1973	7.5		1.5		6.0	6.2
1975	9.9		1.9		7.9	9.1
1977	8.3		1.9		6.7	6.5

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

²⁰ For illustrative purposes, throughout this section we have equated increases in unit labor costs with inflation, fully recognizing that (1) if non-labor costs rise faster than labor costs, price rises will be greater than indicated, and vice-versa; and, (2) in some cases, only part of the increase in unit labor costs may be passed on to customers.

Accelerating Inflation

A slowdown in the productivity growth rate during one period will ignite an inflation speedup not only in that period but in succeeding periods — even after the decline in productivity growth is halted! This relationship can best be illustrated by means of an example.

Assume that in Period 1 workers anticipate no inflation because there was no inflation in the preceding year.²¹ Labor seeks a wage increase of 3%, solely to match the perceived long-run average increase in productivity. In other words, workers expect their real incomes to rise and their purchasing power and standard of living to improve. If productivity actually rises by 3% in Period 1, the year will be inflation free.

Period 1

Assumed inflation	0%
Expected growth in real income	<u>3%</u>
Wage increase	3%
Productivity gain	<u>3%</u>
Actual inflation (unit labor costs)	<u>0%</u>

Next, assume that productivity gains slacken in Period 2, from 3% per annum to 1½%—an assumption which conforms to the reality of recent years. The wage-price spiral is quickly activated:

Period 2

Assumed inflation	0%
Expected growth in real income	<u>3%</u>
Wage increase	3%
Productivity gain	<u>1½%</u>
Actual inflation (unit labor costs)	<u>1½%</u>

Workers anticipated that purchasing power would grow at the same 3% rate as in Period 1. But because productivity dropped off, unit labor costs went up and so did prices. Hence, inflation enters the picture at a rate of 1½%. In effect, wages increase by 3%, half of which is consumed by inflation, leaving only a 1½% increase in real income. Labor is disappointed and readies new wage demands aimed at overcoming the real-income deficit.

Predictably, in Period 3, wage demands go up to 4½%. (The assumption is reinforced by the large number of labor contracts which have cost-of-living escalators built-in.)

²¹ Actually, the process could start from any base level of inflation.

Period 3

Assumed inflation	1½%
Expected growth in real income	<u>3%</u>
Wage increase	4½%
Productivity gain	<u>1½%</u>
Actual inflation (unit labor costs)	<u><u>3%</u></u>

Obviously, the windup of inflation is under way and will continue, as shown below, until something occurs to lower labor's wage demands or to raise productivity.

	Period			
	4	5	6	7
Assumed inflation	3%	4½%	6%	7½%
Expected growth in real income	<u>3</u>	<u>3</u>	<u>3</u>	<u>3</u>
Wage increase	6%	7½%	9%	10½%
Productivity gain	<u>1½%</u>	<u>1½%</u>	<u>1½%</u>	<u>1½%</u>
Actual inflation (unit labor costs)	4½%	6%	7½%	9%
	<u><u> </u></u>	<u><u> </u></u>	<u><u> </u></u>	<u><u> </u></u>

In fact, inflation would probably spiral upward more rapidly than these calculations suggest, since labor almost certainly would begin to anticipate future inflation and try to build it into wage settlements, thereby further fueling the inflation momentum.

Winding Down Inflation

Naturally, at some point labor will have to pare down its wage demands, say to 1½%, in response to the lower rate of productivity gains. Then, the rate of price increase will *level off* and the upward spiral of price rises will be broken. If that occurs in Period 8, the arithmetic would be as follows:

Period 8

Assumed inflation	9%
Expected growth in real income	<u>1½%</u>
Wage demand	10½%
Productivity gain	<u>1½%</u>
Actual inflation (unit labor costs)	<u><u>9%</u></u>

Inflation will decline below 9% only if productivity gains accelerate, say, back up to 3%.²² Assume this happens and that, at least for a time, labor demands only a 1½% gain in real wages (to match the previous plateau in productivity gains). The result is that inflation begins to unwind.

	Period		
	9	10	11
Assumed inflation	9%	7½%	6%
Expected growth in real income	<u>1½%</u>	<u>1½%</u>	<u>1½%</u>
Wage increase	10½%	9%	7½%
Productivity gain	<u>3%</u>	<u>3%</u>	<u>3%</u>
Actual inflation (unit labor costs)	<u>7½%</u>	<u>6%</u>	<u>4½%</u>

Now the process has been reversed, with the rise in productivity causing inflation to decelerate from 7½% to 6% to 4½%. Inflation will continue to wind down so long as the rate of productivity gain continues to exceed labor's expected growth in real income. When those two factors come into balance—say, 3% productivity growth and 3% expected growth in real income, inflation will stabilize at a constant rate until one of the key variables changes again.

A key question is the length of the adjustment periods; that is, how long does it take labor to adjust its wage demands to changes in productivity? Is labor able to argue for wage increases based on historic productivity changes or will labor base its real wage demands on relatively recent productivity performance? Whatever the answer, whatever the length of the adjustment period, productivity plays a key role in this entire process.

At this point in time, increased productivity can serve to help unwind a decade-long process of inflation. Whatever the specific causes—fiscal and monetary mismanagement, soaring commodity prices, the quadrupling of oil prices, dollar devaluations, excess demands, rising unit labor costs—the fact of the matter is that we are in a stage of the inflation process where both costs and wages are leaping upward. Increased productivity in these circumstances is essential to cool inflation while maintaining the nation's commitment to high levels of employment.

²² Inflation would also decline if labor agrees to accept something less than assumed inflation plus a realistic allowance for productivity growth.

POLICIES TO PROMOTE A HIGHER STANDARD OF LIVING

Accelerated productivity growth is essential if we are to come closer to achieving three of our nation's most urgent economic objectives:

- To promote real economic growth and, thereby, a higher national standard of living.
- To create a sufficient number of jobs for all those able and willing to work.
- To restrain price inflation.

Unfortunately, there is no quick way to achieve all three goals simultaneously. In the short-run, rapid growth and full employment may generate inflation—and controlling inflation may limit job creation and growth. In the longer-run, all three objectives can be reconciled through high productivity gains. Thus, a major national commitment to spur productivity would seem to be very much in order.

A Set of Economic Goals

To establish appropriate priorities for the 1980's it would be desirable to identify a series of consistent national economic goals aimed at speeding growth and job creation while restraining inflation:

- **Increase real annual growth in GNP to 4%. To achieve this will require**
- **Raising annual productivity growth to 3%. This, in turn, depends primarily on**
- **Increasing the GNP share of business investment by at least 2 percentage points over the 10% longer-term trend.**

The goals suggested are consistent and realistic. They can be achieved through the promotion of private incentives and the loosening of competitive forces.

A 4% real annual rate of growth is the highest attainable without adding to inflation. But a 4% growth rate can be achieved only if we manage to raise productivity by 3% annually—double the recent anemic 1½% rate. The arithmetic is straightforward. Man-hours worked are expected to increase 1% per year at most. For GNP to grow by 4%, therefore, an annual 3% productivity gain is required. If these goals are met by 1990, average family income will rise 32%, to \$27,000 (1977 dollars); real per capita income will increase 48%, to \$10,000 (1977 dollars); and 16 million new jobs will be created.

The task of doubling the recent trend rate of productivity gain is not an easy one—but neither is it impossible. However, it would require critical contributions in the areas of business capital investment; research and development; education and training; and easing restrictive regulations and practices.

Increases in productivity growth rates cannot be achieved overnight. Considerable time necessarily elapses between the implementation of economic policies—management decisions to step up capital investments and facilities planning—and the completion of expansion and modernization projects.

The importance of lifting the GNP share of business investment at least 2 percentage points is underscored by the Department of Commerce's findings. In a 1975 study commissioned by the President's Council of Economic Advisors, the Department concluded that business capital investment would have to rise from the 10% level of GNP maintained during the preceding 15 years to 12%, if capital requirements are to be met.²³ This substantial 2 percentage point gain will be needed merely to increase capital per worker at the *same rate* as in the previous decade, in the face of the anticipated costs of energy, environmental and safety programs. Increasing capital per worker at a *faster rate* than in the previous decade would require a still greater increase in the proportion of business capital investment to GNP.

As Federal Reserve System Chairman G. William Miller remarked:

"The Japanese economy spends over 20 percent of GNP on capital investment; West Germany 15 percent. It certainly would be appropriate for us to seek a 12 percent level."²⁴

A 2 percentage point shift in output away from consumption expenditures to investment outlays will require a fully coordinated public and private program to redirect priorities toward greater capital formation. Above all, this would require a tax climate that encourages research and development, innovation and risk investment.

Policy Options

As our study demonstrates, many factors contribute to productivity. Thus, there are no set formulas for achieving improvements. Some suggestions for policies which might be considered for inclusion in a productivity program are offered below. They are intended to provide a basis for discussion and analysis in formulating a coordinated program to spur productivity growth.

Some suggestions are as follows:

- Implement policies to increase business capital spending.
- Adopt measures to encourage savings and risk taking.
- Create incentives to spur research and development.
- Develop a national commitment to productivity improvement.
- Relax unnecessary government regulation and other restrictive practices which add to business costs and inflation.
- Improve education and training.
- Establish policies to better match job vacancies and job seekers.
- Promote economic stability.

²³ Nonresidential fixed investment averaged 9.6% of GNP in 1975-1978, and 9.8% of GNP in 1960-1975.

²⁴ Speech before the American Productivity Center's Productivity Conference, October 3, 1978, page 8.

Each of these policy options is discussed below:

Increase Business Capital Spending

Capital investment is the chief conduit for technological progress. Capital must be invested in new plant and equipment if output is to increase. Capital must be invested to move new ideas from the drawing board to the production line, and to make more efficient processes marketable.

A high degree of uncertainty about future returns on investment has reinforced business caution about committing funds for the future. This reluctance to invest has raised the minimum or "hurdle" rate of return required of new investment projects.

Many specific factors can be cited for the persistent lag in capital investment.

- Chief among these is the uncertainty created by inflation, which all too often sends costs spiraling upward faster than prices, thereby lowering profit margins. This conclusion is confirmed in a number of recent studies of rates of return after adjustment for inflation. The pernicious effects of inflation are compounded by the fact that as capital expenditures stagnate and productivity slows, further cost pressures arise which erode profits and, in turn, discourage investment and give another turn to the inflation cycle.
- Inflation also discourages capital investment by creating illusory profits in the form of phantom inventory gains and inadequate depreciation charges based on original rather than replacement costs. But when seemingly satisfactory profits are adjusted for inflation, they shrink in size. To compound the problem, corporations are taxed on book profits rather than on real profits after adjusting for price inflation. Depressed "real profits" discourage capital spending.
- The uncertain energy outlook has discouraged new investments. Higher energy costs have raised investment requirements to finance more energy efficient facilities and equipment.
- Proliferating governmental restrictions, regulations and reporting requirements have added to both costs and uncertainties.
- Over-all, supplies of new equity capital have been inadequate to support the financing requirements of needed modernization and expansion programs.

National policies to encourage business capital spending would seem to be an essential component of any responsible effort to spur productivity growth. Of extreme importance are measures to eliminate taxes on the illusory profits created by inflation. Toward that end, consideration should be given to basing depreciation allowances on replacement rather than original costs. Other policies which would encourage business capital investment include further liberalization of corporate income tax rates and the investment tax credit, and easing regulatory policies which depress corporate profits and retained earnings.

Encourage Saving and Risk Taking

Ultimately, capital investment is limited by the amount of saving that the economy generates. It is not likely that the economy can achieve a sustained 4% real growth rate if steps are not taken to raise the rate of saving. And sufficient additional savings to meet the investment needs of a high-growth economy cannot be generated without greater encouragement to *personal* saving, which has accounted for some two-thirds of net private savings over the postwar period.

However, a larger pool of personal savings is not by itself a sufficient condition to stimulate the business investment required to achieve high productivity and economic growth rates. *The extreme difficulty of raising equity capital has serious implications for increasing productivity gains in the future. Without an adequate equity base corporations will be hard-pressed to raise the long-term funds required to translate expansion and modernization plans into operating facilities.*

To provide the equity base necessary to support a high level of business capital spending, policies to stimulate saving must be fashioned in a manner which would encourage risk taking. It will be necessary, for example, to modify or eliminate tax laws which unduly discourage investment in equities. Among the prime candidates are discriminatory double-taxation of corporate income distributed as dividends (vis-a-vis single taxation of bond interest) and taxation of phantom capital gains resulting solely from general price inflation.

Capital gains taxes have particularly discouraged risk-taking: Although the recent rate changes are a step in the right direction, long-term gains are still taxed without regard to whether they are real or simply due to inflation.

The treatment of losses should be more realistic. Even now, net losses deductible against ordinary income are limited to \$3,000 a year; and only one-half of net long-term losses are deductible. Policy-makers should not be perplexed if investors continue to seek refuge in such tax havens as tax-exempt bonds.

Elimination of the double-taxation of corporate income (first under the corporate income tax and, second, when it is paid out as dividends) deserves careful consideration. The specifics of these and other components of a capital formation package can be debated; but the over-all need for investment tax modifications is clear.²⁵

Inadequate capital formation and the misallocation of capital resources are among the principal contributing factors slowing productivity growth and inhibiting living standard improvements. Determination of the best mix of tax policies to achieve growth objectives would benefit from a major study of the interrelationships among capital flows, tax policies, risk-investment, and productivity.

²⁵ Proposals to ease tax burdens on saving and investment are often rejected because of presumed negative effects on Treasury revenues. However, a recent study by Professor Martin Feldstein and Joel Slemrod (*The Lock-In Effect of the Capital Gains Tax: Some Time-Series Evidence*, National Bureau of Economic Research, Working Paper No. 257, 1978) concludes that Treasury revenues would expand, rather than contract, in response to a lower capital gains tax rate. A lower rate would induce a great increase in the sales of capital assets, and shift capital to those enterprises which are most efficient and profitable — a net plus for productivity growth.

Spur Research and Development

Greater availability of funds for business capital investment would also spur spending for research and development, the fountainhead of technological progress. Advances in knowledge gained through R&D are an integral part of the entire modernization/innovation process. New technology stimulates new plant and equipment investment programs.

As President Carter has noted, "Emphasis on longer-term research that could lead to new products and processes has decreased." This has led to fears that U.S. industry is losing its creative edge.

Professor Kendrick recently recommended that R&D be spurred in the following ways:

- Extend the investment tax credit on equipment to cover industrial R&D, as defined by the Financial Accounting Standards Board or some other body. Better yet, allow a 50% tax credit on *increases* in R&D.
- Allow accelerated depreciation or, possibly, a complete write-off in the year that R&D plant and equipment costs are incurred.
- Provide government grants on a matching basis for industry-wide R&D expenditures.
- Renew Federal support for state technical service centers and, possibly, provide loan guarantees to "lone-wolf" investors.
- Encourage the Federal Government to pursue a reasonably steady and predictable policy with respect to investment of public funds in support of R&D. A sharp cutback in Federal funding was a major reason for the substantial drop in the ratio of R&D expenditures to GNP — from 3% in the mid-sixties to 2.2% in 1977. Had the higher percentage been maintained in 1977, an additional \$15 billion would have been spent on R&D.

In addition, a major study of the impact of Federal regulations on the initiation of new research projects and on R&D spending generally, could provide useful guidelines for overhauling Federal policies to spur innovation.

Develop a National Commitment to Productivity Improvement

The President's newly created National Productivity Council, is designed primarily to improve the productivity of Federal Government agencies. Although it represents a good beginning, its limited focus permits it to address only a small part of the productivity problem.

Determined efforts at the national, regional and local levels are needed to develop and implement programs to encourage greater productivity. One possibility for enlisting active

grassroots participation might be to establish productivity councils throughout the country to assist individual business organizations in setting up their own internal productivity councils.²⁶

The government's contribution to the national effort to raise productivity might include:

- Appointment of a high-level spokesman on economic policies affecting productivity.
- Review of existing and proposed legislation, rules, regulations, and practices at all levels of government for their impact on productivity.
- Conducting productivity impact studies of proposed Federal actions.
- Conducting research studies on means of promoting productivity; and examining on a continuing basis, the sources of productivity growth and factors responsible for increasing or slowing productivity, both at macro and micro-economic levels.
- Provision of a corps of experts to consult, on request, on specific productivity problems.
- Promoting the organization of joint labor-management productivity committees to focus on the particular productivity problems of individual business and directly involve those closest to the problems.

There is no one "best" way to develop a national commitment to raise productivity growth. Whatever specific policies may be implemented should be pursued within the framework of a well-coordinated private and government cooperative effort to integrate broad programs at the national level with more closely focused regional and community programs. Success will come only if the program touches individual firms, and plants and work units within plants.

Governmental and Other Restrictions

Environmental and related governmental controls have been important factors in reducing measured productivity growth.²⁷ That conclusion does not imply that such controls are undesirable. But costs and benefits must be realistically assessed on a case-by-case basis. The benefits are better air, cleaner water, fewer accidents. The costs are more inflation, fewer new jobs, less long-term economic growth. It is estimated that some 10% of all capital investment today is spent on environmental improvements, diverting substantial funds away from productivity-improving investments.

Unrealistic government policies, however well-intended, can stifle innovation, investment, and risk-taking.

²⁶ "The individual producing organization is where the action is with regard to improving operating efficiency under given technologies and making the cost-reducing innovations required for continuing productivity advances." Kendrick, *Understanding Productivity*, John Hopkins University Press, 1977, page 121.

Some companies have begun to look more closely at the nature of productivity at the plant level, thanks to the efforts of the Houston-based American Productivity Center and similar organizations which have sprung up over the last few years.

²⁷ Edward F. Denison, *Effects of Selected Changes in the Institutional and Human Environment Upon Output Per Unit of Input*, The Brookings Institution, 1978.

In his recent anti-inflation message, the President gave particular attention to the impact of Federal agency regulations on costs. We commend such a review. Along these lines, we suggest that each new Federal rule or regulation be subjected to a separate analysis of its productivity impact.

All programs need to be evaluated at the margin. Will the benefits of new Federal restrictions and regulations more than offset the added costs of higher inflation and slower growth? Clearly formulated productivity impact studies before new rules and regulations are adopted could provide the answers.

The blame for restrictive practices which stifle innovation and create inefficiencies must be shared by all sectors of our economy—management and labor as well as government. Some examples:

- Franchise agreements in the trucking industry still prevent the transportation of goods by the shortest route. Competition in trucking remains severely limited by ICC regulations, despite recent easing of some restrictions.
- Full crew laws on railroads, setting of bogus type by printers, and other work-related limitations reduce efficiency and increase costs.
- Local building codes often hamper the introduction of innovative and cost-reducing material. Unrealistically low ceilings are set for work performance.
- Tariffs, quotas and other controls on imports of commodities of all types increase costs to consumers.

Many other examples can be cited. The objective should be to allow competitive forces to operate; to encourage the mobility of resources; to avoid restrictions on the productive use of land, labor and capital; and to minimize political impediments to productivity—whether from government, business or labor.

Business has not been above restrictive practices which deprive consumers of the benefits of greater competition. Too often competition is favored only in the abstract or for some other industry. Business sometimes lobbies for protection from competitive imports, rather than striving to compete more effectively. Practices which restrict output, pricing, innovation and investment should be curbed regardless of who is responsible for them.

Improve Education and Training and Match Jobs and People.

Human capital—The education, skills, and training possessed by people is our most important national resource. The existing work force must have adequate opportunities for upgrading skills and, consistent with other social goals, potential new entrants should be encouraged and assisted to acquire *marketable* skills and training. Of course, schools can teach useful and productive skills only if they have access to the most modern techniques and practices. More attention should be paid to on-the-job training at the workplace as a means of honing skills.

Opportunities abound for modifying work rules and for redesigning jobs so as to enhance the quality of working life and to stimulate productivity. A high degree of cooperation between management and labor will be needed to achieve these goals.

Matching Job Vacancies and People—Economic growth and productivity as well as individual well-being would benefit from efforts to more closely match the skills of people in the job market and the requirements for filling vacant jobs. Schools should be more cognizant of the future needs of the job market, and they must keep abreast of, and train students in, the latest technology. Toward that end, links between the school and the workplace could be strengthened. Cooperative work/school programs and formal apprenticeship programs could be expanded so that young workers would be better prepared to meet job requirements.

Programs might be developed to apprise workers in declining industries of new opportunities elsewhere. Retraining should be encouraged and new methods to aid in retraining older workers should be explored.

It is not uncommon to find workers with specific skills in surplus in one geographic area while those skills are in short supply elsewhere. Removing both real and psychological obstacles to the movement of people to jobs and jobs to people, would be an important spur to productivity. Professor Kendrick determined that decreased labor mobility was one of the key contributors to the slowdown in productivity growth.

Federal, State and Local Government

Perhaps even more than their business counterparts, government agencies have an obligation to measure and improve their productivity. With the public sector accounting for more than 30% of GNP, there is plenty of scope for raising national productivity levels by improving the efficiency of government operations.

In addition to direct programs for increasing individual output, government can do much to enhance productivity in the private sector by reducing paper work, simplifying regulations, and applying "strict cost-benefit principles in revising old standards and promulgating new ones as necessary . . ." ²⁸

Stable Economic Growth

Though broader monetary and fiscal policies are beyond the purview of this study, it is important to recognize that, for maximum effectiveness, specific policies to promote productivity require an environment of relatively steady economic growth.

Recessions typically make sharp inroads into productivity by idling resources and creating inefficiencies in the use of plant and equipment. Moreover, the uncertainties created by the business cycle hamper capital investment planning and create insecurity as to the future. To the extent that economic growth can be steadied and inflation restrained, the environment for investment and productivity growth will improve.

²⁸ Kendrick, Testimony before Joint Economic Committee, June 3, 1978.

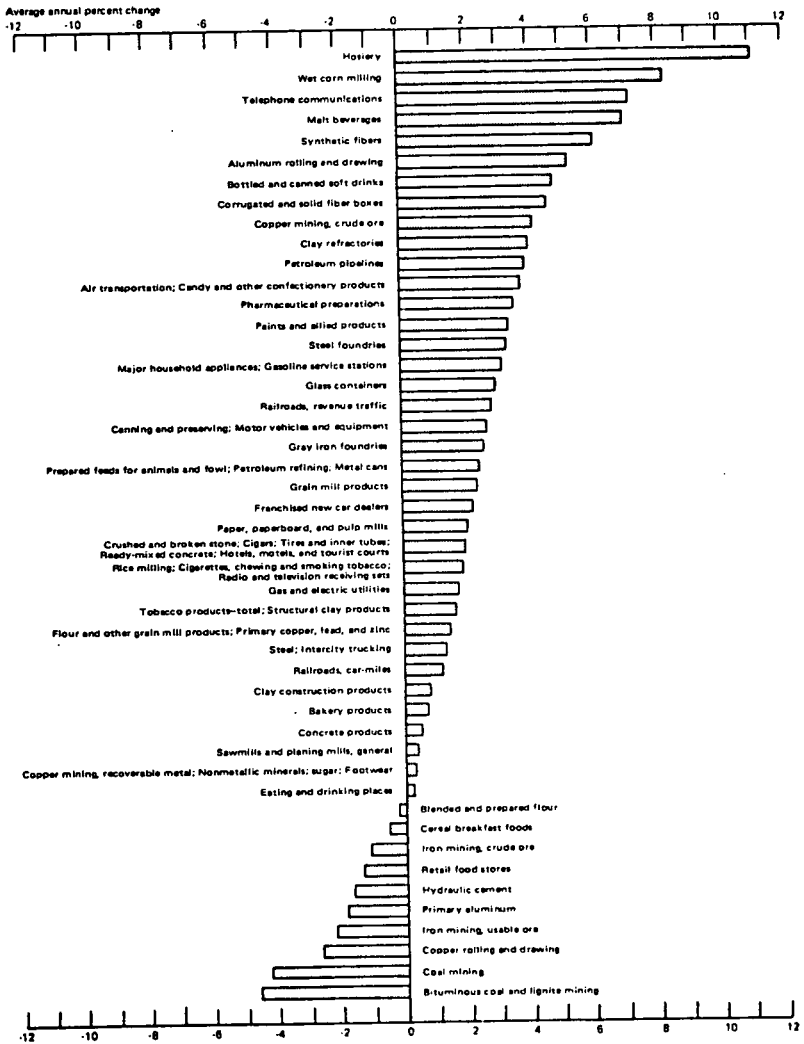
* * * * *

Our main objective in this study has been to highlight the central role productivity plays in fueling economic growth and in restraining inflation. Appropriate public and private policies can be developed to spur productivity—and this should be a high-priority national economic goal. However, a successful national productivity growth policy will also require a high degree of cooperation among government, management and labor. The effort to maximize productivity requires a major management commitment to capital investment as well as a commitment at the individual workplace and throughout the ranks of every business organization.

Only through long-run increases in productivity growth can our economy generate more jobs, less inflation, and a higher living standard for all Americans. There is no easy path. America needs a national focus which will properly place accelerated productivity growth high on our list of national priorities.

APPENDIX I

Growth In Output per Employee-Hour in Selected Industries, 1971-76



Source: Bureau of Labor Statistics. Reproduced from *Productivity Indexes for Selected Industries, 1977 Edition*, page 6.

APPENDIX II

SHARES OF OUTPUT GROWTH
(Private Non-Farm Economy)

	Productivity	Man-hours
1947-1967	79%	21%
1948-1968	78	22
1949-1969	73	27
Average	77	23
1967-1977	55%	45%
1968-1977	52	48
1969-1977	59	41
Average	55	45

Sources: Bureau of Labor Statistics; New York Stock Exchange.
NOTE: see page 9.

Estimates of Potential Employment and Unemployment, 1978-1990

	Civilian Labor Force†	Civilian Employment†	Unemployment	Unemployment Rate
 millions percent...
June 1978 (Actual)	100.6	94.8	5.8	5.8%
1979	101.9	96.1	5.8	5.7
1980	103.2	97.3	5.9	5.7
1981	104.5	98.6	5.9	5.6
1982	105.9	99.8	6.1	5.8
1983	107.3	101.1	6.2	5.8
1984	108.7	102.5	6.2	5.7
1985	109.7	103.8	5.9	5.4
1986	110.6	105.1	5.5	5.0
1987	111.6	106.5	5.1	4.6
1988	112.6	107.9	4.7	4.2
1989	113.7	109.3	4.4	3.9
1990	114.7	110.7	4.0	3.5
Avg. 1978-1990	108.1	102.6	5.5	5.1%
Avg. 1980-1990	109.3	103.9	5.4	5.0%

Source: Bureau of Labor Statistics, NYSE.

†Assumptions: (1) Civilian labor force growth: 1978-1984 = 1.3% per year; 1985-1990 = 0.9% per year (see page 13).
(2) Civilian employment growth: 1978-1990 = 1.3% per year (see page 13).

APPENDIX III

SOURCES OF GROWTH IN REAL GROSS PRODUCT
U.S. Domestic Business Economy

	(Selected Subperiods 1948-1977)		
	1948-1966	1966-1973	1973-1977 ^p
	(Average Annual Rates of Change)		
Real Gross Product	3.9%	3.5%	2.0%
Factor Input — Total	1.2	1.9	1.3
Labor	0.4	1.4	0.6
Capital	2.7	2.9	2.6
Real Product Per Unit of Labor	3.5	2.1	1.4
Capital/Labor substitution	0.8	0.5	0.7
Total Factor Productivity	2.7	1.6	0.7
Sources of Total Factor Productivity Growth:			
	(Percentage Point Contribution)		
Advances in Knowledge	1.4	1.1	0.9
R&D Stock	0.85	0.75	0.7
Informal	0.3	0.25	0.2
Rate of Diffusion	0.25	0.1	—
Changes in Labor Quality	0.6	0.4	0.7
Education & Training	0.6	0.7	0.7
Health	0.1	0.1	0.1
Age/Sex Composition	-0.1	-0.4	-0.1
Changes in Quality of Land	—	-0.1	-0.2
Resource reallocations	0.8	0.7	0.3
Labor	0.4	0.2	0.1
Capital	0.4	0.5	0.2
Volume Changes	0.4	0.2	-0.3
Economies of Scale	0.4	0.3	0.2
Intensity of Demand	—	-0.1	-0.5
Net Government Impact	—	-0.1	-0.3
Services to Business	0.1	0.1	0.1
Regulations	-0.1	-0.2	-0.4
Actual/Potential Efficiency, and n.e.c.	-0.5	-0.6	-0.4

p = preliminary; n.e.c. = not elsewhere classified.

Source: John W. Kendrick, George Washington University, based in part on estimates by Edward F. Denison, *Accounting for United States Economic Growth, 1948-1969* (Brookings, 1974) and an article in the January 1978 *Survey of Current Business*.

APPENDIX IV

THE INTERACTION OF DEMAND-PULL
AND COST-PUSH INFLATION IN RECENT YEARS

Recent economic history demonstrates the intricate interrelation between demand-pull and cost-push inflation.

The current "inflation era" was given major initial impetus by the surge in government spending associated with the buildup of the Vietnam War and the Great Society programs of the 1960s. This spending buildup occurred at a time when the economy was already operating at close to full employment. The results were large Federal deficits and a classic case of demand-pull inflation.

But as government expenditures escalated and demand pressures grew, price increases began to accelerate—from 2% in 1965, to 3% in 1966 and 1967, and to 4½% in 1968. By 1969, wage demands reflected these price rises, as well as the customary demands for additional wage increases to improve living standards. Cost-push inflation was underway.

The 1969-1970 recession coupled a decline in the level of output with continued price escalation as labor sought wage increases to keep up with and even get ahead of mounting inflation. In August 1971, the President instituted Phase I of wage and price controls.²⁹

1973 was a watershed year in the history of inflation in the U.S. Commodity and food prices soared, interest rates went through the roof, and the oil embargo began. Together with the effects of two separate dollar devaluations and declining U.S. productivity, 1973 saw prices jump by 8%. With so many shocks to the system, inflationary expectations intensified. The term "double-digit inflation" entered the lexicon.

Despite the worst recession since World War II, prices rose by 12% in 1974 and by another 10% in 1975. These continuing price rises were fueled primarily by the combination of actual declines in the level of productivity for six consecutive quarters and persistently high increases in compensation per man-hour which exceeded 9% in 1974 and reached nearly 10% in 1975.

Rebounding productivity gains offset some of the rise in unit labor costs in 1976, but 1977 productivity slowdowns sparked further sharp rises in unit labor costs and prices. As this was happening, the unemployment rate began to fall toward a level which many economists would consider close to full employment. Thus, demand-pull factors strengthened and reinforced the inputs of cost-push inflation.

The push-pull of inflation has continued into 1978. Near double-digit compensation increases, coupled with declining productivity gains, have pushed prices up at still faster rates, with little relief in sight. At the same time, some tightness has developed in the skilled and experienced labor force and production bottlenecks have begun to appear.

This history illustrates the interaction between demand-pull and cost-push forces. Prices

²⁹ By 1971, unit cost pressures had actually begun to ease (as it turned out, temporarily) as robust productivity gains offset persistent wage demands. Price rises dipped below 3% per annum in the third quarter of 1971. Thus, as Phase I of wage-price controls was instituted, increases in productivity had already begun to slow the upward spiral of prices. In 1972, inflation ran at only a bit over 3%, due more to continued strong productivity gains than to Phase II of the control program. The 1971-1972 experience strongly suggests the potential of productivity gains as a policy instrument for curbing inflation.

have risen at times in response to peak demands. In turn, wages have increased as labor as sought not only to maintain, but to increase, purchasing power. Over-all, unit labor costs and prices have spiraled upward without full-employment output.

Demand-pull and cost-push inflation, therefore, cannot be separated into two neat boxes. Because they constantly interact with and fuel each other, an array of economic policies is essential to control them.

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Senator JAVITS. It says on page 22—do you happen to have a copy?

Mr. SCHULTZE. Not with me. I have just been handed one.

Senator JAVITS. I think it would be useful if you read it with me.

On page 22, in the middle of the page, about the third sentence, italicized:

But to a degree not widely recognized, increases in productivity can have "multiplier" effects on moderating inflation.

Then you need to move on to the basic points, and I am skipping a lot of the material before you.

Page 27, at the very bottom of the page, reads:

At this point in time, increased productivity can serve to help unwind a decade-long process of inflation. Whatever the specific causes—fiscal and monetary mismanagement, soaring commodity prices, the quadrupling of oil prices, dollar devaluations, excess demands, rising unit labor costs—the fact of the matter is that we are in a stage of the inflation process where both costs and wages are leaping upward. Increased productivity in these circumstances is essential to cool inflation by maintaining the Nation's commitment to high levels of employment.

The fundamental thesis, and I don't want to trouble you to read any more, because I think you get my point, is that the study claims that wage increases cause prices to move up, and then wages move up in sequence. Once that process has started is when we begin stagnant productivity, and it multiplies.

You don't stop the process when productivity begins to increase. You may moderate the inflation process, but in order to really reverse the trend, it takes a period of time to work itself out.

I would hope, and I see my time is up, but I would hope, Mr. Schultze, that either now, or whenever you wish, you would analyze that, because I think that study is critical to policy changes here in Congress and to policy choices of the Government.

Mr. SCHULTZE. I would be glad to give it more careful analysis for the record, Senator.

Let me note that increasing the rate of productivity growth does have more than an immediate impact on the rate of inflation precisely for the reasons indicated. Other things which moderate inflation also have second and third round impacts.

Growing productivity has an additional impact in that it raises real living standards as well as simply reducing the rate of inflation, so I don't disagree with that basic thrust, but I would like to look at it more carefully.

Senator JAVITS. Thank you.

May I have permission that the hearing record remain open for whatever Mr. Schultze produces for us?

Senator BENTSEN. I think it would be very helpful to us.

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

The rate of increase in prices would be moderated in two ways by a more rapid increase of productivity. Most directly, higher productivity would lower the rate of inflation because it would moderate in the rise in unit costs of production. The New York Stock Exchange paper, as well as various sections of this year's Economic Report make this point. To the extent that higher productivity lowers inflation, there will be beneficial secondary effects as inflationary expectations are reduced and wage and other income demands are moderated.

The NYSE paper presents an example of one way in which this could happen. In their example, expectations of increases in real income do not change with the assumed improvement in productivity. As they recognize, real income expectations would eventually adjust upward, but in the interim, a significant anti-inflation benefit would accrue.

Almost anything we can do to lower inflationary expectations will help to brake the momentum of inflation and ease the process of deceleration in future periods. Our present need is to create an environment in which price and wage increases could reasonably be expected to moderate, and to set standards of behavior that are consistent with a modest but significant braking of the momentum of inflation. Chapter 2 of this year's Economic Report sets out in detail the administration's near term policies to achieve this objective.

Senator BENTSEN. Mr. Schultze, one comment.

I was reading an article by Mr. Costello, of the EPA, talking about the Clean Air Act, and I am a member of the Committee on Environment and Public Works, and when he was asked the question of the cost of accomplishing these things, he said the question of cost is not germane, because the law does not provide for any consideration of the cost.

Well, that is a little outrageous, and I am not blaming him. I am blaming us. But in trying to do something about the regulatory costs, and let me say very clearly that many, many regulations are meritorious, they are needed, and we want to accomplish some of these objectives, but many of the regulations are not the most economical way of accomplishing the objective.

I have introduced legislation, and Congressman Brown joined me in that. We are trying to find a way to establish a regulatory budget for agencies on how much they can spend. Some of us think it is time we place limitations on how much they can spend.

What do you think about the possibilities of devising a regulatory budget?

Mr. SCHULTZE. I was trying to find that section, Senator. You will be pleased to note that we discuss that subject, not greatly, but with some care, in one of the chapters of the Economic Report.

It is a subject that is hard to comment on, except at length.

First, it is true that in the regulatory area, we do not have a sense of overall priorities. We are trying to improve this in looking at the economic content, costs, as well as benefits of individual content. We are taking the first step of trying to put this in perspective.

The President has set up a regulatory council, which will for the first time set a regulatory calendar and give us an overall grasp of what the impact of the regulations are likely to be. That is the first step.

Through that process, we will look at the overall effect on different sectors of the economy. It is, as I said, a first step. It is a process that is going to have to be worked through very, very carefully, because while you are exactly right in one sense, that we have no analogous process as set by the budget, if we begin to think through what it would mean to do so, then you begin to realize that while it is a process that we surely ought to begin, it is a process that we will have to approach with great care and caution, not just because of the substance of it, because you begin to think through the relations of the executive and the Congress on the budget as well as through regulations, and they are not analogous at all.

At this stage, I am not giving any answers, except to say that the basic thrust of what you are saying is right. We have taken a basic step, or a little more than that. It is a step in that direction. It is something we will have to develop as we go.

Senator BENTSEN. We want to find a way to achieve the social gains at nominal cost, and you state that in your report, and we are in full concurrence, but you have to find some kind of a limitation that will work automatically, or it just won't be done.

Hopefully, we will work together to develop some kind of a regulatory budget to accomplish that.

Thank you very much, Mr. Schultze.

The committee stands recessed.

[Whereupon, at 12 noon, the committee recessed, to reconvene at 10 a.m., Tuesday, January 30, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 30, 1979

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

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Proxmire, McGovern, Javits, McClure, and Jepsen; and Representatives Reuss, Mitchell, Brown, and Heckler.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, William R. Buechner, Thomas F. Dernburg, L. Douglas Lee, Deborah Norelli Matz, and Paul B. Manchester, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

We are pleased to welcome the very distinguished Chairman of the Federal Reserve, Hon. G. William Miller, to this morning's session of the Joint Economic Committee's annual hearings.

Mr. Miller, I think you would agree that two currently dominant characteristics of the economy are tight money and high rates of interest.

The basic question I have for you today, Mr. Miller, is when this combination of high interest and tight money is finally going to impact on the housing industry? I recognize, of course, that the housing industry has been insulated from tight money problems by the new variable interest certificates available at savings institutions.

I know that since the last crunch we had in 1973 and 1974 when housing starts went down to, as I recall, something less than 700,000 housing starts, that we have had quite a change in the way that the savings have flowed into savings institutions. Bundles of mortgages are now being put together and variable interest rates have come into use.

The variable interest certificates may merely mask a larger, deeper problem since they do not actually increase the overall supply of credit. Funds that in the past would have been drained away from the housing market are simply diverted from capital spending.

Mr. Miller, we look forward to your testimony.

STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MILLER. Thank you very much, Mr. Chairman.

With your permission, I think it might be useful merely to submit my prepared statement for the record so I can address the issues that are of more direct interest to members of the committee. I can respond now to the questions you have asked about housing and the mix of policy, if that would be satisfactory.

Senator BENTSEN. Mr. Miller, you have something in particular on structural unemployment, do you not?

Mr. MILLER. Yes, I also have a paper and some comments to make on structural unemployment and programs that might be addressed to it. With your permission, if we discuss that today, I can submit the paper for the record.

Senator BENTSEN. That will be fine.

Mr. MILLER. Mr. Chairman, the questions you have raised about housing, capital spending, and capital productivity, are critical, of course.

In implementing monetary policy over the past year, while moving toward restraint in order to lower the level of economic activity and thus bring about conditions for wringing out inflation, one of our objectives has been to create that restraint and that dampening of economic activity on a balanced basis. The authorization for thrift institutions to issue 6-month certificates at rates equal to the rates which would apply on 6-month Treasury bills has permitted the housing industry to compete for funds, as you point out. Overall availability of credit has been restrained but the competition for that credit has been more balanced this time than it was in the last economic cycle.

At the end of 1972 the housing starts were running at a 2.5 million annual rate. Because of the massive disintermediation at that time—due to the limitation on interest rates that could be paid by thrifts while higher interest rates prevailed in money market instruments—housing dropped precipitously, so that, by the last quarter of 1974 it reached a level equal to an annual rate of about 900,000 starts.

That was not a recession in housing, but truly a depression, that depression led to considerable hardship and unemployment. Many firms who were engaged in homebuilding were unable to survive, and the result was considerable distress and an aftermath of costs to the housing industry that we still are suffering from. Once you dismantle an industry, particularly a highly cyclical industry, and because of the tremendous penalties that take place in down cycles, starting it up again obviously increases overall costs.

It was for that reason that the regulatory agencies felt that, in this economic cycle, as the economy was restrained, we should allow the housing market to have a fair opportunity to compete for funds. That of course, is what has happened, and housing has been maintained.

To the extent that that increased competition for funds has meant that credit was less available in other sectors, there has been more restraint in other sectors. But, nonetheless, the overall result has been one of considerable balance. We have implemented monetary policy not only to seek balance, but in a smooth way, so as not to create shocks and dislocations that would send the economy into a tailspin.

The mix of policies that you mentioned is critical. There is no doubt that the changes of policy in the last year are very promising.

One change has been the redirection of fiscal policy. A year ago, the contemplated financial plan for the Nation involved a Federal deficit of \$60 billion in fiscal year 1979. Congress and the President, in the face of accelerating inflation, elected to change that direction and to apply more austerity to fiscal policy. They reduced that proposed deficit to \$38 billion, a very commendable redirection of policy. The continuation of that trend from higher deficits toward balance—we will have a deficit of less than \$30 billion in fiscal year 1980—is movement in the right direction. That policy shift has created conditions where we can expect a better mix of fiscal and monetary policy in the period ahead. Continued reduction in Federal spending stimulus would take the pressure off of monetary policy and allow us to proceed through this period with lower economic activity, but without the distortions or the amplitude in cycles that we have experienced in the past; this is encouraging.

Monetary policy, by imposing a posture of restraint, has been successful in beginning to reduce the growth of the monetary aggregates. As seen in the charts that have been attached to my prepared statement, the growth of those aggregates is now beginning to fall within the longer term ranges that the Federal Reserve has felt appropriate to the degree of restraint needed in the economy.

Mr. Chairman, you may like to proceed in a different order. At the appropriate time, I would like to make a few comments about structural unemployment, but perhaps at this point you would like to stick with questions on fiscal and monetary policy.

Senator BENTSEN. I am sorry, I just can't hear you.

Mr. MILLER. I am sorry. Is this better?

Senator BENTSEN. That is better.

Mr. MILLER. I apologize; I hope that I have not been as unintelligible as usual.

Senator PROXMIRE. We heard most of it. We are glad we did.

Mr. MILLER. I should have had the microphone up closer.

I was saying that we can continue with fiscal and monetary issues at this point, and discuss the unemployment situation at some other point in the proceeding, if you prefer.

Senator BENTSEN. That will be fine, Mr. Miller.

Senator JAVITS. Mr. Miller, may I suggest, some of us may not be here so I think maybe, if I may respectfully suggest, you ought to get your whole message across then we can ask questions on everything.

Senator BENTSEN. Let me inquire of the members, is that all right with the rest of you?

Senator PROXMIRE. Fine.

Representative MITCHELL. Sure, fine.

Senator BENTSEN. All right. Then go ahead.

Mr. MILLER. Let me make a few comments about structural unemployment then.

In the overall management of our economy, we have generally and historically followed a policy of dealing with its macrocharacteristics. This macro policy can, of course, contribute to resolving unemployment issues to the extent that unemployment comes about from cyclical conditions. But monetary or fiscal policy alone cannot deal with

the more pervasive problems of structural unemployment which results from conditions other than the cyclical nature of the economy. If we are to deal with structural unemployment, it seems likely that we must find targeted programs to address the problem rather than rely upon macropolicies.

The benefit of targeted programs is not only in reduction of unemployment. There is an additional payoff to the economy in the form of reducing social hardship and, in the long run, from increasing productivity, which is so essential if we are going to break the cycle of wages and prices chasing each other during this period of high inflation.

The approach that undoubtedly needs to be taken is to find targeted programs that do address, explicitly, the problem of the quality of the work force. Targeted programs that only temporarily park those who are not fully participating in the economy are only palliatives, whereas, what we need to do first is to address the fundamental issue of the quality of the work force or the work training of individuals.

Second, we need to be sure that we are preparing people in the skills that are needed in the economy and not teaching skills that are obsolete or not in demand. Otherwise, we will create the disappointment of unfulfilled expectations.

Third, we need to couple these actions with an effective program of placement. We not only have to upgrade the skills of individuals and upgrade them in areas where they are needed, but also see that people flow into permanent jobs.

My experience in business involved a number of these programs; I think most of you are aware of these activities. I might point out that there are some fundamental causes for and characteristics of hard-to-employ Americans, and we need to look more at these causes in order to be sure that our programs address realities and that we are making progress.

One of the problems is that we have changed from a rural economy and a rural society into an urban one. Young people also have lacked exposure to the world of work; they are not familiar with what it is that working adults actually do. For both these reasons, we have had a very difficult time linking up the knowledge and experience of young people with the real world of work and with opportunities for work. The linkage has been very weak, indeed.

So we need to be sure that we expose youngsters, when they are still in school—very early—to the potential careers that exist. They will then begin to make the choices in life that motivate them to self-help and to preparation for careers.

One such possibility has been experimented with in the private sector, and that is programs that relate particular businesses to particular schools, often referred to as "adoptive school programs." If carried out on a much wider scale, this program has the potential for exposing large numbers of young people to the world of work, so that they can see the new skills that they are not familiar with—computers, certain professional services—and areas that are expanding and are more likely to offer opportunities for them.

We also have the problem of the boredom that hits many youngsters today in their school years. As they become less motivated to carry out their studies, we also need, I think, greater and greater numbers

of work study programs, again so that they can be given exposure to the real world of work at an early age.

More recently, there have been some developments in Federal programs that are worth pursuing. One has been in CETA title VII, the Comprehensive Employment and Training Act program that deals with private sector opportunities for the economically disadvantaged. Here, one of the critical ingredients has been the development of the concept of local, private industry councils that involve the local business in the community, the local educators, and local labor leaders where the job opportunities exist. Many of the jobs that are available for young people exist in smaller enterprises. Some of the larger training programs have been difficult to implement in smaller companies.

These new programs to create private sector opportunities, rather than public sector opportunities, are very encouraging. The last Congress approved this concept and did authorize funds for carrying on the program, but appropriations were not approved. One of the urgent needs this year is for Congress to proceed to act on the supplemental request for \$400 million to carry out this program.

It is also important that we look at the hard-to-employ, not just the young people, but in the context of all of the impediments to obtaining jobs.

The tendency, at times when the economy is weak, is to provide public service jobs as a solution. That is very helpful in terms of the immediate alleviation of economic hardship, but in the long term—as far as the possibility of permanent employment and progression—it is important that efforts in the private sector, and linkages from school to work or from public employment experience to private employment, be strengthened.

One of the organizations that has been working on this for some time, as you know, is the National Alliance of Business, which is organized to help in private sector initiatives. But there has also been considerable work done by the National Manpower Institute, which has been creating experimental education work councils around the country to speed up this process of linking up the needs of young people with job opportunities.

Another program that has been pursued more recently, approved by the Congress, is the employment tax credit. Initially, there were some limitations, but the program was broadened in the last Congress. We do not know what extent this effort will be effective, but I certainly would commend your actions which create self-implementing systems; employers are reimbursed and thereby encouraged to find jobs for those who are hard to employ. By meeting the qualifications for tax credits, their burden of training and of introducing these youngsters or adults with low skills into the work force is eased.

Because the problem of structural unemployment exists so heavily among the young and particularly among young blacks in urban areas, I think we ought to reconsider the issue of the minimum wage and its effect upon opening up opportunities for young people.

A couple of years ago Congress narrowly defeated a proposal for a youth differential in the minimum wage that would have set a lower minimum for initial period of work experience as an incentive for employers to hire young people who need experience before they can contribute fully to an enterprise.

I hope this is not legislation whose time has passed; it may be something that should be reconsidered. The problem is going to continue to be with us. The numbers, however, are manageable. Teenage unemployment is one of our most serious problems; the overall rate of unemployment among teenagers is about 16 percent. But that rate of unemployment could be substantially reduced and the problem could be significantly solved if we could provide job opportunities for some 500,000 young people. That is a manageable number. I believe if we can combine more linkage programs between school and work, and more skill training and job opportunities in the private sector, with more economic incentive for employers to reduce the barriers to job experience—and if we can expose young people earlier to potential careers—substantial progress can be made.

I would like to elaborate on these general comments by submitting a paper to you, Mr. Chairman.

Senator BENTSEN. That will be fine.

Does that complete your prepared testimony at this time?

Mr. MILLER. Yes; indeed, sir.

[The prepared statement of Mr. Miller, together with a paper entitled "Programs To Reduce Structural Unemployment," follows:]

PREPARED STATEMENT OF HON. G. WILLIAM MILLER

Mr. Chairman, members of the Joint Economic Committee, I appreciate the opportunity to participate on behalf of the Federal Reserve Board in your annual hearings on the state of the economy. We find ourselves at an important juncture in our Nation's economic progress, a time when patience and persistence are needed until the nation's anti-inflationary economic policies begin to achieve significant results.

The current expansion in economic activity has now almost completed its fourth year—an impressive performance by historical standards. The rate of economic growth moderated somewhat in the past year, yet employment gains were exceptionally large, and major imbalances generally associated in the past with a maturing business expansion did not materialize. There were, however, a number of disturbing developments. In particular, the rate of inflation, already far too high, accelerated further, the foreign exchange value of the dollar declined substantially prior to November, and the level of consumer debt rose sharply.

Outlays for business fixed investment grew strongly in 1978, and housing activity remained at a high level through the year-end. Consumer spending, buttressed by further large increases in consumer credit, continued to provide support for the expansion. Total employment rose by more than 3 million persons during the year; although the labor force also increased rapidly, the unemployment rate declined about ½ percentage point to just under 6 per cent at year-end.

The further expansion in economic activity last year appreciably reduced the margin of unutilized resources in the economy. Skilled workers were in increasingly short supply, and industrial capacity utilization rates moved closer to peaks reached in recent cycles. In these circumstances, the moderation in economic growth last year was a desirable development since a more rapid rate of expansion in aggregate demand could well have exacerbated our already serious inflationary problems.

The general level of prices rose sharply in 1978, with the rate of inflation accelerating to about 8¼ per cent compared with 6½ per cent in 1977. While the moderation in the pace of economic expansion and the lack of significant distortions in major sectors of the economy augur well for the economy's further expansion in the months immediately ahead, the longer-run performance of the economy will depend critically on our success in bringing down the rate of inflation.

Containment of inflationary pressures in our domestic economy is also a major prerequisite for strengthening the dollar in foreign exchange markets while reducing our trade deficit. In 1978 the deficit was about \$35 billion, on an international accounts basis, and the value of the dollar against major foreign currencies fell 17 percent over the first 10 months of the year. Since November 1 when new domestic monetary policy actions and dollar support measures were initiated,

the dollar has risen about 7 percent. The vigorous implementation of the support program through cooperative exchange market intervention has been successful. The expansion of Federal Reserve swap arrangements and the marshalling of other resources have proved very useful in correcting the excessive decline of the dollar. However, the longer-run strength of the dollar will depend on reducing our domestic inflation, increasing our exports, and curbing our oil imports.

Another worrisome aspect of our economy's performance has been our lagging rate of productivity growth. The poor performance of productivity has retarded the rise in living standards and aggravated the inflation problem. There are many causes of this retarded growth, some of which hopefully reflect temporary developments, but tax policies that pay insufficient attention to investment incentives and government over-regulation must rank high among the contributing factors.

In domestic financial markets, conditions have tightened considerably over the past year. Since the beginning of 1978, short-term interest rates have increased 3 to 4 percentage points; mortgage rates about 1½ percentage points; and bond yields about 1 percentage point. Despite higher interest rates, funds for credit-worthy borrowers have remained in ample supply. The total volume of net funds raised in credit markets was lower in the second half of 1978 than in the first half, but total credit flows remained large as borrowing by households in the form of mortgages and installment credit continued to expand at a rapid rate.

The acceleration of inflation over the past year has required major adjustments in economic policies. In the fiscal policy sphere there has been a dramatic movement toward tighter control over government spending and a related reduction in current and prospective Federal deficits. The deficit specified for fiscal 1979 in the First Concurrent Budget Resolution was \$60 billion, but this was cut to \$39 billion in the Second Resolution. This very impressive reduction was a result of highly commendable actions by the President and the Congress that cut contemplated expenditures and moderated proposed tax reductions incorporated in the original financial plan for the year. More recently, President Carter has announced a budget for fiscal 1980 that would reduce the yearly deficit further—to \$29 billion, by far the lowest level in 6 years. There seems to be widespread support for this, initiative, and the prospects favor a further move toward budgetary balance in fiscal 1981 and actual balance by fiscal 1982, if not before.

A second policy initiative in the fight against inflation was the Administration's introduction on October 24 of a broad-based program calling for voluntary moderation in wage and price actions, the establishment of specific standards for wage and price increases, and the offer of various incentives for compliance. Past experience has suggested that incomes policies are of limited effectiveness in reducing the underlying rate of inflation. Yet, an incomes policy can play an important role in circumstances where more basic economic policies are being re-directed in a vigorous way toward the containment of inflation. I am confident that most business and labor leaders will abide by the spirit of an incomes policy if they perceive that the Administration, the Congress, and the Federal Reserve are truly determined to bring inflation under control.

Monetary policy also moved toward increased restraint in the past year as the Federal Reserve sought to foster financial conditions that would contribute to a reduction of inflationary pressures while supporting continued moderate economic growth. Accelerating inflationary pressures were accompanied by rising demands for money and a tendency for the monetary aggregates to expand at rates that were widely viewed as excessive. In the circumstances open market operations became progressively less accommodative in the provision of reserves and the Federal funds rate rose from around 6½ per cent in early January to about 10 per cent recently. The discount rate was increased in a number of steps by 3½ percentage points during 1978, to 9½ per cent. These anti-inflation moves featured actions taken on November 1 in conjunction with the dollar-support program: the System announced a one percentage point increase in the discount rate, imposed a two percentage point supplementary reserve requirement on large-denomination time deposits, and further tightened reserve availability through its open market operations.

Growth in the narrowly defined money stock, M-1, slowed sharply in the final quarter of 1978. The cumulative impact of rising short-term interest rates has undoubtedly helped to restrain the growth of money. But recently, the public has shown a tendency to economize more than might have been expected on their holdings of cash balances. Persisting high levels of short-term rates and the availability of alternative transactions-type accounts, such as the new savings accounts with an automatic transfer feature, have probably caused many depositors to shift

sizable amounts of funds out of demand deposits. Expansion in the broader measures of money, M-2 and M-3, also moderated late in the year, reflecting not only the sluggish performance of their M-1 component but also the weakness in time and savings accounts subject to fixed-rate ceilings.

Rising yields on competing market instruments tended to make such accounts increasingly less attractive as the year progressed. In contrast, time deposits paying interest rates competitive with those on market instruments have continued to attract sizable inflows of funds to banks and nonbank thrift institutions.

The tightening of financial conditions has been accompanied by erosion of liquidity positions in various sectors of the economy. Mortgage and consumer debt burdens rose sharply in 1978 and the ratio of mortgage and consumer debt repayments to disposable income reached a record high. Borrowing by nonfinancial corporations was concentrated heavily in short- and intermediate-term liabilities, especially bank loans and commercial paper, and the ratio of short- to long-term business debt is now only slightly below the 1974 peak. Commercial banks have reduced their holdings of U.S. Government securities and increased their use of interest-sensitive liabilities such as large-denomination CD's and security repurchase agreements. Savings and loan associations have borrowed a record amount from Federal Home Loan Banks. The reduced liquidity of many individuals, business concerns, and financial institutions is likely to exert a moderating influence on credit-financed expenditures.

It should be emphasized that the much needed firming in credit market conditions has not been accompanied by the severe strains and distortions associated with past periods of credit restraint. Current interest rate levels may be inhibiting some potential borrowers, which is the objective of credit restraint, but credit-worthy borrowers continue to find funds available at prevailing rate levels. The housing market in particular has continued to attract a relatively abundant share of financing, though at rising interest rates. A key factor in this development was the introduction in June 1978 of new 6-month money market certificates that have enabled depository institutions to attract funds by paying prevailing market interest rates. In addition, housing has been supported by the lending activities of the Federal Home Loan Banks, the emergence of new mortgage-related securities, and the improvement of secondary markets for mortgages. The net increase in mortgage debt in the fourth quarter of 1978 was only a little below the record increase in the fourth quarter of 1977.

Mr. Chairman, you have asked me to assess the economic outlook. The major threat to the economy is inflation and the concomitant expectations that dominate the setting of prices and wages. Thus, any weakening in our anti-inflationary resolve could seriously damage our domestic economy and have adverse implications for the external value of the dollar.

Policies of fiscal and monetary restraint—together with the cooperation of business and labor in the Administration's wage-price program—can achieve a gradual reduction in the rate of inflation, with progress becoming evident during 1979. While growth of output and employment is expected to slow this year, a recession is unlikely in the absence of outside disturbances to the economy. A moderate rate of economic growth is likely to avoid financial and economic dislocations, such as overinvestment in business inventories, which in turn could foster a recession later. The economy is already quite close to full employment and any new surge in demand must be prevented since it would only be translated into more inflationary pressures.

Spending by consumers, a mainstay of our economic expansion since the spring of 1975, will probably continue to grow but at a reduced pace in light of the increased consumer debt burdens noted earlier. Expenditures on new plant and equipment by businessmen seem likely to be well maintained and they may even increase more than is currently anticipated if visible progress is perceived in the fight against inflation. In the housing area, some decline from the current high level of activity seems probable as financial restraints exert a retarding influence on both builders and homebuyers. Nonetheless, the severely depressed conditions that have periodically affected this sector of the economy will most likely be avoided. Adequate financing will continue to be available thanks to the wide range of government support programs and the access of home-lending institutions to market sources of funds such as the new 6-month certificates. Prospects for our trade balance in 1979 also seem to be brightening.

In your letter inviting me to these hearings, Senator Bentsen, you have asked for comments on the appropriate mix of fiscal and monetary policies. In the area of monetary policy, the restraint that has been put in place is achieving welcome results in the form of a reduced rate of monetary expansion. As may be seen from charts 6 to 8, the monetary aggregates have generally moved into the ranges set by the Federal Open Market Committee. The Federal Reserve is determined to achieve a rate of monetary growth that is consistent with the objective of fostering a decline in the rate of inflation while encouraging moderate economic expansion. The Federal Reserve's task will be eased immensely if fiscal policy remains on the course outlined by the President. Large budget deficits tend to put upward pressure on interest rates as Government demands compete with private demands for funds. It is therefore essential for the Congress to resist programs that lead to increased expenditures. A reduced Federal deficit, including borrowings by off-budget agencies, would ease pressures on interest rates and allow the Federal Reserve to achieve its monetary growth objectives at lower interest rates than otherwise. A reduced budgetary deficit would also foster a financial environment that encourages greater business investment and would improve the prospects for a period of sustained economic growth and a moderating rate of inflation.

Chart 1

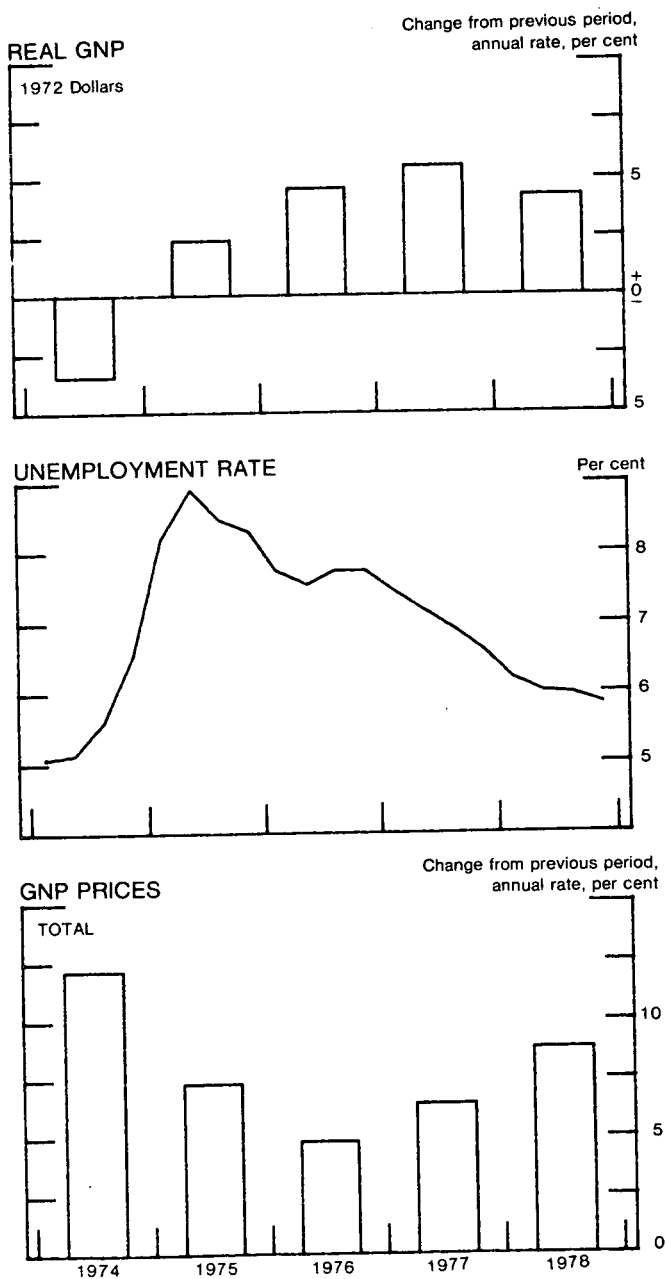


Chart 2

COMPONENTS OF FINAL SALES

Trough, 1975 Q1 = 100

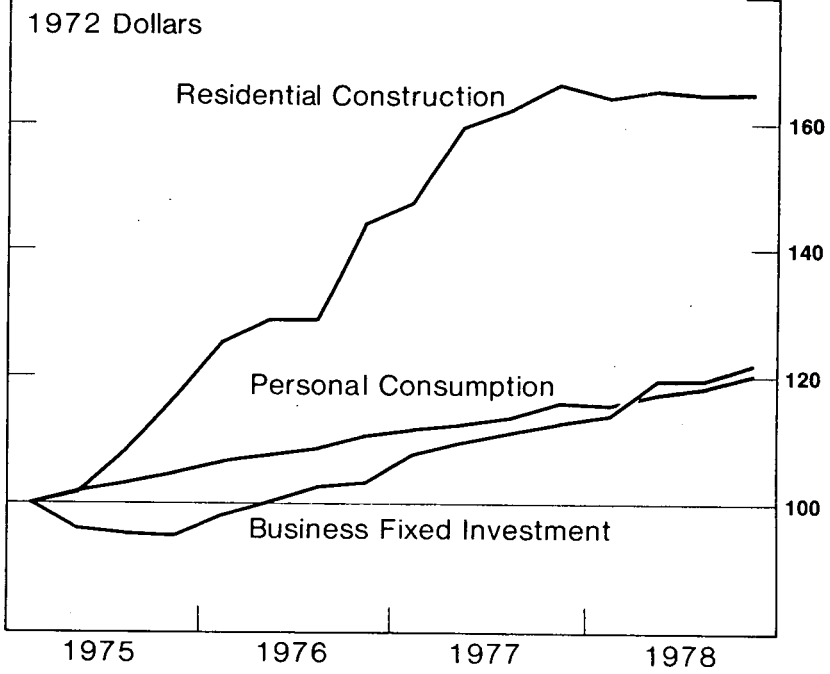
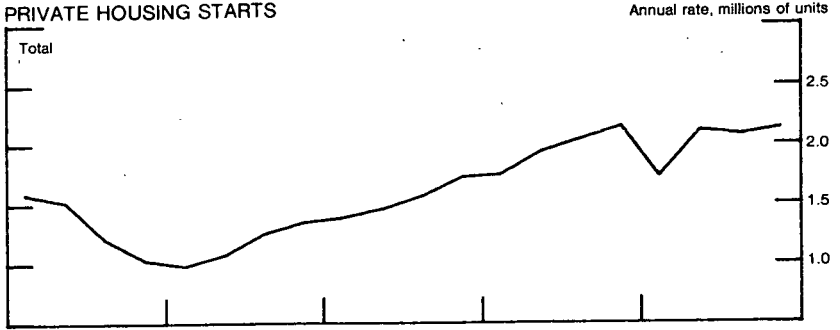
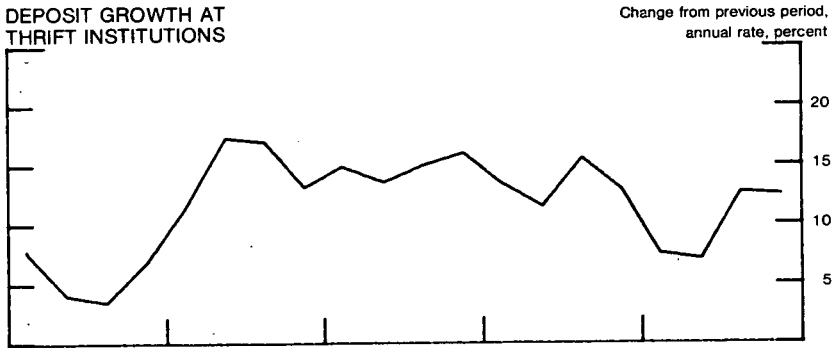


Chart 3

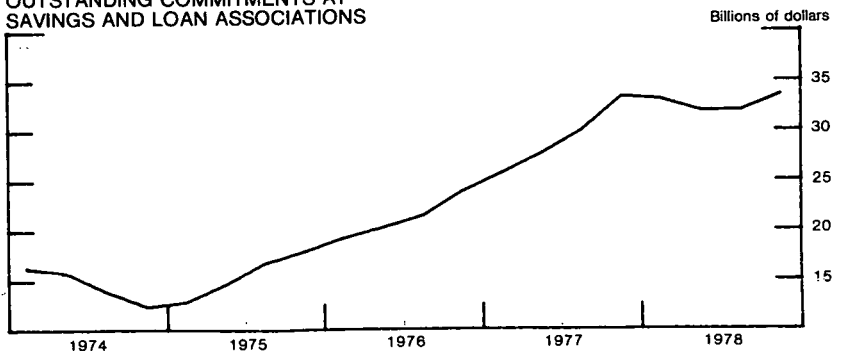
PRIVATE HOUSING STARTS



DEPOSIT GROWTH AT THRIFT INSTITUTIONS

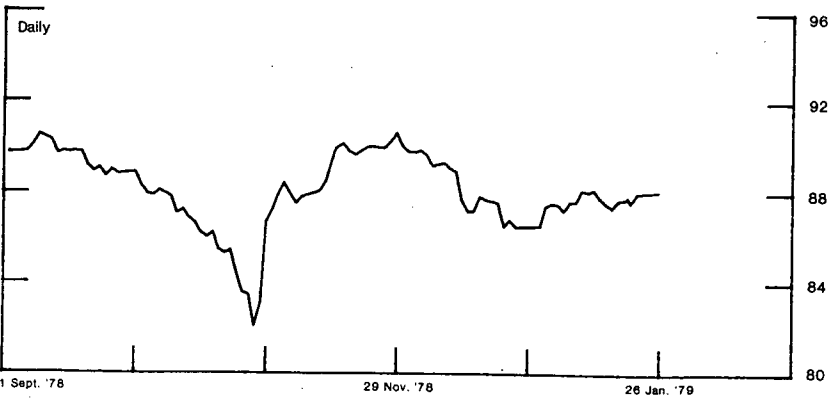
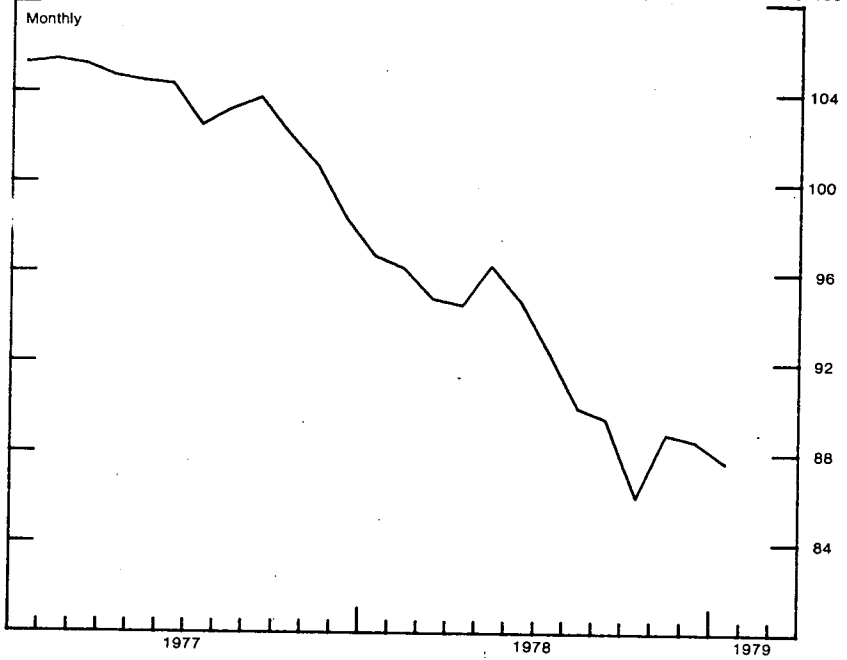


OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS



Chan 4

WEIGHTED-AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR *



* Index of weighted average of G-10 countries plus Switzerland.
Weights are 1972-76 global trade of each of the 10 countries.

Chart 5

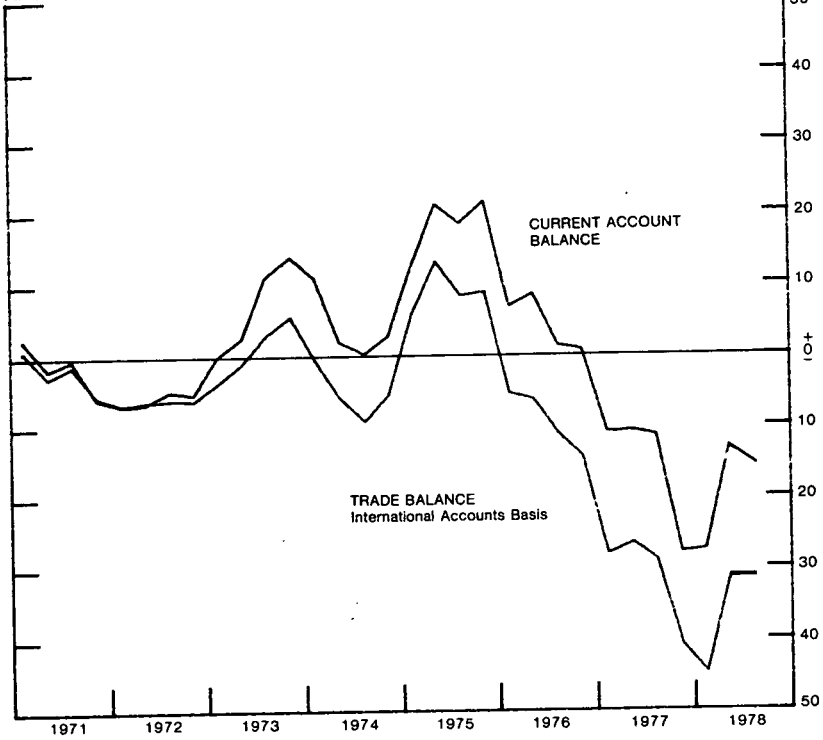
**U.S. MERCHANDISE TRADE
AND CURRENT ACCOUNT BALANCE**Annual rates, seasonally adjusted,
billions of dollars

Chart 6

Recently Established M-1 Growth Rates and Actual M-1

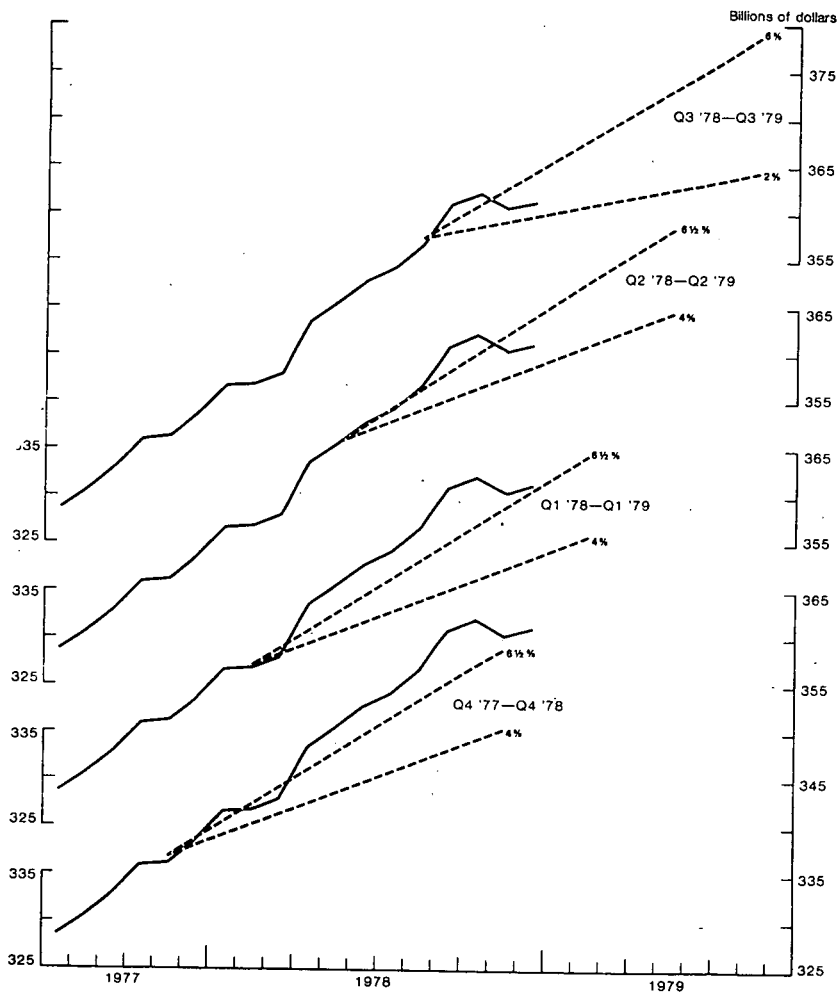


Chart 7

Recently Established M-2 Growth Ranges and Actual M-2

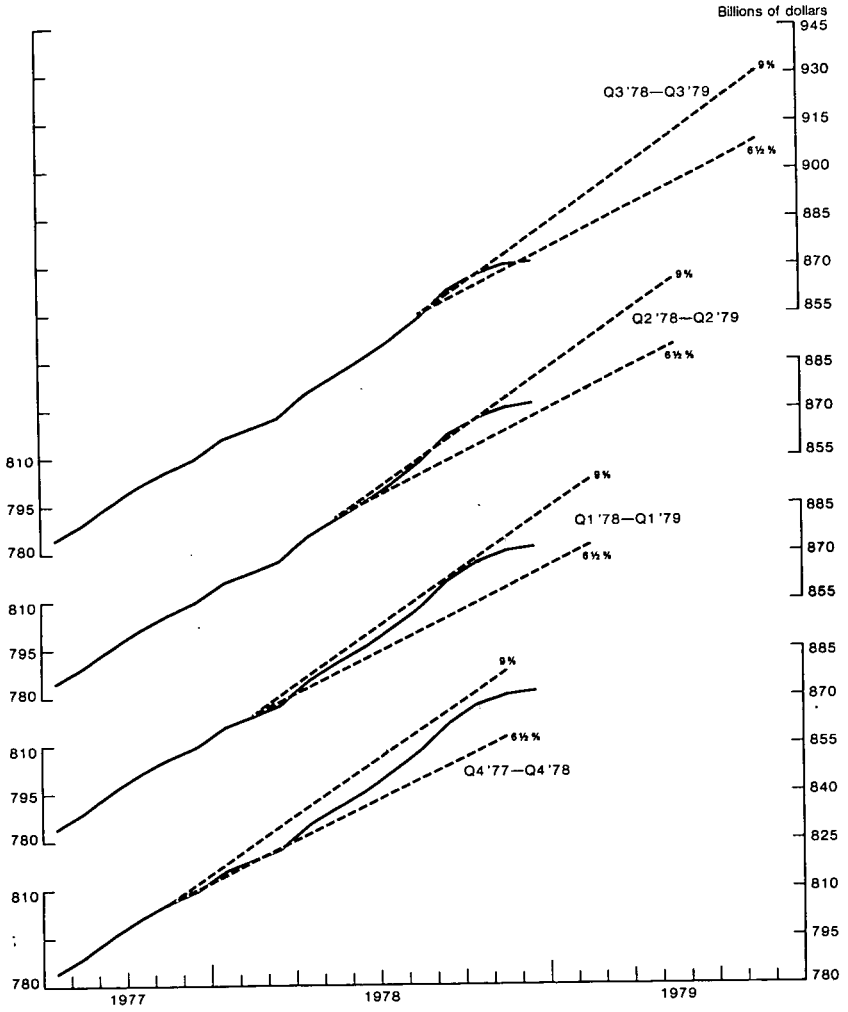
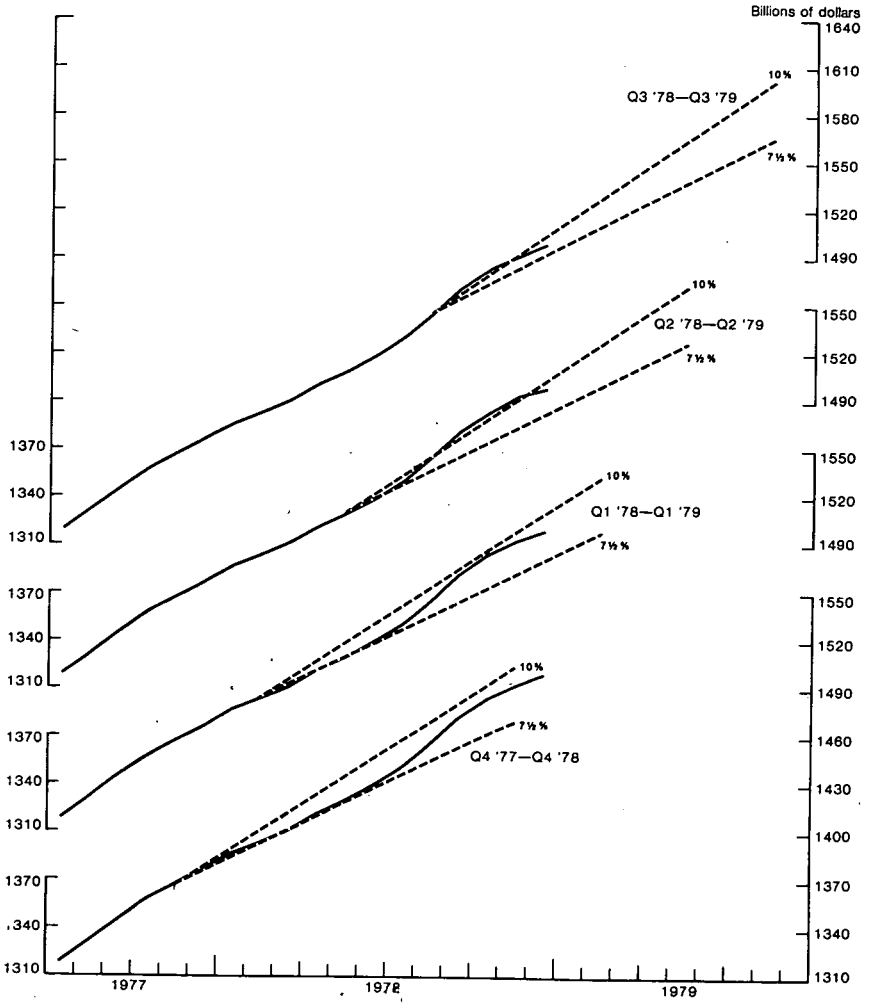


Chart 8
Recently Established M-3 Growth Ranges And Actual M-3



PROGRAMS TO REDUCE STRUCTURAL UNEMPLOYMENT

Conventional aggregate demand management policies historically have been the major instruments for reducing unemployment. The policies generally have been most successful in situations where unemployment has been associated with cyclical contractions in economic activity. Some unemployment, however, is not a consequence of deficient aggregate demand, but rather is a reflection of persistent structural impediments in the labor market. In such cases, traditional monetary and fiscal policy actions alone can not achieve desirably low unemployment rates without generating unacceptably high rates of inflation. For this reason, our arsenal of weapons to combat structural unemployment should include training programs as well as selective Federal policies to promote the creation of jobs.

Aside from their other benefits, such programs can enhance long run productivity growth and ease the inflationary pressures often associated with periods of high employment. As the economy approaches full employment, when jobless rates for certain categories of workers (particularly skilled) are relatively low, unemployment rates for several groups within the labor force remain unacceptably high. A scarcity of skilled workers puts upward pressure on wages and prices, and can inhibit economic efficiency and growth. One of the prime benefits of structural employment programs is that they increase the supply of workers available both for entry level jobs and—through the process of upgrading—at higher skilled positions. The net result is increased efficiency, higher levels of output and income, and further advances in employment.

The social rewards of creatively-designed structural employment programs go beyond near-term readily measurable economic variables. To the extent that these programs contain a training component, they directly increase our Nation's stock of human capital. But, perhaps more important—particularly for young people—are the benefits associated with the positive exposure to the world of work and the reduced dependency of participants on the government's income support systems.

PROGRAM PRINCIPLES

Policies to reduce structural unemployment should be designed to improve the quality of the work force, facilitate the flow of information about skills needed in a growing economy, and provide for effective job placement. In my view, the following principles should be embodied in programs intended to ameliorate structural unemployment.

Emphasis should be placed on preparation for and direct placement in growing industries.—Over the years the private sector has generally provided the bulk of the net increase in payroll employment; reflecting this, structural labor market policies should be aimed at identifying and meeting needs of private sector employers. Moreover, many job openings in the private sector are found in smaller businesses. Thus, structural labor market policies should have a decidedly local emphasis.

The design and operation of training programs should include local employers, educators, and public officials.—Training and guidance programs are likely to be most successful when employers have a direct role in specifying their needs. Indeed, participation by business in such programs often leads to an increased willingness to hire graduates or provide on-the-job training. Similarly, the willingness of educators to adapt curricula to provide students an exposure to the world of work, and the commitment by community leaders to direct their employment and training funds to meet the needs of the local economy are most likely to be forthcoming when they are direct participants.

More generally, incentives to create jobs for the structurally unemployed should be provided and disincentives should be eliminated wherever possible.

SPECIFIC PROGRAMS

CETA title VII.—The Administration has recognized the importance of coordinating training programs with private sector needs in its funding authorization for Private Sector Opportunities for the Economically Disadvantaged, which has been included as Title VII in legislation reauthorizing the Comprehensive Employment and Training Act. I strongly support this program which is designed to demonstrate the effectiveness of directly involving the local business community—particularly small businesses—in the planning and operation of training programs.

Local Private Industry Councils will be created by each CETA prime sponsor, and, in cooperation with the sponsors, these councils will have the opportunity

to direct the use of funds for private sector initiatives. The activities allowed by the legislation are sufficiently broad to encourage innovation. Employers, educators, and manpower planners should be able to develop new linkages that will help meet the demands of private businesses for specific work skills by providing coordinated training and direct placement of the structurally unemployed in permanent private-sector jobs. The needs of the unemployed and their future employers should be better served by such a cooperative arrangement than by the traditional approach of large training efforts, which may not have been based on the fullest possible knowledge of the needs of local employers. The main thrust of this program is efficiency through local decision-making, but a national leadership role—on the part of the Labor Department and the National Alliance of Business—is provided to assure technical assistance and to facilitate the sharing of ideas. I strongly urge Congress to act quickly in granting the \$400 million in appropriations for this program recommended by the President as part of the 1979 supplemental budget request.

Programs to facilitate the movement of youths from school into good jobs.—The transition from school to work is a critical period in a youngster's life. Yet it is a transition which has not had sufficient attention in national policymaking. The nonprofit National Manpower Institute has been promoting the establishment of community education-work councils. There are currently over 30 of these operating, funded either by the Labor Department or nonprofit sponsors. These councils are comprised of government, education, business, and labor representatives. Their purpose is to collaborate with educators on relevant curricula, to develop work-study opportunities, and to help improve placement assistance and career guidance activities for students. This is an important effort that should be expanded.

In addition to education-work councils, other ways must be developed to strengthen the linkages between private sector businesses and secondary schools. Such programs can afford youngsters the opportunity to learn first-hand about the world of work before they make career decisions. One plan that has been successful involves the "adoption" by business of a school. In this arrangement, young people are given an opportunity to experience what adults actually do on the job. These programs should include hands-on activities where possible, and as much in-plant and in-office involvement as can be managed. It is important that these programs have the full support and cooperation of business leaders, parents, and educators, and that the work-place experience be intergrated into formal classroom activities.

The Youth Employment and Demonstration Projects Act signed in August 1977 has funded a series of demonstration projects designed to indicate the feasibility of cooperative efforts by employers, schools, and community organizations to provide special career development assistance to youths. Other experimental efforts under the Youth-Act umbrella are testing the value of guaranteed work opportunities for youths in order to encourage them to stay in school or to return and finish their classroom education. These demonstration projects should be evaluated carefully, keeping in mind the goals of developing mechanisms for continued cooperation among schools, employers, and community leaders, and the emphasis on serving the needs of the private sector.

Eliminating barriers to employment.—Many studies indicate that the minimum wage significantly limits employment opportunities for entry level workers, mainly teenagers. Nevertheless, the House of Representatives defeated in 1977 (by only one vote) an amendment allowing employers to pay teenagers 85 per cent of the Federal minimum wage during the first six months of employment. Some such legislation should be reconsidered in light of the 1½ million teenagers who have been looking for jobs in recent months.

Incentives to create jobs.—In addition to providing useful skills and career guidance, a comprehensive employment policy should include incentives to create private-sector jobs for the structurally unemployed. Congress has recognized this need by incorporating a targeted employment tax credit in the Revenue Act of 1978. Under the provisions of the tax code, employers are allowed credits up to 50 per cent of the first \$6,000 in wages paid during the first year of employment to workers who are certified as disadvantaged; the credit drops to 25 per cent of the first \$6,000 in wages paid during the second year of employment. The total amount of wages qualifying for the credit cannot exceed 30 per cent of a firm's aggregate unemployment insurance wage base for the year. To receive the credits, employers must certify that employees added to payrolls have family incomes less than specified amounts. Also, the plan is aimed primarily at improving job opportunities for young people aged 18 to 24.

In my view, this type of private sector involvement is an important step toward alleviating our structural unemployment problem, and Congress should consider enlarging the scope of incentive grants to private employers. Other possibilities that should be investigated are wage subsidies and payroll tax credits. These would directly reduce labor costs associated with creating new jobs, thereby immediately compensating employers for the costs of hiring and training the structurally unemployed. Payroll tax incentive grants have been tried in France with considerable success as evidenced by broad participation by private employers. The design of any program of incentive grants, however, should be governed by certain principles. To be effective as structural remedies, they should be restricted to workers being hired from appropriate target groups. At the same time, the selection criteria should be broad enough so as not to place an undue certification burden on employers. Furthermore, it is essential that reporting requirements and other "red tape" associated with the subsidies should be minimized to increase their attractiveness to small employers.

In implementing incentive grants, strong efforts should be made to promote business participation on a broad scale. In this regard, Private Industry Councils, authorized under Title VII of CETA and now awaiting Congressional appropriations, can be instrumental in disseminating information on existing employment tax credits and in encouraging support by local business leaders. In addition, the Industry Councils can be an effective vehicle for facilitating placement of the structurally unemployed and for assisting employers in the process of certifying workers eligible for the credit.

Another incentive-type proposal involves the payment of a tax credit to firms that locate or expand in high unemployment areas. Congressional leaders have shown increasing awareness that accelerated depreciation allowances and an increase in the investment tax credit would spur business investment. In an effort to revitalize our Nation's cities and to create jobs in high unemployment areas, Congress also should investigate the possible merit of supplementing any general policies to stimulate investment with differential incentives for business expansion and renovation in high-unemployment areas. An alternative that could be considered is a speed-up in allowable depreciation for firms in those areas to discourage them from moving or closing. Congress should study these tax incentives as possible methods of promoting the growth of job opportunities in the private sector, particularly in areas with the greatest concentrations of the structurally unemployed.

Senator BENTSEN. The Chair will recognize the members in the order in which they arrived and we will limit their questions to 5 minutes on the first round because there are so many here and each wants to deal with his area of interest.

Mr. Miller, this committee has had this kind of attendance, which is excellent attendance, since we started these hearings and we have had more people applying for membership on this committee than we have had in a long time. I think that reflects their deep concern about the problems facing the economy and the complexity of those problems. That is why we are so interested in your testimony.

One of those concerns is the question of productivity and that concern is shared by many members of this committee, what with productivity dropping last year to some eight-tenths of 1 percent, one of the lowest of all the industrialized nations. What do you think we can do to get a larger segment of our national product into capital formation? What in your view is the best way to increase that fraction? Is it accelerated depreciation? Is it liberalization of the investment tax credit? Should we allow business to write off fixed assets on a replacement cost basis?

What do you think would be most effective?

Mr. MILLER. Mr. Chairman, there is no question that our productivity has lagged seriously, which is a long-term threat to our economic progress. It is very alarming to see the low rate of productivity gains in recent years, especially if we recall the high rates of the first two decades after World War II in which the United States led the world

in productivity; this was the basis for real increases in real income and in the standard of living for Americans for a long time. We are not going to be able to continue such gains unless we do solve this problem.

The problem divides into several parts. One part is the experience and skills of the work force. For reasons of demographic and social less experienced workers have joined the labor force; but that will show change, improvement in the next few years, and will be encouraging. The second major area of concern is investment. Our capital stock in relation to our labor force has been dropping steadily. We are falling behind other nations very seriously.

To answer your question about how we can reemphasize investment as an essential component of productivity gains and expand our investment until we are once again leaders in technology and productivity, we have to look at two factors: business conditions that incentivize investment, and fiscal policies that incentivize investment.

To the extent we can create more certainty about our success—and to the extent we can succeed—in bringing down the rate of inflation and introducing more economic stability, we will aid businesses' investments. But it is still important to pursue some of the ideas that you have just suggested.

In my view, the most important incentive for increasing business investment would be faster rates of depreciation. The reason for that is as follows: it is the approach with the best trade off between costs to the Treasury and benefits in incentivizing investment. If we try to create incentives for investment through higher investment tax credits, it takes quite a loss in Federal revenue in order to create enough of a benefit in the analysis of discounted cash flow to change business investment decisions. That is an expensive way to go, at least a more expensive way than higher depreciation, in my opinion.

Accelerated depreciation, on the other hand, has a significant impact on discounted cash flow calculations. For example, if it were possible to write off all production machinery and equipment over 5 years, it would mean a much more rapid recapture of capital, which means that a business making its calculation on the return on investment would find investment more favorable. But faster depreciation means only a deferral of taxes, so the cost to the Treasury is much less to get the same result; there would be more bang for the buck by going to accelerated depreciation, in my view, than by going the investment tax credit route.

As far as allowing depreciation on replacement value, I have generally opposed that approach for several reasons. One is that it might work contrary to our objective: it might be an incentive to keep old machinery and equipment in operation, because the older it is the more would be the depreciation in relation to its current replacement costs. Productivity might not be as important to the calculation as the increased depreciation using replacement value; an obsolete plant would be retained because of its depreciation value even though it should be scrapped. But more importantly than that, a higher depreciation on existing plants and equipment gives no incentive to modernize. It only increases the cash flow to businesses with a cost to the Treasury and without a direct linkage to new investment.

Senator BENTSEN. Mr. Miller, I am going to interrupt you because I have 1 minute left of my time.

Mr. MILLER. Oh, excuse me.

Senator BENTSEN. I want to get one more question in here.

Time and time again we have seen us trying to stop inflation with tight money and high interest rates.

Often it has led us into a recession. Then we have tried to bring it out with tax cuts and our policy mix between fiscal and monetary policy gets really badly out of line resulting in massive deficits, and a mix that it encourages consumption but penalizes capital formation.

Now the tight budget that the administration has proposed—it seems to me—provides an ideal time for a tighter fiscal, easier monetary mix.

Now, where is the Federal Reserve? Are we going to get the easier money that such a change in the mix implies?

Aren't we going to need something like that if we are going to encourage capital spending and productivity and try to lay a basis for price stability in the future?

Mr. MILLER. Mr. Chairman, it would be far better in my view, and in the Federal Reserve's view, for the mix to be made more toward austerity in Federal spending, austerity in fiscal policies, and toward more latitude for moderation in monetary policy; that would have many, many benefits.

To the extent that we have used Federal spending as the force to stimulate the economy, we have created greater competition for private capital from the Federal Government. We have thereby put ourselves on the treadmill of ever increasing Federal deficits, and we have impeded that availability and cost of capital to the private sector which is essential if we are going to achieve the kind of growth, productivity, employment, and price stability that we all seek.

So it is encouraging to see the possibility again developing, as it appears to be now, for some new attitudes about and some new direction in the mix between fiscal and monetary policy.

Let me hasten to say that that shift in policy can in no way offer an excuse for us to let up prematurely the pressure on trying to restrain the forces of inflation. We are still suffering from very high inflationary tendencies in the economy, and it is critical that we stay firm in the confluence of fiscal and monetary policy toward containment. But it is also important that we be alert, so that if the economy begins to drop to too low a level of activity the potential for encouraging moderate economic growth come from the monetary side, rather than from opening up spigot of fiscal policy once again.

Senator BENTSEN. Mr. Miller, this morning they are organizing the Finance Committee and I want to be sure to show up so that I remain on it. In the meantime, I would like to recognize Congressman Reuss for his questions.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Miller, I know that the Federal Reserve, like myself, is concerned about the problem of conglomerate takeovers. Conglomerate takeovers can present a problem of excessive economic power. There are frequently takeovers where there are no economies of scale, no increased exports, no efficiencies in distribution, no faltering management to be taken over. It is pure empire building.

Second, they present a problem in political concentration. If a conglomerate gets a foothold in 218 congressional districts, for example, it owns the United States, which is a pretty good position to be in.

Third, in a time of inflation, conglomerate takeovers may well represent, it seems to me, a misuse of scarce credit resources. Conglomerate takeovers don't result in any new plant and equipment, they simply result in a bidding up of financial pieces of paper.

Fourth, and here the point of the American Express-McGraw-Hill takeover is symptomatic of what frequently happens, they lend themselves to conflicts of interest. For example, the banks involved in that takeover offer—which is currently at \$40 a share level—Morgan Guaranty, Chase Manhattan, Manufacturers Hanover, Chemical Bank, First National of Chicago, Continental Illinois—own, in their trust accounts, about 12 percent of McGraw-Hill's common stock. Just one of these banks, Morgan Guaranty, stands to make a rather tidy \$26 million profit for the beneficiaries of its trust department if the sale at \$40 a share goes through. There are, of course, additional nonfinancial conflicts of interest involved in the matter, too.

My question is really twofold:

First, does the Federal Reserve, in its relationship with the banking system, have a policy on conglomerate takeovers, at least those that don't involve a failing company to be taken over?

Second, has the Federal Reserve given thought to reversing what it did last August? Last August, you recall, the Federal Reserve reduced from 4 percent to zero the reserve requirement on Eurodollar borrowings by U.S. banks. Those Eurodollar borrowings tended to be by the very multinational American banks, such as those I just named, which are also big in the conglomerate takeover financing business.

I realize that the reduction in the reserve requirement from 4 percent to zero was due to a desire on the Fed's part to help the dollar in its balance-of-payments problems, but I question very much whether it really was of much help there. I inquire whether it wouldn't be a good idea to turn off this reserve-free supply of takeover money which is sloshing around the world, some \$500 billion in Eurodollars alone.

Would you address yourself to those two questions?

Mr. MILLER. Congressman Reuss, let me, perhaps, give you a little background on the takeover situation.

We had a rash of takeovers in the late 1960's, as you will recall, which actually resulted in new legislation, because of the degree to which there seemed to be nonproductive activities in mergers and takeovers.

My view, expressed at that time, was one of personal concern about business activity that did not contribute to a more efficient economy and took place either plainly for empire building or perhaps for arithmetical considerations—mergers that had more form than substance.

We see, for new reasons, a rash of takeovers recently. One reason is that, because of the economic course of this Nation over the last dozen years and the emergence of rates of inflation that we have never before seen in peacetime, and because of the effect that that phenomenon has had on the pricing of equity securities, there exists a very, very peculiar market: It is literally cheaper to buy existing assets to obtain production capacity than it is to build new ones, because those assets are often selling well below their book value and substantially below their replacement value.

So the reason this activity comes about is understandable, however, I share your concern that the economy may not benefit even though one can understand the reason for the phenomenon.

The Federal Reserve, in the past, when there has been considerable merger activity, has occasionally given administrative guidance to banks, suggesting they be cautious on nonproductive loans.

We have been reluctant to do that during this cycle because it is so hard to judge what is nonproductive. Despite the concern you and I share for this phenomenon, there are cases where capital is sterile, where it is working poorly, where the management is inadequate in finding a higher and better use for capital. The challenge that someone may take you over unless you do a good job places a certain discipline on the economy that we don't want to destroy. It is a very hard area to judge.

Our preference has been to bring about conditions in the economy that would return a sense of value to the system, that would reduce the tendency for these takeovers by getting us back to more normal conditions where the economics of takeovers aren't as good. I don't know whether we should be doing more or less. I merely say that we have, so far, been reluctant to try to administer an area where the yardsticks are so imprecise.

Now, as far as the action in August to reduce reserve requirements on Eurodollar borrowings, our effort there was to lower reserves so that a higher rate of interest could be paid to attract dollar funds abroad and pull them back into our economy and, thereby, take some of the liquidity out of the Eurodollar market.

The Eurodollar is a big issue, as you know, and I don't think the action taken on November 1 is the last chapter in what should be a continuing effort for us to understand and deal with the liquidity that exists in that market, because that liquidity can make it more difficult for us to deal with the inflationary problem, both domestic and worldwide.

Now, the extent to which the ability to attract those funds may have caused more funds to be available in the United States for financing takeovers rather than for productive loans is of concern to us. Yet, we are trying to balance the one problem against the other. So far, we have felt that the actions that we have taken are moderate and have not really created any excess liquidity in the state that has contributed to this phenomenon.

Evidence now indicates that the growth of the various monetary aggregates has slowed; that loan demand is falling; and that conditions, perhaps, are beginning to move a little more toward the balance that avoids the kind of activity you are concerned about.

There is a problem, and I wish I could give you a more precise answer. We are always faced with the tough decision of whether to add a regulation to correct actions which are not beneficial to the economy or whether to rely upon macropolicies to correct such a situation, although they will take a bit more time.

Representative REUSS. Thank you for a very responsive answer.

Senator PROXMIRE. Before Senator Bentsen left, he indicated that a recognition of members would be as they came in. That means that I am next and then Senator Javits, then Congressman Mitchell, Senator Jepsen, Senator McGovern, and Congresswoman Heckler, and Congressman Brown.

I say that because it will seem like a strong Democratic bias, because that is just the way it is.

Representative BROWN. That would be the last thing I would suspect.

Senator PROXMIRE. I am sure it would be the last thing you would suspect.

Mr. Miller, all of us are concerned as the chairman of this committee indicated earlier, with the very, very high interest rates, close to a record high, punishingly, cruelingly, painfully high, and interest rates that just don't seem to have the kind of bite they should have, that they have had in the past.

In the past when the Fed followed a tight money policy, it got results. The economy slowed down, there was a lot of moaning and groaning and complaint and criticism but the inflation was retarded.

Now, it seems you are riding your way right up. You talk about structural unemployment policies. I think that you should be concerned with structural monetary policies, particularly in the light of what I think was a subsequent criticism by William Griggs of the Schrader Bank & Trust, who argue the Fed's efforts to slow inflation have been increasingly ineffectual and that you are losing control of monetary policy.

Let me just list some of the points that are made here.

One, these are the changes that he points out, one, the easing of ceilings on what financial institutions can be paid for money. Most dramatic was the introduction in the summer of 1978 of the 6-month savings certificates by which banks and thrift institutions could beat out even the U.S. Treasury for funds, a development that has done the most to weaken the Fed's grip on monetary policy.

Second, the astonishing growth in trading in interest rate futures which has gone from zero in late 1970 to a \$378 billion industry by January of 1979.

Third, the movement to floating rate loans by financial institutions. Because banks now merely pass on the higher costs of funds to borrowers, higher interest rates have lost much of their bite and the problem as far as the banks are concerned.

I would point out in the second quarter or third quarter bank profits have gone right through the roof.

Fourth, the rapid growth of these sections of the financial markets lie outside the Fed's jurisdiction. Nonbank institutions are in competition for loan funds that have left the Fed system.

Five, new lending techniques, such as 5-year car loans, graduated mortgage payments and so on.

Six, proliferation of foreign banks in the United States. This has been matched by the growth of the U.S. bank activities overseas with access to funds that the Fed cannot control.

Seven, the housing sector's fast growing attempts to tap national money markets for sale of mortgaged bank securities. There are two or three other elements, too, that indicate that monetary policy is much more difficult now to get a bite on and restrain than it was a few years ago.

What is your comment on that?

Mr. MILLER. Senator, I would tend to disagree with this analysis because I think it is too simplistic. There is a rationale that says

that our policy will probably result in greater likelihood that inflation will be controlled in the long term.

The suggestion that policies pursued earlier in this decade were successful in controlling inflation is false, on the record. High interest rates in 1973-74 were a contributing force toward a very major recession with high unemployment, high social costs, and the worst economic downturn since the 1930's depression. And, we didn't eliminate inflation, we merely brought it down temporarily to a high base of 6 percent. Then, as Federal deficits mushroomed in response to the recession, we started once again on the treadmill, feeding the flames of inflation.

The policies that are being pursued now are different. They are intended to slow down the economy on a more balanced basis; to avoid the dramatic, draconian effects of high amplitude swings; to slow us down to a more moderate rate of growth; and to permit us to continue in that mode for a longer period of time.

The effect in the economy is, I think, more successful if you avoid those sharp swings. The introduction of the 6-month money market certificates was designed technically—

Senator PROXMIRE. Let me just interrupt, Mr. Miller.

Mr. MILLER. Yes.

Senator PROXMIRE. The difficulty is the objective which is to slow inflation. That is one of the big objectives, that is the principal objective and it doesn't seem to be working.

Here we have very high interest rates, we continue to have prices rising very sharply, and where are the results?

It is true that the economy is being cushioned. Housing is cushioned. I just got a question from the staff that I will not ask because it is pretty obvious what the answer is.

How could we cushion capital spending? If you cushion everything you don't have the unfortunate painful effects of retarding inflation by slowing down the economy. You are just not able to have that effect. They are not there, are they?

Mr. MILLER. I just wonder if the comment that we have high interest rates is realistic.

Senator PROXMIRE. You wouldn't deny they are high, would you?

Mr. MILLER. What does "high" mean? Do we mean nominal interest rates or do we mean the real interest rates?

One of the problems is that we have never experienced in this country, in peacetime, such prolonged high rates of inflation nor the corresponding and inevitable high nominal rates of interest that go with high inflation.

So the pressure is on: interest rates are high, and, therefore, the situation is dreadful. But the truth is that real interest rates were higher in the 1930's, when we had a depression.

One of the difficulties in getting the bite you want is the tolerance that the Congress has for making nominal interest rates reflect both inflation and a real rate of return. Real interest rates are lower today than earlier in this decade. I happen to believe that they are in a high enough range to do the job, because they are restraining the economy and the growth rate of the economy is coming down. Inflation that has built up over 12 years is not going to be eradicated in one quarter or two quarters or in 1 year by any sensible degree of monetary or fiscal restraint.

Senator PROXMIRE. My time is—

Mr. MILLER. It will take years to work inflation out. Inflation has now become so deeply embedded in our economy that we are going to have to pull it out by the roots if we are serious about getting rid of it.

Senator PROXMIRE. My time is up, but the last quarter that we have indicates that the economy was moving along at what, a real increase of, a real growth rate that was far above that was anticipated and certainly that doesn't indicate a slowdown.

Mr. MILLER. I should mention that I don't think it is wise to concentrate on one quarter; you could say, then, that the third quarter was lower than you expected.

You have to look at what's happening over a longer period of time. In the first quarter last year, there was zero percent real growth; in the second quarter, when there was a catchup and some anticipatory buying because of inflation, real growth was 8.7 percent, which put considerable pressure on; the rate came down to 2.6 percent in the third quarter; and it was at 6.1, tentatively, in the fourth quarter, which is too high. The average growth rate for the year was a bit over 4 percent.

So we are at least beginning to get the average rate down; we need to get it down lower. But I don't think it would aid our cause to push our economy into a recession, because I am sure that would pressure everyone to get back onto the treadmill of spending our way out of the recession and back onto the path of more inflationary pressure.

Senator PROXMIRE. Senator Javits, you are next.

Senator JAVITS. Thank you, Senator Proxmire.

First, let me welcome you, Mr. Miller, to the committee. You already went into your presentations here and have shown yourself to be an authoritative commentator and also director on the modern scene.

I gathered from the press that you had some differences with the expectations of the administration on which the President's Economic Report were built. And that those related to forecasts in the various critical fields of our gross national product, real increase; interest rates; unemployment; and so on.

Now, one, is that so; and, two, what are the implications for the Feds' policy, if it is so?

Mr. MILLER. Senator Javits, I would say that, on net, there is no serious disagreement between our view and the economic plan submitted by the President. The comment I made the other day was that I thought the outlook for inflation was somewhat optimistic and that perhaps inflation wouldn't come down quite that rapidly.

I did not, however, suggest that the real rate of growth of the economy in that plan was not reasonable, nor that its other forecasts were not reasonable. I did think—and I still do think—that the degree to which it anticipates inflation will abate is a little optimistic; I don't think inflation will come down quite that fast.

Now, there is an interaction between the inflation rate and Federal revenues that comes down to the bottom line of the Federal deficit that we are talking about in connection with the budget situation.

If inflation is, in fact, higher than the administration has indicated in its budget plan, then revenue will be higher. Correspondingly, if

inflation is higher, costs will also be higher because of the inflationary impact on costs. On the other hand, if the administration is right about inflation or inflation goes even lower, then revenue will be lower but costs will also be lower.

So, one doesn't reach a substantially different figure for the Federal deficit based on differing inflation estimates.

The problem comes if there is disagreement on unemployment. Because if, in fact, there is a serious error in estimating unemployment, then you might have a completely different budget situation. Some commentators—not the Fed—have felt that the unemployment rate would be higher under the conditions that are likely.

For every 1 percent increase in unemployment, one can expect something around \$20 billion or so increase in the deficit. It is from that source that some commentators feel there is a degree of risk in the budget estimates; I don't believe so.

Productivity gains have been low, and that means that more people are employed to produce for the same output. So we are not likely to see really serious increases in unemployment at the level of economic activity projected.

My view is that unemployment, on the average, will be about the same in the 1979 calendar year as in 1978, although the figure at year end 1979 may be slightly higher.

So I come out, on net, believing that the bottom line of the budget figure—the deficit of \$29 billion—is reasonable and should be achievable.

I do believe that unemployment will not be significantly different from the budget plan. I do believe that inflation will be somewhat higher.

Senator JAVITS. My time is up, but I would like to make a request of you, Mr. Miller.

I am very deeply worried about rising installment credit and especially the inflated mortgage credit which is based upon highly inflated costs of homes, both new and old. Therefore, would you be good enough to furnish us for the record with what the Fed thinks about that and whether or not, with the uncertainty respecting unemployment, we ought to make some provision in law to deal with the ability of homeowners to keep up with their mortgage payments.

Mr. MILLER. I will do that.

Senator JAVITS. I ask unanimous consent that that be included in the hearing record.

Senator BENTSEN. Without objection, it will be done.

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

The rate of growth in household borrowing has been quite strong during the current upswing in business activity—well in excess of the expansion in disposable personal income since early 1977. Although total household debt levels and debt repayments were higher at the end of 1978, relative to income, than in comparable periods of earlier postwar business cycles, there are no indications of a serious deterioration in the ability to service this debt.

Recent survey information suggests that a considerable part of the increase in consumer installment debt—at least between 1970 and 1977—was accounted for by higher-income families that presumably have greater capacity to carry debt. Moreover, bank-card credit—which has become widely available only in the past decade—is included in full as a component of consumer indebtedness even though about two-fifths of all card users activate their credit cards primarily as a sub-

stitute for cash or check transactions. Finally, other indicators of debt overload—such as delinquency rates or personal bankruptcies—on balance have shown little sign of deterioration.

Taking such considerations into account, the Board believes that spending by consumers probably will continue to grow about in line with income during 1979, subject to some constraint posed by the larger burden of consumer debt, as noted in my prepared testimony. This is obviously an area that bears close watching, particularly if increases in consumer income should unexpectedly falter substantially.

Insofar as the burden of mortgage debt is concerned, home-owners should be able to meet their mortgage payments promptly, and without undue strain in the vast majority of cases, given the prospective environment of moderate general economic growth involving further gains in income and employment. The Board, accordingly, foresees no compelling need at this time for some kind of comprehensive mortgage payment program as an adjunct to broad economic stabilization policies.

Senator BENTSEN. Mr. Miller, I keep commenting on the deep interest of these members in these economic issues. And the attendance here shows the depth of sincerity of interest with all these members here in full attendance and not a TV camera in the house. [Laughter.]

Mr. MILLER. That says something for the chairman of the committee, no doubt.

Senator BENTSEN. Oh, oh, oh.

Mr. MILLER. Cameras usually come for you, I notice.

Senator BENTSEN. No.

Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman.

Can you hear me?

Mr. MILLER. Yes, sir.

Representative MITCHELL. It is good to see you again, Mr. Miller. Just one comment, first, before I get into a series of 15 questions.

The comment deals with your comments on structural unemployment. I visited more than 20 cities last year and in each one of those cities, I made it a point not to just go to the hotel to speak, I go where people are. And, frankly, I don't think the people that I talked with in those 20 cities would believe you nor me nor any member of this committee nor any Member of Congress when we say that we are planning to do something about structural unemployment.

They have been lied to, they have been tricked, they have been misled, they have been promised and the rate of black unemployment and Hispanic unemployment remains just as high as it has been the last 5 years.

These people don't believe in us anymore, and I can understand why. With an administration enunciating a policy which anticipates an increase in unemployment, I think you understand their cynicism and their doubt.

You delineated a number of factors relating to structural unemployment and I agree with most of them. However, you failed to add one—and that is the matter of racial discrimination at the hiring gate.

If you can create a million jobs last year and not dent black unemployment at all across the board, then you must look at discrimination as a factor at the hiring gate.

That is my comment. I wanted you and the members of the committee to hear it.

We have passed the Humphrey-Hawkins act; it is now the law of

the land. There was a lot of snickering and laughter about it being a meaningless piece of legislation. I don't think it is meaningless.

The goals of 4 percent unemployment and 3 percent inflation by 1983, I think are accomplishable if the Congress and all the agencies of Government decide to do their work.

Under the law, you are required to develop aggregate money policies, monetary aggregates to achieve the goals of unemployment and inflation by 1983.

What policies have you developed? What policies have you started implementing, in terms of the Federal Reserve system, to achieve those two goals by 1983?

Mr. MILLER. Congressman Mitchell, next week our Federal Open Market Committee will meet to address that very question for the first time. We have, under Humphrey-Hawkins, a mandate to report to the Senate and the House Banking Committees on the policies that we will pursue and their relation to the objectives of employment, inflation, productivity, and other factors in the Economic Report of the President.

So we will be going through this exercise for the first time next week, and on the 20th of February we will be reporting to the Senate Banking Committee; on the 21st, to the House Banking Committee. By that time, I will be able to give you an outline of how we hope to respond.

Representative MITCHELL. May I interrupt you, those are the dates that you will have developed comprehensive monetary aggregate plans to implement the Humphrey-Hawkins bill?

Mr. MILLER. No, our task is to indicate the monetary plan for the single year 1979 and how it relates to other objectives.

Representative MITCHELL. I understand.

Mr. MILLER. Next July, we will come before those two committees to indicate any midcourse correction for 1979 that we believe would be necessary, and also indicate how we think monetary policy should then operate into 1980.

We report in segments, as I understand it.

Representative MITCHELL. I have time for one more question, Mr. Chairman, or is my time up?

Senator BENTSEN. If you haven't been advised, I assume you do.

Representative MITCHELL. I have a minute left then, I understand this reporting is to be done on a semiannual basis?

Mr. MILLER. Right.

Representative MITCHELL. Twice a year?

Mr. MILLER. Twice a year, yes.

Representative MITCHELL. I think it would be a horrible mistake to do your comprehensive planning on only an annual basis. I think an annual review has been one of the problems of the Federal Reserve.

I certainly don't think it to be wise or prudent not to look at the out years, during which you must achieve the goal.

I will be the first to admit that you cannot develop a plan locked in concrete, but it certainly seems to me that you can establish the parameters of a comprehensive plan to cover that time period.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Congressman Mitchell.

Senator Jepsen, we welcome you to this committee. We are delighted to have you as a new member.

You may proceed.

Senator JEPSEN. Thank you, Mr. Chairman.

Mr. Miller, in both the budget and economic report, President Carter indicates that inflation will be with us for some time to come. You announced earlier that you felt it may be with us a little longer and more severely than the President does. One of the effects of inflation, as we all know, is that it pushes people into higher tax brackets, even though there may be no change in their real income.

In the State of Iowa, which I represent, there is a reasonable rate of productivity; people work hard and have a national and statistical reputation for being productive. But they also share, along with all other Americans, the problem that the harder they work, the further into higher tax brackets they get. Inflation does distort work effort and business finances, and even leads to real capital losses when taxes must be paid on money just in inflated capital gains.

I am sure you are aware of the important work done by Prof. Martin Feldstein of Harvard, in this area. Thus, my question is, isn't it time for us to finally consider indexing of the tax code in order to stop inflation from raising taxes year after year in this manner?

Mr. MILLER. Senator Jepsen, I recognize the burden that all of us bear from the effects on real income from inflation pushing us into higher tax brackets. It is a painful consequence, but I do not believe we can solve anything by trying to shelter ourselves by indexing taxes. I believe we have to suffer that effect as part of the process of trying to correct and address the fundamentals.

I do not think that indexing taxes would result in lower Federal spending. I think the likely consequence, instead, is that Federal deficits would increase. I would think that the need to finance the Federal Government in such a case would put more pressure on capital markets, and that the whole process of trying to achieve productivity gains and to reduce the relative size of the Federal Government, would be aborted. I think the only way we are going to solve the problem is through willingness to cut expenditures before we cut the taxes; if we index taxes, we are going to cut taxes before we cut expenditures.

It would be easy to let automatic indexing produce lower revenues, but it would still be up to Congress to find ways to cut spending, and I don't think that the incentive would be there.

Senator JEPSEN. Mr. Miller, I appreciate what you are saying and I agree, for the most part with cutting expenditures and government spending, which is one of the root causes, in my lay opinion, for inflation.

I would not recommend, and I am not recommending that the indexing should be on a permanent basis.

Back at the ranch and away from our castles here on the Potomac, young people cannot buy homes. They are finding it increasingly difficult to travel. As many others here have, I have come off a number of months of very intensive people contact day after day and hear the story repeated, that those who have saved all their lives now find themselves in a very frustrating and very serious situation of not being able to even remain in and keep the home that they have, and that they have paid for, just because of the increase of the cost of normal upkeep, utilities, insurance, and all the things connected with inflation.

So for those people—whereas, we can talk about philosophies and theories and the whole thing, we might project and talk about the years to come—their problem is now.

I would suggest that the real reason for President Carter's opposition to indexing is based on his desire to get that extra revenue so that he can achieve a balanced budget next year on the backs of the taxpayer.

The figures in the 1980 budget make it quite clear that the reduction in the deficit this year and in the future results primarily from increasing revenues due to inflation, rather than a reduction in the growth of expenditures, which does not quarrel with what you stated toward the end of your last statement about a balanced budget.

I think it is so serious that we should consider a temporary, at least, indexing of the tax code.

Thank you, Mr. Chairman.

Senator BENTSEN. Senator McGovern.

Senator MCGOVERN. Mr. Miller, this is not the first time—as other members of the committee have pointed out—that we have been assured that tight money and high interest rates would cure inflation without putting us into a recession. We heard the same arguments several times over the last 8 or 10 years.

Where do you obtain your confidence that this time this formula that has been tried in the past and found wanting is going to work, that it is going to control inflation without putting us into a recession?

Mr. MILLER. Senator McGovern, I would hasten to state that I don't believe that monetary policy alone can eliminate or wring out inflation. I think it takes a combination of policies; discipline in fiscal policy is a part; an incomes policy to help bridge us over our problem is helpful; policy of balancing our international accounts is essential, because of the inflationary impact of a weak dollar; and policies directed toward improving our productivity are also important.

So, I would be the first to say—to be sure to clear this up—that I do not claim at all that monetary policy alone can do the job. Monetary policy can contribute to the extent that it is consistent with, and combined with, these other policies that are so essential.

In terms of the effect of monetary policy—in its restraining mode to bringing down the rate of activity so that we do not add demand-pull inflation to cost-push inflation and so remove the capacity of our economy to work off and digest and to eliminate the inflationary forces—the extent to which we can use monetary and other policies in this mode to slow the economy and not dip into a recession, that issue is, of course, of concern to all of us.

It is my view that a recession does not contribute to the solution. Most recessions result in inflationary policies to overcome the distress of unemployment—which they should—but that results in higher deficits and we are back on the treadmill.

Senator MCGOVERN. Mr. Miller, if I can just break in there, I recognize what you say is true, that monetary policy is part of the total package. I think I understood you to say in your colloquy with Senator Javits that you were forecasting somewhat higher inflation before it tails off. If that is true—recognizing that these things do affect each other—doesn't that mean that the forecasts on the deficit also are off and also the forecasts on unemployment?

In other words, if you are going to get higher inflation wouldn't you also forecast a bigger Federal deficit than has been anticipated and also a somewhat higher unemployment?

Mr. MILLER. Let me come to all those questions.

First, to clear up what I have said to Senator Javits, I am predicting that inflation will come down, but not by as much down as was predicted in the budget message. The difference is not which way we are going, but by how much.

Senator McGOVERN. My point, though, is that if you disagree with the budget projections, the budget message projection on the inflation rate, doesn't that also throw off the budget projections on the deficit and on the unemployment figure?

Mr. MILLER. Not in my view, because a slightly higher inflation rate—that is, down from the present rate, but slightly higher than in the budget message—means that there will be higher revenues to cover the higher costs from higher inflation. The tax structure is such that, if inflation is higher, incomes will be higher and the revenues will be higher.

You are absolutely correct that if unemployment went higher than planned, we would have a higher deficit. I was saying that it is my view that the inflation projection is slightly optimistic, but that the real level of activity predicted in the economy and the unemployment level seem to me to be reasonable. That is why I come out as I do in the mix of policies.

Now, may I go back to the fundamental question you asked: Why do I have any degree of confidence that we are not headed for a recession as we apply these restraining policies?

Let me point out that, despite the simplistic approach that is often taken as to business cycles, business expansions don't die of old age, they die of some illness; they have to get sick first. Although this economic expansion is 4 years old and will, in March, be entering its fifth year, it is remarkably healthy. The economy is remarkably balanced, and many policies have been pursued to keep it balanced.

So, there continues to be a large increase in employment and therefore in personal income and personal expenditures, the state of inventories is extremely lean and in good condition; there are lower inventory-to-sales ratios than we have seen before. We don't have the overhand, where plants shutdown so they can adjust their inventories. Business spending has not gone through a boom period; it has been moderate. But it is still going to show continued moderate growth.

The Government is a fairly neutral factor, but it is not overextended, or about to drop. Our net export position is an improving one. The one factor in the economy that looks like it will be turning down is housing, which will come down from a 2 million level of annual starts to 1.7 million or so.

So the economy is remarkably balanced and, therefore, that is how I analyze the prospects of whether we can have a slower rate of growth without a recession.

What is it that brings the economy down? Most people have been predicting it is going to slow down because it is x months old. I am saying you have to find some other reason than age. That is the reason I think we have a chance for moderation without it going into recession.

Senator McGOVERN. Thank you, Mr. Chairman, my time is up.

Senator BENTSEN. Thank you, Senator McGovern.
Congresswoman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

It is a pleasure to have you with us again, Mr. Miller. I would like to say that I am encouraged by your forecast and see the rationale behind the projections that you have made. Nonetheless, I am also burdened by the knowledge that when the economy does slow down nationally—or in other words, if the U.S. economy should develop a cold—New England would get pneumonia.

I am concerned about what policies the Fed would take under these circumstances. Now, just recently many economists have been saying that even a mild slowdown could be traumatic for certain regions of the country. I believe that Walter Bogley of the Bank of America made that statement, and with good documentation.

What I am afraid of is that New England, which is your home region and mine, could very well suffer a disproportionate recession or disproportionate injury economically, which it is least able to bear. At the same time, I am wondering if the regional structure of the Fed could possibly permit you to pinpoint relief to disproportionately burdened sectors of the economy should that occur.

Would it be possible to have a split discount rate, under the correct circumstances, which would justify its use where a bank could lend to a small business and then discount the paper at the Federal Reserve Bank of Boston at a preferential rate, if the economy and the data supported the need for that as a result of disproportionate trauma in that region?

Mr. MILLER. Congresswoman Heckler, you have put your finger on one of the problems with which we are struggling. We have a national economy and national economic tools, and yet many regional economic differences—not only in New England, but in other areas. There are parts of the country now that are, if anything, overheated, which creates a problem for us; and there are areas, New England and other parts of the Northeast particularly, that are not doing as well as the rest of the country.

That creates a serious problem for us, because money is fungible, capital is fungible, and it is very hard to direct it toward a particular sector. Possibilities exist, however, for doing things to deal with the regional aspects of our economy.

If we are talking, as Senator Bentsen has about the need to incentivize investment, and accelerated depreciation as a possible tool, then it is possible to tie accelerated depreciation to regions, so that investments in areas with higher than average unemployment would qualify for more rapid depreciation allowances. Such an approach could speed up investment in areas where it is most needed to create jobs. That idea has been proposed from time to time to Congress; it has not caught hold yet, but I think it needs serious examination, because we do need better tools.

The idea of a split prime rate for small business is not new; it has been proposed not just for reasons of Federal Reserve policy, but for good commercial purposes. Many banks have always maintained a differential between lending to national concerns and lending to local customers. In many parts of the country today, local businesses are able to get lower rates than the prime rate quoted for a large credit-

worthy customer. When rates go down, local businesses usually get charged a little more, so it sort of averages out as a way of keeping good customers.

A number of large banks have begun to use a split rate prime rate and for good commercial reasons. They feel that if they support small businesses with lower interest rates now, they will be good and healthy customers when they grow up. Whether or not we should actually start to discount some of that paper at the Federal Reserve, I don't know, Congresswoman Heckler.

At the moment I would prefer to let the industry make those choices, but I would certainly be willing to reexamine that issue if the economy behaves differently than we expect. Fortunately New England seems to be doing a little better since I left.

Representative HECKLER. I doubt it. Then your response is you would be open to the subject?

Mr. MILLER. Yes.

Representative HECKLER. But your first response is you would prefer the Congress legislate the answer concerning the depreciation policy.

Mr. MILLER. Regional economic issues are quite often better handled with fiscal policy than with monetary policy because, as I say, money is so fungible that it will move around, but fiscal policy can be tied to a region. Government can accelerate spending on highway construction in one area, for example. It can, as I say, legislate better depreciation allowances for a particular region based upon economic data such as higher unemployment for let's say, 3 years. A region could get a higher rate of depreciation for new investments, or there could be other similar policies.

Representative HECKLER. Then it would seem that the regionalization of the Federal Reserve would not necessarily be a tool that you would prefer to use. On the other hand, you have stated that if there is a business slowdown, that you would prefer to see the monetary response rather than a fiscal response. So we are caught in a conundrum here.

Mr. MILLER. We sure are. There is a tremendous degree to which our banks do participate in understanding and helping regional economies, when it comes to setting monetary policy. But if we expand the money supply, it doesn't just expand in New England, it flows to other places.

That is the problem with money. But it isn't inconsistent for the Federal Reserve banks to help in other programs, such as the one you suggest of finding a technique for helping smaller enterprises; that is certainly worth examining.

Representative HECKLER. I am advised my time has expired.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Miller, I am fascinated by your opening comments with reference to structural unemployment.

I think your concern about structural unemployment is extremely important because we in the Congress and business people and others have to recognize that it has become a devastating problem for a good segment of our society. The structurally unemployed are forgotten people, in effect, in this effort to balance out the economy and to have

a recovery. I agree that we are stabilized at this moment with reference to the economy, but we sure as heck haven't done much of a job for the structurally unemployed.

As Congressman Mitchell has pointed out before the committee and elsewhere, in the public sector that approach has actually been a failure.

It certainly hasn't effectively cured the structural unemployed problem, and I might also add that the demographics show that in the very short run, near future structural unemployment will be more and more of a problem for minorities in this country; when you consider that the black youths in urban centers already face unemployment rates of above 50 percent, in some cases much higher than that, any worsening of the plight of young blacks in our society becomes a very serious problem. It is literally a ticking bomb that could explode on our society again at any time.

Now, let me say to you that my area of the Nation has been a leader in the collegiate work-study program, that is a semester off campus in finding private employment. The vocational education program which has been developed in Ohio has developed a number of public specialized secondary schools in the vocational area geographically dispersed so as to meet the needs of localities.

We have also a number of 2- and 4-year technical colleges, also geographically dispersed and charging low tuitions. These schools have active local industry advisory committees to recommend what courses should be taught to meet real existing job needs, and the program seems to be working out relatively well.

I think that that is the linkup that is extremely important. So I share your concern that training is given to the structurally unemployed to provide skills that are really needed in the labor market.

Wouldn't it be most efficient if the private sector provided on-the-job training because the skills then would fit in existing jobs? Isn't there some way that we could put the job needs and the job training and the available personnel who have been partially trained together so that we would not have training in unneeded skills?

Mr. MILLER. Congressman Brown, on-the-job training is one of the most effective ways to deal with the problem; there is no question about that. There have been impediments to it, as you well know, and it has declined somewhat recently from the level that existed before the CETA legislation.

I think you are absolutely correct, this is something that needs far more emphasis. There is a probability that a trainee will stay with a company where he has been getting on-the-job experience; there is a greater probability of his moving into continuing employment than there is when he has to be moved from a training institution to the job. I concur with you.

Representative BROWN. Now, you called for a youth differential in the minimum wage law, and assuming that this legislation would not pass the Congress, would you settle for some kind of a training subsidy to be paid to employers who hire structurally unemployed persons?

Mr. MILLER. Yes; the new tax credit is certainly a step in the right direction. The limitation, as I recall, until the 1978 Revenue Act was passed, was \$100,000 in credits for any one firm. Now I understand it is a much higher figure based upon the degree to which

salaries are subject to unemployment insurance. That is a very encouraging step, because it has somewhat of the same effect as a differential. But it's too early, I guess, for us to know how that is going to work; we have no information or statistics.

Representative BROWN. Let me tell you how it works in my county. I run a small newspaper business, and it's the accountant who figures out the tax credit at the end of the year, and, if we have hired additional people, the benefit inures, of course, to the company through the tax credit. But there is very little linkup between the people who file your taxes for you, sometimes a private accountant, and the people who are making the job decisions, the hiring decisions.

If, in fact, you have a program where that job were known in advance as a job that might be subsidized if you hired the right kind of person, that is, a structurally unemployed person, it seems to me that the effective locus of the decision would be put in the right place, that it would be the hiring department rather than the accounting department who would make the determination to go out and hire.

I noticed also you are asking for a stronger link between work and school. I think you are aware, are you not, of the outstanding record of intermediate organizations in strengthening this link? I am talking about OIC and Operation Push, the Urban League, Chicago Alliance of Businessmen for Manpower Services, among others, when I talk about those intermediate organizations.

The record of success of these local nonprofit organizations is far higher, at least in our area of the country, than the State employment services and even the Federal unemployment offices, or employment offices. Do you believe that we need more emphasis on this local nonprofit intermediate organization?

Mr. MILLER. Absolutely.

Representative BROWN. In the job-finding process?

Mr. MILLER. Absolutely. I know OIC has done an outstanding job; the Chicago branch of the National Alliance of Business was nationally known for its efforts. It shows what can happen when the local leadership is mobilized and looks at the problem from a local point of view. They were far more effective than in some other areas by approaching the problem in a slightly different way.

The Manpower Institute, I mentioned, is organizing local councils for somewhat the same reason. The new private sector initiative contemplates such local activities. That is why I was encouraging Congress to move rather quickly on appropriating the \$400 million for the private sector initiative. Obviously, it's too late to spend it all in 1979, because we are many months into the fiscal year, but the sooner that is appropriated, the more likely that local council effort at linking up people with jobs will be increased.

I certainly agree with you that, if the job tax credit is merely used as an accounting technique, we will get no results. That is why we need more and more of local activity, where there is a perceived and measured benefit, bonus, incentive for managers who will be rewarded because they have added more of the structurally unemployed to the firm's payroll.

Representative BROWN. Thank you, Mr. Chairman.

Senator BENTSEN. Senator McClure.

Senator McCLURE. Thank you, Mr. Chairman; and thank you, Mr. Miller, for your statement this morning.

There is much interest and much with which I agree in the statement, and I will want to commend particularly Congressman Brown for his constructive suggestions in the line of questioning with respect to structural unemployment.

I want to return for a moment to the comments that were made by you in response to some questions by Senator Javits and again by Senator McGovern. As I recall, your original statement was that your expectation of unemployment would be a little less optimistic than those of the administration in presenting the budget, that you thought unemployment would be slightly higher, and that the rate of inflation would be slightly higher, and that the rate of inflation would be slightly high at the end of the year, higher than was reflected by the President's budget message.

In response to Senator McGovern, I understood you to say that while you thought inflation might go higher you did not think unemployment would be higher. Am I correct?

Mr. MILLER. Perhaps I should better straighten all that out again. What I had intended to say was that, looking at the budget proposal from the administration—at the components of real growth in the economy, inflation, and unemployment—I came out about as follows: I think that the real growth predicted is reasonable; I think the unemployment levels projected are reasonable; but I think that the inflation projections were a little optimistic.

Now, the administration's inflation figure is down from the current inflation rate. I agree that inflation will be down, but my own feeling is that it will not be down quite as much as they are hoping for.

We are looking, of course, at the year that starts next October 1, which is pretty far ahead in trying to guess these things. But from what I see in the economy now, in terms of its balance, in terms of inherent demand, and in terms of growth of the work force and incomes, I would think that the real growth rate projected for fiscal year 1980 is quite reasonable.

Perhaps I confused you by saying that I expected unemployment to drift up somewhat in the calendar year 1979. That is probably where I misled you; I apologize for that.

Senator McCLURE. Right.

Mr. MILLER. I was mixing up a fiscal year and a calendar year.

Senator McCLURE. Even though the unemployment might drift up in the calendar year of 1979, you think that the projections over term are reasonably accurate?

Mr. MILLER. Yes, sir.

Senator McCLURE. That is the reason why you can anticipate slightly higher rate of inflation but still no larger deficit than s projected?

Mr. MILLER. That is correct.

Senator McCLURE. That contrasts, I am sure you know, with the projections that have been made by the Congressional Budget Office that show that, in their projections, the unemployment rate is optimistic, the rate of inflation is optimistic, the rate of real growth is optimistic, and therefore the size of deficit is at the most favorable side of each of the variables and, therefore, they conclude that the budget deficit may be, indeed, some \$10 to \$12 billion higher than the President's budget estimate.

Mr. MILLER. Senator McClure, I have not had a chance to analyze that Congressional Budget Office review in detail, but I believe that roughly \$4 billion of the difference in deficit is accounted for by a different viewpoint on spending; the rest of the difference is because of a different view on the unemployment level. If one's judgment on the unemployment level were more consistent with the administration's judgment, then the difference in deficit is quite narrow. So I think the thing to focus on is what is the probability of meeting the employment goal? If we can achieve that goal, then I think the deficit levels will fall in with the administration's budget submission.

Senator McCURE. I appreciate that clarification. I think those are extremely important points.

There is one other that bothers me a little, and I agree with the emphasis that Congressman Mitchell placed upon structural unemployment, and that Congressman Brown did. I think this is one of our continuing problems. But there is another one that, another phenomenon that has accompanied our current economic development, and that is the changing composition of the labor force.

If I recall the figures correctly, last year, if the labor force participation rate were the same as it was 15 years ago, that unemployment rates would have been at about 3 percent rather than the figure that we had.

Now, you point correctly to the continuing activity in the housing market, and I think that that is probably because of the inflation expectation on the part of people who are paying very, very high rates of interest to get into housing, rather than trying to save money, which they would be taxed upon if they saved it—they would be taxed upon the interest—and, if they paid very high rates of interest, they would deduct that from their income. So we have made it favorable for them to go into the market from a taxing policy.

But, as a result, that requires very high rates of monthly payments, high interest rates, high prices, low downpayments, very high monthly payments. That almost requires there be two wage earners in the family just to pay for housing.

I think that we see that occurring with many, many young families in particular where almost the total paycheck of one of the two wage earners in the family goes to pay for their house.

Now, if interest rates remain high and if inflationary expectation remains high and housing starts remain high, as you indicate they may, then we will also see an increasing or at least a continuing pressure for the increasing numbers of two wage earners within the same family. It isn't totally a desire on their part. Sometimes economic necessity or a desire for things that money buys forces them into the wage earners' market.

Do you see any change in that, or am I correct in assuming that that labor force participation rate change that has been going on in recent years will continue?

Mr. MILLER. The change in labor market participation rates is an interesting phenomenon which undoubtedly has been brought about for a number of reasons.

One is demographic. The effect of the baby crop after World War II reaching working age did have an impact. Social change in the role of women in society, which is a favorable trend, has also made

an impact. Inflation has made it either more necessary or more attractive for two or more wage earners per family to enter the labor force. These have all been interesting factors.

One outcome is that we now have the highest percent of our adult population employed that we have ever had—over 59 percent for the first time in our history. That has an economic consequence, because certainly aggregate real income is up, and therefore aggregate demand is up, and therefore the sustainability of economic growth is somewhat different than it might have been under different circumstances.

We may even be introducing a higher degree of flexibility, because to the degree that we do have households with multiple wage earners, there is more flexibility within those families as to their own options of entering or exiting the labor force.

As far as housing is concerned, yes, there has been anticipatory buying of housing in fear of future price increases. There has been buying because of the recognition of the store of value that is represented in a house. There has been buying because of the attractiveness of the method of financing—the tax deductibility of interest—and the recognition that if inflation continues, the repayment will be in cheaper dollars. All of these have been considerations.

The choice that we had, as a policy matter, was whether to continue to let interest rate cycles, fueled fundamentally by inflation, create a drying up of capital for housing, and whether to let the housing market go into a slump. We elected not to do that, not because we believe that there should be an excessive production of housing, but because we believe that little is gained by periods of boom in housing followed by the bust in housing that causes the dismantling of an industry with resultant high unemployment, the breaking up of the employment pattern of skilled workers, and the high cost of putting the industry back together. A pattern of sharp ups and downs also has the effect of creating instability in the industries that produce building materials; they tend to underinvest because they are concerned with the prospects for steep downturns.

So all of these reasons would tend to make us want at least to narrow the amplitude of swings within that industry.

Our expectation is not for continued rates of housing at the 2-million level of starts; and anticipate the rate will drop off to somewhere between 1.6 and 1.7 million starts this year, which we take to be healthy, because it would be a relatively modest decrease in activity which would not dismantle the industry, but still sufficient to take some pressure off and allow us to work on the side of reducing the cost of housing.

Senator McCLURE. Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much.

Mr. Miller, Congressman Brown made a point, I thought a good one, about the employment tax credit and the fact that the fellow doing the hiring didn't fully understand its availability and that the accountant might, but there was not sufficient communication.

I was the author of the employment tax credit that passed the Finance Committee in the Senate, and it was opposed by the Treasury. We finally got it into law in 1976 but it remained a well kept secret. Treasury did nothing to publicize it, because they were opposed to it.

In spite of that we had Professor Bishop of the University of Wis-

consin who testified before the Finance Committee that his economic models showed that it did have salutary effects. Now the administration has come along with what frankly I think is an improved version of what I had proposed and is getting it more on target in relation to unemployment. The program is trying to get people not to go into dead-end jobs, but jobs they have hopes of progressing in, and jobs that add to productivity.

But I hope we get the kind of publicity where the businessman, the small businessman, understands that it is available to him and that he will do the things that Congressman Brown is talking about. Hire this person, because there is an advantage if he will hire him and hopefully get him permanently into private sector employment.

But back to one of the questions on monetary policy. It seems to me it is one of the few times we have seen foreign economic relationships really dictate something to the Federal Reserve, as opposed to domestic considerations—at least take priority over them—that is when we saw the substantial devaluation of the dollar, the drop in the value of the dollar.

If you see another serious weakening in the foreign exchange markets, would you be inclined to force up interest rates even though that might be risky for the domestic economy? Where do you balance this out?

Mr. MILLER. We have to be very cautious, Mr. Chairman. While there has no doubt been a confluence of policies which protect both domestic and international balance, it seems to me that our monetary policy, in the past year has not really been dictated by international factors. International factors have been one of the considerations that influence domestic policy.

Senator BENTSEN. Well, maybe not dictated, but certainly influenced by it, when the whole package was announced at one time—this was apparently a part of it—to have some effect on saving the dollar.

Mr. MILLER. Let me just back to, though, to point out the interaction that I think exists and what our future policy reactions might be. The decline of the dollar introduced a very serious domestic inflation component. Failure to arrest the decline of the dollar would also create a very great domestic impact.

Senator BENTSEN. Well, that was what I was pointing out.

Mr. MILLER. My point is that the 1-percent inflation we had in 1978 from the decline of the dollar, translates into about a \$15 billion effect on consumers. Any action has to be weighed in terms of whether you can relieve what is, in effect, that tax. That is what I mean by saying that we were also trying to protect our domestic economy from the effect of the dollar's decline.

If we had some weakening of the dollar today, given the condition that our own domestic economy is in, I would think that we would want to look at a mix of policies. We would not want to crunch our domestic economy, because we would gain nothing by doing that. At the moment, I think other policies and opporrunities for dealing with the dollar are more attractive.

We do have a very substantial interest rate differential now between the deutsche mark, the yen, the Swiss franc, and the dollar, that makes it quite attractive to hold dollars. The Treasury also has the capacity, now that it has made the policy decision to borrow in foreign

currencies, to intervene in markets without expanding the money supply of other countries. This gives us another alternative.

Senator BENTSEN. Thank you very much, Mr. Miller. That concludes my questions.

Senator PROXMIRE.

Senator PROXMIRE. I don't want any more time than anyone else. I think on the second go-round we ought to have 10 minutes.

Senator BENTSEN. Senator, let's do 5 minutes and we can make a third round. We have other members here that I know have other commitments, including me.

Senator PROXMIRE. Very well then.

Senator BENTSEN. Maybe even Mr. Miller has some other commitments.

Senator PROXMIRE. Mr. Miller, the New York Times reports that the Nation's biggest banks have reported some of the most extraordinary earnings in years. Regional banks in California and elsewhere did even better than the money centers. CIT Corp. was up 28 percent in profits, J. C. Morgan & Co., where I used to work, was up 21.9 percent, Bank of America was up 34 percent, Western Bank Corp. was up 35 percent, and the explanation is that banks have pushed the prime rate to near all-time highs.

A very interesting comment by Warren Marcus, a general partner in Salomon Bros.:

He says the most surprising thing is lack of political response with interest rates flirting close to the all-time peak in the prime. I would have expected the relationship between it and the C.D. rate would be very poor, perhaps even a negative spread, but it hasn't happened. That is because we don't have people running around in Washington claiming that the bankers are raping the country.

The biggest question is whether the politicians will remain quiescent. I just don't want to count on this prosperity continuing. The Times reports that this man isn't alone, that other banks and bankers, also bank analysts, cited the absence of jawboning or public urging from Washington to hold down interest rates as a major reason for the impressive earnings.

I for one am delighted to see profits for the banks. They need it. Their capital is much too thin. This is one way of improving their capital, but there is a price you pay for this kind of thing and I wonder if maybe it isn't time for some Wright Patman or Lyndon Johnson, who were great people, to now jawbone down the interest rate with some success, to speak out in view of what appears to be the ineffectual effects of high interest rates in having any bite in slowing down inflation.

What is your response to that, as the No. 1 politician in Washington who Wall Street looks to on interest rates?

Mr. MILLER. As a nonpolitician, I would be glad to respond.

Senator PROXMIRE. We are all nonpoliticians, and Ronald Reagan is still a nonpolitician, too.

Mr. MILLER. Yes; and I understand Governor Connally is a politician now.

I disagree, of course, that the monetary restraints have had no bite. I think they have had a bite. The fact that we chose to give everybody a fair race—fairer competition—for the available capital doesn't mean to me that there has not been restraint.

Senator BENTSEN. You said "rate" or "rape"?

Mr. MILLER. "Race." Yes; I would have to be careful on that. I hope you got "race."

For example, I am convinced that businesses have managed their inventories more prudently because of the cost of money, or the cost of carrying inventories, and this has had an effect.

I am convinced that, generally, throughout the economy, many decisions about spending have been somewhat attenuated.

Senator PROXMIRE. Let me just interrupt, Mr. Miller—

Mr. MILLER. Yes.

Senator PROXMIRE [continuing]. To ask you whether you wouldn't disagree with the notion that these high interest rates tend to be passed on in higher prices; that what business does is that they can't eat the higher interest rates and their profits are going up, too, but they must pass on this higher cost in money, which is a very important element for many businesses. They must pass it on in higher prices. Isn't that correct?

Mr. MILLER. Not in all cases.

Senator PROXMIRE. Not in all cases, no, but in most cases.

Mr. MILLER. In some cases, the cost is passed on. But because of the competitive nature of businesses, businesses still have to restrain their inventory. Even if they carried higher inventories and were able to try to pass along the interest costs, they would become less competitive. So the truth is that inventories have been held in extremely good control.

I am not going to take your time here debating whether or not we had some bite. I think the rate of growth of the economy has been slowing, and is down from what it otherwise would have been. I think there is no question that the general perception is that there is constraint on business activities because of the monetary restraint that has existed. We see the inverse yield curve which is characteristic of periods when there is actual restraint on the economy.

The second part of your question is, why not jawbone interest rates down? In terms of real interest rates, I must again point out that, if anything, they are low. On the one hand, I argue that nominal rates have had an impact on restraining the economy; on the other hand, I argue that real interest rates have not been very high, and because they are not very high, the degree of restraint has been affected. Therefore, the consequence of trying to jawbone down interest rates would be to stimulate more economic activity at a time when we are trying to dampen inflation. That would seem to be working in the wrong direction.

Senator PROXMIRE. The issue is how high interest rates restrain and lower interest rates stimulate more activity. There is some question about that.

Let me ask you another question right now because the Governor of California has just electrified the country by coming out in favor of a constitutional amendment to require a balanced budget.

Now, you are a great believer in sound fiscal policy and you are viewed by many as the No. 1 economist in fighting inflation in view of your position.

How do you feel about the constitutional convention to require a balanced budget? As you know, 24 States have adopted this position.

It appears very possible, maybe likely, that the 34 required States will do so. If that is the case, we are going to be faced with quite a dilemma here and we would like your advice. It might be very helpful in letting the State legislators around the country know how the Chairman of the Federal Reserve Board feels about this matter.

Mr. MILLER. Senator Proxmire, I feel that a constitutional amendment to deal with the issue of balancing budget is inappropriate. The Constitution is not the place to exercise such discipline. That discipline must be exercised by every Congress and by every administration. We must face the music, and we should not lock into our Constitution a restriction that destroys our flexibility to respond over the decades to conditions we cannot now predict.

I don't believe the Constitution is the right place for such a restriction. Many Americans were not too approving of our involvement in Vietnam, but we didn't adopt a constitutional amendment saying we could no longer engage in war because we must be able to protect our country.

Senator PROXMIRE. My time is up, but let me ask you: Would you feel such an amendment could have a perverse economic effect frequently in this country in times of recession or depression?

Mr. MILLER. Yes. I think I would like to see us manage our economic affairs better, but we must remember that in our lifetime—in fact, in the history of this Nation, and in the history of modern nations—I don't know about way back at the beginning of colonial times—we have not seen high inflation rates in peacetime except within this recent period. To change our Constitution because we have gotten off track one in peacetime in the last 100 years and don't want to face the issue, is I think, an inappropriate way to tamper with the fundamental structure set by the Constitution. The Constitution ought to lay down the grand charter of the Nation; it ought not to be the place for carrying out specific policies.

If Congress feels that it needs more restraint than it is able to vote each year, there is no reason you can't lay down a permanent law that requires some discipline as to deficits.

What is important in exercising our economic policy is to correct the fundamentals that have gotten us into trouble and then manage our economy with a recognition that there will be business cycles, but they should be within narrower bands. We should not allow excesses in either direction. But that means there will be periods when you need deficits and periods when you need surpluses.

Senator PROXMIRE. Thank you.

Senator BENTSEN. Thank you, Senator Proxmire.

Congressman Brown.

Representative BROWN. Now that you have straightened out the State legislators around the country, I would like to remind you that last month before this committee, in a similar nature to Governor Brown's electrifying statement, you electrified us with the announcement that monetary policy is not really tight and that real interest rates are very low.

Now I agree with you on that, and you submitted a chart with your prepared statement here on mortgage rates, indicating that in the period 1955-65 the mortgage rate had a real mortgage rate impact of about 4 percent, from 1966-72 real mortgage rates were about 3 percent; and 1973-78 it was about 1 percent and, as I look at the 1978

average, it is, I would say, one-eighth to one-tenth of 1 percent in terms of real rates; in other words, what you get when you take the home mortgage rate and lay it against the Consumer Price Index.

I would assume that the mortgage bankers would not be adopting an interest rate that was a great deal below the Consumer Price Index. You predicted that less money growth would reduce inflation and bring nominal interest rates down, and it would help the dollar; and you are right, I think, because that seems to occur.

Key interest rates are showing signs of falling and the dollar seems to be firming. You agreed with me that problems with inflation and taxes were discouraging investment. You discussed the indexing of depreciation, or faster writeoff of equipment an example, and we got some positive comments about that from Mr. Schultze yesterday, although no indication that they are ready to bite that bullet and take that action in the administration or that the Council of Economic Advisers is ready to recognize that.

I am sorry that it is always going to be done tomorrow. I would like for us to get to tomorrow sometimes. But last week you said the Fed would ease up if recession occurred. You didn't want to get the Government to stimulate growth through spending.

I agree with the spending restraint, but why should the Fed ease up if you have not been tight, as we agreed the other day? Why shouldn't you keep your moderate posture of restraint? If there is to be stimulus, the Government should stimulate growth by removing tax barriers. Wouldn't you accept that as another approach?

Mr. MILLER. Congressman Brown, I don't believe that I said that we should ease up. I think I said that I would prefer a posture of continuing to be disciplined and austere in spending, but if there was a tendency for the economy to fall to too low a level of activity, we would take a look at monetary policy.

Monetary policy should continue to treat inflation as the primary enemy and not relent, not be too quick in removing the restraints put on in order to wring out inflation. I certainly don't want to leave the impression that we were suggesting or would suggest any easing in the foreseeable future, but I think that we would let monetary policy be more flexible and let the discipline stay on in Federal spending.

The time may come in the next few years, if the discipline in spending continues, when one would look at the possibility of tax relief to recognize that spending has been cut and that a tax adjustment is desirable.

Representative BROWN. Now, here again you seem to be putting that off into the future.

Mr. MILLER. Yes.

Representative BROWN. I would like to see that future come a little quicker. The broker loan rate fell at several major banks from 11.5 to 11 percent. Do you think we have seen a peak in other interest rates?

Mr. MILLER. I think it is premature to say. As we mentioned here this morning, we are still looking at performance of the economy. The economy performed stronger in the fourth quarter than we would have liked, in view of our objective to slow down activity. If that carries over into this year at that level of activity, it is premature to guess what interest rates will do. There may also be a seasonality in this.

Representative BROWN. Now, I don't want to contradict you in your own words, but you were quoted in the Post at least as saying that if a recession does occur, you would ease money and credit.

Mr. MILLER, considering that the CBO predicts a recession this year and inflation of 8 percent, don't you think that if the recession hits and if we have an easy money policy, we will eventually simply have more inflation, easily double-digit inflation? Because we are pushing to that point now, which would lead to another recession with even higher inflation. In other words, what I am describing here is kind of a harmonic effect that once it gets out of phase, it gets further out of phase with each move.

How is what you said last week conflicting with what you told us today concerning the importance of fighting inflation, and how severe would a recession have to get before you are forced to back down from your policies?

Mr. MILLER. I don't recall what I said, and I don't believe I did say, there would be an easing of monetary policy. What I have said is that it would be better to continue fiscal austerity, and that any adjustment in policy should be made on the monetary side.

There is a difference in saying that than in saying we are about to ease up on money, which I don't foresee. If you are talking about amplitudes, I am certainly in favor of getting away from high amplitude swings in economic activity, which have been characteristic in this decade and which, in my mind, are poor policy. You can certainly deal with that problem much better through monetary effort than you can through fiscal policy, because monetary policy can change more quickly and it can go in either direction quickly. It can be tightened up again, and it can be eased up a bit—it can go in the direction that is indicated—while fiscal policy quite often takes a long time to effect.

Congress goes through a long process of voting on spending authorizations and appropriations, and it is a long time before the levels get adjusted again. Once you have opened the spigot, it goes for quite a while. So I share with you the thought that we should get rid of the high amplitude swings. It is easier to do so by letting the throttle be on the monetary side more than on the fiscal side.

Representative BROWN. Finally, Mr. Miller, because my time is up, in testimony before this committee last year, you recommended deferral of the recent minimum wage increase as anti-inflationary. We didn't get that deferral because apparently the leadership of the Congress decided that no action should be taken.

How about the next increase scheduled for next January, from \$2.90 to \$3.15? Are you ready to make a recommendation in that area?

Mr. MILLER. Yes; I would like to see that deferred or, as I mentioned this morning, a youth differential which would address itself to the problem we have of starting young people in the world of work.

Representative BROWN. Thank you. I finally would like to submit a question on the inflexibility of Federal financing requirements that I think is resulting from the increased deficits that we have been having, and the fact that it builds in major debt that must be serviced, and the fact that we will be increasingly inflexible as a result of it. I will send you that question.

I would like for you to send me a written response.

Mr. MILLER. I would be delighted to answer.

[The following question and answer were subsequently supplied for the record:]

RESPONSE OF HON. G. WILLIAM MILLER TO AN ADDITIONAL WRITTEN QUESTION
POSED BY REPRESENTATIVE BROWN

Question. We are making great improvement in the budget picture this year, but \$29 billion is still a very large deficit. In view of our economic expansion over the past 4 years, and the credit demands that have accompanied it, is there any danger of "crowding out" in private credit markets this year? What effect does the rollover of our huge Federal debt have on the capital markets?

Answer. Any time the Treasury has a budget deficit to finance, interest rates tend to be higher and the volume of funds available to private borrowers to be lower than they would be if there were no deficit. But, with the deficit at \$29 billion, down significantly from preceding years and a satisfactory supply of loanable funds likely to be available in financial markets, it does not appear that crowding out will be a serious problem.

Treasury securities are free of default risk and can be traded in a market in which even large blocks of issues can be sold quickly without significantly affecting their price. Thus, financial institutions, nonfinancial corporations and other investors wish to hold these securities in order to enhance the safety and liquidity of their balance sheet positions. Accordingly, outstanding Treasury debt, far from being an impediment to the efficient functioning of our financial markets, actually serves to increase that efficiency.

The Treasury encounters little difficulty in refinancing maturing Treasury securities. Given the advantages provided by Treasury securities, there is a strong tendency for holders of maturing issues to roll them over into new issues, and, in addition, of course, there are always investors who wish to add to their holdings of these securities. Treasury financing operations proceed smoothly not only because of the continued strong public demand, but also because the Treasury tailors its security offerings—by adjusting maturities and other terms—to meet the portfolio needs of investors.

Senator PROXMIRE [presiding]. Senator McClure.

Senator McCLURE. Thank you. I just have a couple questions and a comment.

One, you indicated that the economy is quite close to full employment already. We have bandied those figures around in recent years. It seems to me that there is a growing consensus that the way we measure unemployment today, we have reached relatively full employment at about 5.5 percent, statistically.

What range would you use or what figure would you use to determine when we have reached full employment?

Mr. MILLER. I believe the Council of Economic Advisers has now adopted a 5.1 percent figure in their new analysis of the growth capacity of the economy, and I think that is fairly reasonable.

Senator McCLURE. Second, you have made reference to the housing starts coming down to maybe the 1.6 or 1.7 million range. One of the reasons for hoping to be able to take the fluctuation out of the housing market is the capacity of industry to provide the necessary materials for the housing industry. The housing starts will depend upon their expectation of what the market will return on their investment.

The timber industry has a fixed investment equal to the needs of housing at the rate of about 1.5 million per year and anything we do above that will either put a strain on timber supply or induce further investment in those production facilities.

The thing that would perhaps militate against increased production facilities is the supply of timber largely from Federal lands, which is now being inhibited by a whole range of Federal policies and lack of decision. If that is true, then you would expect that the investment will not be made, the capacity will not be there, the lumber supply will grow tighter and tighter, and we will see another spurt in timber price as well as an increase in the growing problem of importing soft lumber supplies from outside the country.

Would you disagree or agree with my expectation?

Mr. MILLER. I share the concern that you have expressed, and I think efforts underway to release additional Government lands for harvesting timber would be desirable. That would be an anti-inflation move and it would relieve some of the strains on supply that have been or could be a problem to us.

Senator McCLURE. We are already importing 20 percent of the Nation's softwood needs at a time we are not utilizing the wood we could produce in this country, which has an adverse effect on balance of payments as well, and an unneeded adverse effect on balance of payments.

Mr. MILLER. I concur.

Senator McCLURE. I might just conclude, Mr. Miller, by making a comment to my friend from Wisconsin that I suspect that had there been an increase in profits in something like oil companies equaling the increase in profits by the banking industry, we would have some of our colleagues proposing that those were obscene profits, that, as a matter of fact, the industry ought to be required to divest, that we would be talking about vertical or horizontal integration of the industry, and trying to find ways to break them up into smaller units so they would make smaller profits.

I suspect we might even have somebody assuming it would be good in the national economy to have the banking industry taken over by the Federal Government because of all the money that is printed belongs to all the people and any profits that are derived in using that money ought to be a Federal profit. But since it is the banking industry and not the oil industry, I don't suppose we will hear those comments.

Senator PROXMIRE. Well, don't be so sure.

Mr. MILLER. The Federal Reserve had very good earnings last year, too, but we gave those to the Federal Government, 100 percent.

Representative BROWN. They did better than the Government in general.

Senator PROXMIRE. I think, from my standpoint, it is a great thing that people are growing up on profits. It is a great thing for this country when real wages go up, profits go up, and people are better off. Profits, after all, are a big element in providing jobs and providing incentives and so forth. I think we always ought to applaud it.

At the same time we have to recognize that when they go up that much, that there is often a price to pay. There is no gain without paying.

Let me get to a couple other things quickly, Mr. Miller.

What contingency plans do you have if the situation gets worse? You are assuming the situation will get a little worse on the inflation front than the administration assumes, but you say it will be an improvement over this year.

Supposing it is not an improvement? Last year, as you recall, the consensus was that inflation for 1978 would be about 6 percent. It turned out to be 9 percent.

Now this year the administration's position is that inflation will be 7.5 to 8 percent. Supposing it turns out to be 10 percent? Do you have any notion on what we can do about it or should do about it, both monetary policy, fiscal policy and incomes policy?

Mr. MILLER. Among the things that are talked about, of course, is a greater degree of controls, mandatory controls either on wages, prices, or credit. I oppose those. I think that—

Senator PROXMIRE. Even if the situation worsens substantially?

Mr. MILLER. Even if the situation worsens. Experience tells us that those controls merely cap over the fundamental problem, but the fundamental problem doesn't get solved. We merely defer the day of reckoning.

If we are wrong on inflation, then it means that we will be in for more economic dislocations and the Nation will suffer. Our job is to keep the situation from getting worse. But I don't believe that we could contribute to the solution by imposing controls.

Senator PROXMIRE. I agree with you on controls.

What can we do?

Mr. MILLER. I think the only thing we can do in the face of worsened conditions is to look at a series of other possibilities. If the problem were the dollar, it might be necessary to put some restraint, direct restraint, on imports with a surcharge perhaps—although this is not desirable or likely.

Senator PROXMIRE. I am sorry, I didn't hear.

Mr. MILLER. We might have to do something on imports.

We might have to consider changing the conditions for financing of housing, which we have preferred to leave with more freedom. We might have to put some caps on that situation, in order to dampen excess demand.

We might have to consider some of those kinds of things.

Senator PROXMIRE. Now the administration has proposed a wage insurance program. In the first place, do you approve that?

Mr. MILLER. Well, I think—

Senator PROXMIRE. Is it vital? Is it marginal, or is it a fundamental element in fighting inflation in your view?

Mr. MILLER. I have viewed it as a very interesting idea, one that deserves consideration.

On the scale that is proposed, I have not considered it to be vital to the antiinflation efforts, personally, but I have thought that the idea of finding a technique, an automatic device, for motivating those who set prices and those who bargain for wages is desirable.

Senator PROXMIRE. Now what the administration has done, as I understand it, is to buy the Okun approach of the use of the carrot.

Now, Wallich, your colleague on the Federal Reserve Board, Henry Wallich, Governor Wallich, prefers a penalty approach of the tax increases if you exceeded the guidelines on prices and wages?

Mr. MILLER. That is correct.

Senator PROXMIRE. Do you think that is a possibility if the situation worsens?

Mr. MILLER. Both of those approaches are worth looking at. Both of them have a good many potential problems in terms of their administration and in terms of their impact.

Let me give you an example. If you use a carrot, the tendency is for everybody to get it. The first thing you know, a good idea can become a handout, because everybody complies when you have a carrot. If you use a stick, on the other hand, the tendency will be for nobody to be subject to the stick. Those very capital-intensive industries that have the least control over complying with some of the price and wage standards may be the ones that get hit the hardest with the stick. They may be the ones least able to provide alternate sources of capital to keep our economy going.

My only point, Senator, is that I am very openminded on the subject. I think these proposals are well worth consideration, and I hope that debate and dialog will enlighten us all as to how they may work. I see pluses and I see minuses. I would hope that Congress would look at real wage insurance as possibly a good experiment, and find out more about it, perhaps through a 1-year trial of whether it works. In that sense, it is well worth doing. If it is not done, I don't think it would be the end of the fight against inflation.

Senator PROXMIRE. To me, one of the real losers in this game, and you have talked about how interest rates are high because inflation is high, but the real losers are the small savers.

As you know, we have a statutory limit on the interest that can be paid to the small saver at the bank of 5 percent and 5¼ percent at the S. & L. As I pointed out, the banks are making great profits. Why shouldn't they, particularly when they can buy deposits at 5 percent and can get 10, 11, or 12 percent for their loans?

The margin is enormous, and the discrepancy is growing, and it seems unlikely that we will get interest rates down to a point where 5 percent would be fair to a small saver, in view of the fact that small saver is by definition a person who has limited means. But there are many of them. Why shouldn't we consider at least some program of changing regulations and making it possible for some relationship between the interest that is paid to the small saver and the prime rate or other governing rates?

Mr. MILLER. Senator, I agree with you completely. The regulation Q ceilings came into being in other times, for reasons which were then logical; I believe they have outlived their usefulness. But I think we have a timing problem. We cannot change them abruptly without creating distortions.

Senator PROXMIRE. Supposing legislation that provides for gradual increase at 6-month intervals, of a quarter or half percent?

Mr. MILLER. I would think that that would be desirable. Or certainly, if we have an interest rate cycle downward, which I hope we will, we ought to use that occasion to change the ceiling so as to allow the small saver to have the opportunity to earn appropriate yields, more commensurate with what is available to others in another cycle.

I might point out that one of the problems, Senator, as you well know, is that when you have rigid systems that do distort reality, then because of our ingenuity, our Nation finds alternate solutions.

What is happening is that new forms of savings are being invented for small savers, and this proves how unwise it is to have artificial

ceilings. For example, money market funds are now growing up to provide an alternate way for small savers to get a better yield. Consequently, we are seeing passbook funds move out of banks and thrift institutions.

Well, that is not healthy because it disrupts a financial system that has been built up over a long period of time, and that is important to our economy.

I agree with you in every way, and I'm pointing out that if we don't solve the problem, unfortunately things will break down anyway, so we should solve the problem sooner.

Senator PROXMIRE. Now, last November you told the Senate, or my committee, the Senate Banking Committee, that the Congress should attempt to cut the deficit in 1980 to about half its level in 1979.

The current estimate for 1979 is about \$39 billion. You recommend, therefore, a 1980 deficit of about \$20 billion rather than the \$29 billion recommended by President Carter?

Mr. MILLER. Senator, I was referring to a path, from 40 to 20 to zero. I have also said, however, that from \$38 billion, to \$29 or \$50 billion, to virtually zero is not unreasonable on the basis of my analysis. I would prefer the figure to be a little lower, but I am not disturbed by any discrepancy. It is consistent with the Economic Report to predict a modest deficit, if any, in fiscal year 1980.

We are getting there about on the track I had in mind.

Senator PROXMIRE. Well, we are getting there, but they are expecting again, they are putting off the day when it is going to be tougher to get to zero, or zero in 1980, if you only go down to \$29 billion this year, is going to make it harder.

There are also going to be some very tough decisions made. For example, there is growing sentiment to eliminate revenue sharing. That would be a \$6.9 billion savings right there. The States and localities have had difficulties, but they are still running surpluses by and large compared to our deficits. That is not for any specific program. It is not as if you are taking it away from the poor and the needy. By and large, that money doesn't go in that direction.

What would you think of eliminating revenue sharing?

Mr. MILLER. My own information on the present uses of revenue sharing money and the present plans is inadequate to give you an intelligent answer at the moment.

I am not that familiar with the present application of those funds. I would certainly not want to impact adversely local programs that are critical to revitalizing the cities or to assure—

Senator PROXMIRE. Those are separate programs, of course.

Mr. MILLER. Yes.

Senator PROXMIRE. We have community development programs, as you know, and the President's proposed an Urban Economic Development Bank.

Mr. MILLER. Yes.

Senator PROXMIRE. What about a tax cut in 1980? It's an election year, Presidential election year, and I think the pressures for a tax cut are likely to be very considerable, but I think we ought to look at this in the perspective we have this year, and I would like your advice on that.

Mr. MILLER. I would think it unwise. I believe that we must continue on this track of moving toward a balanced budget and maintaining a moderate rate of growth. I think a tax cut in 1980 would be premature.

Senator PROXMIRE. Even a moderate tax cut?

Mr. MILLER. I believe so.

Senator PROXMIRE. You wouldn't view the wage insurance program as a tax reduction even though it would result in that?

Mr. MILLER. That is in the budget for \$2.5 billion; it is contemplated within the \$29 billion deficit.

Senator PROXMIRE. That may be a pretty modest estimate. If we have the inflation you anticipate, it will be substantially higher than that.

Mr. MILLER. It would be a bit higher.

It's a form of tax reduction, one, as I said before, that's worth exploring. Without feeling that committed to it, I do think that a general tax reduction, even a modest one, in 1980, is premature.

Senator PROXMIRE. Do you think we can maintain a moderate rate of growth without a tax cut in 1980?

Mr. MILLER. The probabilities are that we could. We all recognize that we are looking pretty far ahead in this process, and developments can take place that we cannot now forecast. But, based upon the general trend of the economy, the probabilities are that we can dampen the rate of real growth in 1979 and create conditions where we will continue to see a moderate rate of growth in 1980.

Senator PROXMIRE. For the first time, the administration's budget contains a forecast of interest rates, the forecast average Treasury bill rate of 8.8 percent in 1979 and of 7.6 percent in 1980. What do you think about that forecast?

Mr. MILLER. I understood, Senator Proxmire, that that is not a forecast. I understood that it is a mechanical linking of the interest rate to the inflation rate. Had the inflation rate been projected to be higher, I understand that that formula would have resulted in a higher interest rate. Had the forecast of inflation been lower, the rate would have been lower.

Now, there is, as we know, a reasonable correlation between inflation and nominal interest rates, inflation being one component. So I think there is some rationale for a formula that links assumptions related one to another.

I would not think it not desirable for the administration to engage in interest rate forecasting, because that would become a device for sheltering us all from looking at the realities of budget implications. There is much more reason to believe that the linkage they have adopted is reasonable because, as I pointed out, if inflation is slightly higher and interest rates are slightly higher, revenues will be higher, but so will interest costs. I think the idea of looking at an interrelation there is certainly reasonable.

Senator PROXMIRE. But you have already implied, at least, higher interest rates in view of your feeling that interest and inflation are linked, and you told us that you expect inflation to be higher than the administration assumes it will be or expect it to be. Therefore, I would gather that you would assume that interest rates would be higher, too. You see, I am reading from the budget, which says:

Average rate on new issues within the period in the past, interest rates for the forecast period have been assumed to remain at the levels prevailing at the time the estimates were made because it would be unrealistic to assume continuation of the current unusually high interest rates. These estimates assume by convention that interest rates decline with the rate of inflation.

Mr. MILLER. Yes. To the extent I believe that the administration's outlook for inflation in fiscal year 1980 is slightly optimistic, I would have to say that I would agree with you, that to that degree there would be a slight variation from their view of interest rates, based on the linkage to inflation.

Senator PROXMIRE. I understand. Incidentally, I have been given a note, that no State is projected to have a deficit for fiscal year 1979. Many of them are cutting taxes. In my State they are recommending a tax cut. The Governor is recommending a very large tax cut. The legislature is recommending a big one, biggest we have had in history by far. New York is supposed to cut its taxes \$750 million; they are recommending another tax cut for this year. So those are reasons why I think the revenue sharing does seem to be something that we might reconsider.

Mr. MILLER. I would be delighted to take another look. As I say, I have not been that close to the issue.

Senator PROXMIRE. I have no more questions. I would just like to conclude, Mr. Miller, by saying that I think we ought to take a hard look at the effect the very high interest rates are having in slowing inflation. I think we are tending to cushion almost everything, not only housing, but with the futures market and so forth, a great deal of the whole financial structure is being given an ability to resist the pains of the credit crunch; and, while you can make a strong case in each instance, the overall effect I think can be that we are disarming the weapons we have relied on in the past to fight inflation, and I think we should be sensitive to that.

Mr. MILLER. Senator Proxmire, I understand your point. I would just point out that we do live in an adaptive society, and, as we have experienced these rates of inflation in the decade of the seventies, rates which we have never experienced in peacetime before, our system, with its creativity, has begun to adapt. You are correct; attitudes and expectations have changed and, therefore, it is true that it takes a greater dose of policy input to shift behaviors. But I would also suggest, very respectfully, that I am not sure we solve our problem by seeking credit crunches, distortions, and stress in the economy. The course that makes more sense to me is to move the throttle more smoothly but surely toward restraint, and keep it there for a longer period of time, in order to accomplish our objective.

Senator PROXMIRE. I just suggest that I think you are very right, and, as this works out for a period of time, I think we ought to stick with it for a little while. But I think we ought to keep alerted to the fundamental problem of fighting inflation, and maybe we have to take a more tough, more painful route, if necessary, in some of these areas, including even in housing, which I think is so important.

But, even there, in 6 months we may have to reconsider if the inflation situation continues.

Mr. MILLER. I think you are correct. We have been working and mobilizing the anti-inflation forces now for 10 months—we really started last spring in a serious way—and to the extent that the arsenal

of weapons we have mobilized and put in place is beginning to have an impact, we have to keep a very careful watch. If we are not making the progress we expect, we have to look at appropriate adjustments. And I think you are correct, the money market certificates have to be evaluated constantly.

We shall do that, and I shall certainly appreciate your counsel and guidance in this continuing dialog.

Senator PROXMIRE. I understand Governor Teeters is working with you on revising the kind of aggregate monetary figures that we get because of the shifts in financial structure.

Mr. MILLER. This innovation in our system means that the various deposit forms of money are taking on new functions. What we are looking at, and what we are going to publish very soon, is a tentative proposal for everyone's examination and input, so that we can redefine the monetary aggregates in terms of the function of money rather than the class of deposit. I think that will give us all a better handle on what is really happening on the monetary side of our economy, and perhaps sharpen our capacity to respond.

Senator PROXMIRE. Mr. Miller, you and I have had our differences, but I want to let you know how much I respect you and how remarkably responsive and direct and effective a witness you are. You have done a fine job.

Mr. MILLER. Thank you very much, Senator Proxmire.

Senator PROXMIRE. We will stand recessed until tomorrow morning at 10 o'clock, when we will have Secretary Blumenthal here.

[Whereupon, at 12:33 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, January 31, 1979.]

