1101

OUTLOOK FOR RECESSION

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

FIRST SESSION

OCTOBER 21, 1981

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WEDNESDAY, OCTOBER 21, 1981

OUTLOOK FOR RECESSION

WEDNESDAY, OCTOBER 21, 1981

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

The committee met, pursuant to notice, at 10 a.m., in room 2118, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Richmond, and Brown.

Also present: James K. Galbraith, executive director; Louis C. Krauthoff II, assistant director; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; and Chris Frenze, Keith B. Keener, Paul B. Manchester, and Richard Vedder, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for a consideration of the question put, Are we in a recession?

In the second quarter of this year real output fell at an annual rate of 1.6 percent. In just a few minutes the Commerce Department will release the report on gross national product in the third quarter, and if real GNP, as expected, has dropped, then the official definition for recession will unhappily be satisfied.

Signs of economic decline are everywhere, as these charts indicate. Long-term interest rates have hit record highs, with mortgage rates over 18 percent. The unemployment rate in July was 7 percent. Last month it was up to 7.5 percent. Two of our witnesses this morning, Mr. George Perry of the Brookings Institution and Mr. John Rutledge of the Claremont Economics Institute, both postulate a worsening of unemployment to 8.5 percent, which would mean that from July, when the President's economic program was passed by Congress, to early next year 1.5 million Americans who would otherwise have jobs will be jobless. Single family housing starts, on an annualized basis, were at a record low of 918,000 last month, down 28 percent from the previous year. Auto sales in the first 10 days of October were 35 percent below the comparable level the year before. Industrial production fell at an annual rate of 3.8 percent in August and 9.0 percent in September. President Reagan himself announced over the weekend that a recession has begun. Since he has access to the material that will be available to the rest of us in a few minutes, I assume, unfortunately, that he's right.

The question is whether the President shouldn't have told the Congress and the world all about this unhappy state of affairs last February and in the months after that when he was presenting his program.

In his "Program of Economic Recovery" of February 18, 1981, the President said: "The program we have developed will break that cycle of negative expectations. It will revitalize economic growth, renew optimism and confidence and rekindle the Nation's entrepreneurial instincts and creativity. The benefits to the average American will be striking. Inflation, which is now at double digit rates, will be cut in half by 1986. The American economy will produce 13 million new jobs by 1986, nearly 3 million more than if the status quo in Government policy were to prevail. The economy itself should break out of its anemic growth patterns to a much more robust growth trend of 4 to 5 percent a year. These positive results will be accomplished simultaneously with reducing tax burdens, increasing private saving, and raising the living standard of the American family."

The question could legitimately be asked, If the President knew what was going to happen—namely, the creation between now and early next year of perhaps a million more unemployed; if he knew that we would be plunged into a recession 9 months after his inaugural, why didn't he tell the Congress and the people that? That might have been an ingredient in the debate on his program.

Second, if he didn't know, then obviously there's something wrong with his program and it behooves him speedily, upon his return from Cancun, to tell the American people what went wrong and what he proposes to do about it.

Obviously, some of us think that what went wrong is that the President's program, when he put it together, spelled a murderously high level of interest rates which would ruin construction, housing, farmers, small business, and now the capital goods industry, and bring us to a recession; and this is precisely what has happened.

This regime of high interest rates is something the administration itself mandated when it issued its marching orders to the Federal Reserve back in February and almost every day since, saying they should lower their targets, which the Federal Reserve did. Under those orders the Federal Reserve is mandated to lower its monetary targets even more starting January 1; and this in the face of a recession which is now upon us and a recession that has been brought about by a high interest rate regime laid down by the administration.

So I call on the administration once again to repeal its policy, revoke its program, and withdraw its instructions to the Federal Reserve to further tighten money on January 1. It's done enough harm. We think it should cease.

We are fortunate this morning to have three superb witnesses: Mr. George Perry of Brookings, Mr. Lawrence Chimerine of Chase Econometrics, and Mr. John Rutledge of the Claremont Economics Institute.

I'm just told that the Department of Commerce has made its announcement, and that the President had the right dope. We are in a recession. The figures for the third quarter represent a real decline of 0.6 percent in gross national product. And in that unlovely situation I hope Republicans and Democrats will now join so that we may emerge speedily and unscarred from the recession into which we unnecessarily have been plunged.

[The Department of Commerce press release follows:]

UNITED STATES DEPARTMENT OF
COMMERCE
NEWS
WASHINGTON, D.C. 20230

BUREAU OF
ECONOMIC ANALYSIS

FOR WIRE TRANSMISSION 10:00 A.M. EDT, WEDNESDAY, OCTOBER 21, 1981

Leo M. Bernstein: 523-0824

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THIRD QUARTER 1981
GROSS NATIONAL PRODUCT (PRELIMINARY)

Gross national product -- the market value of the nation's output of goods and services -- increased $61.2 billion or 8.8 percent at a seasonally adjusted annual rate in the third quarter of 1981 to $2,947.0 billion, according to preliminary figures released by the Commerce Department's Bureau of Economic Analysis. In the second quarter, GNP increased $32.8 billion or 4.7 percent.

Real output (GNP adjusted for price changes) decreased 0.6 percent at an annual rate in the third quarter, compared with a decrease of 1.6 percent in the second. The decrease in real output was attributable to both final sales and inventories. Real final sales decreased 0.5 percent, compared with a decrease of 4.7 percent in the second quarter. Real inventory accumulation decreased slightly in the third quarter.

The decrease in real final sales was more than accounted for by net exports, residential investment outlays, and State and local government purchases, all of which also decreased in the second quarter. Real personal consumption expenditures increased in the third quarter, following a decrease in the second.

Prices, as measured by the GNP fixed-weighted price index, increased 9.2 percent in the third quarter, compared with 7.9 percent in the second. The larger increase in the third quarter is primarily due to prices paid by consumers for food and services; food prices increased 8.8 percent in the third quarter, compared with 0.5 percent in the second, and services prices increased 11.9 percent in the third quarter, compared with 9.0 percent.

The Bureau emphasized that the third-quarter estimates are based on preliminary and incomplete source data. Information on assumptions used for missing source data is available on request from the Bureau of Economic Analysis. Revised estimates based on more comprehensive data will be issued next month.

Final sales and inventory investment (current dollars)

Final sales increased $66.9 billion in the second quarter, compared with $14.0 billion in the second. Personal consumption expenditures, nonresidential fixed investment, and government purchases increased. Residential investment and net exports, both of which decreased in the second quarter, continued to decrease in the third.

Inventories increased $17.6 billion in the third quarter, following increases of $23.3 billion in the second quarter and $4.5 billion in the first. Thus, the change in inventory investment, which added $18.8 billion to the second-quarter increase in GNP, subtracted $5.7 billion from the third-quarter increase.

Personal consumption expenditures

Personal consumption expenditures increased $59.5 billion in the third quarter, compared with $19.0 billion in the second. Purchases of durable goods increased $12.7 billion, following a decrease of $11.0 billion. Both the third-quarter increase and second-quarter decrease reflected sharp changes in purchases of new cars. Purchases of nondurable goods increased $14.8 billion, compared with $9.3 billion. Expenditures on services increased $32.1 billion, compared with $20.7 billion.

Disposable (after-tax) personal income increased $54.5 billion in the third quarter, and personal outlays increased $60.9 billion. As a result, personal saving decreased $6.4 billion and the saving rate (saving as a percentage of disposable income) decreased from 5.4 percent in the second quarter to 4.9 percent in the third.

Fixed investment

Business fixed investment increased $6.2 billion in the third quarter, compared with $8.7 billion in the second. Nonresidential construction outlays increased $4.7 billion, compared with $5.9 billion. Nonresidential producers' durable equipment purchases increased $1.6 billion, compared with $2.8 billion. Residential investment outlays decreased $9.3 billion, following a decrease of $6.0 billion.

Net exports

Net exports of goods and services decreased $2.8 billion in the third quarter, following a decrease of $8.4 billion in the second. Exports decreased $5.4 billion, following an increase of $0.8 billion. Imports decreased $2.7 billion, following an increase of $9.3 billion. The decrease in imports is attributable to purchases of foreign oil, which fell $12.4 billion in the third quarter, following an increase of $1.5 billion in the second.

Government purchases

Federal government purchases of goods and services increased $8.2 billion in the third quarter, following a decrease of $2.1 billion in the second. Defense spending increased $6.4 billion, compared with $3.0 billion. Nondefense spending increased $1.7 billion, following a decline of $5.1 billion. The increase in nondefense spending is due to an increase in net purchases of farm commodities by the Commodity Credit Corporation, following a decrease in the second quarter. State and local government purchases increased $5.0 billion, compared with $3.0 billion.

Implicit price deflator

The GNP implicit price deflator increased 9.4 percent in the third quarter, compared with 6.4 percent in the second. Changes in the implicit price deflator reflect changes in prices and in the composition of output. Changes in the fixed-weighted price index reflect only changes in prices.

Definitions

Price indexes

The fixed-weighted price index uses as weights the composition of output in 1972. Accordingly, comparisons over any time span reflect only changes in prices.

The implicit price deflator is a weighted average of the detailed price indexes used in the deflation of GNP. In each period, it uses as weights the composition of constant-dollar output in that period. Changes in the implicit price deflator reflect both changes in prices and changes in the composition of output.

The chain price index uses as weights the composition of output in the prior period, and therefore, reflects only changes in prices between the two periods. However, comparisons of the percent changes in the chain index reflect changes in composition of output.

GNP and personal income statistics are shown in the accompanying table. Additional data will appear in the July issue of the Survey of Current Business, a monthly journal of the Bureau of Economic Analysis.

The Survey of Current Business is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. First class mail: annual subscription $46.00 domestic. Second class mail: annual subscription $27.00 domestic, $33.75 foreign; single issue $3.75 domestic, $4.70 foreign.

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FORM BE-679
(2-23-76)

GROSS NATIONAL PRODUCT AND

GROSS NATIONAL PRODUCT	1978	1979	1980	1980 III	1980 IV
				Seasonally	
				Billions of current dollar	
Gross national product (GNP)	2156.1	2413.9	2626.1	2637.3	2730.6
Personal consumption expenditures	1348.7	1510.9	1672.8	1682.2	1751.0
Durable goods	199.3	212.3	211.9	208.8	223.3
Nondurable goods	529.8	602.2	675.7	674.2	703.5
Services	619.6	696.3	785.2	799.2	824.2
Gross private domestic investment	375.3	415.8	395.3	377.1	397.7
Fixed investment	353.2	398.3	401.2	393.2	415.1
Nonresidential	242.0	279.7	296.0	294.0	302.1
Structures	78.7	96.3	108.8	107.3	111.5
Producers' durable equipment	163.3	183.4	187.1	186.8	190.7
Residential	111.2	118.6	105.3	99.2	113.0
Nonfarm structures	106.9	113.9	100.3	94.5	107.6
Farm structures	1.8	1.8	2.0	1.7	2.2
Producers' durable equipment	2.6	2.9	3.0	3.0	3.1
Change in business inventories	22.2	17.5	-5.9	-16.0	-17.4
Nonfarm	21.8	13.4	-4.7	-12.3	-14.0
Farm	.4	4.1	-1.2	-3.7	-3.4
Net exports of goods and services	-.6	13.4	23.3	44.5	23.3
Exports	219.8	281.3	339.8	342.4	346.1
Imports	220.4	267.9	316.5	297.9	322.7
Government purchases of goods and services	432.6	473.8	534.7	533.5	558.6
Federal	153.4	167.9	198.9	194.9	212.0
National defense	100.0	111.2	131.7	131.4	141.6
Nondefense	53.4	56.7	67.2	63.5	70.4
State and local	279.2	305.9	335.8	338.6	346.6
Addenda:					
Final sales (GNP less change in business inventories)	2133.9	2396.4	2632.0	2653.4	2748.0
Gross domestic product (GNP less rest-of-world sector)	2126.2	2370.1	2576.5	2586.9	2682.0
Implicit price deflator, index numbers, 1972 = 100:					
GNP	150.05	162.77	177.36	179.18	183.81
Gross domestic product	150.1	162.8	177.4	179.2	183.8
Gross domestic business product	149.6	162.6	177.4	179.5	183.8
Change from preceding period, percent at annual rate:					
GNP	12.4	12.0	8.8	11.8	14.9
Gross domestic product	12.2	11.5	8.7	11.6	15.6
GNP implicit price deflator	7.3	8.5	9.0	9.2	10.7
Gross domestic product implicit price deflator	7.3	8.5	9.0	9.2	10.7
Gross domestic business product implicit price deflator	7.4	8.7	9.1	9.7	9.9
GNP chain price index	7.5	8.7	8.6	9.3	10.5
GNP fixed-weighted price index	7.6	9.4	9.6	9.0	10.4
DISPOSITION OF PERSONAL INCOME					
Personal income	1721.8	1943.8	2160.2	2182.1	2256.2
Less: Personal tax and nontax payments	258.8	302.0	338.5	341.5	359.2
Equals: Disposable personal income	1462.9	1641.7	1821.7	1840.6	1897.0
Less: Personal outlays	1386.6	1555.5	1720.4	1729.2	1799.4
Equals: Personal saving	76.3	86.2	101.3	111.4	97.6
Per capita disposable personal income, dollars	6,571	7,293	8,002	8,074	8,299
Personal saving as a percentage of disposable personal income	5.2	5.2	5.6	6.1	5.1

Source: U.S. Department of Commerce, Bureau of Economic Analysis

POSITION OF PERSONAL INCOME

U.S. DEPARTMENT OF COMMERCE
BUREAU OF ECONOMIC ANALYSIS

1981			1978	1979	1980	1980		1981		
I	II	III^p				III	IV.	I	II	III^p
sted at annual rates						Seasonally adjusted at annual rates				
			Billions of 1972 dollars							
33.0	2885.8	2947.0	1436.9	1483.0	1480.7	1471.9	1485.6	1516.4	1510.4	1508.2
10.1	1829.1	1888.6	904.8	930.9	935.1	930.8	946.8	960.2	955.1	965.2
38.3	227.3	240.0	146.3	146.6	135.8	132.6	139.1	146.8	137.4	142.4
26.0	735.3	750.1	345.7	354.6	358.4	354.9	360.4	364.5	367.0	368.2
15.8	866.5	898.6	412.8	429.6	440.9	443.3	447.3	448.9	450.7	454.6
37.1	458.6	449.8	229.7	232.6	203.6	195.3	200.5	211.6	219.7	214.4
32.7	435.3	432.2	215.8	222.5	206.6	200.2	207.6	213.1	208.9	204.1
15.9	324.6	330.8	153.4	163.3	158.4	155.5	157.0	162.0	161.1	161.0
17.2	123.1	127.8	44.6	48.5	48.4	46.8	47.8	49.6	50.4	51.3
98.7	201.5	203.1	108.8	114.8	110.0	108.8	109.3	112.4	110.7	109.7
116.7	110.7	101.4	62.4	59.1	48.1	44.7	50.6	51.0	47.8	43.2
11.4	105.4	95.8	59.5	56.2	45.2	41.9	47.5	48.0	44.8	40.2
2.2	2.1	2.3	1.0	.9	.9	.7	1.0	.9	.9	1.0
3.2	3.2	3.2	1.9	2.0	2.0	2.0	2.0	2.1	2.0	2.0
4.5	23.3	17.6	14.0	10.2	-2.9	-5.0	-7.2	-1.4	10.8	10.3
6.8	21.5	13.9	13.9	7.8	-2.4	-3.1	-5.6	-.3	9.9	8.4
-2.4	1.8	3.8	0	2.4	-.5	-1.8	-1.5	-1.1	.9	1.9
29.2	20.8	18.0	24.6	37.7	52.0	57.6	48.5	50.9	46.2	39.5
67.4	368.2	362.8	127.5	146.9	161.1	160.5	157.4	162.5	161.5	157.9
38.2	347.5	344.8	103.0	109.2	109.1	102.8	108.9	111.6	115.4	118.4
76.5	577.4	590.5	277.8	281.8	290.0	288.2	289.8	293.6	289.5	289.1
21.6	219.5	227.7	99.8	101.7	108.1	106.9	107.4	111.2	108.7	110.2
15.2	148.2	154.6	65.4	67.1	70.9	70.9	71.9	72.1	72.6	74.0
76.4	71.3	73.0	34.4	34.6	37.2	35.9	35.4	39.0	36.1	36.1
54.9	357.9	362.9	178.0	180.1	181.9	181.3	182.4	182.5	180.7	178.9
48.5	2862.5	2929.4	1423.0	1472.9	1483.6	1476.9	1492.7	1517.8	1499.6	1497.9
00.7	2835.5	2894.5	1416.8	1455.9	1452.4	1443.4	1458.9	1488.4	1483.8	1481.0
8.14	191.06	195.40	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
8.2	191.1	195.4	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
8.2	191.1	195.6	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.2	4.7	8.8	4.8	3.2	-.2	2.4	3.8	8.6	-1.6	-.6
3.9	5.1	8.6	4.6	2.8	-.2	2.2	4.4	8.3	-1.2	-.7
9.8	6.4	9.4	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.8	6.4	9.4	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.9	6.3	9.8	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.8	7.7	9.5	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.2	7.9	9.2	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
9.8	2368.5	2440.0	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
2.0	382.9	399.9	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
7.8	1985.6	2040.1	981.5	1011.5	1018.4	1018.3	1025.8	1033.3	1036.8	1012.6
.9	1879.0	1939.9	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
.9	106.6	100.2	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX
4	8,651	8,865	4,409	4,495	4,473	4,468	4,488	4,511	4,517	4,530
.6	5.4	4.9	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX	XXXXXX

Reliability of the Estimates

The GNP figures issued in the month after the end of the quarter are based on preliminary and incomplete source data. They are revised as more comprehensive and final data become available. The first revision is made one month after the preliminary figures are issued, and a second revision is made one month later. The figures also are subject to further revisions in the following three years, usually in the month of July. The table below provides summary measures of the amount of revision in past years in quarterly percent changes in GNP, real GNP, and the GNP implicit price deflator. These measures provide some guidelines in assessing the likely size of the revisions in estimates for the current quarter. For example, nine of ten times the revision between the estimate of the quarterly change in the preliminary estimate of real GNP and that in the following July has been within a range of -1.8 to +2.0 percentage points as shown by the range from the 5th to 95th percentile. Thus, based on past experience, it is likely that the third quarter change in real GNP now estimated at -.6 percent at an annual rate will not be revised above 1.4 or below -2.4 in the first July revision.

The second revision of GNP was introduced in December 1977. There are not yet enough observations to compute the likely size of the revisions between the first and second revised estimates and between the second revised and July estimates. It is expected, however, that these revisions will be smaller than those between the preliminary and first revised estimates and between the first revised and July estimates.

The summary measures for the GNP implicit price deflator also indicate the likely revisions in the two other GNP price indexes.

Revision in Quarter-to-Quarter Percent Changes at Annual Rate

	Average without regard to sign	Range of revision between specified percentiles: 25 to 75	Range of revision between specified percentiles: 5 to 95
		Current-dollar GNP	
Preliminary/1st revision	.5	-.1 to + .6	-.4 to + 1.3
Preliminary/1st July	1.0	-.2 to + 1.4	-1.4 to + 2.2
Preliminary/3rd July	1.4	-.4 to + 1.8	-1.9 to + 3.0
First revision/1st July	.9	-.2 to + .6	-1.4 to + 1.6
First revision/3rd July	1.0	-.3 to + 1.4	-2.1 to + 2.3
		Real (constant-dollar) GNP	
Preliminary/1st revision	.5	-.3 to + .4	-.8 to + 1.1
Preliminary/1st July	1.0	-.5 to + 1.1	-1.8 to + 2.0
Preliminary/3rd July	1.4	-.8 to + 1.5	-2.1 to + 3.4
First revision/1st July	.9	-.6 to + .9	-1.5 to + 2.3
First revision/3rd July	1.4	-1.0 to + 1.7	-2.0 to + 2.9
		GNP implicit price deflator	
Preliminary/1st revision	.3	-.1 to + .3	-.4 to + .7
Preliminary/1st July	.5	-.2 to + .6	-.8 to + 1.5
Preliminary/3rd July	.6	-.2 to + .7	-.7 to + 1.9
First revision/1st July	.5	-.2 to + .4	-1.1 to + .9
First revision/3rd July	.6	-.3 to + .6	-1.3 to + 1.8

NOTE: Measures are based on the period from 1964 to 1979. For additional measures, see Reliability of the Quarterly National Income and Product Accounts of the United States, 1947-1971, Bureau of Economic Analysis Staff Paper No. 23, July 1974. It is sold by the National Technical Information Service, U.S. Department of Commerce, Springfield, Virginia 22161, for $6.00; the accession number is COM 74-11508.

Representative REUSS. With that, I turn to my colleague, Congressman Brown, for a statement.

OPENING STATEMENT OF REPRESENTATIVE BROWN

Representative BROWN. Mr. Chairman, I'm glad the President has the right dope. I wish you had the right dope in terms of who is responsible for this. The facts indicate that we are in a recession. It is not clear when it began. Some would say last month. Some would say 3 weeks ago, the day that the President's program took effect. I think that's a little bit too much focus of specific blame to be rational. Others would say last spring, and still others would say in the spring of 1979, because real GNP has increased very little since the first quarter of 1979, less than 3 percent in the 2½ years from then until now.

If we looked at the automobile sales over the last 3 years, the chart [indicating] that we have over here that begins in January 1981 would in effect be flat because it would have dropped from a rather much higher level of automobile sales in 1979 down to the level that is shown on the picture over here when you just take the last few months. The same thing is true in housing starts. The housing starts have been a sawtooth situation. The decline did not necessarily begin in January 1981. It began really much earlier than that, given the previous performances that were sustained for a long period of time.

Why has our economy performed so badly since early 1979 and what could be done about it? I believe our recent miserable economic performance is rooted in profligate Government spending and monetary policies that began in the late 1960's, worsened in the late 1970's and continued through 1980. These policies produced, in turn, inflation, high interest rates, and recession; and then inflation, high interest rates and recession again, and again and again.

I further believe that we can turn the economy around if we stay with the policies that we installed this year. Really, that's even an extreme statement—that we installed 3 weeks ago. It is now October 21, and none of those policies took effect until October 1, when the budget cuts first took effect, and the tax cuts in large measure will not take effect until July of next year, and the tax cut program is a 3-year program designed to unscrew an economy that's been screwed up now for about the last 8 years.

I would remind the chairman and others in the audience that the prime rate in December of 1980, when Ronald Reagan was not President, was 21 percent. The prime rate has come down a bit and if the President's program that began 3 weeks ago gets all the blame for the current recession, then certainly he ought to get all the credit for the fact that the prime rate has dropped from that 21 percent.

I think that we can turn the economy around if we are consistent and if we are not panic stricken by what really is another component in what people predicted some years ago would be a "W" or a double dip—a double "U" recession.

The need to slow monetary growth in a noninflationary way is still there. Keeping it there and reducing permanently the burdens of high taxes on the American people that have destroyed our capacity to produce in this country and our capacity to be competitive is still important. High Government spending, if it were the cure-all for our problems, certainly ought to see us in a boom time because we have been spending more than we have taken in for the last 20 years. And on that basis we ought to really be in good times if that were the answer to the problem.

I'm anxious to hear what our witnesses think, so I'll take no more time. My guess is that they will be as diverse in their opinions as the two of us are—perhaps the three of us—on this panel.

Representative REUSS. Congressman Richmond, do you want to indicate your opinion?

OPENING STATEMENT OF REPRESENTATIVE RICHMOND

Representative RICHMOND. Mr. Chairman, you and I think alike, as you know. I just want to call your attention to the obvious fact that perhaps the Congress erred seriously in this latest tax bill. I think what this country needed was modernization of its industrial tax code provisions, modernization of the marriage penalty, modernization of many other items of the Tax Code. Certainly what we didn't need was a personal tax reduction. That's certainly inflationary. That certainly will keep interest rates up. What this country must work toward is lower interest rates and lower inflation.

How do you do that? You do it by balancing the Federal budget. How do you balance the Federal budget? You don't cut social programs. You use many of the items you and I, Mr. Chairman, worked on so diligently on our "Share the Burden" budget. There's no reason why consumer interest should be tax deductible. There's no reason why we shouldn't increase our highway tax fund. It hasn't been increased since 1954. In 1954 we had a highway users tax of 4 cents a gallon. If we just indexed that for inflation, we would be getting 14 cents a gallon now. That money could be used to improve the highways and put people back to work and improve the 170,000 bridges that are indeed unsafe in the United States.

As you know, Mr. Chairman, in our "Share the Burden" budget we have $40 billion worth of increased revenue which we could generate for the Federal Government through user taxes. That would certainly do a great deal toward dropping interest rates, dropping inflation, and balancing the Federal budget, without balancing the Federal budget on the backs of poor people.

I look forward to your testimony, gentlemen, and certainly during my question period I'd like to ask you specifically what you think of introducing some of these methods. Thank you very much.

Representative REUSS. Thank you. Congressman Rousselot will not be here today because of a conflict in his schedule, but has requested that his written opening statement be included in the record, which I will do at this point, without objection.

[The written opening statement of Representative Rousselot follows:]

WRITTEN OPENING STATEMENT OF HON. JOHN H. ROUSSELOT

Mr. Chairman, discussions of whether the Nation's production is recessed, depressed, or just sputtering along are important because all of the dialog focuses attention on restoring economic growth. Attention of this committee should be centered on fullfilling our charter, providing policy for "full employment and stable prices."

The President has proposed a four-point Program for Economic Recovery. For some of us in Congress, stable currency, low taxes, limited spending, and affordable regulations have long been our goals—the goals necessary to establish the economic opportunity to provide more jobs, more production, and more income.

Government spending must be paid for by taxes, inflation, or interest expenses to finance the deficit. Government spending crowds out private development by imposing business costs—taxes, inflation, and upward pressure on interest rates—on private entrepreneurs who must then pass the expenses on to the consumer.

Stable currency should be the product of balanced budgets, rather than the product of a monetary policy designed to remove excess government spending from circulation. It is a waste of resources for a country to pay interest charges for its present spending. Deficit finance should be considered only in times of national crisis.

Undue Federal regulations have imposed excessive business design and planning expenses without yielding any appreciable gains. Minimum wage laws for instance have discouraged employers from hiring youth. If the country is to compete in world markets, and bring additional income to our neighborhoods, people must have the ability to make the most of their resources.

Enactment of President Reagan's request to reduce the Federal budget by $16 billion for fiscal year 1982 will require political "profiles in courage" from at least a majority of Congress. I believe that a belief in limited government comes down to the question of whether the private sector is more efficient than the public.

Representative REUSS. Mr. Perry, we will hear you first, please proceed in any way that's convenient to you.

STATEMENT OF GEORGE L. PERRY, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. PERRY. Thank you. I have kept my prepared statement[1] brief and will read from it.

It is a privilege to testify before this committee on the general economic outlook and on the desirability of policy changes. I shall organize my remarks by responding to the five specific questions you raised in your letter of invitation.

One. I expect the economy is entering a serious recession. The table at the end of this statement provides a summary of my economic forecast completed early this month. Although it does not reflect the upward revisions in industrial production that become available last Friday and the preliminary estimate of GNP for the third quarter that becomes available today, the forecast for coming quarters is still the one I would make in all important respects. Here are some important features of this outlook:

Real GNP and industrial production will decline noticeably over the next three quarters.

Corporate profits will be substantially below year-earlier levels over this period.

Unemployment will rise to 8½ percent.

Bankruptcies and business failures will increase as weak sales add to the problems already caused by sustained, record high interest rates.

Inflation rates will be moderate by recent standards.

The year 1982, as a whole, will be the third year in a row of disappointing business investment, rising unemployment, and near-depression in the housing and automobile industries.

Two. Compared with last year, inflation has slowed in recent months for a number of reasons. The improvement will be maintained in 1982, when the inflation rate measured by either average hourly earnings or by the CPI or PPI on the price front should average 6 to 8 percent. There is a good chance inflation will be held at this

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[1] The views expressed in this statement are my own and not necessarily those of the officers, trustees, or staff of the Brookings Institution.

rate beyond 1982. If unemployment remains high and vigorous expansion of the economy is thwarted again by monetary policy, the inflation rate could even be reduced further in subsequent years. However, such a further slowing of inflation seems incompatible with a sustained and vigorous economic expansion. Some of the reasons for this assessment include the following.

Relatively stable prices for energy, food, and housing are the biggest source of improvement in inflation compared with the 1979–80 period. These added 4 to 5 percentage points to average price increases in those 2 years.

Persistent and growing economic slack for an extended period is another important element contributing to lower inflation. By next summer it will have been 3½ years during which industrial production has been well below or, at best, up to its level reached in early 1979.

Unemployment will have risen 2½ points over that time.

Under the pressure of threatened bankruptcies or plant closings, a rash of wage concessions have already been made to individual firms in a wide range of industries.

In many prominent industries that will soon be negotiating new labor contracts, wages have risen very rapidly over the past decade and have gotten out of line with wages in other sectors.

Many of these industries have already lost markets to competition and to the protracted weakness in the economy, and their economic positions will weaken further next year. Thus, for the first time in over a decade, there is a good chance of moderation in these major wage settlements.

Some spillover from these settlements, together with the downward pressure from business recession and high unemployment, will hold down economywide wage increases.

Three. Interest rates should decline along with the economy. Within limits, the Federal Reserve can delay or accelerate the timing and extent of this decline. With a sustained recession, I expect short-term interest rates to decline several percentage points between now and next spring, with commercial paper and Treasury bill rates falling below 10 percent. The longer such a decline is delayed or resisted by monetary policy, the worse the recession is likely to be. Auto sales and home construction are especially sensitive to interest rates. In the third quarter of this year, auto sales averaged 9 million units and housing starts just under 1 million units, both at annual rates. Both are heading lower and they may not bounce back promptly. Mortgage interest rates will fall much less than short-term rates—because it is reasonable to expect that short rates will rise again. And auto sales will continue to be depressed by high prices and rising unemployment. Neither industry has experienced such a sustained depression in the postwar period.

Four. The current policy mix combines a very restrictive monetary policy and, as one looks ahead to future tax cuts and rising defense spending, an increasingly expansionary fiscal policy. As a result of this mix, even if interest rates decline substantially in coming months, one should expect them to rise again as expansion resumes, and to be high on average, over the next several years. How did we get here and what might we do?

The tight monetary policy that is being used to fight inflation would itself insure relatively high rates.

The expansionary fiscal policy that accompanies it adds to the pressure for high rates by pushing up on demand and forcing a greater competition for available funds.

A tighter fiscal policy, involving smaller deficits or even surpluses at high employment, would permit lower interest rates and encourage investment of all kinds. However, to reap the full benefit of any future fiscal tightening, it should be accompanied by some monetary easing. This change in mix deserves a high priority on our economic agenda. Business investment is needed for economic growth and housing investment is needed for economic and social well-being.

Five. A substantial recession will enlarge the fiscal 1982 deficit to the neighborhood of $100 billion. With present programs and tax changes, the deficit for fiscal 1984 is likely to be greater than that. The appropriate response to these two situations is quite different.

The fiscal 1982 deficit is large because of the recession, and fiscal policy should not worsen that recession by getting tighter in the short run.

The longer run deficits represent poor economic policy. But some ways of attempting to cut those deficits would be so undesirable on other grounds that the status quo should be preferred. It would be poor economic policy and unconscionable social policy to place the burden of further budget tightening on the less privileged, on State and local governments, on public investment, on education and research, and on important general government activities such as data gathering and dissemination. We are the world's greatest and richest economy. We should not behave like mean-spirited paupers toward government activities and responsibilities that are an accepted and important part of a modern society.

The first places to look for ways to reduce the future high employment budget deficit should include some combination of the following: Carefully screening for any excesses the very rapid expansion now projected in defense outlays; eliminating the third stage of personal income tax cuts; raising tax revenues by closing loopholes that reduce the tax base; and decontrolling gas prices while levying a windfall tax like that on oil.

Thank you, Mr. Chairman.

[The table referred to by Mr. Perry follows:]

PERCENT CHANGES AT ANNUAL RATES FOR SELECTED ECONOMIC INDICATORS, 1980-82

	Quarters								
	1st to 2d, 1980	2d to 3d, 1980	3d to 4th, 1980	4th, 1980, 1st, 1981	1st to 2d, 1981	2d to 3d, 1981	3d to 4th, 1981	4th, 1981, 1st, 1982	1st to 2d, 1982
Gross national product	−1.1	11.8	14.9	19.2	4.1	7.6	6.3	6.2	4.2
Real GNP	−9.9	2.4	3.8	8.6	−2.4	.4	−1.6	−1.6	−3.1
Industrial production	−18.5	−6.7	21.2	7.4	2.4	−.8	−4.9	−5.0	−5.3
GNP price deflator	9.8	9.2	10.7	9.8	6.6	7.2	8.0	7.9	7.5
Consumer Price Index	15.2	7.7	11.4	10.5	9.6	11.6	10.4	7.2	7.5

	2d, 1980, to 2d, 1981	3d, 1980, to 3d, 1981	4th, 1980 to 4th, 1981	1st, 1981, to 1st, 1982	2d, 1981, to 2d, 1982	Year 1930 to year 1931
Profits after tax	2.5	−11.8	−14.7	−15.4	−5.0	−8.1
Gross cash flow	9.3	3.2	1.9	1.2	6.8	9.4
Industrial production	5.6	7.2	.9	−2.1	−4.0	3.3
Real GNP	3.0	2.5	1.2	−1.3	−1.5	1.9

Policy assumptions: Budget expenditures are projected at $721,000,000,000 in fiscal year 1982. This assumes half the new budget savings proposed in October are achieved.

Representative REUSS. Thank you, Mr. Perry. Mr. Chimerine.

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STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. CHIMERINE. Thank you, Mr. Chairman. I appreciate the opportunity to testify before the Joint Economic Committee on the economic outlook and economic policy.

I'd like to begin by focusing on the issue of recession and summarizing the current state of the economy and prospects thereafter, and to present my views concerning the appropriate policy response in the context of this environment.

First, I tend to agree with Congressman Brown. While the economy is clearly in a state of decline apparently and the decline will continue for several more months at least, probably into early 1982, I'm not sure I would use the world recession, primarily because in my view the current environment is far different than the environment historically in the United States when the word recession was used generally to define a period during which the economy declined temporarily during a process of economic expansion. That no longer characterizes the U.S. economy.

In fact, we have been in either a period of stagnation or constant recession ever since late 1978. We have experienced 3 years now during which the economy has not grown at all and, in my judgment, if this really is a recession, it began back in late 1978 or 1979.

Second, while the economy has been stagnant for these years, it has also been relatively volatile. We have had consistent movements of a stop and go pattern during this period of no growth on average. In my judgment, the volatility is primarily a result of a shift in Federal Reserve policy during 1979 where they now focus on controlling the monetary aggregates rather than on focusing on control of interest rates. When the money supply grows at a rate more rapid than their targets they are forced to tighten. In fact, the markets now anticipate that tightening. This pushes interest rates up. Then 3 or 4 months after that, the economy weakens somewhat and money supply growth falls below the targets, interest rates decline, and the economy tends to move up.

What we have had is a cycle pattern or a stop and go pattern around that average performance of no growth, and, in my judgment, we are right back in that stop pattern again. The economy is now weakening in response to rising interest rates earlier this year. There's absolutely no question at this point that the economy will continue to decline for several more months. The only concern is how far and how deep that decline will be.

I think that depends on two factors. It seems to me, even though there is some pervasive weakness, a real serious recession can only occur if either there is a sharp decline in consumer spending or a large amount of inventory liquidation in the economy.

On the first score, consumer spending has held up relatively well thus far. It is certainly not growing, but it has not declined sharply. In my judgment, this reflects a number of factors, probably the most important being the moderation of inflation so far this year due to lower oil prices, slower growth in food prices, and a small rise in productivity. All of these factors have combined to reduce inflation so that most people, at least those who are still working, are now experiencing some modest improvements in purchasing power for the first time in a number of years. In my view, the squeeze on household purchasing power during the last 4 or 5 years, in addition to high interest rates, is the major factor in the economic stagnation that has developed.

Second, households have just experienced a modest tax cut effective a couple of weeks ago, which is also bolstering purchasing power.

Third, most families have considerably reduced their debt burden compared with 2 or 3 years ago, not only because of heavy repayments but, as you know, they have cut back on new borrowing during this period. So the debt position is significantly less than it was 2 years ago.

I think, as a result of these factors, it's most likely that household spending will hold up reasonably well and will not decline too sharply during the next 6 months, and under those conditions, I think it's likely that we can avoid a serious recession.

The major risk in that assessment is the impact of the recent sharp decline of the value of household assets, both the value of homes which have gone down dramatically in most parts of the United States in response to high interest rates, and obviously the value of stocks and bonds have declined sharply. A retrenchment by consumers cannot be ruled out in an effort to rebuild savings. Again, I don't view this as most probable, but it certainly cannot be ruled out.

The second point is inventories. It is clear that in three or four industries, particularly autos, farm equipment, construction materials to some extent, and consumer durables, there is currently an imbalance to the extent there has been some involuntary accumulation of inventories during recent months. I think in most cases these are the industries that have been hard hit by high interest rates and where economic activity has weakened, and I think we are likely to see a runoff of inventories in these sectors during the next several months. Also cutbacks by State and local governments will prolong the recession or decline in economic activity in the months ahead.

Again, however, I don't think the excessive inventory situation is very widespread in the economy so I don't see the kind of massive liquidation of inventories that would produce a real sharp recession, for example, a repeat of those in the spring of 1980 or 1974–75.

In any case, even the modest decline that I'm talking about will produce considerable increases in unemployment. The unemployment rate will reach over 8 percent sometime late this year or in early 1982 and will probably stay at those levels throughout the rest of 1982.

What should the appropriate policy response be in this environment? I agree with Mr. Perry that a significant distinction has to be made between the deficits that we are currently experiencing and those we are likely to see in 1983 and 1984. Clearly, the Federal deficit in fiscal 1982 will be far above the administration's estimates. In my judgment, it will be between $80 and $90 billion unless new actions are taken. But a significant part of that increase in the deficit, probably $20 to $30 billion, will result from the weakness that currently exists in the economy. Obviously, tax receipts are depressed as a result.

The proper policy response, in my judgment, is to offset that increase in the deficit by either additional budget cuts or other tax increases that would be effective in fiscal 1982 because that would obviously aggravate the decline that's already begun in the economy.

However, when we look at 1983 and 1984, in my judgment, even if the economy were to rebound, the Federal deficit will exceed $100 billion in each of those years and in fact is likely to exceed $100 billion a year as far out as we can see unless additional steps are taken to reduce those deficits.

I think there are a number of reasons for this outlook for the Federal deficit. One, of course, is the imbalance in the program. The budget cuts are far less—even if new reductions are adopted, they will be far less than the total of the defense spending increases that are currently planned and the tax cuts that will be implemented, and that imbalance will grow considerably larger as we enter fiscal 1983, 1984, and 1985.

Second, even taking into account the budget reductions that have already been adopted and others that may come, in my judgment, Federal expenditures will sharply exceed current budget projections. There are a number of reasons for this. I will summarize them for you very quickly.

First of all, there are likely to be offsets to the budget cuts. Many people who lose benefits—CETA workers and so on—under the existing budget cuts are likely to move over to other entitlement programs. They must be paid benefits under the existing nature of these programs. In my judgment, not enough of these efforts were included in the budget projections.

Second, if the entire military buildup goes ahead as currently planned, the cost of that buildup will far exceed current budget projections because the cost of military weapons will far exceed current estimates.

Third, I don't think it's possible politically, or even desirable, to make additional budget cuts of the magnitude that the administration assumed in preparing its budget calculations for 1983 and 1984.

And, finally, as everyone knows, interest on the national debt will far exceed current budget projections. By our estimates, that gap will be at least $25 billion a year by fiscal 1984. Also the static revenue loss for many of the tax cuts is likely to considerably exceed current estimates: three examples are the all-savers certificates, the extension of IRA's, and the tax loss due to the easing of leasing provisions as part of business tax cuts. So even on the revenue side there will be a sizable shortfall from current estimates.

If you combine all these factors, we're expecting deficits, as I said earlier, of at least $100 billion a year during that period, and what's most disturbing about them is that they are likely to occur during period when the economy may be beginning to rise so that deficit will not be the result of inadequate revenues caused by slack in the economy or economic weakness.

Under those conditions, in my judgment, there will be a direct conflict between this fiscal policy and the Fed's efforts to continue to slow money growth, and there is this distinct potential for a sizable additional increase in interest rates. This would be self-defeating because it would only choke off some of the stimulus that we were supposedly going to get from the administration's program. In an environment where the Fed tightens money and controls the growth of the money supply, a significant portion of these tax cuts will simply push up interest rates instead of pushing up economic activity.

It is essential therefore, in my view, that steps be taken to reduce those deficits. We must target at least $50 or $60 billion worth a year of add tional budget cuts and tax increases aimed at fiscal years 1983 and 1984. In my view, the sooner the better, because one of the factors that could bring interest rates down more quickly during the months ahead and prevent a more serious economic decline is if the markets felt comfortable that actions were being taken to reduce the deficit in the years ahead from programs currently in place.

I therefore suggest the following policy program:

One, no additional budget cuts or tax increases be designed for fiscal year 1982 in view of the weakness in the economy and the risk that the recession could be considerably worse than I expect.

Two, some steps be taken as soon as possible to reduce the large deficits expected for fiscal years 1983 and 1984. Selected modest tax increases either from new revenue sources or by postponing some of the tax cuts already enacted will actually be very constructive for the economic environment because it will take pressure off interest rates and off financial markets but still leave enormous fiscal stimulus to generate economic recovery and adequate tax incentives for savings and investment.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Joint Economic Committee to provide my views on the economic outlook and economic policy.

SUMMARY

1. The economy is likely to continue to trend downward at least through the fourth quarter; however, a sharp recession is not likely.

2. Provided that steps are taken to bring down interest rates, a moderate expansion should begin some time in 1982. The recovery will be led by moderating inflation and the impact of increased fiscal stimulus.

3. The outlook for the federal deficit for the next several years is extremely poor. In my view, it is essential that fiscal actions be taken to reduce these deficits in order to take pressure off financial markets and bring interest rates down further.

STATE OF THE U.S. ECONOMY

The U.S. economy has essentially been stagnant since 1978. Almost all indicators of macroeconomic performance, including real GNP, industrial production, orders, real retail sales, etc., are roughly at the same level now as they were nearly three years ago. Thus, the typical historical pattern of continuous economic growth interrupted every four or five years by modest recession no longer characterizes the U.S. economy. Furthermore, the economy has been very volatile during this period as a result of fluctuations in interest rates, the imposition of credit controls, and other factors, but this volatility has occurred within a period of virtually no growth.

In my judgment, the stagnation that has developed in recent years is primarily the result of the acceleration in inflation, fueled in part by sharp increases in OPEC prices, the decline in productivity, and other factors. This increase in inflation significantly squeezed household purchasing power and resulted in stagnant consumer spending during the last three years. In addition, the acceleration in inflation and the Federal Reserve's tight money response have resulted in sharp increases in interest rates. Real interest rates have been considerably higher during the last several years than at any time in the postwar period. The shift from relatively low to relatively high rates has, of course, had its greatest impact on the housing industry, including construction companies and their major suppliers. In addition, the thrifts are facing enormous earnings losses because they are now locked into old mortgages which provide very low returns while, with deregulation, their cost of funds has moved up in proportion to the rise in short-term interest rates. The farm equipment industry has also been severely impacted by high interest rates, not only because farmers finance most of their equipment purchases, but because high rates have depressed commodity prices and farm income. In addition, farm equipment manufacturers are experiencing sharp increases in interest expense on their dealer inventories.

There have, of course, been several sectors of the economy that have grown sharply in recent years, with energy related industries being the most prominent. The growth in these industries has just about offset the sharp decline in autos, housing, and agriculture and as a result has kept the economy relatively stagnant instead of in a continuous recession. Sharply rising exports in 1979 and 1980 also helped prevent a serious economic decline during those years.

As mentioned earlier, while the U.S. economy has been relatively flat on average for about three years, there has been a significant amount of volatility during that period. In my judgment, the major factor in that volatility has been the shift in the focus of Federal Reserve policy which began in late 1979. Since that time, the Fed's efforts to control the growth in the money supply rather than interest rates has led to a sharp increase in the volatility of those rates. Each time the money supply has grown more rapidly than the Fed's targets, the Fed has significantly reduced the growth in reserves in order to bring money growth within those targets, causing interest rates to rise. Each upward thrust in interest rates has been followed by a weakening in economic activity, led by declines in interest rate sensitive industries--declining rates have, of course, been followed by improved economic activity. In addition, the imposition of credit controls was a major factor in the sharp decline in the economy in the spring of that year. Once the controls were withdrawn, the economy rebounded strongly later that year.

In my view, the weakness we are currently experiencing in the economy represents another stop period in this stop-and-go pattern of recent years, rather than a traditional recession. The current decline is in lagged response to the sharp increase in interest rates which occurred during the spring and early summer months of this year and it will continue for several months at least. The recently adopted budget cuts are also contributing to weakness in the economy by reducing income of many benefit recipients, and by aggravating the financial position of state and local governments, requiring significant declines in expenditures or tax increases by many of those governments. In addition, the U.S. trade position continues to deteriorate as a direct result of the sharp increase in the dollar experienced earlier this year. Finally, excess inventories in the automobile, farm equipment, and several other industries are also contributing to declining production. I expect these forces to produce another small decline in GNP in the fourth quarter, following the declines which occurred in the second and third quarters. Unemployment will rise into early 1982 to somewhat above 8% (see **Table 1**).

While I believe that there is considerable downside risk, a steep decline as in 1980 will probably be avoided for several reasons. First, the current weakness is concentrated in interest rate sensitive sectors in response to increases in rates earlier this year. However, these industries are already so depressed that additional declines will be less than in 1980, and, because of their reduced share of economic activity, the impact on the overall economy will be further reduced relative to prior periods. Furthermore, interest rates have at least temporarily peaked and efforts to reduce the deficit may in fact bring rates down further. And credit controls will not be imposed as they were in 1980. Second, consumer spending for nondurables and services are for the most part insensitive to interest rates and are relatively stable. In part, this reflects the effect of higher interest payments on personal income as a result of higher rates and of continued shifts in savings from low yielding passbook accounts to money market certificates and money market funds. An easing in inflation, especially oil prices, has also bolstered household purchasing power, as has the first installment of the tax cut. Third, defense spending and energy related activity are insensitive to interest rates and are continuing to rise.

Fourth, business fixed investment has not declined sharply, as in other recession periods. Industrial production for business equipment has risen at a 7-1/2% annual rate during the last five months. Furthermore, nondefense capital goods orders increased in August and have shown no signs of the sharp decline that generally accompanies major recessions. Fifth, inventories appear to be relatively lean outside of the few industries mentioned previously. Thus, a sharp correction in the months ahead as a result of widespread liquidation of inventory seems unlikely.

There are two risks in this scenario, however, which could lead to a sharper decline than anticipated, with declines of real GNP in the 4%-5% range for the next two quarters and unemployment exceeding 9%. One is that interest rates begin to rise again, as a result of renewed Federal Reserve tightening or other factors--this would result in additional declines in interest rate sensitive sectors instead of the anticipated bottoming out within the next several months. Second, declines which have already occurred in the value of financial assets and home prices have dramatically reduced household wealth. It is possible that consumers will respond by cutting spending in order to build savings (as they did in 1974).

INFLATION

Virtually all measures of inflation have already shown a significant deceleration thus far during 1981. While some of this improvement is the result of relatively temporary forces, especially the declines in commodity and oil prices, there are a number of reasons to believe that inflation will moderate to the 8% range during the next several years, a significant improvement from recent performance. First, the sharp decline in petroleum demand in recent years as a result of conservation and substitution of other fuels, and increased production in other countries outside OPEC, suggest that any oil price increases will be relatively modest in comparison with the 35% average annual rate of increase since 1973. Second, the outlook for food prices continues to improve as a result of greater than expected supplies. Furthermore, the demand for grains in the U.S. and other countries has been reduced by a sizable shift away from beef to less expensive foods as a result of squeezed family purchasing power. Under these conditions, grain prices are not likely to rise during the period ahead. Even meat supplies should be more favorable because lower grain prices are ameliorating the profit squeeze on cattle producers so that herds are not likely to be cut back as much as previously expected. Third, after three years of flat or declining productivity, it appears that some improvement is already beginning. In fact, productivity will rise by about 1% in 1981 despite a very weak economy, the first increase since 1977. A slowdown in the influx of young and inexperienced workers, the easing of business regulations, tax incentives for capital formation, and efforts to reduce labor and energy costs, will combine to increase productivity further during the next several years. Fourth, several key measures of wages have shown significant deceleration during the last several months (**Table 2**). In particular, wages are actually being frozen or reduced in a number of distressed industries including airlines, tires, automobiles, farm equipment, and steel, as a result of declines in employment and low profits in those sectors. Despite the fact that 1982 is a relatively large year for labor negotiations, these recent actions suggest that wage increases will be relatively modest by recent standards. The recent deceleration in the CPI will also take pressure off wages by holding down cost-of-living adjustments in unionized industries. Wage increases will average in the 8% to 8-1/2% range during the next several years, a significant improvement from the 9%-10% rates of recent years.

INTEREST RATES

In my judgment, the dominant factor responsible for high interest rates is the outlook for the federal deficit. Unless new steps are taken, the Federal deficit will probably reach $80 billion in fiscal 1982 and will exceed $100 billion a year in each year thereafter. In part this reflects the fact that the magnitude of the tax cuts and the defense buildup rise sharply in 1983 and beyond and are far greater than the budget cuts, even with inclusion of the unspecified cuts in the budget projections. This is illustrated in **Table 3** which combines all parts of the program. As can be seen, the tax cuts and military spending increases will exceed all budget cuts by nearly $60 billion in fiscal 1984 and by $122 billion in 1985. Furthermore, several other factors suggest that the imbalance will in fact be considerably wider, implying a larger impact on the deficit. First, the additional budget cuts of over $30 billion in fiscal 1983 and $50 billion in fiscal 1984 will be very difficult to achieve without a major cutback in social security expenditures. However, large short-term reductions can only be made if benefit levels are reduced dramatically. Increases in the retirement age, reduced incentives for early retirement, changes in the indexing formula, etc. would produce only a small part of the savings needed in the short run. Furthermore, the precarious financial position of state and local governments will make it difficult to make additional cuts in revenue sharing and federal grants. Second, interest on the national debt is already far exceeding budget projections, with the likely gap rising to as much as $25 billion a year by 1984 even if interest rates come down somewhat. Third, actual federal expenditures will likely be higher than projected even with the budget cuts. This will primarily reflect offsets that will occur as many who lose benefits shift over to other entitlement programs. Furthermore, it appears that the cost of the military buildup will far exceed current budget projections as a result of higher than anticipated costs for military weapons. Fourth, the Administration has significantly underpredicted the static revenue loss associated with several features of the tax cut. This is particularly true of the All-Savers Certificate and the extension of IRAs, as well as the reduction in corporate taxes that is likely to occur as a result of an easing of the leasing provisions.

These prospective deficits already are causing upward pressure on interest rates. The markets are particularly concerned about 1983 and 1984 when, as mentioned above, the deficits will likely rise sharply and when private credit demands may be expanding because of a stronger economy. While it is true that these deficits as a share of GNP are not far outside the range of prior historical experience, they will occur at a time when the economy is not as weak as it was during similar periods historically (particularly 1975). Furthermore, conditions are different today than in prior periods. The Fed is not accommodating deficits as readily as in the past. In fact, M1B has risen at only a 4% annual rate thus far this year, or about a 5% decline in real terms, for below the rate of increase during periods of large deficits in the past. Thus, while the deficit is not a large fraction of GNP, it is a relatively large share of total credit available--federal borrowing as a share of total funds raised in credit markets is now running at over 35%, as compared with about 15% in the second half of the sixties and between 25% and 35% between 1975 and 1979. In addition, private savings are far lower now than they were several years ago, as a result of both the decline in the personal saving rate and an erosion of corporate liquidity. Thus, the federal deficit as a share of available savings is also extremely high. These deficits not only cause direct pressure on interest rates but have also worsened inflationary expectations, which has an additional adverse effect.

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Unless additional steps are taken to prevent these large deficits from occurring, interest rates could move up substantially and jeopardize the economic recovery anticipated in the next several years. First, higher nominal and real rates would cause further declines in several key industries, which would not only adversely affect economic activity but could cause numerous bankruptcies and other financial problems. Second, further increases in rates could cause a rebound in the value of the U.S. dollar relative to other currencies, and an additional weakening in our trade position. Third, higher rates could cause additional declines in the value of financial assets and in home prices, which could lead to increased caution by households in an effort to increase savings in order to compensate for the decline in real wealth. This would short-circuit an expected increase in consumer spending. Obviously, the burden would be felt most in those industries which are already in very serious condition.

POLICY RECOMMENDATIONS

In my view, the objectives of economic policy during the period ahead should be twofold. First, it should be designed to prevent a further deterioration in the economy in the months ahead. A steeper recession than the decline now anticipated would serve very little useful economic purpose. Sufficient excess capacity in the economy already exists to prevent any major demand/pull related inflation in the near term. Furthermore, additional declines will likely cause a significant scaling back in investment plans because of higher excess capacity and lower profits, which would be counterproductive from the standpoint of improving productivity and bringing down inflation in the longer term. Second, a resurgence in interest rates could jeopardize the economic expansion which is expected once the current weakness ends. Thus, policy actions should be implemented to reduce interest rates during the next few years.

In view of these objectives, I recommend the following actions.

1. It is important to distinguish between deficits which will result from tax cuts and other factors and those caused by weakness in the economy. In particular, I expect the federal deficit to be at least $80 billion in fiscal year 1982, far above current budget projections. Some of this increase will result from the fact that the economy is entering the fiscal year in its current weak state. Despite the need to bring down the deficit, it is important that that portion of the deficit caused by weakness in the economy not be offset by additional budget cuts. This would only weaken the economy further.

2. While additional restrictive actions should be avoided in the months ahead, it is equally important that no new stimulative measures be adopted to provide a short-term boost to the economy. As discussed earlier, the amount of fiscal stimulus inherent in the already enacted program will begin to build rapidly in mid-1982 and will accelerate further thereafter.

3. In my judgment, the relatively modest growth in M1B thus far this year is a reflection of relatively tight money despite the fact that other measures have grown somewhat more rapidly. Structural shifts and the sharp increase in interest rates on money market funds and other investments have distorted many of these measures and made them less meaningful. Furthermore, historically high real interest rates, the plunge in housing and agriculture, and the sharp increase in bankruptcies among small businesses also reflect relatively tight money despite the growth in M2 and other measures. I believe that the recent efforts by the Federal Reserve to increase growth in the money supply are appropriate and should not be offset by new tightening measures.

4. In view of the increase in nonborrowed reserves already engineered by the Fed, and the likelihood that money growth will accelerate in response, additional easing by the Federal Reserve is not likely. This makes it even more imperative that fiscal actions be taken to reduce the large deficits that are expected in fiscal years 1983 and beyond, which will occur even with a growing economy boosting revenues. These deficits will combine with rising private credit demands to collide with the Federal Reserve's efforts to limit money growth and could cause another sharp explosion in interest rates. Thus, the fiscal stimulus implicit in the President's program will in part push up interest rates instead of economic activity as long as the Federal Reserve does not accommodate the resulting deficits. Furthermore, whatever savings that will be generated will be needed to finance the deficit and will not be available for capital formation. High interest rates, and the excess capacity and weak profits they lead to, will also provide considerable disincentives to investment and offset the favorable impact of accelerated depreciation and other business tax cuts.

   In my view, new fiscal actions amounting to at least $60 billion per year by fiscal 1984 are necessary to bring the expected deficit to acceptable levels. Since it is not likely or desirable that cuts of this magnitude can come from either social programs or defense, I strongly suggest that some selective tax increases be enacted, or that the tax cut recently enacted be scaled back (and indexing be delayed). Selective modest tax increases and expenditure cuts will actually improve the outlook for the economy by insuring that interest rates will not exceed previous peaks while still leaving ample fiscal stimulus, and many incentives for saving and investment to insure future growth will also have a favorable short-term effect on financial markets and reduce the risk of a steeper decline in economic activity in the months ahead. Thus, such tax increases will actually make the Administration's program more effective and prevent a backlash from high interest rates and budget cuts which could potentially cause the entire program to unravel. Furthermore, additional tax cuts can always be enacted in the year ahead if conditions warrant.

ECONOMIC OUTLOOK

If these actions are adopted, the still large fiscal thrust plus the benefits of lower inflation and slow declines in interest rates will generate a significant improvement in economic activity beginning in 1982. In particular, the combined effect of an easing in inflation and the large personal tax cuts already enacted will result in significant increases in household purchasing power for the first time since the early 1970s. In view of the large pent-up demand for many consumer goods, as well as the fact that the household debt burden has been reduced significantly in recent years, we expect that this increase in purchasing power will be reflected in growing consumer expenditures. And, despite the emphasis on savings and investment, improvements in household spending are absolutely necessary for economic recovery. Consumption not only accounts for about two-thirds of economic activity directly but rising consumer spending will reduce some of the excess capacity in many industries and combine with the business tax cuts to stimulate investment. In addition, the sharp increase in defense spending currently planned will also provide stimulus to the economy during this period. Finally, housing, autos, and other interest rate sensitive sectors will gradually improve in response to lower interest rates (**Table 4**).

Efforts to cut the deficit will be augmented by the following factors in helping bring rates down. First, some of the net tax cuts will be saved because of increases in the expected return on savings and also because the short-run marginal propensity to consume is relatively small. Furthermore, deficits which result from tax cuts cause less upward pressure on interest rates than those which result from spending increases. Second, inventories in the auto, petroleum and other industries are being cut, reducing credit demands. Third, the business tax cuts will bolster corporate cash flow, increasing business savings and reducing business borrowing. Finally, continued slow moderation in inflation will ultimately be reflected in lower interest rates.

There will be several factors which will limit economic growth to the 3.5%-4% range. First, we continue to expect a significant deceleration in expenditures by state and local governments as a result of their already weakened financial positions and the adverse effects of reductions in federal grants. Accelerated depreciation will also reduce corporate tax receipts for many state and local governments. Many of these governments will not only be forced to slow spending but may raise taxes as well. This will act to retard economic activity somewhat. Second, many beneficiaries of government transfer programs will experience reduced income during the next several years as a direct result of federal budget cuts. Those who receive food stamps, welfare, unemployment benefits, and government pensions, will be primarily affected. Third, the U.S. trade position should continue to deteriorate at least through 1982 in lagged response to the sharp increase in the U.S. dollar earlier this year. The change in exchange rates has dramatically eroded the U.S. competitive position in world markets. The U.S. trade balance is already deteriorating after rising sharply during the prior three years, as exports decline and imports of steel, farm equipment and other goods rise as a result of the competitive advantage of many foreign producers in U.S. markets. Fourth, several factors will keep real interest rates relatively high even with some decline from current levels. The focus on monetary aggregates has created more volatility in rates--higher volatility implies higher risk which has raised the average level of rates somewhat. The increased risk of bankruptcies, in part the result of high interest rates, is also adding an additional risk premium. Deregulation of financial institutions, along with the introduction of many new credit instruments, has increased competition for funds and produced greater efforts on the part of depositors to achieve higher rates. And of course, continued efforts to moderate the growth in the supply of money has been and will remain a major factor in higher real interest rates.

Table 1
Forecast Summary
Major Economic Indicators
(Percent Change, Annual Rates)

	(Actual) 1981.2	1981.3	1981.4	1982.1	1982.2
Gross National Product	4.7	6.2	9.0	10.5	13.7
GNP in 1972 Dollars	-1.6	-1.4	-0.7	2.8	4.0
Total Consumption, 72$	-2.1	3.7	1.5	3.6	2.1
Fixed Nonresidential Investment, 1972$	-2.2	-2.1	-3.2	4.6	7.2
Government Purchases, 1972$	-5.5	-0.1	-1.0	3.1	1.0
GNP Deflator	6.4	7.7	9.7	7.4	9.3
Consumer Price Index	7.5	11.4	9.2	8.1	7.9
Corporate Profits Before Taxes	-37.0	-17.9	6.5	-10.1	74.2
Corporate Profits After Taxes	-33.7	-18.2	6.0	-3.9	59.6
Unemployment Rate (%)	7.4	7.3	7.9	8.1	8.0
Prime Commercial Bank Rate (%)	18.93	20.32	18.02	17.57	16.69

Table 3
Tax and Spending Changes—Reagan Administration Estimates
(billions of dollars)

	Fiscal Years					
	1981	1982	1983	1984	1985	1986
Tax Cuts	1.6	37.7	92.7	149.8	199.2	267.7
Individual Income Tax Reductions	-	26.9	71.1	114.7	148.2	196.1
Business Tax Cuts	1.6	10.7	18.6	28.3	39.3	54.5
Savings Incentive Provision	-	0.3	1.8	4.2	5.7	8.4
Other	0	-0.2	1.2	2.6	6.0	8.7
Increases in Defense Spending	0.5	12.3	34.1	43.3	65.8	81.4
Sum: Tax Cuts & Incr. Defense	2.1	50.0	126.8	193.1	265.0	349.1
Budget Reductions	6.4	38.4	99.3	135.7	144.4	160.8
Already Enacted	6.4	35.2	67.2	81.2	92.8	102.7
To Be Proposed	-	3.2	32.1	54.5	51.6	58.1
Budget Increases	1.6	1.2	1.8	1.9	1.8	1.7
Net Fiscal Thrust	-2.7	12.4	29.3	59.3	122.4	190.0

Table 4
Forecast Summary

	1979	1980	1981	1982	1982
GNP (Bill. 72$)	1483.0	1480.7	1508.6	1538.6	1604.7
% Change	3.2	-0.2	1.9	2.0	4.3
Personal Consumption (Bill. 72$)	930.8	935.1	961.1	987.4	1023.3
% Change	2.9	0.5	2.8	2.7	3.6
Nonresidential Fixed Investment (Bill 72$)	163.3	158.4	160.6	165.0	176.0
% Change	6.5	-3.0	1.4	2.8	6.6
Consumer Price Index (67=100)	217.6	247.0	272.4	295.9	319.3
% Change	11.3	13.5	10.3	8.6	7.9
Corporate Profits Before Tax (Bill.$)	255.3	245.5	231.4	253.9	304.0
% Change	14.4	-3.8	-5.8	9.7	19.7
Federal Surplus or Deficit (Bill.$)	-14.8	-61.2	-58.4	-79.6	-81.0
Unemployment Rate (%)	5.8	7.1	7.5	8.0	7.0
Prime Commercial Bank Rate (%)	12.67	15.27	19.12	16.37	15.14
Total Housing Starts (millions of units)	1.72	1.30	1.11	1.40	1.72
New Passenger Car Sales (millions of units)	10.6	9.0	9.0	10.1	11.2

Representative REUSS. Thank you, Mr. Chimerine. Now, Mr. Rutledge.

STATEMENT OF JOHN RUTLEDGE, PRESIDENT, CLAREMONT ECONOMICS INSTITUTE

Mr. RUTLEDGE. Thank you, Mr. Chairman. It's a pleasure to be here to speak to the Joint Economic Committee. I have submitted my prepared statement for the record but I'd like to give a further summary of that if I may and deal with another point or two.

It seems to me like we have been here before. We have done a newsletter recently called "Deja Vu." We have made some progress on inflation. Now real output is starting to weaken and we shift our worries from the inflation fight to the real output fight.

But lest we get too smug about the progress we've made on inflation, let me read you a few sentences from the Survey of Current Business of March 1969:

> Over the past 3 years the total GNP deflator has increased at an annual rate of 3.5 percent. Over the past six quarters the rate has accelerated to almost 4 percent. The lastest quarter, 4.3 percent, shows no slackening in the degree of overall inflation. The fourth quarter increase in the deflator for consumption expenditures, 4.7, was the largest since the fourth quarter of 1951.

Many times before when the inflation rate has gotten down from what it had been the previous year, we have begun to think that that problem is over and that it's time to shift our guns to the other one. The argument I want to make today is that the main ingredient on the inflation battle is consistency, maintaining a program over many years. Unless that happens you cannot get business to engage in the kind of capital expansion projects which will allow them to increase productivity.

As a summary of the remarks, though, the economy right now is in pain and a great number of people are in pain. When I travel around that usually is evidenced by people wondering about interest rates. Interest rates are as high now as they have ever been. They are imposing enormous costs to people in terms of housing costs, business costs, and the lack of housing starts we see.

Recently a lot of analysts have been worried about whether the interest rates will stay high forever—or at least for the next year or two—and whether the high deficits that everybody is talking about for next year and the year after are going to mean even higher interest rates.

I would like to read two sentences from the August Wall Street Journal, if I may. One is—these are from "Dr. Gloom" and "Mr. Doom" by the way. One is from August 21. Henry Kaufman, in a memo to portfolio managers said, "Continued inflation will swell credit demands in several key sectors," meaning the budget of course and restrictive monetary policy. He sees intense credit markets for the next half. On August 6th, Al Wojnilower, from First Boston Corp., said, "The highs in long- and short-term interest rates may not come down until near year end or even later." Alan Sinai from Data Resources says, "The inflation and defense spending insure against an early return to sharply lower interest rates."

These are all people arguing that the rising deficit is going to make for such credit demands that interest rates will explode.

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Well, what I didn't tell you is that these are all quotes from the August 1974 Wall Street Journal, and that within 6 weeks of the writing of those articles, interest rates had fallen by one-half. Now these people were all right. The deficit in the next year went from the range of $20 to $30 billion to more than $100 billion—on an annualized basis—at one point. Nevertheless, interest rates fell. So what I would like to concentrate my remarks on is the interest rate question which I think lies behind a lot of the other questions we're talking about.

Who determines interest rates is the real question. As far as I can tell, there are three different theories of interest rates. One theory is held by people on Wall Street. They say that Wall Street determines interest rates and they worry that the investment bankers and the portfolio managers and the pension fund managers won't buy enough bonds to make interest rates come down. You've seen a poster, I think, that they have on Wall Street that has Wall Street, Central Park, Mississippi River, and Japan. Well, that's the view of Wall Street about interest rates.

There's a second view that says the Fed determines interest rates and there could be another poster just about like the Wall Street one, but with the idea that the Federal Reserve, by manipulating some $200 billion of assets, can affect the yields on a stock of wealth in this country totaling something like $10 to $20 trillion. This concept just escapes me.

There's a third one which is really the one that I'd like to talk about, that interest rates are determined by the little people. There are 200 million people in this country and the wealth-holding decisions of those people is what determines the level of interest rates.

Last week, James Tobin received a Nobel Prize. The reason he received the prize is for that idea, that interest rates are determined by whether or not the people want to hold their assets, not by the actions of one or two isolated yet important groups in the economy.

This Wall Street/Fed theory—the best analogy I know to that is a very short section out of the "Little Prince," where the king talks about—the little prince meets the king who lives on a planet. He's the only occupant of the planet and the little prince says, "Over what do you rule?" And the king says, "I rule over everything." The little prince asks, "You mean you make the sun rise and set too?" The king says, "Yes, I do that too." The little prince says, "Would you please make the sun set for me now?" And the king says, "No, I can't do that because that would be bad government."

Well, that's precisely the same influence that Wall Street and the Federal Reserve have over the credit markets, that the king had over the rising and setting of the sun.

So how do these people make their adjustments? Interest rates are really the prices of financial assets. They are nothing different than that. And the structure of those prices depends on whether or not people want to hold those assets. Again, that's Tobin's message.

What most analysts forget or don't talk about is the fact that private citizens in the economy don't only hold Treasury bills. They also hold automobiles and they also hold timber land and they hold all sorts of other real assets which they arbitrage against paper assets just like bankers arbitrage commercial deposits of paper.

Households and business in the United States, according to the Federal Reserve, hold more than $10 trillion of assets. Each household is free to allocate its wealth among these competing categories of assets, for example, tangible and financial assets, in any way they want to, based on yield comparisons.

Well, the point we've learned in the last few years is that rising inflation means rising yields on real assets. If you think about it, a basket of goods is nothing different than a basket of real assets that people can hoard. You can have a 10 pound bag of dog food instead of a 2 pound bag, or a bigger house instead of a smaller house. Real asset yields and inflation are very nearly the same thing. So rising inflation creates an arbitrage spread in favor of real assets.

As households try to buy them, they have to finance them. I defy you to explain how you can buy a house without simultaneously selling a financial asset. So rising inflation makes people want to buy more houses, gold, condominiums, and other things, and means, dollar for dollar, net increases in credit demand or reductions in credit supply.

The years 1973–74, for example, was a period very comparable to right now. From 1973 to 1974 the inflation rate went up by about 6 percentage points. At the beginning of that time households held 38 percent of their wealth in terms of real assets. One year later that ratio had increased to 44 percent. Six percent of total household wealth in the country shifted from paper into redwood. How much money is that? Six percent of $10 trillion is $600 billion. The numbers we're talking about of household portfolio switching are enormous relative to any open market operation of the Fed, relative to any of the deficit numbers we're talking about.

What about 1974–75, the period of these quotes I read? Well, in 1974–75 the inflation rate pulled back some. In those 2 years household wealth in real—tangible—assets decreased by almost 3 percentage points. That means households desired to sell real assets. And what are you going to buy with the proceeds? The only thing you can buy is financial assets, which forces their prices up and which in that case caused a very sharp reduction in interest rates.

So credit demands and supplies, the kind of arguments we make, must include these sorts of voluntary portfolio switching that goes on at the household level. It's going on right now. The inflation rate, we've already heard twice, has fallen by almost a third, maybe even almost a half, in the last 18 months. That means the yields on capital gains on housing and other real assets have fallen by many times that. Households are now facing yields on current ownership of housing stock of minus 10 to minus 50 percent, depending on their leverage. They have the opportunity of earning 15 or 20 percent on a money market fund. So what are they doing? They are attempting $1 at a time to shift out of real assets into financial assets. Every week when you see a $2 billion increase in the money market funds, that is not an increase in demand in the economy. That is the avenue through which households manage to convert real assets into financial assets. The money market funds buy bank CD's, the bank CD's come out of the Federal funds market, and the Federal funds rate begins to fall.

The point of that is that we have already, through monetary policy and through the good fortune of turning oil prices around, managed to get the inflation rate down quite a bit. It takes a while for that to restructure the economy. Rising inflation makes people buy various things to protect themselves from inflation. It will take them a year or two to manage to adjust to falling inflation as well, but we don't want to give up the fight before that adjustment is done. It's just started.

The interest rates have already started falling. In the forecast I've presented to you, our institute's forecast, we project a recession as well. We have an unemployment rate which reaches 8.5 percent in the first quarter of 1982. We have real growth falling for the next two quarters as well. But we also have falling inflation, which is the forecast we made 1 year ago which hasn't changed a whit—that inflation by the end of next year will be down around 6 percent. As I remember, 12 months ago, there weren't very many people who thought that was possible. They were thinking maybe 9 or 10 percent. That 6-percent-inflation rate is the goal that we have been working for for so many years. Let's not give it up just now when it's very nearly in our reach.

You need to have longer term control over inflation. Rising inflation makes asset holders not willing to make long-term commitments. Between 1865 and 1900 the price level fell by almost two-thirds in the United States. That means anybody who held anything out in paper made a lot of money. In 1900, railroads were able to sell 100-year bonds to finance railroad expansion. Ask any of your corporate constituents if they could find anybody now who would buy a 100-year bond.

I have participated in a number of planning projects for aluminum smelters, large manufacturing facilities that project output for 50 or 60 years. They need long-term financing. They cannot get it now. That's the reason why they are not investing. That's the reason why productivity growth is so low.

So for policy prescriptions, this all suggests to me that we have made progress, but let's not be too smug about it. We have just begun that fight. Six or eight percent inflation is terrible; it's not good. Zero percent inflation is the only inflation that makes any sense. You may have wondered why God put a zero in the middle of all the numbers. That's because that's the optimal inflation rate. It's the only 1; 6 is not much more than 5 or 11 is not much more than 10, but zero is right in the middle and that's the only credible inflation rate over the long term. We can't stop until we get there.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Rutledge follows:]

Prepared Statement of John Rutledge

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to speak to you this morning on the state of the American economy. I strongly believe we are right now in a critical period, a turning point in the course of inflation. Three times in the past twelve years, in 1969-1970, 1974-1975, and now from 1979 up to the present, we have undergone serious and major efforts to reduce the rate of inflation. Three times we have chosen to undergo the pain that is associated with any disinflation process, knowing that the benefits of removing inflation make it worth undergoing that pain.

In each of these three episodes, preliminary improvements accrued in terms of lower inflation rates. However, in the two previous episodes, serious anti-inflation efforts were abandoned and replaced with stop-gap superficial measures in the hopes of mitigating the pain of disinflation. In each case, the results were eventual failure. Inflation resumed at ever higher rates. Since interest rates are inexorably linked with inflation, the experience has been the same here as well. Interest rates have seemed to rise without limit, and the dreams of many citizens to own their own homes or borrow to start their own businesses have seemed out of reach.

Each bout and each failure in our fight with inflation has made more of our citizens and more of our friends abroad convinced that U.S. inflation will continue to increase unchecked.

We have known the pain of high inflation and high interest rates, and we have also known the pain in terms of higher unemployment and slower growth of efforts to stop inflation. This is why the present period is so important. I would agree with some of you that there is skepticism on Wall Street and elsewhere about the tax reductions passed recently. This has added upward pressure to interest rates. But based on my conversations with investors and businessmen, I can assure you that the most overwhelming fear in the financial markets, and by far the most powerful factor keeping interest rates high is the fear that the Federal government and Federal Reserve will not have the resolution and courage to continue its anti-inflation efforts: the fear that we will once again abandon our anti-inflation efforts as we have so often before, just when victory is so very nearly within our grasp.

I am sure you will agree with me that it is only by continuing to restrain federal spending and to slow the growth of the money supply that we will be able to lastingly reduce inflation, that we will be able to win back the confidence of the people, and permanently lower interest rates. Such policies have been followed for nearly two years now. Already we have begun to see some results. Still we continue to suffer from some of the hardships of inflation as well as the hardships of slowing inflation.

Only by continuing our policies a good deal longer still can we rid ourselves of the hardships we face. If I leave you with one thought today, I hope it is of the utmost importance of steadfastly continuing the anti-inflation efforts you have so nobly begun. Let me detail this point by discussing the various issues you have asked me to address.

Fiscal and Monetary Policy

In the last few weeks, much criticism has arisen of the tax and spending policies you enacted only a few weeks ago. Some of my respected colleagues have criticized the federal government for following an inflationary fiscal policy and a tight monetary policy. I have a deep professional respect for these men, yet I honestly fail to understand their characterization of fiscal policy as stimulative.

As courageous as the tax revisions embodied in the Economic Recovery Act are, and as much as I support them, there are virtually no net reductions in personal income tax burdens forthcoming in the next four years. Nowhere in the government or in the financial markets have I seen adequate appreciation of this fact. So let me discuss it with you in detail.

The effective tax policy of the last ten years has been to let inflation serve to increase taxes. Though the Federal government has enacted three tax-cut bills since 1971, inflation has singlehandedly wiped out these declines to increase taxes on net every year since then.

Because of the way the tax codes have been written in the past, when inflation occurred, if a worker's income rose merely to maintain pace with higher prices, he nevertheless was pushed into even higher tax brackets, and his total tax burden as a share of his income rose. Remember that this higher tax burden occurred even with no true increase in the worker's pre-tax wealth or pre-tax purchasing power.

Let me give you some examples. Consider a worker who made $6,000 in 1971. Assuming he had three dependents and normal itemized deductions for a worker in his income tax group, he paid $177 or 3.0 percent of his earnings in federal income taxes in 1971. In order to have maintained pace with inflation, that worker would have to earn $13,500 in 1981. Assuming the same relative level of deductions, this worker now pays $707 or 5.3 percent of his current earnings in federal income taxes.

Similar phenomena have occurred across all income groups in the last decade. They have occurred despite three major tax reduction bills, and even if one's income only kept pace with higher prices. Those who enjoyed any improvement in their real earnings experienced an even sharper increase in their relative tax burden.

The point of all of this is that inflation exerts hidden -- and therefore insidious -- tax increases on each of us every year. The indexation of income tax brackets beginning in 1985 which you passed this year will halt this insidious trend. Therefore, while some have branded indexation an unfair burden to impose on the government, I believe that the lack of indexation of tax brackets is a grossly unfair burden to have been placed on the electorate.

But let us look at the three-phrase 25 percent reduction in tax rates that began this month. The 5-10-10 percent declines will, in truth, effect only a 23 percent decline in tax rates. But we then have to net out the effects of inflation through 1984 in raising effective tax rates.

If we consider that same mythical worker with $13,500 in 1981 earnings whom we discussed earlier, and if we assume the Administration's inflation projections hold, in 1984, even after three years of phased tax reductions, his tax burden will stil have risen to $885, 5.2 percent of his burden, up from 5.3 percent in 1981 and 3.0 percent in 1971. If you assume less optimistic inflation projections than the Administration's, then this worker's money wages will be even higher, and so will his tax burden.

It is true that workers in some income groups will enjoy a net reduction in tax burdens after inflation's effects are accounted for. But even in those groups, the net reduction is small, and still leaves these workers with about the same relative tax burden as they had in 1977.

In other words, even the 23 percent reduction in tax rates will have only about the same effect as an indexation of tax rates. Where, then, will come the massive fiscal stimulus from the tax cuts? I answer that there is none.

Let me quote from an illustrious colleague, recent Nobel Laureate James Tobin, in remarks made at the Federal Reserve Bank of San Francisco on May 1st of this year. "The [Reagan] fiscal policy, viewed from the standpoint of conventional aggregate demand analysis does not seem to be a significant factor of either stimulus or contraction." Keep in mind that these remarks were made with respect to the initial 10-10-10 Kemp-Roth plan, with the first phase set to go into effect July 1, 1981. They are even more relevant with respect to the actual tax bill passed, with its 5 percent cut in place on October 1, 1981. I would argue that these remarks of Professor Tobin are more accurate than the recent criticisms he has made of the tax packages as being wildly inflationary.

So the tax plan will provide little in the way of net stimulus. Yet it does present a very radical change in policy compared to the last ten years. In the past, the budget process has relied on inflation to boost tax revenues in order to finance higher spending levels. Typically, government spending increases have absorbed all the higher revenues and then some, so that deficits have grown even with a rapid increase in revenues.

The major achievement of the tax act will be to halt this process. It will freeze the relative tax burden for the economy for the indefinite future, and it will freeze it at a level significantly below the current spending burden of the government budget. This, then, presents an enormous challenge to the government to freeze and then reduce the relative level of government spending in the economy back to a level commensurate with a reasonable tax burden for the populous. The spending cuts already approved for this year are a significant first step in this direction, but they are only that.

If no further spending cuts are enacted in coming years, I estimate that the federal government's on-budget deficit will swell to $85 billion in fiscal 1982. It will rise to this level not because of falling tax rates, but because of the effect on tax revenues of lower real levels of income.

Thus, I would strongly advise against a general tax increase. General tax burdens have risen steadily for fifteen years and for the sake of our economic vitality, I would hope they will rise no more. I am no expert on strategic defense, and so have no specific recommendations there other than to urge you to press for a military spending program which efficiently but adequately promotes the defense of our nation.

I would urge you to push for spending cuts among a whole array of inefficient farm support programs and entitlement programs which have long since outlived their usefulness. Programs to subsidize tobacco growing even while government studies catalogue its harmful effects, oil depletion allowances designed to increase energy profitability even under today's oil prices and even while windfall profits taxes attempt to reduce profitability, are obvious examples of originally well-intentioned programs where costliness has outlived usefulness. I am sure you can recite a litany of similar programs throughout the fderal government.

There will be enormous political pressures aiming to block significant reductions in any of these areas. Yet I would urge you to do all in your power to overcome these pressures to make further, substantial cuts in spending in coming years in pursuit of a balanced budget.

In fiscal 1982, a continuing weak economy and falling inflation will allow us to finance a $70 billion deficit with sharply falling interest rates. But the economy will be recovering by 1983, which will mean growing private credit demands. And similar or larger deficits in recovery years would be an unmitigated disaster for the credit markets and interest rates.

As for monetary policy, I would expect that the M1B monetary aggregate will finish 1981 with an average growth rate of 4.5 percent. This will represent a satisfactory slowdown from the 6.7 percent growth rate in 1980, especially after the Federal Reserve's shift-adjustments for NOW accounts lower the 1981 figure even further.

Yet I would remind the Committee that a 4.5 percent growth rate, if maintained, would be consistent with 4.5 percent inflation rates. In the Humphrey-Hawkins Act passed only three years ago, the Federal government committed itself to a long-term goal of 3 percent price inflation or less. Thus, even further reductions in money supply growth will have to be achieved in coming years. Such reductions will temporarily slow economic growth.

Still, continued advances against inflation will be sufficient to lower interest rates, even with slowing money growth. And any sizable increase in money supply growth will take us even further from our eventual goals, and will make the financial markets even more skeptical of the government's resolve to eradicate inflation. Such likely results make monetary stimulus counterproductive at this time.

Thus, I believe that the government has embarked on a sound policy mix of anti-inflationary monetary policy, neutral tax policy, and anti-inflationary spending policy. This mix will continue to make inroads into inflation in the year ahead.

The Economy

However, it is bound to slow down the economy. There is no reason to expect a pickup in economic growth soon. While I do not foresee a serious recession in the next nine months, I do see a period of sluggish growth and rising unemployment.

I project growth in the inflation-adjusted gross national product to be negative over the next two quarters (see Table I). The unemployment rate will continue to rise and will peak at 8.5 percent next spring.

	Real Output Growth	Unemployment	Inflation: GNP Deflator	3-Month Treasury Bill
Q1/80	3.07	6.23	9.29	13.35
Q2/80	-9.89	7.33	9.79	9.62
Q3/80	2.37	7.53	9.21	9.15
Q4/80	3.78	7.50	10.74	13.61
Q1/81	8.55	7.33	9.78	14.39
Q2/81	-1.57	7.40	6.35	14.91
Q3/81	-.58	7.23	9.20	15.05
Q4/81	-2.60	8.18	8.01	11.60
Q1/82	-1.50	8.47	6.85	9.70
Q2/82	.78	8.59	6.54	8.60
Q3/82	4.04	8.15	6.12	10.60
Q4/82	6.25	7.85	5.76	11.50
Q1/83	5.30	7.68	5.82	10.68
Q2/83	6.57	7.51	5.29	9.60
Q3/83	5.38	7.41	5.24	9.05
Q4/83	4.14	7.20	5.05	9.02
Q1/84	3.28	7.13	5.30	9.21
Q2/84	2.22	7.15	5.12	8.64
Q3/84	3.77	7.15	5.17	7.70
Q4/84	4.52	7.05	5.15	7.35
Q1/85	4.32	6.99	5.29	7.69
Q2/85	4.33	6.92	5.18	7.97
Q3/85	4.73	6.82	5.10	7.87
Q4/85	5.02	6.70	4.87	7.40

Not until the second half of 1982, by which time interest rates will have fallen considerably and the second phase of the tax reductions will be in place, do I expect the economy to begin a healthy recovery.

Inflation

While the recent course of monetary and fiscal policy implies slow economic growth ahead, we have already started to see the benefits in lower inflation. From a peak of 18 percent in early 1980, consumer price inflation has dropped to 8 percent rates for much of this year. Inflation in the GNP price deflator has fallen from 11 percent to 6.4 percent, and producer prices have risen at rates less than 7 percent for most of this year.

Inflation will fall to even lower rates in 1982. I expect the GNP deflator to grow at an average rate of 6.4 percent in 1982. Since mortgage interest rates exert a heavy influence on the consumer price index, and since I expect mortgages interest rates to decline next year, the CPI will grow at an even slower average rate, probably around five percent in 1982.

For the rest of 1981, the prospects are less sanguine. Producer prices will continue to grow at 6 to 8 percent rates. However, just as lower mortgage rates next year will slow the CPI then, so the increases in mortgage interest rates experienced through September will distort upward the CPI through December, and so keep it close to double digit rates until then. As my comments would suggest, such an upturn is temporary and technical and does not affect the actual deceleration in inflation we will continue to enjoy.

This slowdown in inflation next year will have been made possible in part by a similar slowdown in wage settlements. Slow growth and rising unemployment will exert a disciplining influence on labor demands, while slowing CPI growth will reduce contractually indexed (COLA) wage settlements. This will be a bitter pill for unions to swallow, and a series of strikes similar to the air controllers' situation is likely. Still, negotiated wage increases will be slow, and I expect growth in manufacturing wages to average 7 percent in 1982.

Interest Rates

This evidence of slowing inflation will exert a powerful influence for sharply lower interest rates. Already, evidence of a weakening economy has served to reduce short-term interest rates, even in the face of a large fourth quarter borrowing requirement by the Treasury.

Rates on 90-day Treasury Bills have fallen from 15.7 percent in early September to 13.10 percent levels last week. The rate on overnight Federal funds has fallen from 20 percent in July to the 12 to 15 percent range in the last two weeks. These declines have occurred with little or no stimulus from the Federal Reserve.

With inflation continuing to fall, interest rates will fall sharply next year, even with a modest monetary policy by the Federal Reserve. Treasury bill rates in the 9 to 11 percent range by mid-1982 would be a conservative estimate for the extent of an iterest rate decline next year. The path to these or lower rates will be an uneven one, but I would expect rates to begin to decline significantly within the next month, following the November Treasury refunding.

This decline in financing costs will be a major factor in restoring viability and profitability to some of our troubled financial institutions. However, the home mortgage industry has suffered terrible losses this year, and will need lower financing costs merely to restructure and solidify their financial positions. It will be at least another year before they will be able to actively seek to expand their mortgage portfolios. Consequently, mortgage rates will remain high compared to other interest rates, and this will continue to depress the housing industry.

One activity that would broaden the asset base of savings and loans and thrift institutions would be an expansion of their auto and commercial loan business under the wider powers that have been granted them recently. Such loans have a maturity structure much shorter than do home mortgages, much closer to the maturity structure of these institution's liabilities. Thus, these loans can be profitable and make good financial sense, and they would provide new sources of financing for the auto industry.

While such new funding sources and lower interest rate conditions in general will help the auto industry, continued weakness in the general economy will limit the extent of any turnaround in auto sales. Conditions there, then, will remain less than ideal for the rest of the 1982 model year.

Conclusion

In summary, inflation has turned down and we expect continued slowing over the next year at least. Interest rates have begun to fall and will decline further. The economy is currently in a mild recession and will begin to recover by next spring.

I know we all seek prosperous economic growth and price stability. I know you will agree with me that it will take responsible policies steadfastly pursued for a long period of time to achieve both these desires.

It is crucial that we continue to eschew a short-term quick fix for some of our ills. In spite of the considerable progress which has been made in reducing inflation, consumers and investors are still highly skeptical about the ability of policymakers to sustain anti-inflation policies. Consequently, any switch to monetary or fiscal stimulus will surely mean a quick resumption of accelerating inflation and rising interest rates.

The most criticial time in an anti-inflation struggle is when initial gains against inflation have been made, but when the painful elements of high interest rates, slow growth, and high unemployment are present as well. This is when the public will to fight inflation and the political will to make hard decisions is tested, and when public skepticism surfaces. I cannot overemphasize to you the importance of sticking to the path upon which you have embarked.

Representative REUSS. Well, now, to examine that, is zero the optimal unemployment rate too?

Mr. RUTLEDGE. No, I would not say that.

Representative REUSS. Did God switch signals on that?

Mr. RUTLEDGE. No. God never made a target for unemployment as far as I know, in the St. James version anyway.

Representative REUSS. Speaking of theology is unsuccessful, at least in resolving this.

Mr. Chimerine, as you know, I believe that high interest rates got us into this recession and lower interest rates can sure help us get out of it, and generally you agree with that, do you not?

Mr. CHIMERINE. That's correct.

Representative REUSS. I note with interest that you say here in your prepared statement, "Additional restrictive actions should be avoided in the months ahead." And then again, speaking specifically of monetary policy, you say "I believe that the recent efforts by the Federal Reserve to increase growth in the money supply are appropriate and should not be offset by new tightening measures."

Now it is a fact, is it not, that in the President's massive program for economic recovery, February 18, 1981, not only was not a word said about a recession or an 8.5 percent unemployment rate, but specifically on the question of monetary policy the Federal Reserve was urged to reduce dramatically the growth in the money supply. To that end, the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986. With the Federal Reserve gradually but persistently reducing the growth of money, inflation should decline at least as fast as anticipated.

Now you know what the figures were in 1980, and that was the baseline. M1B's target range was 4 to 6.5 percent. M2's range was 6 to 9 percent. And over protests from the Democratic members of the Joint Economic Committee, the administration and the Federal Reserve reduced their 1981 M1B target from 4 to 6.5 percent to 3.5 to 6 percent, and it appears that unless the administration changes its position, as of January 1, 2½ months from now, the M1B target will be reduced to 2.5 to 5.5 percent.

In your judgement, doesn't that constitute precisely the kind of new tightening measure which is going to make the recession, already unconscionable, even worse?

Mr. CHIMERINE. Mr. Chairman, I was referring first to what I expect to happen over the next several months, that the Fed has significantly increased nonborrowed reserves during the past 3 or 4 months, and I think there's a very strong possibility that this will develop into faster growth in some of the money measures during the rest of this year. I think that's necessary because I think M1B growth so far this year has been well below that target, and inadequate.

To be very honest about it, I'm not certain what any of these M's mean right now. When interest rates are the highest they've ever been and when 80 percent of homeowners are priced out of the housing market and many small businesses are going bankrupt, nobody can tell me that that's not tight money, regardless of what the M's show. We have extremely tight money.

It's not all the Fed's fault because, in my judgment, there's a direct conflict between what the Fed has been asked to do and the tax and budget program.

As a result, my own preferred solution on a longer-term basis is not to ask the Fed to ease to such an extent that they accommodate all of these deficits, because in the long term I think that would be self-defeating.

Representative REUSS. I agree with you. Print money, never. But does it make sense for the administration to adhere so its dogma, as evidenced by the President's program, and require the Fed on January 1 to compound and make the situation worse by lowering the target range for the monetary aggregates, specifically M1B, which is cash and checks? Is that wise?

Mr. CHIMERINE. I think the administration's response, Mr. Chairman, would be that the Federal Reserve has tightened or reduced the money supply growth this year far more than their target would suggest and that what they are asking the Federal Reserve to do—in fact what I'm asking it to do—is to bring money growth up to the target and not 3 or 4 percentage points below it.

Representative REUSS. But just look at the state of the record which seems to me extraordinarily real. Here the administration has requested the Fed to lower—by the Federal Open Market Committee—the money supply targets by a percentage point or half a percentage point a year until you get them down to half of what they were in 1980, which would be 2.2 to 3.25 percent for M1B and 3 to 4.5 percent for M2.

Now I think the progressive lowering of our money supply targets is a good thing and I support it, but what I'm saying is that when you are confronted with a recession, it would be the better part of wisdom to use discretion to leaven the loaf, to follow the rule of reason, and to say for 1982 and until further notice the Fed shall not be required to lower its monetary targets but may keep them where they now are.

Would you, one, agree that such a repeal by the administration of its economic program—that portion of it—would be in the public interest and that it would not represent, if done, such a backtracking, such a lack of fortitude, such a throwing in the sponge when the game is all but won, as to alarm the markets? I don't think it would.

Mr. CHIMERINE. I agree with you, Congressman, for two reasons. First of all, I don't think half a point makes much difference. We can't even measure the money supply within that kind of range of accuracy.

Second, I think there's some logic for it because it seems clear now, if you take M1B, they're not going to make their target for this year. They will be considerably below it, even if it accelerates somewhat for the rest of this year. So you could make a case that we should offset some of that during the course of 1982, particularly in view of the weak state of the economy.

I must reemphasize again, I don't think that this is the long-term solution to the problem because another half point growth in the money supply will not address the issue raised earlier about the problems of 1983 and 1984 and, in particular, Mr. Chairman, I disagree with Mr. Rutledge. There are some differences between 1974 and 1975 and the situation now. When the deficit is a larger share of GNP—particularly the deficits in 1983 and 1984—these are going to represent a large share of GNP for a nonrecessionary period, unlike 1975.

Second, the Federal Reserve is not accommodating deficits now like it did in 1975.

And third, the amount of private savings to finance the deficit has been squeezed dramatically in recent years. Corporate liquidity has worsened and the personal saving rate has declined.

So in these conditions, I think the deficit does have a bigger potential impact on interest rates.

Representative REUSS. Finally, wouldn't you think any such rescission by the administration of its monetary policy program—backtracking until further notice—would well serve useful political and economic purposes? It isn't really edifying for the administration at one and the same time to be enjoining supertightness on the Fed under pain of exposure as inflationist and at the same time bucking them from time to time for being too tight as has occurred in recent days. That can't be a good way to run a railroad.

Mr. CHIMERINE. Well, Mr. Chairman, I'm not wedded, as I said, to these specific money targets and I agree with your basic thrust. In these circumstances, given the fact that money growth is probably too low, given the fact that money is extremely tight and high interest rates are doing severe damage to several industries in the United States, yes I think some acceleration is warranted and I would certainly not redecelerate, so to speak, or cut back after the next big bulge in the money numbers because I think this is necessary to offset the slow growth so far this year.

Representative REUSS. Let me just ask Mr. Perry. You've heard the colloquy of Mr. Rutledge and Mr. Chimerine. Would you, in general, agree or disagree with Mr. Chimerine?

Mr. PERRY. I would, in general, agree. I would point out that the Federal Reserve, in fact, has a great deal of discretion even within the targets it has set for itself in terms of the various monetary aggregates. The fact is that it has chosen to use what discretion it has to keep money very tight. It could, within the bounds of its own targets, have allowed interest rates to come down a good deal more already than it has, but it has chosen, I think quite deliberately, to keep them very high and to use its discretion to do that. It is doing exactly what the administration asked it to do and I think it is unseemly that the administration now criticizes them for it.

Representative REUSS. My time is up. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

I have a number of comments, and then I want some comments from you if you will.

First, the decrease in the real GNP that's just been announced is 0.6 percent. That's a rather marked improvement from the second quarter decline of 1.6 percent and it seems to me that may mean that the rate of decline is slowing some.

The disturbing thing is that there is a fall in the savings rate to less than 5 percent. Now that's before the tax cut took effect and I'm not sure what that infers. This report today from the Department of

Commerce says that disposable after-tax personal income increased $54.5 billion in the third quarter and personal outlays decreased $60.9 billion. As a result, personal savings decreased $6.4 billion and savings as a percentage of disposable income decreased from 5.4 percent in the second quarter to 4.9 percent in the third quarter.

At the same time, consumption went up. Personal consumption expenditures increased $59.5 billion in the third quarter. Purchase of durable goods increased $12.7 billion following a decrease of $11 billion. Both the third quarter increases and the second quarter decrease reflect sharp changes in the purchase of new cars. The purchase of nondurable goods increased $14.8 billion compared to $9.3 billion in the second quarter.

Those trends seem to me to have both some good news and some bad news. The durable goods increase may be helpful, but the consumer expenditure jumped and the decrease of savings may in fact presage an inability to finance such public debt as we have and increase the impact on the inflation rate or the interest rates.

Would you agree with that or do you find more good news in what find more good news in what I have just read than I do?

Mr. PERRY. I think that we have to look ahead, not at where we have just been. The question is, Are we in a recession that's going to deepen and get substantially worse than it is today? This personal saving rate varies on a quarterly basis. One interpretation of the low rate in the third quarter is people began spending that tax cut even before they got it. I think there are economists who would analyze it in that way.

I rather think it's a sign that consumers are strapped and that consumer spending is going to weaken further in the coming quarters.

Representative BROWN. So you suggest, Mr. Perry, that that means that the tax cut was not sufficiently focused on increasing savings?

Mr. PERRY. I believe that we kid ourselves if we think the tax cut was focused on increasing saving. I don't believe you can cut personal income taxes without having the dominant effect of that to be to increase consumption.

Representative BROWN. Well, that doesn't—I don't agree with that. I have to say that I think you can cut taxes in such a way as to stimulate savings, and one of the ways to cut taxes to stimulate savings is simply to reduce the tax entirely that one pays on return on investment, interest or on the dividends that one gets from investment in productive assets.

I think the argument as to whether one consumes or saves is frequently—I have to support Mr. Rutledge in this—the decision is frequently made by the individual who sees a benefit in savings or a benefit in putting money into gold bricks and makes the determination accordingly.

Now let me go back and ask the question again. Do you think we could have focused the tax cut more specifically to encourage savings rather than a tax cut that—if what you say is correct that people are just merely spending the tax cut 9 months before they get it—allowed people to further consume?

Mr. PERRY. Well, I think we do know a way to increase saving, and that is not to have the tax cut. The Government can save——

Representative BROWN. Personal savings?

Mr. PERRY. Total savings is what determines total investment.

Representative BROWN. You're getting into a psychological response. If the Government took all the money that all of us made each year, you would increase savings because even the Government probably couldn't spend it that fast, although it would probably only take them about 1½ years for them to catch up.

Mr. PERRY. I'm not proposing increased spending.

Representative BROWN. If we leave any money in the hands of the people who earn it, then if we encourage them to invest that money in savings rather than to spend it at the same rate Government does, which is faster than they make it, wouldn't we be increasing savings and have the opportunity to finance the debt?

Mr. PERRY. No, I'm afraid that would not be the way I would look at it, sir. I was not proposing that the Government have higher taxes and higher spending but, rather, that the Government keep its taxes so as to reduce the deficit. In that case, you increase saving in the maximum way. Any time you choose, instead, to cut income taxes, as we did this year, the overwhelming portion of that is going to be put into increased consumption.

Representative BROWN. Only, I might say, if you put the taxes or the tax cuts in that form.

Mr. PERRY. Well, the form in which we put them, which was across-the-board tax reductions, benefiting primarily people in higher income groups. But it wouldn't have mattered if it had benefited primarily people in lower income groups. That kind of reduction is going to primarily increase consumption and will reduce total saving.

Representative BROWN. People in high-income groups and low-income groups save at the same rate?

Mr. PERRY. The difference is not large in saving rates in those two groups with a marginal change in taxes. If I give two people an extra $10, what fraction of that they will spend may differ—perhaps $9 for one and $8 for another. But in both cases, from everything we know from past analysis, most of it will be consumed and only a smaller portion will be saved.

Representative BROWN. I'll put a little chart up here for you to look at. I wonder if you would comment on this, Mr. Chimerine and Mr. Rutledge.

Mr. CHIMERINE. Yes. I'd like to make several comments, Congressman.

First of all, I believe we need some more savings, but if we do not get a significant increase in consumer spending in the years ahead, we will not get an economic recovery. And I would point directly to the automobile industry. If we have tax cuts and every nickel of those tax cuts are saved and auto sales stay at 9 million units, you're not going to get more investment in the automobile industry.

Two of the fundamental problems with investment spending right now are high interest rates and lots of excess capacity, both of which have reduced the expected return on new investments by more than the tax cuts will improve them.

Second, I don't see what good it does to have a $150 billion or $100 billion deficit if all the savings goes to finance this deficit. It certainly can't be used to finance investment at the same time.

Also, we have already had an enormous increase in the return on savings simply because of the increase in real interest rates. I don't see people saving a lot, as you mentioned, because they don't have anything to save. People are fundamentally strapped and the low saving rate is more a reflection of the fact that people don't have the wherewithal to save more rather than high taxes discouraging savings.

There is one other point regarding your question about the specific incentives. And I would answer that, yes, Congressman, I think you get much more bang for the buck out of IRA extensions and these programs to promote savings than we do out of large across-the-board personal tax cuts, without the adverse effect on the deficit.

So my answer would be, yes, when we do scale back those tax cuts, which I think we ultimately have to do, it should be on the across-the-board personal tax cuts, not the specific incentives for investment and savings that have been implemented as part of the package.

Representative BROWN. The latest report of today's GNP inflation rate is 9.2 percent. Municipal bonds free of Federal taxes are yielding about 12.2 right now. That makes the real interest rate about 3 percent. That's not much different than it was back in 1963, 1964 and 1965, a rather stable period, when the municipal bonds yielded about 4 percent and the inflation rate averaged 1.5 percent and you had a real interest rate then of 3 percent.

Now I would submit to you that the real interest rate may have something to do with where we are and maybe the situation is improving because of that real interest rate.

Mr. Rutledge, if you have any comments to make, my time is up, but you can go ahead and make them in this dead time between me and the next question.

Representative REUSS. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Perry, I suppose first of all we can say that the past few years there has been stagflation. We have had a rather stagnant ecomony and we have had inflation. Apparently, we are now going into a period where the next 2 years will be inflation plus a recession.

Mr. Perry, I think you have done a lot of work in this area. Yesterday, the Joint Economic Committee heard some experts on Scandanavia, all of whom indicated they have been able to keep their economies relatively stable through income polices, particularly in periods of not rampant inflation but just inflationary periods. The chairman and I, as you know, have for many months been very anxious to discuss the possibility of instituting wage, price, and credit controls in the United States as a means of stopping inflation, stablizing wages and prices, giving our manufacturers an opportunity to retool their factories to make them competitive with our Japanese neighbors who in 1983 will be the world's No. 1 industrial power. By 1983, Japan will beat the United States in industrial volume. Why? Because of their large rate of savings, 24 percent, against our 5 percent, and the fact that all of these savings go right back into factories in new equipment and the Japanese industries are much more modern than our industries.

First of all, I wonder what you think about wage, price and credit controls right now, and then I'd like to discuss the benefits of a balanced Federal budget in times of recession and inflation—balanced budget through use of this "share the burden" budget, copies of which I've left in front of all three witnesses. Mr. Perry.

Mr. PERRY. I think there are important objections to wage and price controls and I would not favor them except as a last resort and under extreme circumstances. Those circumstances could arise, but I don't think they are with us today.

I would favor—and I believe inevitably we're going to have to take seriously some incentive schemes for encouraging wage and price moderation.

Representative RICHMOND. The same as controls then?

Mr. PERRY. No; I don't think they're the same thing as controls, sir. They would be voluntary and there would be incentives for people to moderate wages and prices.

Representative RICHMOND. Something like the Japanese system for profit sharing?

Mr. PERRY. There are many variations and perhaps the Japanese profit sharing situation is one such. I'm not very familiar with it. I think in European countries and in Japan there are arrangements between the government, business and labor which amount to a form of voluntary wage and price restraint and I think that we realistically should be thinking in those terms here. Instead, what we are doing is trying to wind down inflation by depressing the economy. That's the kind of experiment that we have set out on today and I think we should look at it in exactly those terms. I think we're kidding ourselves if we think we are doing something different than that. That might succeed. It might succeed partially. Unfortunately, how much it succeeds is going to depend on how much we are willing to depress the economy. But that's the experiment that we're going on now.

Perhaps if that one is so costly in terms of business failures, unemployment, and lost output, we'll take more seriously proposals that might combine price stability with prosperity. I certainly hope that we can reduce inflation without too much pain, but I'm skeptical of whether we can do that.

Representative RICHMOND. And a balanced Federal budget?

Mr. PERRY. I think the notion on the Federal budget is a rather straightforward one. Certainly in a recessionary economy, the deficit that exists is consistent with interest rates falling. It would be a mistake, and it would be Hoover economics, to try to reduce that deficit by further restrictive fiscal measures that would only deepen the recession.

That speaks to the issue of 1982 when we have a seriously unemployed economy and where the large deficit will not hurt us. As we look further ahead——

Representative RICHMOND. I didn't say to reduce the Federal deficit by restricting Federal expenditures. I said reduce the Federal deficit by instituting roughly $40 billion of user fees that would increase employment. If you have a $10 billion user fee for highways, that employs many, many hundreds of thousands of people fixing our highways, and then you would also print $10 billion less money at the end of the year. So it would both put people back to work and make our highways and bridges much safer. The chairman of the Public Works Committee tells us there are 170,000 bridges in the United States that are not safe today. We have this great potential to fix those bridges and nobody wants to do it. This isn't Hoover economics. We would tax people for using various items and put people back to work thereby balancing the budget.

Mr. PERRY. Let me clarify what I said. I share completely your concern about the deteriorating public investment in this country. We are behaving not like a rich and sensible nation which understands that public investments are vitally important to us all but, rather, our country seems very much afraid of its own public sector. So I agree completely with that concern which is a longer run concern.

I only point out that at a time when we are confronted by a large recession, that is not the time to raise taxes. We could expand public spending in the areas you're saying in the coming months if we could conceive of doing that quickly enough, and not be concerned about raising taxes at that point; but if we look a little down the road, then I think it's important to reduce the high employment deficit because at that point we will be crowding out private investment by having so much government borrowing in a situation where the total funds available are going to be limited. They are going to be restrained by Federal Reserve policy.

For that situation, I believe we should look for ways to do two things: One, to reduce the size of the deficit in the budget; and, two, to better organize our priorities and to have more concern for public investment in some of those other areas.

Representative RICHMOND. Mr. Chimerine.

Mr. CHIMERINE. Congressman, I have a few comments. First, on your question about wage and price controls or similar methods to slow inflation, my own feeling is that there has been a fundamental change in underlying inflation in this country. A lot of it is due to better prospects for oil and food prices than in a number of years. I think the administration program will help productivity. Even wage increases are starting to moderate significantly, particularly in those distressed industries in which wages have risen sharply in recent years and which are at a competitive disadvantage with the Japanese and other foreign competitors.

My own feeling right now is that inflation is not the No. 1 priority. I think inflation is moderating and there is every reason to expect continued moderation, and I think that the Fed has also made a contribution in this respect.

The more fundamental concern has to be interest rates and the economy. If interest rates rebound to higher levels, this would in the long term be self-defeating. The whole thrust of this program is to stimulate investment. I don't see how you can get an investment boom in this country with interest rates of 20 and 25 percent.

Representative RICHMOND. And we have a $100 billion Federal deficit. You said in your last comments that if all of the savings were generated through the all-savers certificates and nothing else, it would just be used to help pay the Federal deficit, so we're gaining nothing. Hadn't we better bite the bullet and put in a lot of unattractive user fees so the people who use the facilities will pay the price and put people back to work?

Mr. CHIMERINE. Yes; I think that would be one way of reducing the deficit, but I would not do it right now, Congressman, because of the weak state of the economy. I would aim it more toward 1983 and 1984. Second, that money has to come from somewhere, and if you go ahead and spend it to improve the bridges and highways you're going to wind up with the same deficit anyway. You've got to be careful. We need net revenue increases for net spending reductions for 1983 and 1984.

Representative RICHMOND. I disagree. That wouldn't end up with a deficit. It would end up with increasing employment, increasing tax revenues, decreasing Federal deficits, and improving our highways and bridges.

Mr. CHIMERINE. But if you go through the sequence, first you increase user fees and that's got to come out of somebody's pocket.

Representative RICHMOND. People who use our highways would just pay 10 cents more per gallon of gasoline.

Mr. PERRY. But then you respend this. You impose user fees and you wind up spending it for something anyway, so you still have a net deficit problem.

Representative RICHMOND. I disagree. You're creating employment. You're increasing the tax base. You're improving the assets of the United States.

Mr. PERRY. Congressman, that's what the administration program was supposed to do, but high interest rates are not going to allow that to happen.

Representative RICHMOND. My time is up. Thank you.

Representative REUSS. Gentlemen, on your unemployment predictions for calendar year 1982, Mr. Chimerine says 8 percent; Mr. Rutledge says—correct me if I'm wrong—it would peak at 8.5 percent, but that the annual average will be approximately 8 percent. I think that's a fair statement, is it not? And Mr. Perry, your prediction is to the same effect, as I understand it. You agree with Mr. Rutledge that it would get up to as high as 8.5 percent and you come out for the year 1982 with approximately 8 percent?

Mr. PERRY. Something over 8 percent, yes.

Representative REUSS. The administration, again, in its program for economic recovery, last February postulated the unemployment for 1982 at 7 percent. Well, you know, 1 percentage point is a million men and women who would have jobs at 7 percent but don't have jobs at 8 percent. That's a rather serious misunderstanding and shortfall, is it not?

Mr. PERRY. Yes; I think it represents a very different economy. What we have been promised was solid economic expansion and that's not what we're getting. I think that very early in the game many outside observers did not believe that the program combining fiscal and monetary policy was consistent with those goals, and we would force the economy into a slump. The timing was open to question, but it was almost inevitable.

I think that we're looking at a very different economy than the one that the new program was designed to deliver and a very different economy than the one that the budget projections are based on.

Representative REUSS. Congressman Brown.

Representative BROWN. Mr. Perry, let me call your attention to this chart if I may. The purpose of the chart is to try to put in graphic form the direction of what I understand the administration program to be, and that is to reduce Federal spending—or at least hold back its growth to the extent that the deficit is reduced and you therefore reduce interest rates because the pressure is taken off from the Federal Government to borrow.

Now the other part of it is through the depreciation and tax cuts to encourage business to expand, which tends to bring back the pressure on interest rates if business is expanding.

We find in this last quarter that there was some increase in capital goods expenditures. So the way to deal with the problem—if you're going to just move it over into a business deficit or personal deficit for housing and for business expansion, even though you reduce the Federal deficit—is to try to increase the amount of loanable funds or borrowable capital that's available by increasing savings.

Now I want to go back to whether or not there's a correction here that needs to be made in the program and that is to try to see that we stimulate the increase in savings further so that you expand this base from which people have by choice put their money into savings and give you more funds from which private capital expenditures can be made as a result of private borrowing.

Isn't that a sound theory or is it an unsound theory?

Mr. PERRY. Well, the question is—as you describe the question right now, I believe that's correct. The Government deficit declining with other things being equal leaves more funds available for private borrowing.

The problem is that the Government deficit under the tax cuts and defense increases that are scheduled threatens to grow very sharply, not to decline. So I think the general idea is correct, but the program isn't doing that.

Representative BROWN. But just pause right there. If the program also stimulates additional saving, then that does provide more—even if you get no shrinkage in the Federal borrowing, it does provide more for private capital to borrow.

Mr. PERRY. Well, the best estimates that I can make and that I believe most economists can make is that as Government saving is reduced through tax reduction, private saving doesn't increase anywhere near enough to net out to zero, let alone a positive number. So I think inevitably we have to consider both sides and——

Representative BROWN. Well, now, let me go back to your other principle that you mentioned earlier, and that was the increase of Government spending. In other words, that we leave the taxes where they are and merely increase the income to the Government. Is that preferable?

Mr. PERRY. I'm sorry. Perhaps I didn't speak clearly on that, sir. I did not propose——

Representative BROWN. You said leave taxes where they are, which increases the income to Government because if the tax rates were left untouched the rate of income to Government would go up sharply. The rate of income to individuals and the private sector would stabilize or go down. It's going down in real terms for many private individuals.

Mr. PERRY. By leaving them where they are, I meant postpone or eliminate some of these future tax cuts.

Representative BROWN. You mean just leave them where they are, don't change the tax rate at all? With inflation we're all being pushed into higher and higher brackets, so the Government gets a higher and higher percentage of our funds, our money, what we earn.

Mr. PERRY. That's obviously a matter of degree. I think some tax reduction was appropriate, but, yes, I agree, had we cut taxes as much as we did in this summer's legislation, we would be confronting lower interest rates and more investment in the out years because the Government would have a smaller deficit and that would tend to reduce interest rates for private investors, yes.

Representative BROWN. Mr. Rutledge, do you want to comment on that? You did not get a chance to respond to my comments earlier.

Mr. RUTLEDGE. I think this loanable funds way of talking about interest rates is fundamentally wrong. It's two-thirds right. It's correct that when people want to borrow more money it makes interest rates go up. So that definitely makes credit demands go up.

But where is that money coming from? Who's supplying all that money? Credit supplies are the poor cousin as far as financial analysis is concerned.

If I'm a private citizen, I can supply credit two separate ways. I can supply it out of my current income by not spending it. That's saving and that's what everybody harps on. But I can also supply credit by selling another asset I've got and buying securities. This supplies the sort of big shifts in credit supplies that can make interest rates go up and down.

Representative BROWN. Can you explain to me how we can get people to sell their Florida land and oriental rugs and their gold and put it into loanable savings so that we get this result?

Now it seems to me one way would be the way the tax laws or the tax changes are made so that you encourage people through the change in the tax law, and that's the concern that I have about the program that passed. It seems to me that did not sufficiently stimulate the process of savings or disinvestment in the investments people had made betting on the coming of inflation. Do you want to comment on that?

Mr. RUTLEDGE. There are definitely things you can do in the Tax Code to stimulate more savings and investment and less consumption, absolutely. I think that's essential. But as far as those decisions for people, the most obvious thing to do is to show people if they make the wrong investments they lose money. In other words, to take away their rate of return on real assets, which means reduce the inflation rate. That's the only way to stimulate savings.

Representative BROWN. But, if you will, you've got two choices here. One is for the Fed to ease up, to start printing money or ease up on the restrictions on the money supply and, of course, we know that they don't just print money; they change the discount rates and so forth and so there's more money borrowed and you expand the money supply in that way. But if they did that, that might change the utility of thinking about whether or not the Florida land investments and so forth were desirable. So are you suggesting that we ask the Fed to ease up on their restrictive monetary supply?

Mr. RUTLEDGE. No; I think that would be a great tragedy.

Representative BROWN. Then how do we get people to decide to sell the Florida land and to put it into the stock market where somebody gets a job out of it or to put it in a savings account or in a savings and loan where somebody can borrow it and build a house?

Mr. RUTLEDGE. The effect of the monetary policies you're talking about is to reduce the inflation rate, which is the rate of return on alternate assets. In other words, persistence of this policy long enough to allow it to work, our monetary policy, reduces the rate of return on things that people buy when they don't buy securities. They have no choice. I mean, calculate the rate of return on gold since last fall. Gold has fallen from the $800's down to the middle $400's. That is the primary incentive for buying securities; when there's nothing else to buy and that's what people are left with.

Regarding the tax bill, I fail to see where there are any personal tax cuts. Most taxpayers' tax burden will increase next year. They won't decrease. There's a very large change in posted tax rates, but they are virtually fully offset by the tax-increasing effects of bracket creep and by rising social security taxes.

Representative BROWN. Will you explain why that is?

Mr. RUTLEDGE. Absolutely. Because the rising prices and the increase in social security taxes more than offset that initial rate cut for a great many taxpayers. The cut in the top end tax rate from 70 percent is a real one and it's a sizable one, but it's targeted exactly at the investors that are the financial asset buyers. The depreciation allowance is a real one and a very large one too and it goes dollar for dollar into corporate savings. So I think there have been things done in the tax bill to stimulate savings.

Savings is a useful thing to have, but it's a mistake to think that the big lever for savings is the tax code. The big lever for savings is the inflation rate, because that's what decides for people whether they save through hoarding assets which have been previously produced or by buying securities.

Representative BROWN. If that's true, why do I see all the ads about tax-free interest in the paper?

Mr. RUTLEDGE. So you won't have to pay taxes.

Representative BROWN. Somebody in the marketing department in the bank says that tax-free interest is attractive to the individual investor.

Mr. RUTLEDGE. It is.

Representative BROWN. Is that not right?

Mr. RUTLEDGE. It is.

Representative BROWN. Well, you just said it wasn't.

Mr. RUTLEDGE. No, I did not.

Representative BROWN. You said the tax rate didn't make any difference, that it was some other mysterious——

Mr. RUTLEDGE. I said that the effects of taxes, is a small factor and the inflation is a big factor if you look at the changes in household net worth.

Representative BROWN. I understand what you're saying, that if the inflation rate was zero, people wouldn't be betting against inflation. That's easy to say, but the accomplishment of that zero inflation rate is the thing we're talking about. And the three weapons which the Government has are the Tax Code, fiscal practices—Federal spending and deficit or reduction in Federal spending and reduction in deficit, not necessarily going hand-in-hand always—and the monetary supply.

Now what is your recommendation about how we get the inflation down? I gather it's not to start printing money, not to increase the money targets, another way of printing money, or to let the money targets continue to go to the lower level, which is what we always do, because my definition of inflation—I put down here a minute ago—is the money supply increasing faster than the real growth, and that creates inflation; does it not?

Mr. RUTLEDGE. Increasing the money supply, I agree, pushes prices higher.

Representative BROWN. So you've got to get the money supply down someplace related to real growth or your projecting inflation into the future?

Mr. RUTLEDGE. Yes.

Representative BROWN. Now if we're going to try to keep the money supply under some degree of control—and apparently Paul Volcker is, regardless of who says what—then what are the other methods by which you get the inflation down?

Mr. RUTLEDGE. Well, not through incomes policies.

Representative BROWN. I'm not asking what we don't do. I'm asking what we do do.

Mr. RUTLEDGE. The primary role is through monetary control. A secondary but very important role is through decreases in Government purchases, decreases in Government spending, and a third role would be to target the tax bill so it does not stimulate consumption and so it is targeted to investment.

Representative BROWN. Mr. Perry, do you have a preference for public versus private debt or the other way around?

Mr. PERRY. I'm not sure what you mean by preference, sir. It depends on what the state of the world is at the moment. I think we should be finding ways in the future to reduce Government debt so that private borrowing and private investment can be enlarged.

Representative BROWN. Why do we want to do that? Could you just elaborate one step further? The reason for doing that, am I not correct, is so we become more competitive in the world to try to recapture some of these markets that we've lost around the world, so we don't continue to lose markets right here in this country to people who are able——

Mr. PERRY. I wouldn't think in just that way, but investing in a more modern capital stock has benefits in terms of future economic growth and the growth of real incomes, and I don't think we should focus our attention on the fact that American consumers have the ability to buy foreign goods. I think that's a benefit to us all. I think we should not be concerned about that directly, but we should be concerned about improving our own capital stock and modernizing it for our own benefit, and I do think that means encouraging private investment. Incidentally, I don't think it's only business investment. I think housing investment is very important.

Representative BROWN. Sure.

Mr. PERRY. And that's the area that gets most badly squeezed with the kind of policy we have been pursuing. I think that housing is getting a bad name these days. I hear all sorts of people saying that what we ought to do is squeeze out housing because we have too much of it. I couldn't disagree more. I think it's a very basic element in our society—homeownership and the ability for everybody really to own a home—and I think one of the great casualties of the kind of policy we have been pursuing is the destruction of the construction industry in the last couple years.

Representative BROWN. Douglas Fraser has said that the stock of automobiles is being reduced more rapidly by the turning in of old cars—that is, the junking of old cars—than it is increasing by the purchase of new cars, and that that will create a pent-up demand for the automobile industry in the next few years to where people will go back to owning a car and a half in a family rather than reducing from a two-car family down to a one-car family. Does that make sense? It seems to me it does, and that there will be a pent-up demand for some of these consumer goods. But the important thing right now is the capital investment in new plant and equipment that makes it possible for the companies, whether they be Japanese or American that will make those cars for us when we get back to wanting to spend our money on automobiles, to be able to produce them efficiently and cheaper so we aren't all paying $15,000 per car, and be able to get them somewhat cheaper. Does that make sense?

Mr. CHIMERINE. Yes, I think it does; although, Congressman, I think there's been a fundamental change in the automobile market. People are driving less for other reasons than high prices. I'm not certain that sales will ever rebound to the levels we saw 3 or 4 years ago, but there certainly will be some rebound. I don't think any of us are disagreeing with your basic premise. The fundamental issue is, can we get that kind of investment when interest rates are 20 percent and when the industry is not selling any cars?

Representative BROWN. I want to go back to one point I think you made. There's a lot of unused capacity out there and my guess is it's not only unused but it's unusable, some of it because it was designed to make a 1957 Cadillac with tail fins and it is not going to be very good for whatever the market is when people do decide to come back into the automobile business. They are not going to be buying the kind of things that are produced in a lot of those old factories and what we've got on our hands in terms of this unused factory potential is a lot of junk in some cases.

Mr. CHIMERINE. In some cases, but the lumber mills aren't closing down because lumber is obsolete. They're closing down because people aren't building houses. We now have accelerated depreciation and that will be very helpful, but the best way to get them to modernize those facilities is to show them that they are going to sell the cars that they are going to manufacture and to provide low enough interest rates.

Representative BROWN. One of them might be the American steel industry where we haven't had much modernization since 1923 and my guess is that with the 1923 plant you really don't compete too well with the Japanese and the Germans. I think my time is up.

Representative REUSS. Mr. Rutledge, in your testimony you said that there are virtually no reductions in percentage income tax burdens forthcoming in the next 4 years, referring I believe to the fact that for the average taxpayer the tax cuts merely provide an offset for expected inflation and bracket creep.

However, for a very limited group of taxpayers, very wealthy ones earning more than $50,000 a year or those with large incomes other than in wages and salaries—namely, in stocks and bonds or nonwage income—they in fact do receive tax cuts, do they not, much larger than those needed to compensate them for inflation?

Mr. RUTLEDGE. Yes, they do.

Representative REUSS. Thank you. Congressman Richmond.

Representative RICHMOND. Gentlemen, can we all say that one of the most pressing problems we have in the United States today is the necessity of retooling our factories? I can't think of anything more important for the future of the United States but to create a climate through which we can become competitive with Japan, Germany, and other vastly modern industrialized countries. Is that right? Where are we going to find those billions upon billions of dollars that industry needs to retool at reasonable interest rates unless we enact some of these programs that I discussed during the first round of questioning?

Mr. CHIMERINE. Congressman, I'd make two points. No. 1, I think it would be very desirable if corporations in this country increased the rate of investment and turned over some of the old equipment and, as a result, experienced some improvement in productivity because that's the best way out of the situation we're in.

I wouldn't limit it to that. Public investment has been neglected for many years and the current program may worsen that during the next several years—I think its necessary to reverse that. Corporations are going to finance investment the way they always finance it, by borrowing or from internal funds.

In the current environment, their profits and cash flow are being squeezed so they have less retained earnings to spend, and 20 percent interest is certainly not a strong inducement to finance investment by borrowing. It is essential that we have tax incentives and accelerated depreciation is certainly desirable, but by itself it is not the sole solution.

Representative RICHMOND. Mr. Rutledge.

Mr. RUTLEDGE. Investment is the real problem for the long term, I think. I think a steady set of policies for the long term is the only way to achieve that. Ask any one of the technical experts how long an aluminum smelter produces aluminum or how long a steel mill produces steel, and you find out that those people cannot start a new project unless they are sure they can get financing for the length of that project and there's no long-term financial market available currently, and the only way there can be one is to provide owners of those assets with some security for the purchasing power of the money they're going to get back at the end.

Representative RICHMOND. And this country is reduced to the humiliation of having to ship our copper ore to Japan to be refined into ingots and reimport those ingots, and you can see how antiquated our production facilities have become.

Mr. RUTLEDGE. That's right.

Representative RICHMOND. Well, what are we going to do about it? Clearly we want to get America back on the road again and the companies modernizing our factories so we can become more productive. There's nothing wrong with the American worker. The American worker is just as good as any other worker in any other country in the world. What's wrong is very frequently management and most frequently the equipment that the American worker has to use.

Mr. RUTLEDGE. Yes.

Representative RICHMOND. It's true we can make the management more aware of their problems and get the labor unions to work closer with management, but until you put vast amounts of money into your industrial complexes there's no way to get out of the mess we're in today.

Mr. RUTLEDGE. That's correct. There are two reasons why you're not getting investment. One is on the output side people are not able to forecast a steady enough environment to invest. On the cost side they are unable to have long-term investment. Both of those are a result of policies that cannot be predicted 6 or 8 months ahead. You need to achieve a steady policy environment for more than 1 year at a time so you don't have to ask questions about whether we should reverse policy because output rate fell at a 0.6-percent rate. That's not even a measurable change.

Representative RICHMOND. Well, we start from a very low base, Mr. Rutledge.

Mr. PERRY. I'd like to disagree with a few of the things Mr. Rutledge has said. It's true that the prospect of steadily growing markets is what motivates investment. That is not the same thing as the policies that have been put in place. The fact is that the market correctly conceives the policies that have been put in place as policies that are going to be very hard to live with, policies that promise hard times for growing output and growing markets.

A sensible projection of the growth of output over the 4 years of this administration is that it's going to be very weak by historical standards. It will have its ups and downs, but I think what sensible businessmen and the financial community are saying is that we are not going to have a strong growth of output over this period. That is what they must focus on.

The notion that we must get interest rates down—Mr. Rutledge pointed with some glee to a mistake by some Wall Street analysts in August of 1974 and he pointed out that interest rates indeed fell a great deal. That's a very partial version of history. Interest rates fell a great deal. They fell a great deal because unemployment rose a great deal and because we entered the biggest recession of the postwar period. The unemployment rate rose about 4 percentage points. If you add 4 to today's 7.5 percent, you get 11.5 percent.

I don't have any trouble forecasting extremely low interest rates in that kind of a world. That way of bringing interest rates down is not constructive to investment. It's very damaging to investment. If investment plans are weak and faltering today, it's because they anticipate poor output performance over the next several years. Investment was badly depressed in 1975, not encouraged by the fact that low interest rates had finally come about, and of course it was badly depressed for precisely the reasons that commonsense would tell you. Output declined and nobody needed to do much investing in that kind of environment.

We are looking at a period now when I think interest rates are going to decline again, but they are going to decline for similar reasons; the economy is going to weaken; and that is not good for investment.

Representative RICHMOND. Mr. Perry, you say interest rates will decline. Do you think they will decline permanently?

Mr. PERRY. No.

Representative RICHMOND. For the next few years?

Mr. PERRY. No; I think that interest rates are on a roller coaster.

Representative RICHMOND. I personally think they are going to go down a couple points and then they are going to go right back up to 22 percent.

Mr. PERRY. Yes.

Representative RICHMOND. Do you agree with me?

Mr. PERRY. The current interest rate decline is going to be temporary unless the slump in the economy is permanent. That's hardly the way we want to bring interest rates down. Now what the markets are telling us and what those farsighted businessmen are telling us is they don't like prospects for the next several years and that's why we're getting the interest rates and very timid investment plans we see.

Incidentally, there's a great deal of difference in this. In some industries investment is going ahead very briskly because the prospect of profits is very good. Investment in the oil industry has been very strong for a long time.

Representative RICHMOND. But the vast lot of American industry is in serious trouble with just a few bright spots.

Mr. PERRY. It's not very happy with what it sees, despite the fact that we did pass tax changes that are very favorable to investment.

Representative RICHMOND. But as Mr. Rutledge said, those tax changes are only good if you make profits. Those tax changes really don't help United States Steel, General Motors, or Ford Motor Co., particularly because they all have to do with renewable profits. If you have no profits to start with and you have this crushing need to spend many billions of dollars to bring yourself up to date, I wonder how we're going to do it if we don't have a vehicle for increasing personal savings and some way to get that money into the corporations at some type of reasonable rate they can afford.

Mr. CHIMERINE. Congressman, may I make a few comments? First of all, I don't think anyone is suggesting that, simply because of the decline in GNP in the third quarter, that current policies are wrong. Several of us are suggesting that, despite the fact that the economic program has many favorable aspects, it was somewhat imbalanced from the start and probably should have been altered before it was passed, and now is the time to go ahead and make those corrections.

Second, while I think it's constructive if we have policies that are known in advance, somehow we became the largest country without perfect knowledge of future tax rates. In fact, I think there's more uncertainty now regarding taxes than there was a year ago. Most businesses and individuals realize that the deficit is going to be so large that there will be some tax changes. That uncertainty is now greater than what we had 6 months or a year ago. On top of that, I agree with Mr. Rutledge on one point—many people won't be experiencing any tax cut over the next several years after inflation and social security taxes. But we haven't removed inflation from Federal spending even before the big defense increase. Defense spending will rise significantly over the next several years despite all the budget cuts. If you take inflation out on the tax cuts and don't take it out on the spending side, you're pushing the budget toward deficits. I think that's the fundamental problem.

If we can produce a balanced program that brings interest rates down and yet still leaves us with a significant amount of stimulus and incentives for saving and investment, that's the best of all worlds. We will have more investment in a growing economy, more investment in an economy in which interest rates are somewhat lower and, of course, more investments when profits are rising in response to the growing economy.

Representative RICHMOND. Mr. Rutledge, in the couple minutes I have left, could you comment on the agricultural sector? As you know, it's saved the economy of the United States in the last couple years. If we didn't have that $4 or $5 billion generated by our farmers I don't know where we would be.

Mr. RUTLEDGE. I think the agricultural sector is a perfect example of how uneven some of the program is—the program of high interest rates. It doesn't always show up in the GNP. It does to a degree, but the impact of this on agriculture and oils and housing and so on has been very dramatic and agriculture has been hurt in a number of ways. These high interest rates have just killed commodity prices.

Representative RICHMOND. They're probably lower today than they would be in the Great Depression if we indexed them back; $2.30 for a bushel of corn, if you index it, comes to something like 35 cents.

Mr. RUTLEDGE. I haven't made a calculation. It's obviously depressed. Added to that, the farmers borrow very heavily, so they are very sensitive to interest rates. Every industry that depends on agriculture, like farm equipment, is just going down the drain.

Representative RICHMOND. Yet we find half the tractors in the United States are coming in from Japan.

Mr. RUTLEDGE. Yes; I think there are a lot of reasons for that. You talked about Japan earlier and I think one thing I hope you will learn from Japan—I think they are more innovative than we are in developing new technology. I think they have two or three advantages over us. One is that they can implement technology much more quickly than we do because they turn over their equipment more rapidly.

In part, I think we tend to oversimplify. Only 6 or 7 percent of their GNP is spent on defense, so that becomes available for other things. So you can't always make it on that kind of basis.

Representative RICHMOND. The vast source of capital in Japan is from the worker who takes his bonus and deposits it into the factory bank which in turn loans it back to the factory.

Mr. RUTLEDGE. That's it. There's no question they have policies which encourage that kind of thing.

There's another thing they have and that's their labor-management relations. They haven't allowed all the indexing to creep into the economy which perpetuates the inflation, and particularly industries like we have in the United States where there is heavy indexing and massive cost-of-living adjustments—the wages are just pricing those industries out of the market.

Representative REUSS. We are very grateful to all of you for a very professional and very thoughtful presentation on our economic problems. So, with gratitude, we now stand adjourned.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

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