

# QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

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## HEARINGS BEFORE THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES NINETY-FIFTH CONGRESS

SECOND SESSION

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PURSUANT TO THE FEDERAL RESERVE REFORM ACT OF 1977  
PUBLIC LAW 95-188

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MARCH 7, 9; APRIL 10, 1978

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Committee on Banking, Finance and Urban Affairs



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## QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

TUESDAY, MARCH 7, 1978

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,  
*Washington, D.C.*

The committee met at 10 a.m. in room 2128 of the Rayburn House Office Building; Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, Gonzalez, Minish, Annunzio, Hanley, AuCoin, Evans of Indiana, D'Amours, Cavanaugh, Vento, Barnard, Hansen, Leach, Steers, Evans of Delaware, Caputo, and Green.

The CHAIRMAN. Good morning. The House Committee on Banking, Finance and Urban Affairs will be in order for the beginning of its hearings on monetary policy for 1978.

We are very pleased to welcome this morning for our opening session a very distinguished panel of economists: Lawrence R. Klein, professor of economics at the Wharton School; Jerry L. Jordan, senior vice president and chief economist of the Pittsburgh National Bank; and Rudiger Dornbusch, associate professor of economics at MIT.

The committee will hear from G. William Miller, the newly approved Chairman of the Federal Reserve Board later, but today we inaugurate our first hearing under the legislation provided for by the Federal Reserve Reform Act of last November.

That act provides for correlating and evaluating the conduct of monetary policy. Its effect is to focus these hearings more sharply on the real world objectives—maximum production, stable prices, and moderate long-term interest rates—which monetary policy is supposed to pursue.

Accordingly, it is appropriate that we seek the advice of our panel on the best feasible path of the domestic economy and the role of monetary policy in the pursuit of that path.

Professor Klein and Mr. Jordan will discuss this in detail. Professor Dornbusch brings a new perspective to these hearings. Lately, it has become apparent that monetary policy is being used to a limited extent in an unaccustomed role: To support the international value of the dollar. This is being done, with considerable restraint, through the mechanism of currency swaps with foreign central banks, and with perhaps less restraint, by raising domestic interest rates above the levels that otherwise would have been maintained.

I, for one, entertain some very grave doubts about the wisdom of either of these policies, and I am delighted to have Professor Dornbusch to explain whether my doubts are well founded or ill founded.

Professor Klein, will you start out? May I say that all three of you have compendious papers and, under the rules and without objection, they will be received in full into the record. Proceed in any way you wish—by reading it, summarizing it, whatever.

**STATEMENT OF L. R. KLEIN, PROFESSOR OF ECONOMICS, WHARTON SCHOOL OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.**

Mr. KLEIN. Thank you, Mr. Chairman.

My presentation is focused on the economy as a whole in giving the framework in which monetary policy must be conducted. It is not directly or wholly, in any sense, on monetary policy—though I will come to that—but as it affects the prospects ahead. And what I have really done is to take a look at the set of standard forecasts—forecasts that my own group is making for the next year—and put monetary policy in that kind of a setting.

One year ago, the unusually cold weather—beyond normal seasonal adjustment—was a central issue in appraising the prospects for the economy in the first quarter and the whole year, 1977.

As it turned out, the severe winter of January/February 1977 was not a deterrent to economic growth, as many had expected. The first quarter performance was the best in a long while, at 7.5 percent real growth, and the year did not suffer.

The makeup in late February and March was very strong. The weather disruption left its toll, however. Consumer prices increased at a high 7 percent rate, partly because of a relative shortage of fresh fruits and vegetables. Later in the year, prices rose less rapidly, and the growth rate of real GNP also fell as the year wore on, but the unemployment rate came down a bit.

What can we expect this year? The weather has again been unusually severe, more from snow and blizzard, less from low temperature. After last year's fuel shortages, particularly in natural gas, suppliers and major industrial users were careful enough to plan in advance to have ample reserves; therefore, this year's weather has been less disruptive on account of fuel shortages. But something else is now responsible for large fuel outlays and unfavorable changes in the fuel mix—namely, the coal strike.

Any major strike has ripple effects, and the coal strike is no exception. Coal carriers have been partially idle and coal users are having to draw down stocks sparingly.

A main unfavorable aspect of the strike is that some power systems are having to use—through generation or purchase—more oil-fired electricity. This hurts the overall pocketbook as well as the trade balance.

The January trade figures continue to paint a dismal picture of large monthly deficits, and they also show strong oil imports. We have already had reports of slow industrial production, a small increment in monthly personal income, and high price rises.

These add up to an inflationary first quarter and a drop in the real growth rate below the figure for year end 1977, which is placed at about 4 percent for the final quarter of last year.

The slow start that the economy is realizing, as a result of severe winter storms and the coal strike probably will not be fully made up through compensatory spending in the second quarter, even if the strike is settled fairly soon.

For the year as a whole, the best judgments for overall growth are at about 4.5 percent; some are fractions of a percentage point higher or lower, but the central figure of 4.5 percent remains firm for the year as a whole, implying some greater shows of strength, above 1977's final quarter.

At this point, I would like to mention that I have appended, at the end of my prepared statement, a table of summary statistics of the standard forecast, and distributed a supplementary table which deals with a coal strike that is considerably prolonged.

The first table would be the outlook for the economy on the assumption that the coal strike was settled at the present time.

The second table assumes that the coal strike is settled, and coal is delivered on a full-scale basis by the first of May. That, of course, may even be optimistic at this point.

Nevertheless, the results of the two simulations are very interesting, in the sense that you can see very clearly the extent to which the disruptive effects of the prolonged coal strike would hurt the growth rates of the current quarter, and the next quarter as well—assuming that it goes on to May 1. And in this assumption, we have written in the constraint that about 1½ million people would be unemployed, but it would not last for the whole quarter, if the thing were settled by May 1.

The other interesting aspect is that, by the year end, the economy ought to be back to its old track, corresponding to the absence of a strike, and the yearly figures are not very seriously out of joint. They are probably certainly within any kind of error band of each other; so I would say that, on an annual basis, the coal strike is not the issue. But it will have very disruptive effects in the short run. We would have a very slow second quarter—and, indeed, this would show up in some slightly higher inflationary effects in the near term.

Other features of this respectable but unspectacular forecast of growth rates are a higher inflation rate, up from about 5.6 percent last year to about 6.1 percent this year—if we measure it by the GNP deflator. The CPI and WPI each increased at a higher rate than the GNP deflator in 1977.

In 1978, the CPI should change at about the same rate as the GNP deflator, but the WPI rate may be slightly lower. That is really because of the different treatment of social security and services in the two indices. In the Wholesale Price Index we see only—mainly, only goods and not services. It is expected that the services will be rather strongly rising during the year.

The components of this GNP growth include an investment expansion of about 7.9 percent, a percentage point off last year's rate; a slight drop in housing starts, hit very hard by severe weather in January/February; and a continuing trade deficit.

The merchandise deficit in January indicated no change in the overall trend for 1977, that gave us a record \$27 billion deficit for the year, but it is reasonable to expect some improvement later in 1978 as a result

of the cumulative effect of dollar depreciation, potentially better agricultural exports, and the pumping of a great deal of Alaskan crude.

In addition, invisibles may be more favorable than they were in 1977. If the sinking of the dollar discourages some foreign tourism by U.S. residents and if recovery in partner countries picks up a bit, our overall deficit on goods and services together could improve. This is what happens in the Wharton forecast for 1978.

You can see that in the table I have distributed, where the net export position of goods and services is listed in row 30.

The GNP forecast is thus reasonably good for 1978, with some imbalances—the most serious being the poor outlook for the trade accounts. But the 1979 outlook is less robust and recovery may very nearly come to a halt during 1980.

Implicit in the forecast for 1978 and the ensuing years is a significant tax cut, as proposed by the administration for the fiscal year beginning October 1, 1978. This generates a pickup in what would otherwise be a slowing pace of economic activity, but it is not strong enough by itself to keep the recovery going beyond 1979 because of countervailing effects of social security tax increases and higher energy prices.

Also implicit in this forecast is a continuation of a moderately strict monetary policy. I would measure “strictness” by money market rates. This instrument cannot readily be used, together with a fiscal stimulus, in the near future because of pressures on the dollar.

Our severely adverse trade position weakens the dollar, and foreign capital inflows must be attracted to keep the dollar from sliding even further. This situation mandates relatively high U.S. interest rates.

The Wharton forecast has  $M_1$  growing at about 5 to 7 percent each quarter, and of course my numbers are quarterly compounded interest rates—that is, the quarterly rate compounded four times a year; slightly different, perhaps, from the rate used in this committee’s calculations.

$M_1$  averages about 6.8 percent for the year, and that is a 12-month average over a 12-month average—1978 over 1977;  $M_2$  at about 8 percent and short-term interest rates increasing by about 75 to 100 basis points over a yearly span.

On the tables that I have distributed, you will see money supply, on lines 32 and 33, forecast, and various interest rates on lines 38 through 41.

These upward creeping rates tend to hold down new housing starts. That is, in addition to the unseasonal weather effects. Recessionary conditions are not generated, but the rate of housing capital formation should begin to decline slightly.

Most segments of the American economy are expected to participate fully in this moderate advance over the next year or two. Farmers did not fare very well in 1977 in the sense that their income level remained far below previous high values.

Modest growth is projected again in 1978, but farm earnings are held in restraint by crop limitations, soft prices, and sharply rising costs. The food component of the CPI should rise by about 6 percent, reflecting an increase in prices received by farmers of about 6 percent, up to the harvest season, with some seasonal slackening after that point.

In midyear 1977, farm prices were actually declining, and this held consumer prices in check. We cannot expect such a consumer windfall this year.

Another important factor in the overall cost-price situation is the average wage increase. Wage rates were held to a very moderate rate of increase last year—7.5 percent—but total compensation rose by 8.6 percent because social security contributions continued their rise.

This will occur by a big jump in 1979, according to present legislation. There are not many major collective bargaining contracts coming due in 1978; the picture will be quite different in 1979. The miners' settlement, though costly, should not set the tone for the labor market as a whole.

During 1977, on a fairly steady basis, unemployment rates gradually declined. The monthly pattern is considerably confused by problems of seasonal adjustment, but the official rates did fall. This occurred when the real GNP growth rates were well in excess of 4 percent each quarter, until the fourth.

The more moderate pace of expansion forecast for 1978 should be associated with less of a decline in unemployment, but the national rate can be expected to fall below 6 percent by year's end. Movements in labor force—often erratic—contribute a great deal to movement of the unemployment rate.

I would say that if 1½ million people are displaced for an extra month by the coal strike, up to May 1, then we would see the unemployment rate go back up from its present figure on a quarterly average presently being 6.3 percent; we would get it up at least to 6½ percent. And then, if the economy were to resume its expansion after a strike settlement, the general configuration of a slightly falling unemployment rate getting down to 6 percent, or slightly below, would be the general projection.

Corporate profits before tax rose by about 9 percent in 1977. This was only a fair showing. This year's Wharton model projection is for 8.8 percent. Profits are a residual, and as such are subject to error from many sides—not the least of which is the erratic behavior of the "statistical discrepancy" in the national income and product accounts.

Between the middle of 1976 and 1977, the quarterly value of the discrepancy account fluctuated between \$8 billion plus and minus \$1.2 billion, practically as large as the fluctuation in profits.

Another large and important residual account is the Federal deficit. Unfortunately, this year it is expected to be as large as or larger than last—\$50 billion and \$57 billion, respectively, on a national income and product accounts basis.

As long as the predominant policy initiative remains as a conventional use of fiscal policy through tax cuts, it will be very difficult to keep the economy going forward at a reasonably good pace without a large deficit—possibly, a rising deficit.

It is absolutely essential to introduce more supply-oriented structural policies that get at some of the target variables of the economy without generating such large strains on the public budget.

This means that more private sector activity must be stimulated in capital formation, jobs programs, and export lines in order to get overall stimulus without deficit spending.

These considerations call for more careful analysis of: tax stimuli for private business investment; export incentives; and subsidization job training in the private sector for the hard-core unemployed.

One can look at this projection and conclude that the economy is going forward in a slow, lackluster fashion that will leave high unemployment among many groups of the population and inflationary pockets in others. This kind of situation is crying for more structural policies.

The world economic situation has great influence on our own; conversely, we have significant impact on the world. Last year, our performance was strong among the industrial democracies, but left us with unbalanced trade and a weak dollar.

Hopefully, a number of our partner countries will be able to reflate on a stronger basis this year than last. That should help the growth of world trade which slipped to about 4 or 5 percent expansion last year, and consequently our own trade suffered as we share in the world total.

If a broad grouping of partner countries join with our fiscal stimulus by introducing like measures, there can be an extra one-half or 1 percentage point added to the world growth rate of GNP and perhaps even more to world trade.

World inflation has been slowly winding down, and this is clearly a time for widespread coordinated reflation, when the dangers of sparking significant price rises are slight.

Reflation—not protectionism—should be the key to healthy mutual recovery in the world economy as a whole.

Thank you.

[Mr. Klein's prepared statement with attached tables follow:]

## ECONOMIC PROSPECTS, March 1978

Statement by L.R. Klein before the  
House Committee on Banking, Finance and Urban Affairs  
House of Representatives, March 7, 1978

One year ago, the unusually cold weather -- beyond normal seasonal adjustment -- was a central issue in appraising the prospects for the economy in the first quarter and the whole year, 1977. As it turned out, the severe winter of January/February 1977 was not a deterrent to economic growth, as many had expected. The first quarter performance was the best in a long while, at 7.5% real growth, and the year did not suffer. The make-up in late February and March was very strong. The weather disruption left its toll, however. Consumer prices increased at a high 7.0% rate, partly because of a relative shortage of fresh fruits and vegetables. Later in the year, prices rose less rapidly, and the growth rate of real GNP also fell as the year wore on, but the unemployment rate came down a bit.

What can we expect this year? The weather has again been unusually severe, more from snow and blizzard, less from low temperature. After last year's fuel shortages, particularly in natural gas, suppliers and major industrial users were careful enough to plan in advance to have ample reserves; therefore this year's weather has been less disruptive on account of fuel shortages. But something else is now responsible for large fuel outlays and unfavorable changes in the fuel mix, namely, the coal

strike. Any major strike has ripple effects, and the coal strike is no exception. Coal carriers have been partially idle and coal users are having to draw down stocks sparingly. A main unfavorable aspect of the strike is that some power systems are having to use, through generation or purchase, more oil fired electricity. This hurts<sup>the</sup>/overall pocketbook as well as the trade balance. The January trade figures continue to paint a dismal picture of large monthly deficits, and they also show strong oil imports. We have already had reports of slow industrial production, a small increment in monthly personal income, and high price rises. These add up to an inflationary first quarter and a drop in the real growth rate below the figure for year end 1977, which is placed at about 4.0 percent for the final quarter of last year. The slow start that the economy is realizing, as a result of severe winter storms and the coal strike probably will not be fully made up through compensatory spending in the second quarter, even if the strike is settled fairly soon. For the year as a whole, the best judgements for overall growth are at about 4.5 percent; some are fractions of a percentage point higher or lower, but the central figure of 4.5 percent remains firm for the year as a whole, implying some greater shows of strength, above 1977's final quarter.

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The components of this GNP growth include an investment expansion of about 7.9 percent, a percentage point off last year's rate, a slight drop in housing starts (hit very hard by severe weather in January/February), and a continuing trade deficit. The merchandise deficit in January indicated no change in the overall trend for 1977, that gave us a record \$27 billion deficit for the year, but it is reasonable to expect some improvement later in 1978, as a result of the cumulative effect of dollar depreciation, potentially better agricultural exports, and the pumping of a great deal of Alaskan crude. In addition, invisibles may be more favorable than they were in 1977. If the sinking of the dollar discourages some foreign tourism by US residents and if recovery in partner countries picks up a bit, our overall deficit on goods and services together could improve. This is what happens in the Wharton forecast for 1978.

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and higher energy prices.

Also implicit in this forecast is a continuation of a moderately strict monetary policy. This instrument cannot readily be used, together with a fiscal stimulus, in the near future, because of pressures on the dollar. Our severely adverse trade position weakens the dollar, and foreign capital inflows must be attracted to keep the dollar from sliding even further. This situation mandates relatively high US interest rates. The Wharton forecast has  $M_1$  growing at about 5 to 7 percent each quarter (averaging 6.8% for the year, 1978),  $M_2$  at about 8 percent and short term interest rates increasing by about 75 to 100 basis points over a yearly span. These upward creeping rates tend to hold down new housing starts. Recessionary conditions are not generated, but the rate of housing capital formation should begin to decline slightly.

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fluctuated between \$8.0 billion and -\$1.2 billion, practically as large as the fluctuation in profits.

Another large and important residual account is the federal deficit. Unfortunately, this year, it is expected to be as large as, or larger than, last, \$50 billion and \$57 billion, respectively (NIPA basis). As long as the predominant policy initiative remains as a conventional use of fiscal policy through tax cuts, it will be very difficult to keep the economy going forward at a reasonably good pace without a large deficit, possibly a rising deficit. It is absolutely essential to introduce more supply oriented structural policies that get at some of the target variables of the economy without generating such large strains on the public budget. This means that more private sector activity must be stimulated in capital formation, jobs programs, and export lines in order to get overall stimulus without deficit spending. These considerations call for more careful analysis of

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year our performance was strong among the industrial democracies, but left us with unbalanced trade and a weak dollar. Hopefully, a number of our partner countries will be able to reflate on a stronger basis this year than last. That should help the growth of world trade, which slipped to about 4 or 5 percent expansion last year, and consequently our own trade suffered, as we share in the world total. If a broad grouping of partner countries join with our fiscal stimulus, by introducing like measures, there can be an extra 1/2 or 1 percentage point added to the world growth rate of GNP and perhaps even more to world trade. World inflation has been slowly winding down, and this is clearly a time for widespread coordinated reflation, when the dangers of sparking significant price rises are slight. Reflation -- not protectionism -- should be the key to healthy mutual recovery in the world economy as a whole.

THE WHARTON QUARTERLY MODEL  
 POST-MEETING CONTROL SOLUTION 1 MAR 1 1978 1 MSP0781(CNTLPOST81)

LINE VAR LABEL	I T E M	TABLE	1-00	SELECTED	MAJOR	ECONOMIC	INDICATORS	1977.4	1978.1	1978.3	1978.4	1979.1	1979.3	1977	1978	1979	1980	
1	GNS	I	GNP	CURRENT	\$	2068.7	2121.2	2187.0	2240.0	2290.0	2349.9	2405.0	01189.0	1	2097.1	2320.0	2513.0	
2	GNS	I	X	CHG	GNS	10.36	10.12	11.84	10.56	12.49	10.06	9.22	9.95	10.65	10.76	10.95	10.63	9.61
3	GNP	I	1978	1360.7	1372.6	1391.2	1404.7	1425.1	1441.3	1452.4	1462.3	1474.5	11337.4	1399.4	1457.6	1501.3		
4	GNP	I	X	CHG	GNP	4.01	3.55	5.52	3.95	5.94	4.63	3.10	2.76	3.39	4.93	4.56	4.23	3.00
5	GNP	I	IMPLICIT	GNP	DEFLATOR	144.3	146.6	148.7	151.0	153.5	155.4	157.7	160.4	163.1	141.3	149.9	159.1	169.4
6	POGDP	I	X	CHG	POGDP	6.15	6.34	5.99	6.35	6.86	5.19	5.45	6.94	7.02	5.55	6.12	6.14	6.43
10	PC	R	X	CHG	CP	4.51	5.97	6.37	6.11	5.95	7.14	7.42	7.14	6.49	5.99	6.52	7.04	
11	PC	R	X	CHG	WP	4.66	7.69	6.38	4.55	5.48	5.55	6.32	9.38	9.17	6.13	5.56	6.70	7.73
12	YDPS	I	DISP	PERSONAL	INCOME	1368.2	1396.0	1431.1	1465.1	1529.6	1559.8	1595.5	1634.5	1679.2	11309.2	1455.4	1617.0	1771.4
13	YDPS	I	X	CHG	YDPS	14.11	8.36	10.45	9.84	16.81	8.15	9.47	10.12	11.41	10.41	11.17	11.10	9.55
15	YDPS	I	DISP	PERS	INCOME	953.2	961.5	972.6	982.5	1012.6	1019.4	1026.7	1035.5	1047.0	930.6	982.3	1032.2	1083.4
17	YDPS	I	X	CHG	YDPS	9.21	2.68	4.67	4.13	12.86	2.70	2.90	3.45	4.53	4.52	5.55	5.07	3.03
18	RAXNMPV	I	PRIV	OUTPUT	PER	MANHOUR	8.85	8.91	8.95	8.99	9.06	9.11	9.12	9.14	9.18	8.83	8.98	9.14
20	RAXNMPV	I	X	CHG	RAXNMPV	-1.96	2.90	1.85	1.55	3.40	2.15	0.58	0.85	1.41	1.66	1.65	1.78	1.20
21	WRCPV3	I	PRIV	COMP	PER	MANHOUR	7.40	7.59	7.74	7.89	8.03	8.21	8.37	8.53	8.70	7.21	7.61	8.45
23	WRCPV3	I	X	CHG	WRCPV3	7.13	10.67	6.49	7.70	7.83	9.83	7.73	7.68	8.03	8.60	8.41	8.18	8.42
25	IP	B	FRB	INDUS	PROD	INDEX	139.3	140.6	143.1	144.6	146.4	148.3	149.9	151.1	152.3	137.1	143.7	150.4
26	IP	B	X	CHG	IP	2.43	3.91	7.14	4.36	5.19	5.19	4.50	3.42	3.13	3.62	4.82	4.68	2.99
27	NRUT	R	UNEMPLOYMENT	RATE	(%)	6.63	6.39	6.38	6.16	6.04	5.99	5.98	5.91	7.02	6.33	5.98	5.94	
29	TBR3	I	NET	EXPORTS,	CURRENT	\$	-15.1	-12.7	-10.1	-7.6	-6.8	-5.6	-9.9	-7.9	-5.9	-10.1	-9.4	-7.3
31	FPI3	I	MONEY	SUPPLY	-M1	334.1	340.2	343.9	346.8	351.2	357.3	364.1	368.1	375.8	324.5	346.5	366.3	388.2
32	FPI3	I	X	CHG	FPI3	6.9	7.45	4.44	5.19	5.21	4.1	7.61	4.43	6.1	6.88	6.78	5.72	6.89
35	CUMIP	B	CAPACITY	UTIL,	TOTAL	90.50	91.09	92.39	92.40	93.12	93.76	93.82	93.88	94.09	89.89	92.25	93.89	94.42
36	CUMIP	B	X	CHG	CUMIP	0.18	2.63	5.82	0.03	3.15	2.87	0.17	0.27	0.90	2.71	2.62	1.78	0.55
38	FMR3M	B	90	DAY	TREAS	BILL	RATE	6.11	6.51	6.64	6.85	6.95	7.24	7.54	7.21	7.35	5.27	6.74
39	FMR3M	B	FEDERAL	FUNDS	RATE	6.51	6.80	7.09	7.38	7.43	7.88	8.31	8.07	8.15	5.54	7.23	8.10	7.76
40	FMR3M	B	BANK	PRIME	LOAN	RATE	7.67	8.12	8.57	8.73	8.99	9.32	9.27	9.26	6.82	8.45	9.21	9.05
41	FRVCS	B	MOODY'S	TOTAL	CORP	ROND	8.46	8.79	8.79	8.78	8.75	8.76	8.85	8.96	9.06	8.43	8.78	8.91
42	YDPSAVR	I	PERS	SAVINGS	RATE	(%)	5.50	5.55	5.70	5.70	7.04	6.87	6.54	6.62	6.83	5.10	6.00	6.66
44	CPURTS	I	CORP	PROFITS	BEFORE	TAX	176.1	178.6	184.2	184.8	186.8	189.0	202.8	201.7	203.0	171.1	186.1	201.6
45	CPURTS	I	FEDERAL	SURPLUS	(NIA)	-61.6	-57.0	-51.7	-68.8	-71.3	-63.5	-63.0	-63.6	-69.5	-49.9	-57.2	-64.9	-70.5

THE WHARTON QUARTERLY MODEL  
MARK 5.0  
COAL STRIKE TO MAY 1 1978 ; MSPR5 1978 ; MSPR1(COAL781)

LINE VAR LABEL	I T E M	1977.4	1978.1	1978.2	1978.3	1978.4	1977	1978	1979	1980	
1 GNS	I GNP CURRENT \$	1663.7	2120.1	2098.8	2136.2	2190.4	2293.3	2292.8	2607.8	1690.1	289.8
2 GNS	I % CHG GNS	10.3	11.0	7.8	18.5	10.5	10.0	9.9	10.1	10.7	10.6
4 GNP	I GNP 1972\$	1360.7	1372.5	1380.3	1415.0	1428.0	1448.5	1455.0	1484.9	1477.0	1337.4
5 GNP	I % CHG GNP	4.0	3.5	2.3	10.4	3.7	4.6	2.9	3.7	3.5	4.3
7 PDGND	I IMPLICIT GNP DEFLATOR	144.3	146.5	148.5	151.0	153.4	157.3	157.6	160.3	163.0	141.3
8 PDGNDP	I % CHG PDGNDP	6.1	6.2	5.3	6.8	6.1	5.1	5.9	7.0	7.0	5.5
10 PC	R % CHG CPI	4.5	5.3	5.8	6.3	6.3	5.7	7.2	7.4	7.1	6.9
11 PC	R % CHG WPI	4.6	7.6	5.8	4.8	4.8	5.3	6.1	6.3	6.1	5.4
13 YPDS	I DISP PERSONAL INCOME	1368.2	1395.9	1424.3	1466.7	1530.6	1541.1	1596.9	1635.9	1679.7	1309.2
14 YPDS	I % CHG YPDS	14.1	4.3	9.6	11.9	10.6	6.2	9.4	10.1	11.1	10.4
16 YPD	I DISP PERS INCOME 1972\$	955.2	961.6	971.6	984.6	1013.9	1021.1	1028.3	1037.1	1048.6	930.6
17 YPD	I % CHG YPD	9.2	2.7	0.3	5.4	12.4	2.8	2.8	3.4	4.3	4.5
19 RANHPV	I PRIV OUTPUT PER MANHOUR	8.8	8.9	8.9	9.0	9.0	9.0	9.1	9.1	9.1	8.3
20 RANHPV	I % CHG RANHPV	-1.9	2.4	-0.7	7.8	0.7	2.1	0.3	0.8	1.3	1.6
22 MRCPV\$	I PRIV COMP PER MANHOUR	7.4	7.5	7.4	7.8	8.0	8.2	8.3	8.3	8.4	7.2
23 MRCPV\$	I % CHG MRCPV\$	7.1	10.6	6.1	7.8	7.8	9.5	7.7	7.8	8.0	8.0
25 IP	R FRB THOUS PROD INDEX	139.3	140.6	142.0	145.0	147.0	148.9	150.4	151.7	152.0	137.1
26 IP	R % CHG IP	2.4	3.8	4.0	4.7	5.8	5.3	4.1	3.3	3.0	5.6
27		6.6	6.0	6.9	6.3	6.0	5.9	5.9	5.9	5.9	7.0
30 TB\$	I NET EXPORTS, CURRENT \$	-15.1	-12.7	-10.1	-9.0	-7.5	-6.3	-6.2	-6.2	-6.2	-10.1
31 FM\$	I MONEY SUPPLY - M1	334.1	340.2	343.2	348.6	353.6	357.6	362.4	368.3	376.1	324.5
32 FM\$	I % CHG FM\$	6.9	7.4	5.8	6.4	5.7	4.6	7.4	4.3	6.7	6.8
35 CUMIP	R CAPACITY UTIL, TOTAL	90.5	91.0	90.3	93.9	93.0	93.9	94.0	94.2	94.2	89.9
36 CUMIP	R % CHG CUMIP	0.1	2.3	-3.0	15.3	-1.2	2.5	-0.1	0.2	0.5	2.7
37		6.1	6.5	6.6	6.6	7.0	7.2	7.5	7.6	7.9	5.2
39 FANFF	R FEDERAL FUNDS RATE	6.5	6.8	7.1	7.1	7.6	7.8	8.3	8.2	5.4	7.9
40 FANFF	R BANK PRIF LOAN RATE	7.6	7.7	8.0	8.6	8.6	8.6	9.3	9.3	8.2	6.2
41 FANFF	R MORTGAGE TOTAL CORP RND	6.4	6.7	6.8	6.7	6.7	6.7	6.8	6.8	6.9	6.3
42		5.5	5.5	5.7	5.8	5.7	5.8	5.8	5.8	5.8	5.1
43 YDSRVP	I PERS SAVINGS RATE (%)	5.5	5.5	5.7	5.8	7.1	6.7	6.6	6.6	6.6	5.1
44		176.1	176.2	169.1	197.3	199.4	200.4	203.6	202.5	203.4	171.1
46		-61.6	-57.2	-59.4	-43.0	-69.8	-62.4	-62.0	-62.9	-66.7	-69.9
47 GVSURP\$	I FEDERAL SURPLUS (MIA)	-61.6	-57.2	-59.4	-43.0	-69.8	-62.4	-62.0	-62.9	-66.7	-69.9

The CHAIRMAN. Thank you, Professor Klein.  
Mr. Jordan?

**STATEMENT OF JERRY L. JORDAN, SENIOR VICE PRESIDENT AND  
ECONOMIST, PITTSBURGH NATIONAL BANK, PITTSBURGH, PA.**

Mr. JORDAN. Thank you, Mr. Chairman.

My prepared statement is rather long, and I will only summarize it.

I appreciate this opportunity to present my views on monetary policy. I have been very much encouraged by the role that congressional oversight has played in recent years. I think that in the 3 years since these quarterly hearings began, the quality of the discussions concerning the issues involved in monetary policy have greatly improved, and I think also the process of formulation and implementation of monetary policy within the Federal Reserve has improved. And I think that there is hope for some further progress in the future.

The requirement that the Federal Reserve announce monetary growth targets is potentially an important contribution to the objective of promoting economic stability, but only if these targets can be relied upon. I cannot emphasize strongly enough how important it is to retain and to strengthen the public disclosure of monetary policy targets as an aid to the planning process in the private sector.

Last year the growth of money exceeded the Federal Reserve's targets by a significant margin, and it is widely believed that the same will be the case this year.

These hearings are the appropriate forum for seeking from the Federal Reserve some explanation for the past errors and for assurances that they are serious about the announced targets.

I want to spend my time this morning commenting on what we can and cannot expect from monetary policy, while not abandoning the goal of gradual reduction in the trend rate of inflation.

In addition, there are a few issues concerning the measurement and implementation of monetary policy that should be dealt with over the next few years.

In my prepared statement, I suggest that an appropriate role of congressional oversight of monetary policy would be to monitor the progress towards improving the quality of the monetary data and to encourage reconsideration of the techniques that are used by the Federal Reserve to achieve its monetary growth targets. I will not take the time to repeat those recommendations in my oral summary, but I will be glad to answer any questions that you have about them.

On previous occasions the chairman and other members of this committee, as well as several witnesses, have emphasized the importance of lags between monetary policy actions and observable responses in the economy. The pervasive effects of the severe winter weather in recent months, especially when they are in combination with the extended strike in a major portion of the coal industry, should not cause us to lose sight of the foundation of very strong demand that has been provided by the highly stimulative monetary and fiscal policies that began in 1977 and are continuing at the present time.



Growth of the monetary base and the narrowly defined money supply during the last three quarters of 1977 was more rapid than at any time in 30 years, with the exception of 1972. At the present time, the growth of government spending at the Federal level began to accelerate in the second half of fiscal 1977 and is scheduled to rise 15 percent in the current year.

Normal lag relationships suggest that the strong thrust from these monetary and fiscal policy actions assure that growth of total spending in the economy will be strong this year.

Gross national product rose almost 12 percent last year, up significantly from the 9.7 percent increase in 1976. That increase exceeded every year since 1950 and was accompanied by a number of other measures of economic performance that also indicated strength.

Total new automobile sales were close to a record. New single-family housing starts of over 1.4 million were an alltime record. The actual number of people employed in our economy increased by over 4 million, to achieve both the highest total number of people employed in history by a significant margin, but also the largest portion of the population of working age that we have experienced since World War II.

These excellent results in labor markets do not mean that we don't still have problems in unemployment, but they do suggest approaches other than general stimulus to aggregate demand must be sought in order to achieve the national objective of providing job opportunities for all that desire them.

I am also confident that the overall rate of unemployment is going to be below 6 percent sometime this year. At the same time that specially tailored programs are implemented to further reduce unemployment, overall monetary and Federal budget policies should be focused on the longer term objective of achieving a much lower rate of inflation by the mideighties, if we are to maintain any hope of eventually returning to the low average rate of inflation that prevailed in the 1950's and in the 1960's.

Aggregate demand policies must be moving in the direction of achieving a growth of total spending in the economy that is less than one-half the rate that was achieved last year.

In the last few years, Federal budget policies have been discussed in the context of a 5-year plan, and I think it would also be appropriate to view monetary policy programs within that time frame. Over the next 5 years, we should be pursuing monetary policies that would accompany a reduction in the growth of total spending in the economy to about a 7 or 8 percent rate, which would be associated with a rate of inflation of 4 percent or less, and a 3 to 4 percent growth of real output.

Such a program would involve a gradual reduction in the rates of monetary growth from the upper ends of the current target ranges announced by the Federal Reserve to no more than the low end of the current target ranges.

It should be emphasized that the stability in the growth rates of the monetary aggregates around the underlying trend, and only gradual changes in these average growth rates, are far more important than the exact figures that are sought or achieved.

I also want to caution against a “whites of the eyes” approach to setting shorter run monetary growth targets. A substantial amount of research effort has been devoted to demonstrating that the fluctuations in the growth of the money supply around the underlying trend rate are reflected primarily in fluctuations of output and employment, while the trend growth of money over a period of several years is reflected in the prevailing average rate of inflation.

The clear implication of this research is that a significant acceleration in the growth of money above the underlying trend can have a short-run positive effect on output and employment. However, such a policy sows the seeds of its own failure, since an unavoidable dilemma is created where a choice must be made between sustaining the new higher growth of the monetary aggregates—and accepting a rise in the trend rate of inflation—or suffering the contraction in the growth of output and employment that would be induced by a marked reduction in money growth back toward, or below, the previous trend rate.

This means that, in 1978, the continued outgrowth in the narrowly defined money supply might be accompanied by a somewhat higher rate of output and employment growth than would an immediate return to the previous 6-percent trend rate of growth of money.

However, continuation of the high rates of monetary growth this year would create a situation where the Federal Reserve had no good options remaining, once they began to focus on 1979.

If the Federal Reserve immediately returns to and maintains monetary growth within the announced target ranges, a severe credit crunch and major recession can be avoided. But a continuation of the policy actions of the past year for another 6 to 9 months would make it less likely that the excesses can be corrected without suffering a major economic adjustment.

I am going to skip some comments in my statement regarding the amount of capacity or slack that remains at the present time, but I would be happy to elaborate, if you desire.

I have no doubt that the movements in interest rates this year are going to receive a lot of attention and discussion about monetary policy. It obviously is going to be tempting to tolerate rapid money growth and credit in an effort to prevent increases in interest rates in order to promote increased private spending for investment and to assure a continued strong flow of funds to the housing industry.

But, that option carries with it the danger of more serious problems at a later time. Since investors pay increasing attention to the growth of the money supply, in forming their expectations about future inflation, a more rapid growth of money for the purpose of holding down short-term interest rates would actually cause long-term interest rates to rise more.

This is because managers of investment funds, as well as individual savers, would attempt to avoid incurring the capital loss that would occur when the price of long-term bonds declined as the inflation premium in bond yields was revised upward.

The only way to bring about a permanent reduction in the long-term interest rates, including mortgage rates, is to permanently reduce inflation.

Last year, short-term market interest rates rose approximately 2 percentage points, and some observers interpreted that as a sign of a more restrictive monetary policy. I disagree with that view. Since the quantity of credit extended was rising at very rapid rates, the only interpretation that follows from the rise in the price of credit is that the demand for credit was rising even more rapidly than the ample increase in credit supplied. That is a sign of a strong economy.

The rise in short-term yields last year occurred mostly in the spring and summer, at a time when bank reserves and the money supply were growing at the most rapid rates in over 30 years. Such a high rate of monetary growth, accompanied by a rapid rise in short-term interest rates, occurred in only one other year—1972. Certainly the inflation of 1973 and 1974 suggest that the excessive monetary growth in 1972 was a better measure of monetary stimulus than was the rise in the price of credit.

It is important to emphasize that a year ago the forecasts of higher interest rates in 1977 were based on assumptions of an acceleration of growth in the money supply, not slower growth of money, than had occurred in the previous year.

Similarly, continued monetary growth in 1978 at the rate that occurred in the final three quarters of last year would imply a larger rise in long-term interest rates this year and in 1979 than if the growth of money was returned to and maintained at no more than the upper limits of the Fed's announced targets.

If market participants can rely on the Federal Reserve to reduce monetary growth this year to their announced target ranges, the rise in the short-term yields will be viewed as only a temporary cyclical increase. Consequently, the rise in long-term yields will be small, since there will be no reason to revise further upwards their expectations about the trend rate of inflation.

A brief comment about the outlook for housing in the next year or two is warranted. If nothing else is done—and I am not suggesting that other things could not be done—but if that is the case, and the return of monetary growth to the Federal Reserve's announced target ranges does result in increased short-term interest rates and causes some disintermediation of savings from the thrift institutions and a downturn in home construction activity, there is no reason to believe that the downturn will be very sharp nor very long in duration.

It is unfortunate that we cannot expect housing to stay strong indefinitely, but, because of developments last year, that cannot be expected. And, since it cannot, it would be better to suffer a mild downturn in the next year or so and lay a foundation for resumed healthy growth in the 1980's than it would be to promote vigorous activity this year and in 1979 and risk a subsequent deep and long contraction in the industry.

Now, I want to turn to a few comments about the role monetary policy might play in promoting some increase in capital spending.

The experience of the last couple of years suggests that the traumatic events of 1974 and 1975 have caused businessmen to be very cautious about being too myopic in analyzing the strength of final demand for their products. The business community is very sensitive to the possibility that monetary and fiscal policies in the short run will become overly stimulative and leave the Government with no alternative

but to combat accelerating inflation, either by administering a strong dose of traditional monetary and fiscal restraint—which would render any new investment unprofitable during the ensuing recession—or by adopting some form of administrative controls over prices, which also would render new capacity unprofitable for a while.

There is a desire by business planners to see Government avoid the excesses of shortsighted stop-and-go policies in favor of more stable policies that reflect the kind of patience necessary to promote a prolonged period of continued economic expansion.

In 1978, it is still possible for capital spending to continue to strengthen in real terms, to match or exceed the pace of last year. However, if high rates of monetary growth are the results of policies designed to resist further increases in short-term interest rates this year, then greater uncertainties will be generated about the economic environment that will prevail 2 or 3 years from now, when new capacity is becoming available.

As a result, corporate planners will want to go slow on major long-term projects until they have a better idea about the timing, depth, and duration of the next recession and until the prospects for some form of administrative controls over prices are assessed.

I do not believe that the controls are desirable or necessary, but in business it is prudent to assume that they will be imposed if it appears that monetary and fiscal policies are excessively stimulative and will result in accelerating inflation.

In conclusion, monetary policy actions in 1978 will be critical in determining whether another major recession should be expected in the next few years. Contrary to conventional analysis, the probability I would assign to the occurrence of a major recession in the next 2 or 3 years would be greater the more stimulative our monetary policy action this year.

It is my hope that the Federal Reserve adheres to the monetary growth targets for this year that are no higher than they announced but greatly exceeded last year.

Thank you.

[Mr. Jordan's prepared statement follows:]

Statement by

JERRY L. JORDAN

Senior Vice President and Economist  
Pittsburgh National Bank

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives  
United States Congress

March 7, 1978

## Statement by

JERRY L. JORDAN

Senior Vice President and Economist  
Pittsburgh National Bank

Mr. Chairman and Members of the Committee:

It is indeed a pleasure to have this opportunity to present my views on monetary policy. I would like to state at the outset that I have been very much encouraged by the role that Congressional oversight of monetary policy has played in recent years. In the three years since these quarterly hearings began under Concurrent Resolution 133, the quality of the discussions concerning the issues involved in the conduct of monetary policy has greatly improved. I think that the process of formulation and implementation of monetary policy has been improved by these hearings, and I am hopeful that further progress will be achieved in the future.

The requirement that the Federal Reserve announce monetary growth targets is potentially an important contribution to the objective of promoting economic stability, but only if the targets can be relied upon. Decision makers in the private sector, both management and labor leaders, would find it valuable to know in advance the rate of inflation that will be tolerated by the monetary authorities.

The credibility of the central banks' stated intentions is the key to the success of monetary policies in Germany, Switzerland, and other countries that also announce monetary growth targets. Last year the growth of money exceeded the Federal Reserve's targets by a significant margin, and it is widely believed that the same will be the case this year. These hearings are the appropriate forum for seeking from the Federal Reserve explanations for past errors and assurances that they are serious about announced targets for the future.

In general, there is reason to be optimistic about the outlook for our economy, and for that matter for world economies in the years ahead. There are some unavoidable problems that must be dealt with in the next year or two, but there is still time for a mid-course correction that will lay a foundation for strong growth and declining inflation in the 1980's.

I would like to spend my time this afternoon commenting on what can and cannot be expected from monetary policy in achieving our national objectives regarding capital formation and job creation, while not abandoning the goal of a gradual reduction in the trend rate of inflation. In addition, there are a few issues concerning the measurement and implementation of monetary policy that it is timely to deal with over the next year, and I will suggest that

an appropriate role of Congressional oversight of monetary policy is to monitor the progress towards improving the quality of monetary data and to encourage reconsideration of the techniques used by the Federal Reserve to achieve its monetary growth targets.

I will begin with a brief summary of my views on where we stand at the present time and the appropriate objectives for monetary policy in 1978. On previous occasions the Chairman and other members of this Committee, as well as several witnesses, have emphasized the importance of lags between monetary policy actions and observable responses of the economy. The pervasive effects of the severe winter weather in recent months, especially in combination with an extended strike in a major portion of the coal industry, should not cause us to lose sight of the foundation of very strong demand that has been provided by highly stimulative monetary and fiscal policies that began in 1977 and are continuing at the present time. Growth of the monetary base and the narrowly defined money supply during the last three quarters of 1977 was more rapid than at any time in thirty years, with the exception of 1972. At the same time, the growth of government spending at the Federal level began to accelerate in the second half of fiscal 1977 and is scheduled to rise 15 percent in the current year. Normal lag relationships suggest that the strong thrust from these monetary and fiscal policy actions assure that growth of total spending in the economy will be strong this year.



In fact, the average 16 percent rate of increase of personal income in the closing months of last year suggests that additional stimulation of final demand is not necessary at the present time.

Total spending in the economy as measured by Gross National Product rose by almost 12 percent last year, up significantly from the 9.7 percent increase in 1976. That increase has been exceeded in only one year since World War II and was accompanied by a number of other measures of economic performance that are equally satisfying. Total new automobile sales were almost a record and new single family housing starts of over 1.4 million were an all time record. Maybe most important, the actual number of people employed in our economy increased by over seven million last year to achieve both the highest total number of people employed in our history by a significant margin, but also the largest proportion of population of working force age employed that we have experienced other than during World War II.

These excellent results in labor markets do not mean that we do not still have problems with unemployment, but they do suggest that approaches other than general stimulus to aggregate demand must be sought in order to achieve our national objective of job opportunities for all that desire them. I am confident that the overall rate of unemployment

will be below 6 percent sometime this year. Progress towards reducing unemployment further involves: much more selective approaches to identifying who the unemployed are and where they are; providing information to potential employers and perspective employees; removing some of the obstructions and barriers to employment that are faced by many people; and providing the kind of training and actual work experience that will enhance the skills and productivity of the unemployed in order that they can become active participants in our economy at acceptable wages.

At the same time that specially tailored programs are implemented to further reduce unemployment, overall monetary and Federal budget policies should be focused on the longer-term objective of achieving a much lower rate of inflation by the mid-1980's. If we are to maintain any hope of eventually returning to the low average rate of inflation that prevailed in the 1950's and early 1960's, aggregate demand policies must be moving in the direction of achieving a growth of GNP (total spending in the economy) that is less than one-half the rate that was achieved in 1977. In the last few years Federal budget policies have been discussed in the context of a five-year plan, and I believe that such a time horizon also would be appropriate for discussing the monetary policy program. Over the next five years we should be contemplating the monetary policies that would accompany a reduction in the growth of nominal total spending to only a 7 or 8 percent rate that would be associated

with a rate of inflation of 4 percent or less and a 3 to 4 percent growth of real output. Such a program would involve a gradual reduction in the rates of monetary growth from the upper ends of the current target ranges announced by the Federal Reserve to no more than the low end of the current target ranges.

It should be emphasized at this point that stability in the growth rates of the monetary aggregates, and only gradual changes in the average growth rates, are far more important than the exact figures that are sought or achieved. I will have more to say about this in a few moments, in connection with some comments on appropriate monetary policies to foster a greater rate of capital spending, but at this point I want to caution against a "whites-of-the-eyes" approach to setting shorter-run monetary growth targets.

A substantial amount of research effort has been devoted to demonstrating that fluctuations in the growth of the money supply around the underlying trend rate are reflected primarily in fluctuations of output and employment, while the trend growth of money over a period of several years is reflected in the prevailing average rate of inflation. The clear implication of this research is that a significant acceleration in the growth of the money supply above the underlying trend can have a short-run positive effect on the growth of output and employment. However, such a policy action sows the seeds of its own failure since an unavoidable dilemma is created wherein a choice must be made between

sustaining the new higher growth of the monetary aggregates -- and accepting a rise in the trend rate of inflation -- or, alternatively, suffering the contraction in the growth of output and employment that would be induced by a marked reduction in money growth back towards, or below, the previous trend rate.

In the present environment this means that in 1978 a continuation of 8 to 9 percent growth in the narrowly defined money supply might be accompanied by a somewhat higher rate of output and employment growth than would an immediate return to the previous 6 percent trend rate. However, continuation of the high rates of monetary growth this year would create a situation where the Federal Reserve had no good options remaining once they began to focus on 1979. The choice at that time would be between continuing the high rate of monetary growth and tolerating an acceleration of inflation into the 7 to 9 percent range next year, or administering a dose of traditional monetary restraint in order to combat the emerging inflation and, consequently, necessitating a credit crunch and recession next year.

If the Federal Reserve immediately returns to and maintains monetary growth at no more than the upper ends of the announced target ranges a severe credit crunch and major recession can be avoided. However, a continuation

of the policy actions of the past year for another six to nine months would make it less likely that the excesses can be corrected without suffering a major economic adjustment.

This outlook for the next year or two is influenced by an interpretation of the "slack" or idle capacity in the economy that differs significantly from the view put forth by others, notably the Congressional Budget Office staff. Briefly, they take at face value the relatively low capacity utilization numbers and the data that suggest that there still is a large "gap" between actual output and so-called potential GNP, and they conclude that we are not in danger of "spilling-over" into a condition of excess demand and rising inflation.

In my view their analysis might be correct only if the long and deep recession of 1974 and 1975, and the associated decline in capacity utilization, had been caused solely by prior restrictive monetary and fiscal policies. However, we all know that that is not the whole story. During 1973 and 1974 we experienced a number of major one time "real shocks", such as the quadrupling of oil prices, that decreased the real economic capacity of much of the existing plant and equipment. Given the much higher input prices, especially for energy, substantially higher output prices became necessary to restore profitability. Many of the basic industries such as steel, aluminum, rubber, paper, glass and plastics had installed capacity that was

economically efficient only at much lower energy prices than prevail today. Some of this capacity was relatively new and modern in a physical sense, but became economically obsolete (unprofitable to operate) at prevailing output prices in view of the significantly higher input prices. Consequently, demand increases in these basic industries have been met, and will continue to be met, with output price increases long before full utilization of physical capacity is reached. This means that the capacity utilization numbers are not a very reliable measure of pressure for price increases in this environment.

This analysis does not suggest that it is not possible to achieve the old potential capacity output levels, but it does suggest that the rate of inflation associated with the achievement of those higher output levels may be considerably greater than a traditional "gap" analysis would suggest. On the positive side, it should be noted that the fact that the nominal price of oil from OPEC has not risen since the middle of last year and, therefore, the real price of oil to the United States has declined, means that (as long as it continues) there will be less inflation than otherwise. On the other side, the eventual resolution of our own domestic energy policies will have a significant bearing on the outcome regarding energy prices and availability.

I have no doubt that movements of interest rates are going to receive a lot of attention in discussions about

monetary policy this year. It obviously is tempting to tolerate more rapid growth of money and credit in an effort to prevent increases in interest rates in order to promote increased private investment spending and assure a continued strong flow of funds to the housing industry. But that option carries with it the danger of much more serious problems at a later time.

There is a view that rising short-term interest rates tend to push up long-term interest rates, and tendencies for short-term interest rates to rise must be resisted by the monetary authorities in order to avoid rising long-term interest rates. However, that view is not supported by recent experience nor by theoretical analysis. Since investors pay increasing attention to the growth of the money supply in forming their expectations about future inflation, a more rapid growth of money for the purpose of holding down short-term interest rates would actually cause long-term interest rates to rise more. This is because managers of investment funds, as well as individual savers, would attempt to avoid incurring a capital loss that would occur when the price of long-term bonds declined as the inflation premium in bond yields was revised upward. The only way to bring about a permanent reduction in long-term interest rates, including mortgage rates, is to permanently reduce inflation.

Last year short-term market interest rates rose approximately two percentage points, and some observers interpreted that as a sign of a more restrictive monetary policy. I disagree with that view. Since the quantity of credit extended was rising at historically very rapid rates, the only interpretation that follows from the rise in the price of credit is that the demand for credit was rising even more rapidly than the ample increase in credit supplied. That is a sign of a strong economy. The rise in short-term yields last year occurred mostly in the spring and summer, at a time when bank reserves and the money supply were growing at the most rapid rates in over thirty years. Such a high rate of monetary growth accompanied by a sharp rise in short-term interest rates occurred in only one other year -- 1972. Certainly the events of 1973 and 1974 suggest that the excessive monetary growth in 1972 was a better measure of monetary stimulus than was the rise in the price of credit.

At the present time, participants in money and capital markets seem to be expecting that short-term market interest rates will rise one percentage point or more this year, that inflation will be at least as rapid as last year, and that long-term interest rates will rise by one-half percentage point or more. It is generally accepted that the money and credit markets will be much tighter this year in spite of the somewhat slower real output growth that is generally expected. Market participants understand that



there is no reliable correlation between real growth in the economy and movements in interest rates, as evidenced by recent experiences such as 1973 and 1974. The dominant reason for expecting upward pressure on interest rates this year is that the stimulative monetary and fiscal policies of last year, and continuing into this year, have produced strong credit demands in the private sector which are competing increasingly with the continuing large credit demands of the government sector, all of which leads inevitably to a substantially higher price of credit.

It is important to emphasize that a year ago the forecasts of higher interest rates in 1977 were based on assumptions of an acceleration in the growth of the money supply, not slower growth of money, than had occurred in the previous year. Similarly, continued monetary growth in 1978 at the rate that occurred in the final three quarters of last year would imply a larger rise in long-term interest rates this year and in 1979 than if the growth of money was returned to and maintained at no more than the upper limits at the announced targets.

I firmly believe that if market participants can rely on the Federal Reserve to reduce monetary growth this year to no more than the upper ends of the announced target ranges, the rise in short-term yields will be viewed as only a temporary cyclical increase. Consequently, the rise in long-term yields will be small since there will be no

reason to revise upwards expectations about the trend rate of inflation.

The reasons for the apparent paradox -- that slower money growth means a smaller rise in interest rates -- lie in the way market participants form expectations about future credit demands and inflation and in their judgements about actions that may be taken by the Federal Reserve to offset undesired deviations of monetary growth from their targets. Even though traditional analysis holds that faster growth of money implies lower interest rates and slower growth of money implies higher interest rates, market participants have come to understand that it is actually just the opposite.

Over the past few years market participants have recognized that when faster money growth actually is observed, higher short-term interest rates can usually be expected as the Federal Reserve raises the Federal funds intervention target rate in order to slow reserve availability and bring money growth back down into the target range. Conversely, when money growth persists for some time at relatively slow rates, interest rates begin to decline as market participants begin to expect that the Federal Reserve will increase reserve availability in order to promote faster growth of money to maintain target growth rates. The implication for the present environment is that the way to promote lower long-term interest rates late this

year and in 1979 is to allow the competition between government and private sector credit demands to raise short-term interest rates as much as necessary while open market operations by the Federal Reserve provide reserves at a rate that permits money growth at no more than the upper limits of the current long-term target growth ranges.

The obvious problem with this conclusion for economic objectives in 1978 is that tolerating further increases in short-term market interest rates will be viewed by some to be in conflict with the desire to promote a higher rate of capital spending and to insure continued strength in the housing industry. The argument will be heard many times this year that rising short-term market interest rates increase the likelihood of an outflow of savings deposits from the thrift industry, especially of short-term maturities, and that, in turn, implies a reduced availability of funds for construction and mortgage finance of housing. While that analysis by itself is undeniable, the various alternative policies and their implications must be considered.

For the Federal Reserve to merely peg short-term interest rates at near the current levels and tolerate a marked acceleration in the growth of money and credit would delay the occurrence of disintermediation and might assure a continued strong flow of funds to the housing industry through this year. However, those same actions would insure that inflation would accelerate substantially next

year and a major credit crunch and recession would become inevitable.

Cyclical movements in interest rates contribute to cyclical swings in home construction activity, but it is also true that high secular rates of inflation have a major adverse effect on the housing industry and people's ability to afford adequate housing. Part of the reason that the demand for housing was so strong last year and residential housing prices rose so sharply was because of people's fears about future inflation. Even though housing prices have risen sharply in the past decade, and in 1977 were substantially higher than just one year earlier in some parts of the country, there was considerable speculative activity based on the assumption that general inflation would be greater and new homes would become even more expensive relative to incomes in future years. A policy of holding down interest rates and permitting very rapid growth in money and credit is not the solution to the problems of the housing industry and the thrift industry, if it means continued high rates of inflation.

Even if nothing else is done and a return of monetary growth to the Federal Reserve's announced target ranges causes increases in short-term interest rates and some disintermediation of savings from the thrift institutions and a downturn in home construction activity, there is no

reason to believe that the downturn will be very sharp nor very long in duration. It would be far better to suffer a mild downturn in the next year or so and lay a foundation for resumed healthy growth in the 1980's than it would be to promote vigorous activity this year and into 1979, while risking a subsequent long and deep contraction in the industry.

Now I will turn to some comments about the role of monetary policy in promoting an increased rate of capital spending. First, there is a view about the way government economic policies influence capital spending plans of business that I disagree with. It holds that monetary and fiscal policies can be used to stimulate current consumption spending and thereby give business decision makers the confidence to implement plans for increased productive capacity. According to this view, the key to stimulating capital spending is to take actions that cause this month's sales to increase and order books to fill up. My conversations with business leaders do not support that view.

The experience of the last couple of years suggests that the traumatic events of 1974 and 1975 have caused businessmen to be very cautious about being too myopic in analyzing the strength of final demand for their products. The business community is very sensitive to the possibility that monetary and fiscal policies in the short-run will become overly stimulative and leave the government with no alternative but to combat accelerating inflation either

by administering a strong dose of traditional monetary and fiscal restraint which would render any new investment unprofitable during the ensuing recession, or adopting some form of administrative controls over prices which would also render new capacity to be unprofitable. There is a desire by business planners to see government avoid the excesses of short-sighted "stop and go" policies in favor of more stable policies that reflect the kind of patience necessary to promote a prolonged period of continued economic expansion.

A review of the conditions that made possible the extended period of sustained growth in the 1960's suggests that moderation in the monetary and fiscal policies pursued early in the period, especially in 1961 and 1962, dispelled the view that alternating short periods of growth and recession were inevitable. Another development that contributed to the length of the expansion of the 1960's was the willingness of the monetary authorities to suffer a correction of some excesses that were building up part way through the period. The 1966 credit crunch and the mini-recession in the first quarter of 1967 were unfortunate and unpleasant, but they were also probably unavoidable as a result of the overheating of the economy that occurred in 1965 and early 1966. Their occurrence enabled the economic growth to continue for three more years.

In 1978 it is still possible for capital spending to continue to strengthen and in real terms to match or exceed the pace of last year. However, if high rates of monetary growth are the results of policies designed to resist further increases in short-term interest rates this year, then greater uncertainties will be generated about the economic environment that will prevail two or three years from now when new capacity is coming on stream. As a result, corporate planners will want to go slow on major long-term projects until they have a better idea about the timing, depth, and duration of the next recession and until the prospects for some form of administrative controls over prices are assessed. I do not believe that controls are desirable or necessary, but in business it is prudent to assume they will be imposed.

Now I will turn to some comments about implementation and measurement of monetary policy actions. At the hearings conducted by this Committee in July of last year, the subject of seasonal adjustment of the monetary aggregates was raised, yet the situation is the same today as it was at that time. Two years ago a non-partisan committee of academic economists, commissioned by the Federal Reserve and chaired by Professor Leland Bach, made a number of recommendations regarding the measurement of monetary statistics. Yet no action or explanation for failure to implement the recommendations has been forthcoming from the Federal Reserve, and I think it would be an appropriate role for Congressional oversight to seek some progress on these issues, or at least some reasons why the recommendations have not been implemented.

At the mid-year review of the economy conducted last September by the Joint Economic Committee, Congressman Ruess presented additional views with which I concur substantially and will not repeat at this point, but will only say that they are as relevant today as at that time. In addition, at the hearings of this Committee last July on monetary policy, the subject of lagged reserve requirements was raised and an analysis by the staff was included in the record. I would like to associate myself with the analysis presented by the staff and suggest that on this year's agenda for Congressional oversight the Federal Reserve should be asked to plan a return to coincident reserve requirements or provide a detailed defense of maintenance of the present structure of lagged reserve requirements.

Finally, I concur with the concern expressed by a number of observers regarding the emphasis placed on the weekly money supply numbers, but I would like to suggest that the Federal Reserve's continued emphasis on the weekly average and even daily or hourly Federal funds rate is equally cause for concern, and frequently has been a source of past policy errors. Neither the level of the Federal Funds rate nor the weekly M1 and M2 measures are appropriate short-term operating targets for the Federal Reserve. Alternatively, the adoption of a reserve aggregate, such as the monetary base, as a short-run operating target would enhance the ability of the Federal Reserve to achieve its



quarterly and annual money supply growth targets and also to avoid wide cyclical swings of interest rates. Again there is an apparent paradox, in that excessive preoccupation with short-run movements in interest rates and efforts to stabilize them over weekly averages (or even daily) may actually contribute to substantially greater swings in interest rates over full business cycles. In order to minimize the long-run movements in interest rates the Federal Reserve should allow them to fluctuate over a wider range in the very short-run.

In summary, monetary policy actions in 1978 will be critical in determining whether another major recession should be expected in the next few years. Contrary to conventional analysis, the probability I would assign to an occurrence of a major recession in the next two or three years would be greater, the more stimulative are monetary policy actions this year. It is my hope that the Federal Reserve adheres to monetary growth targets for this year that are no higher than were announced, but greatly exceeded, last year.

The CHAIRMAN. Thank you, Mr. Jordan.  
Mr. Dornbusch.

**STATEMENT OF RUDIGER DORNBUSCH, ASSOCIATE PROFESSOR OF  
ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAM-  
BRIDGE, MASS.**

Mr. DORNBUSCH. I would like to address myself primarily to the role of monetary policy in relation to the exchange rate, but I do have to place the discussion in some perspective about the U.S. priorities on the macroeconomic scene and what should be the right policy mix.

I find myself in some disagreement with Mr. Jordan.

First, I believe there is continuing high unemployment and that sustained real growth considerably above the trend is required for 2 or more years to reduce unemployment to the point where structural policy should predominantly take over; that unemployment exists now both for the labor force and for the capital stock, and it requires attention.

The first priority then should be continued expansion in aggregate demand.

Second, we should be concerned about inflation, not to reduce the level of the rate of inflation but to prevent by all means an acceleration in inflation. The experience since 1974 has taught us that we can't use aggregate demand to reduce inflation at anything like a price we should be prepared to pay. But we do have to be concerned not to raise inflation, and I see implications in that for fiscal policy.

Third, we should be very much concerned about investment and capital formation. That concern arises because the productivity growth will have a dampening effect on inflation and because capital formation is required to absorb the labor force in the longer term and give labor the real income growth that it expects. Investment and capital formation should therefore stay in the center of our attention in the policy mix.

And, finally I think we should pay attention to the fact that growing competitiveness of new U.S. trading partners, primarily the LCD's will force us increasingly to pay attention to shifting resources and increasing productivity. I take it that a high investment economy is a better environment in which to achieve that transformation.

Now, the policy mix to implement the variety of targets is, I think, one that has a considerably easier monetary policy and a shift in fiscal policy, first toward investment and toward the control of inflation, and second, as the economy further recovers, toward some tightening.

I want to emphasize that at present I really don't see an excessively expansionary fiscal policy. In my statement on page 4 I show some numbers for the consolidated budget for State, local, and the Federal Government. In real terms the budget deficit compared to years of comparable slack. As a fraction of GNP, it is certainly exceedingly low. So, I want to draw your attention to the fact that both for macroeconomics and for capital market questions the consolidated budget must be looked at and, of course, with large savings by State and local governments, the Federal Government ought to be expansionary.

The particular policy mix I would favor is that on the fiscal policy side we use a considerably larger fraction of the tax cut that has been proposed for excise tax reductions, wage subsidies for youth unemployment, and measures like that which have a direct effect on inflation.

I say that primarily because we have a number of factors, from the coal strike to the depreciation, will already tend to raise inflation at prevailing wages. We therefore ought to have this year extra policies to be considered now in view of these new developments that will make an inroad on that extra inflation and stabilize the rate at the prevailing level.

Fiscal policy also requires a shift toward investment and capital formation. There has been a neglect of the stock market at the expense of the exchange rate.

On the monetary policy side, I don't really see that monetary policy has by any means been very expansionary. I certainly don't share Mr. Jordan's belief that we had a monetary growth rate in excess of the last 30 years, with the exception of 1971. Through February 1978 the growth rate of  $M_1$  was 6.6, since 1959, there are 4 or 5 years with comparable monetary growth. So there was certainly in the last year no excessive monetary growth—there were erratic fluctuations in the growth rate of money. We can pick our quarters, but 6.6 year on year I don't think is an extremely high growth rate of  $M_1$  for an economy that has a built-in inflation rate of 6 percent.

Now, I want to come to the exchange rate and place it in that macroeconomic perspective I have laid out. First I want to point out some facts about the exchange rate.

The first concerns the extent to which European currencies and the yen have appreciated. I show on page 7 in my statement for the mark, for example, an appreciation to the extent of 15 percent since the end of 1976. There is a large appreciation, also, for the yen.

What matters though for the United States is not the appreciation of particular European or Far Eastern currencies, but what has happened to the average dollar. And to create an average we look at the U.S. trading patterns. The last column shows the effective dollar exchange that is adjusted for the U.S. trading pattern. When an attempt is made to adjust it for the U.S. trading pattern, of course, the depreciation is much less, reflecting the importance, for example, of Canada to U.S. trade. Canada in the world economy is very small, but in U.S. trade it is very large. Canada has appreciated relative to the dollar, and accordingly that tends to dampen the decline of the average dollar relative to foreign moneys. In fact, the effective rate that is shown here overstates the extent of the U.S. depreciation because it does not include LDC's, most of whom are dollar peggers.

If you turn to page 8 of my statement, you have a breakdown of U.S. trade. The point that should come out of that table is that Western Europe and Japan, even taken in combination, really account for less than half of U.S. trade, and we should pay equal or more attention to Canada and the developing countries when we talk about what has happened to the dollar.

So one adjustment, then, in looking at dollar depreciation or appreciation of foreign currencies is to take into account the particular pattern of U.S. trade.

A second adjustment is necessary because we can't look at the exchange rate independent of prices. Ultimately we want to know what are the real effects of a change in the exchange rate. For what we have to adjust for price changes that have taken place. An exchange rate that depreciates simply because one country's inflation rate is higher than another's will have no real effects because it just makes up for differences in inflation rates.

On page 9 in my statement I show inflation adjusted exchange rates, and you will see in the first column that the dollar on that basis has depreciated relative to its 1973-77 average by only 3 percent. Similarly, the mark appreciation and the yen appreciation have been considerably more modest than is shown by the large changes in nominal exchange rates, so that these rates here are more nearly what we expect to affect trade flows.

Again, they are still an overstatement because they do not take into account fully the U.S. trade pattern. If we made that adjustment, I think the U.S. real exchange rate would show an even more modest depreciation.

The next factor is exchange rate volatility, and I think is the main concern expressed in newspapers—it affects financial markets when the exchange rates go up and down because anybody that holds a position is exposed to large speculative gains or losses. I don't think that the volatility has so much an effect on trade activities. I do want to point out, though, that the volatility has been considerably less in 1976-77 than it had been, for example at the beginning of floating in 1973-74.

On page 10 in my statement I show charts designed to convey that impression, although, of course, using as a benchmark a trend of 6 months is something very arbitrary. We could use 3 or 9 months. But the point I want to make is that volatility has been reduced. Seventy percent or more of the fluctuations in weekly exchange rates are explained by the trend. That poses a problem for intervention, to which I will come back.

I want lastly to turn to another "fact." There has been widespread argument that the dollar depreciation is due to excessive U.S. monetary growth. The argument was made only this morning by a Belgian Government official. Implicit in that argument is a comparison with Germany; namely that Germany had very tight monetary growth compared to the United States.

I show on page 11 in my statement data for the United States and for Germany, and of course, in the last quarter of 1977 the German monetary growth for  $M_3$  was almost double the U.S. growth. It is grotesque to argue that the United States had very expansionary monetary growth compared to Germany. Throughout 1977 they were roughly equal with Germany, a bit on the high side; in the last quarter, there is a very strong depreciation of the dollar. The last quarter of 1977 shows, however, that the German monetary growth was considerably larger than that in the United States.

I would also reject the notion that depreciation relative to the mark is due overwhelmingly to inflation differentials because they are in fact very modest. They are 2 to 3 percent. And one can't really see a very large divergence. Current wage settlements in Germany are threatening to be on the order of 5 to 8 percent, and you don't get reduced inflation out of that. And in the United States, while, no doubt,

the depreciation caused problems and a lot of protectionist measures threaten to raise inflation, I don't see that it would produce a large enough increase in inflation to warrant the exchange rate changes that we have observed.

I come from facts about the exchange rate to the place of the exchange rate in the economy, and then I will ask whether, in effect, we should use monetary policy to use the exchange rate for macroeconomic purposes.

When the dollar depreciates relative to the rest of the world, it will have three effects. We have, one, an effect on the level of prices in the United States; second, an effect on competitiveness and trade flows; and third, we have effects in financial markets.

The price effects are important because independent of the level of aggregate demand, a depreciation would produce an increase in prices. Depreciation would raise import prices, given world prices, and that would be more important for raw materials and agricultural commodities. For that class of goods that are important in U.S. trade—25 percent—there would be a direct impact on wholesale prices and on the price level. When we look to manufactured goods and industrial supplies, the price effects are much more modest. It will take time and the adjustment of U.S. prices to competitive prices would only be gradual and partial, so for that class of goods the inflationary effect of depreciation would be considerably less.

We have to be very careful in that context to look at oil, because if we had a sustained large depreciation of the dollar in terms of other currencies, we would expect oil prices to increase somewhat as oil producers tried to protect their real position. But that is an administrative price, and for that reason we can leave that as something to be considered but not be assigned too high a probability.

As to the real effects on trade flows we have to ask, how much would a real dollar depreciation produce, and I conclude that the effects are quite limited. They are quite limited because the range of commodities where the United States can gain competitiveness relative to the rest of the world is essentially manufactured goods and industrial supplies, and that accounts for perhaps 50 to 65 percent of U.S. exports, and a smaller fraction on the import side. So on the competitiveness side, we clearly will gain, but we would not get an overwhelming advantage because we have a lot of agricultural goods where prices are determined in the world market and equalized cross countries, and there is no edge for competition then. That leaves us really with manufactured goods to have those gains.

There is a second reason why the competitive effects on trade flows are likely to be limited, and that is because the United States cannot effectively depreciate relative to much of the rest of the world.

LDC's, Canada, a country like Mexico, will not allow the United States to depreciate relative to them and gain competitiveness at their expense. They are pegged to the dollar in real terms. They will go with the dollar, and the only depreciation that the United States is likely to achieve is relative to countries like Germany and the German currency area and the yen. But that implies that to achieve a given improvement in the trade balance through depreciation, the depreciation will have to be much larger. It only acts on a small segment or half the segment of goods that the United States produces, and it only acts

with respect to very few trading partners. And I think that accounts in part for the large depreciation that we have observed; that you have to change a lot relative to the mark to get a given improvement in the U.S. real trade position.

The last point concerns the role of the exchange rate in respect to financial markets—and I think that ties in with monetary behavior. We read now in the press that when the dollar depreciates, interest rates rise because people anticipate that the Federal Reserve may tighten monetary policy to prevent further depreciation. Well, if that is correct, then, in fact, exchange rate targets will become much more important in financial markets. Any time any disturbance works in the exchange market, that would be interpreted as a sign for monetary action and will go into interest rates. This is at present not the case, but I can see with the exchange-rate-oriented monetary policy that this might become a very fast and disturbing mechanism.

I come from here to the question of whether the United States should use monetary policy to stabilize the dollar. And I have argued before that we should have easier monetary policy to accommodate the growth in investment, and from that perspective I don't see an advantage in using monetary policy to stabilize the dollar.

In order to prevent the depreciation, we can ask, what would have to happen to monetary policy. I think a year ago we would have argued that a small increase in interest rates, 25 or 30 basis points, would already produce an effect on the exchange rate and generate some appreciation of the dollar over 2 or 3 months. So a year ago we would have argued, with modest interest increases, we can in fact stabilize the dollar and save a lot of trouble. I don't think that is true anymore. The dollar now is overwhelmingly dominated by expectations, not by interest differentials, and I believe that it would take considerably more in terms of monetary policy to reverse the depreciation.

What people would want to see is an actual decline in the inflation rate, and second, an improvement in the trade balance. To generate that through monetary policy we would have to have a very sharp slowdown if not actually a decline in economic activity. To improve the trade balance through a depression you have to have a lot of depression because the trade sector is so small relative to the whole economy.

I can't see that such a policy is in the U.S. interest, and so—both because it would take actually a recession and, perhaps even importantly, because monetary policy should be expansionary for the purposes of investment and the stock market, I think that it would be exactly the wrong policy assignment.

It has been argued that the stabilization of the dollar is important for U.S. economic activity because the present disruption of European competitiveness will mean that their incomes decline and they will import less from the United States. I think that is a fallacy, because the only reason that their economic activity declines is because the United States sells more abroad. It is true that as their incomes decline, that the U.S. benefits are reduced; but it would not reverse them. So that certainly should not be of worry to us.

I would argue, too, that declining U.S. economic activity could not benefit most of the world because LDC's that have a level of economic activity constrained by their export earnings would have to contract

along with the United States, and in the end, that can't be of interest to the Europeans, either. In Europe the strategy has been to keep up GNP through export growth. Once their exports decline because of the U.S. decline in economic activity, engineered solely to restore the dollar, there would be an increased recession abroad, and they would ultimately have to expand through domestic policies, something they could very well do now.

So I conclude, then, that there is really no overwhelming U.S. interest in stabilizing the dollar through dramatic monetary policy moves, and I conclude, too, that I don't think minor monetary policy moves would contribute much.

I want to address the last question of whether the United States should intervene on the foreign exchange market. I separate that from monetary policy. I take it that intervention might be more decorative and might not be seriously matched on the domestic front by monetary and interest rate implications.

The question of intervention is, of course, important because foreign official holders last year accumulated in excess of \$30 billion in the course of stabilizing the exchange rates. The concept of exchange market intervention has been to prevent disorderly conditions and, of course, it is hard to see how a group of central bankers in a year can buy \$30 billion that way. On average, they should not be buying any.

I take it then, that there was considerable fighting of trends, and I would argue that that may well account for a considerable part of the uncertainty that exists in foreign exchange markets now. It is quite clear that traders do not know whether or not the Federal Reserve will intervene, whether they will intervene after European hours close, or whether Germany and the United States will pass an agreement on how to share the losses of intervention.

I think the question of intervention now has created additional uncertainty in the foreign exchange market. I am not familiar with any evidence that on average intervention has smoothed exchange rates in a beneficial way and in a way that has created certainty; in fact, I am aware of the school of thought that says intervention is designed to create uncertainty in order to reduce speculation. But I find it terribly worrying, if that is the conception that presided over U.S. intervention policy.

I want to conclude that the best policy toward the dollar is a policy of continued expansion with a very close watch to prevent accelerating inflation in the United States. The expansion should certainly not have tight money as part of it. For the rest, the dollar problem will be solved, in part, through the real depreciation that has occurred and that restores U.S. competitiveness, and in part it will have to be cured through increased expansion abroad that is now in prospect as foreign countries like Germany realize that they stayed considerably below their proposed targets during the last year.

Thank you.

[Mr. Dornbusch's prepared statement follows:]

STATEMENT BY

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HEARINGS ON THE CONDUCT OF MONETARY POLICY

Before the Committee on Banking, Finance and  
Urban Affairs  
U.S. House of Representatives

March 7, 1978



Increased volatility of exchange rates, the sharp appreciation of the DM and related currencies, as well as outright moves by the Federal Reserve to orient monetary policy toward external targets have raised once more the policy dilemma about the appropriate use of monetary instruments in the conflict between internal stability and external balance. The Federal Reserve's move in January to motivate a discount rate increase by exchange rate considerations as well as the continuing upward trend of interest rates suggest that the external objective is taking a dominant place in policy setting. I should like to argue that concern with the book losses of foreign central banks should not take precedence over the requirements of continued expansion in the domestic economy. To make that case I will first review what I consider the priorities for U.S. policy and then place exchange rate considerations in that perspective.

#### U.S. PRIORITIES

In the short term the U.S. has an overriding interest in two objectives: First, the continued move toward full employment along with attempts at resolution of structural unemployment and poverty problems. Unemployment of labor and capital remains high even by the standards of those who will make substantial adjustments in the conventional unemployment and capacity utilization figures. Certainly, in the case of labor, a figure of 5 - 5½ percent is now a more appropriate indicator of full employment from a macro-economic perspective than the 4% of the fifties and early sixties. Needless to say, reaching that level in the near future requires continued real growth

in the 4½-5% range. Once that target is approached, macroeconomic policies should increasingly give way to structural policies to cope with the large residual labor market problem. Second, the concern for stabilization of inflation at its present level or, with good fortune, a progressive reduction of inflation. I believe it important to qualify that the main concern should be with the prevention of accelerating inflation, not with a reduction in inflation. The lessons of the last few years have forcefully established the point that low aggregate demand is a very poor instrument with which to attack the inflation problem.

In a slightly longer perspective two further policy concerns must be added, namely growth of capacity and productivity and adjustment to shifts in competitive advantage. Growth of capacity and productivity are essential not only because of their desirable impact in dampening inflation, but also, of course, to enable absorption of the labor force and the rising trend of real incomes that labor expects to receive.

Shifts in competitive advantage over the intermediate term will become an important issue for policy because of the rapid progress that developing countries have been making in areas that figure prominently in traditional U.S. manufacturing production. If the U.S. is to meet that challenge without resort to increased protectionism we must either be prepared for a longrun trade balance problem or else achieve flexibility in production patterns toward higher technology products and continued technological leadership. This, of course, presupposes a high-investment economy and a relatively homogeneous, high-skill labor force and thus ties in with the shorter run macroeconomic and labor market problems and the policies chosen to meet them. The reason this question deserves attention in the present context is that trade balance problems are likely to persist beyond the immediate problems posed by oil and the U.S. cyclical position relative to the rest of the world.

THE POLICY MIX

The policy priorities and concerns, as I have outlined them, suggest the need for continued expansion of aggregate demand above trend. They also suggest an increasing effort to shift the composition of aggregate demand toward investment. Fiscal policy should be used with a view to its impact on inflation and investment rather than consumption.

On the side of fiscal policy I do not see a risk of excessive stimulus. The accompanying table compares the consolidated government budget deficit in relation to GNP. By the standards of that comparison, fiscal policy in 1977 was by no means out of line, nor is the proposed budget for 1978. In passing I note that the relevant fiscal measure both for questions of economic activity and for the capital market is the consolidated deficit of the entire government sector and that accordingly the large savings of state and local government must be credited against the federal deficit.

Table 1

	BUDGET DEFICIT * (Billion 1972 \$s)	GNP GAP %	DEFICIT AS % OF GNP *
1958	19.1	6.1	2.8
1971	19.0	3.4	1.7
1975	50.3	9.5	4.2
1976	26.6	7.0	2.1
1977	14.4	5.6	1.1

\* Consolidated deficit of Federal, State and Local Governments in the National Income Accounts.

Source: Economic Report of the President, 1978.

The particular make-up of fiscal policy measures is in my judgement unfortunate in that it does not include sufficient measures that work directly to reduce or dampen price increases. Rather than distribute the fiscal drag of increased output and inflation in the form of income tax cuts I should prefer a policy of foregoing social security tax increases, a more important use of revenues to reduce excise taxes and a strong concern for the use of fiscal policy to raise the profitability of capital and investment. Fiscal policy should start showing more attention to inflation and the stock market.

The monetary-fiscal policy mix in the recovery has been strongly marked by relatively tight money for the control of inflation and easy fiscal policy to support aggregate demand. The lack of synchronization has meant that, on top of other uncertainties and impediments, stabilization policy has affected the composition of aggregate demand in a manner adverse to capital formation. The problem is apparently compounded as monetary policy is now used to keep up the dollar rather than the stock market. Interest rates should not be allowed to rise further and, indeed, a rollback is desirable.

The difference between a high investment economy and the present conditions is brought out in Table 2 where we compare the period 1964-69 with the recovery period 1975-77.

Table 2

	Ratio of Market Value to Replacement Cost of Assets	Rate of Return on Equity	Share of Invest- ment in GNP
1964-69	1.24	7.5	10.3
1975-77	0.79	5.9	9.4

Source: Economic Report of the President, 1978.

The striking fact is of course the sharply lower incentive to investment reflected in a reduced, inflation-adjusted, after tax return on net assets and the decline in the stock market relative to the reproduction cost of capital.

Once we accept the position that inflation control through aggregate demand is too clumsy a policy we can go a step ahead and reshape the policy mix. Fiscal policy should help control inflation; monetary and fiscal policy should look to investment and the stock market. As economic slack declines, a tightening of policies should be concentrated on the fiscal side, leaving room for investment to expand. In a more immediate perspective, an easier monetary policy is required because the slowdown in the growth of monetary aggregates, in particular  $M_2$ , in combination with rising interest rates, shows the signs of disintermediation and foreshadows reduced activity in the construction sector.

#### SOME FACTS ON THE DOLLAR EXCHANGE RATES

To place the role of exchange rates in the U.S. economy in perspective I will start with a review of some facts. The central fact is the continuing depreciation of the dollar in terms of the DMark and, to a somewhat lesser extent, in terms of the snake currencies. There is, of course, also the depreciation of the dollar in terms of the Yen. Table 3 reports some of these exchange rate changes since 1973:

Table 3  
(March 1973=100)

	DM/\$	YEN/\$	EFFECTIVE \$ RATE
1973	92.8	102.2	98.5
1974	91.2	110.9	101.5
1975	87.6	113.3	99.9
1976	88.9	112.1	108.9
1977	81.8	101.0	107.3
73-77	88.3	107.2	103.2
Feb 78	73.3	91.7	101.3

Notes: A decline in the index measures a depreciation of the dollar. The effective exchange rate is formed, using multilateral trade-weights for the group of ten major industrialized countries.

Source: Board of Governors of the Federal Reserve.

While there is some arbitrariness in the choice of the base period the table reflects nevertheless the continuing depreciation of the dollar in terms of the DMark and the more recent depreciation in terms of the Yen. More importantly, though, the table shows that these particular two exchange rates vastly overstate the depreciation of the dollar. Once an adjustment is made for the place of various countries in world trade the effective exchange rate in the last column shows a considerably smaller depreciation. The first point to recognize then is that we should not impute too much importance or effects to the course of the DMark and the Yen exchange rates. These rates do matter because they influence our competitiveness compared to Germany and Japan in world markets and at home but they do not give sufficient importance to the patterns of U.S. trade.

The geographical pattern of U.S. trade summarized in Table 4 shows the importance of Canada and LDC's to be considerably larger than that of Japan and Germany or even all of Western Europe. Since Canada and LDC's have certainly not shared the appreciation of the European currencies, a more comprehensive effective exchange rate index would show an even smaller external depreciation of the dollar.

Table 4  
SELECTED SHARES IN U.S. TRADE: 1977

	U.S. Exports (%)	U.S. Imports (%)
Western Europe	29.0	18.4
Canada	23.3	19.6
Japan	8.6	12.2
OPEC	10.7	24.2
Developing Countries	23.1	23.1

Source: Economic Report of the President, 1978

More importantly the exchange rate data, even adjusted for trade patterns, do not make allowance for differential inflation. To arrive at an indicator of changes in competitiveness we have to turn to real exchange rates or effective exchange rates adjusted for divergent price movements. Real exchange rate indices, adjusted for divergent movements in wholesale prices, are reported in Table 5. The table brings out quite strongly the fact that U.S. competitiveness has not nearly changed as much as the movements in nominal rates might suggest. Indeed it is only the depreciation of the last half year that has had an important effect on competitiveness. Again, the index overstates the effective depreciation to the extent that it deemphasizes the

role in U.S. trade of Canada and the LDC's who have moved with the dollar if not depreciated relative to the U.S.

Table 5  
REAL EXCHANGE RATE CHANGES: 1973-78  
(March 1973=100)

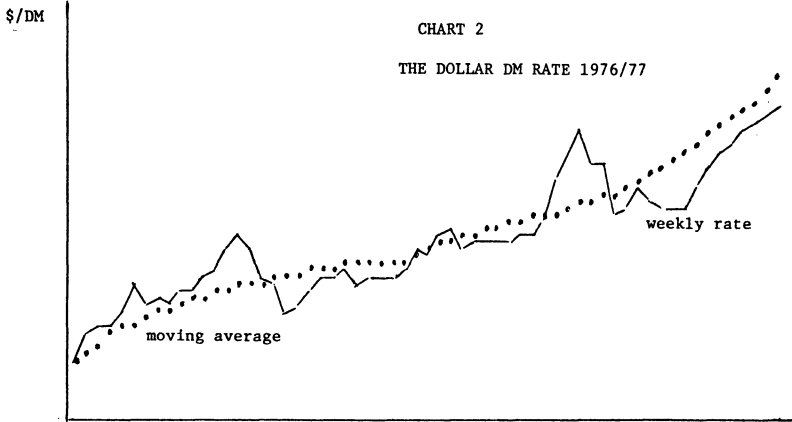
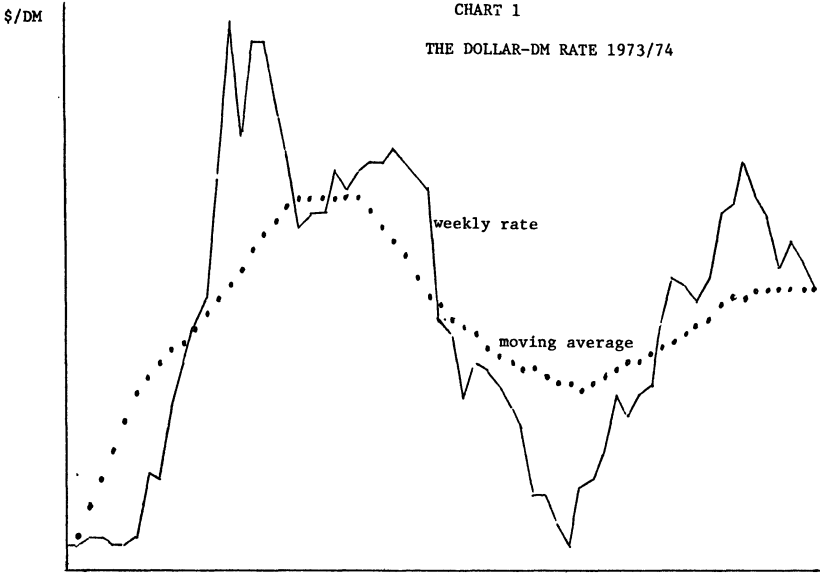
	U.S.	GERMANY	JAPAN	CANADA
1973	98.3	103.9	99.1	101.6
1974	97.2	102.0	99.2	105.9
1975	98.6	105.2	92.0	100.3
1976	102.9	108.0	96.6	107.1
1977	100.3	108.1	101.4	99.0
73-77	99.2	105.4	97.4	102.9
Feb 78 <sup>e</sup>	95.8	106.6	103.1	93.8

Notes: Exchange rates adjusted for changes in wholesale prices. e=estimated. The indices are trade-weighted multilateral measures using the group of the ten major industrialized countries. A decline in an index indicates a gain in competitiveness.

Source: "Price Adjusted Exchange Rate Indexes," Board of Governors of the Federal Reserve, Feb 1978.

Having placed in perspective the depreciation of the dollar I turn next to the question of volatility. There is no doubt that there have been large shortrun movements in exchange rates compared to their trend. But, as Charts 1 and 2 show, that volatility has been less in 1977 than it was, for example, in the early period of floating. Indeed, taking as a measure of the trend a six-month centered moving average we find that for the entire 1973-77 period over seventy percent of the movement in exchange rates is explained by their trend. This suggests the difficult problem posed for intervention in "disorderly markets" since the trend element accounts for so much of the exchange rate movement.





The last point I wish to make here concerns a non-fact. Over the course of the last half year one widespread explanation for the dollar depreciation has been excessive U.S. monetary growth. The implicit comparison was with Germany. Table 6 shows without question that in fact monetary growth in the U.S. was as low or lower than it was in Germany throughout 1977 and particularly in the recent period of accelerating depreciation. A simple monetarist explanation for the depreciation is therefore inappropriate.

Table 6  
MONETARY GROWTH  
(percent per year, seasonally adjusted)

	GERMANY		U.S.	
	M <sub>1</sub>	M <sub>3</sub>	M <sub>1</sub>	M <sub>2</sub>
1977	8.3	9.4	6.6	10.5
1977/IV	8.9	13.2	7.0	7.6

Source: Federal Reserve Bank of St. Louis and Deutsche Bundesbank.

I would also reject the notion that the large change in the dollar/DM rate--15% since late 1976--reflects primarily divergences in actual or prospective inflation. The actual differential in inflation performance has only been two to three percent over the last year. Furthermore there is little reason to anticipate either a significant success in Germany at further reducing inflation or a severe worsening of the inflation outlook in the U.S.

THE ROLE OF THE EXCHANGE RATE IN THE ECONOMY

To decide whether to use intervention, monetary policy or neither to arrest the depreciation of the dollar it is helpful to identify the channels through which exchange rate movements affect domestic policy objectives. I would single out three major channels: Exchange rate effects on the price level, the implications of exchange rate movements for competitiveness and hence aggregate demand for U.S. goods and services and, lastly, a spill-over from exchange rate changes to financial markets.

Depreciation of the exchange rate, given world prices, will raise U.S. prices of imports and exports. For some goods, in particular raw materials and agricultural products, the exchange rate movement is quite fully passed through and thus cannot avoid raising wholesale prices and consumer prices. For other commodities, the price effects are less pronounced in the short run, in part because U.S. prices respond only gradually and partly to an increase in the dollar prices of competitors. For oil, which deserves special attention here, the experience is mixed but we would expect a sustained, large depreciation to lead to some increase in the dollar price of oil. The net effect then of a depreciation on the price level is hard to nail down very precisely. Estimates that are available would suggest a cumulative effect on consumer prices of a ten percent depreciation to be of the order of one to two percent and taking well over a year to materialize.

It is important to qualify the inflationary effects of depreciation in respect to price behavior in the rest of the world. If the depreciation merely reflects divergent rates of inflation so that the dollar depreciates say at the rate of 3% per year because our inflation rate exceeds that in the rest of the

world by that amount, there is no further and additional inflationary impact. To some extent the dollar depreciation has reflected these divergent inflation trends and accordingly we should adjust downward the inflationary impact that we assign to observed depreciation.

I should also emphasize the strong difference in the inflationary implications of exchange rate movements between the U.S. and countries like the U.K., Switzerland and Germany. These countries are considerably more open and for that reason the price effects of exchange rates are more direct and pronounced. It is of course in good measure for this reason that these countries were able to reduce their inflation rates with the help of currency appreciation.

Exchange rate movements, to the extent that they are not fully offset by compensating price adjustments by domestic inflation or foreign cuts in profit margins, change relative prices and thus competitiveness. Table 5 above showed that the U.S. had achieved by February 1978 some gain in competitiveness. The implications of that gain in competitiveness for the trade balance are, however, limited for two reasons. The first is that only manufactured goods and perhaps industrial supplies fall into the group of goods where compensating price effects are minor and thus the gains in competitiveness are important. These groups, however, comprise only 50 to 65% of U.S. trade. In addition, and perhaps more importantly, the dollar has not depreciated in real terms compared to a large part of U.S. markets and competitors including Canada and many LDC's. These considerations provide, therefore, some bounds on the demand-creating effects of a depreciation and the prospect of a major trade balance improvement from this source.

Within limits then, a real depreciation acts in the manner of expansionary monetary or fiscal policy. It shares with these policies the expansionary effects on demand, although the extent and timing of the effects is a matter of conjecture rather than extensive experience. Unlike monetary or fiscal policy,

a depreciation has the undesirable side effect of a direct impact on inflation, independent of aggregate demand. A very significant point of difference arises because a real depreciation causes a shift in world demand toward our goods but not an expansion in world demand. Such a policy is appropriate when various countries are in different stages of the business cycle, not when there is slack around the world. In the present circumstances the only merit of a depreciation would be that of a strategy forcing other countries to substitute domestic expansion for a loss of net exports.

A final and important place of the exchange rate is in relation to financial markets. Such a channel is emerging in the U.S. at present because financial markets see monetary policy being tied to exchange rate targets. A depreciation of the dollar leads financial markets to expect a tightening of monetary policy and thus increasing interest rates.<sup>1</sup> The expectation of rising interest rates feeds into current rates and thus exerts adverse effects on aggregate demand.

#### SHOULD MONETARY POLICY BE USED TO STABILIZE THE DOLLAR?

I have argued above that the exchange rate occupies an important place in a macroeconomic perspective. The question to be raised next is whether monetary policy can and should be used to stabilize the dollar. Such a direction of policies is already showing in Federal Reserve actions and it is a demand widely supported in the appreciating countries. In these countries it is argued that the dollar depreciation is starting to disrupt economic activity and that it is in the U.S. interest to avoid such disruption because it cannot

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<sup>1</sup>See for example the New York Times, March 2, 1978, main financial page.

fail to adversely affect U.S. exports. This is, of course, incorrect because the only way their economies can be disrupted is for the U.S. to gain in trade at their expense. Any secondary effects from their reduced income levels--assuming no compensating domestic expansion--can only dampen but not reverse the U.S. gains.

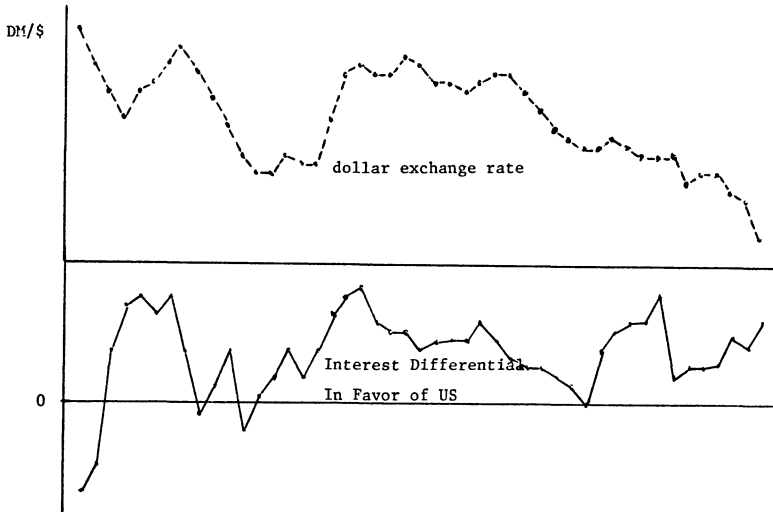
I take it then that the main case for a U.S. monetary policy to stabilize the dollar must be to prevent the gains in U.S. competitiveness and the domestic inflationary effects of depreciation. To stabilize the dollar or to reverse some of the depreciation monetary policy might be used in small doses. An increase in short term interest rates of 25 basis points might create a sufficient interest differential to reverse capital flows to finance the trade deficit and stabilize the dollar. Such an effect can readily be observed until early 1977, as shown in Chart 3 where the exchange rate is shown to be influenced by the interest differential. It is quite apparent, though, that since early 1977 the exchange rate has come to be dominated by expectations and that the dollar has continued depreciating even in the face of a rising differential.

The conclusion then must be that to reverse the trend of a depreciating exchange rate, monetary policy would have to be used in a much more dramatic manner to attack the more basic factors such as the current account deficit and inflationary expectations. There is no doubt that to reduce substantially the trade deficit monetary policy would have to create a major slowdown, if not a contraction, in economic activity. The same applies to the prospect of reducing inflation through tight money. I cannot see any good reason to attach so much importance to exchange rate targets, all the more so since the real depreciation that has occurred does serve to narrow the deficit. A policy of tight money would run directly counter to the needs of continued expansion and a policy mix that favors investment. From a point of view of domestic objectives

it would be a first-rate mistake. Even from a world point of view I cannot see a merit since it would slow down worldwide economic activity and place increasing distress on many LDC's and small industrialized countries whose level of economic activity depends on their export earnings. Without an active use of monetary policy to stabilize the dollar where can we expect the exchange rate to go? The main determinant, given a U.S. commitment to continuing expansion without accelerating inflation, will be economic recovery abroad. With world demand more nearly at full employment there will be a significant reduction in the U.S. current account deficit and hence a reduced requirement for a real depreciation. Even at full employment, though, there is the need

CHART 3

THE DOLLAR EXCHANGE RATE AND INTEREST RATES: 1974-77



for a real depreciation to offset reduced competitiveness stemming from the oil price increase and growing competition from developing countries. To achieve such a real depreciation the dollar has to depreciate significantly relative to the DMark block and the Yen because those are the only currencies relative to which a real devaluation can effectively be achieved. Moreover, since as I have argued above, the real depreciation will be effective only for a small subset of the U.S. product range, the depreciation has to be commensurately larger to achieve a given improvement in the trade balance. I take these considerations to be the main explanation for the sizeable depreciation of the dollar and accordingly do not see at present a substantially undervalued dollar.

INTERVENTION IN "DISORDERLY MARKETS" ?

The principle of intervention in "disorderly markets" is shared among central bankers and has been practiced on a massive scale during the last year. Official accumulation of dollar balances in the last year have been upward of \$30 billion. A large part of these assets were acquired by the U.K. and Japan and Germany in an effort to stem the appreciation of their currencies that has since materialized. They would thus hardly qualify as stabilizing speculation on short term exchange rate movements. The Federal Reserve has also intervened, although on a much smaller scale. Against this background we are faced with a proposal that the U.S. float a major foreign currency loan to accumulate a pool of foreign exchange assets with which to engage in massive exchange stabilization.

I see very little merit in such a proposal and would argue strongly that



the Fed should stop altogether intervention in the foreign exchange market. If foreign countries insist on stabilizing the dollar in order to prevent increased U.S. competitiveness then it surely should not fall to the U.S. to share in their capital losses. That would amount to a U.S.-financed foreign employment program which I consider a poor use of our fiscal resources.

A separate and more important objection to intervention is the overwhelming difficulty in telling trend movements from erratic, reversible disturbances. I am not aware of any evidence in support of the view that intervention has in fact--and on average--smoothed exchange rates relative to their trends and thus created an atmosphere of increased certainty. On the contrary, one view of the role of intervention that has been advanced is that "such intervention does nothing to solve the fundamental problems but it can help to create individual uncertainty as to where and when the central banks might intervene, thereby discouraging speculation against the dollar and helping to maintain orderly trading conditions."<sup>1</sup> The implicit distinction between orderly traders and speculators has no sound foundation in economics and such a concept of the role of intervention would meet with strong professional disagreement. Nevertheless I believe that intervention may well have actually worked to increase uncertainty and this all the more so in view of the disagreement about the proper sharing of the burden and losses of intervention. I would therefore argue strongly that the Federal Reserve should desist from all and any kind of intervention.

The best policy toward the dollar is to set a clear target of continued domestic expansion with assurance that inflation will not accelerate. Along that path monetary policy should provide for increased investment and growth in capacity and productivity. If such a policy should imply continuing depreciation than I cannot see any overriding consideration that should make us prefer a stable, overvalued dollar.

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<sup>1</sup>Statement by Tilford Gaines, Senior Vice President and Economist, Manufacturers Hanover Trust Co., before the Subcommittee on International Finance, U.S. Senate, February 6, 1978.

The CHAIRMAN. Thank you, Professor Dornbusch and gentlemen.

All three of you in your statements appear to subscribe to the view that we would be much better off with unemployment-attacking programs that were, so to speak, microeconomic, that were aimed at structural unemployment, rather than to place the emphasis that we are apparently doing on overall macroeconomic methods of getting unemployment down.

Have I misinterpreted anybody?

Mr. KLEIN. I think it is not an all-or-none proposition; simply that we should work on them.

I think the present tendency is to emphasize the macro, demand-side stimulus. I would argue that that must be mixed. There must be some of that, but there must be a much larger introduction of the structural policies.

The CHAIRMAN. Would Mr. Jordan and Mr. Dornbusch generally agree with that?

Mr. DORNBUSCH. Yes; I would agree with that argument, that once we come to a 5½ percent, policies should become almost entirely structural, and that it should start now so that we don't have to have this large shift in policies.

Mr. JORDAN. I would agree that the structural efforts should be begun now, but I think that an approach of gradually reducing total growth and total spending in inflation, as an antiunemployment program out into the 1980's—and we are concerned about unemployment in 1980, 1981, and beyond as much as we are today—should also begin. Reducing the amount of inflation is consistent with achieving maintaining a lower unemployment rate later. So these are not alternatives of using macro stimulus to get it down or using structural; they are really complementary approaches, if you view it over a longer time horizon.

The CHAIRMAN. If I follow you, you are even more against macro excesses than your two colleagues.

Mr. JORDAN. I am against short-run macro policies. I think long-run macro policies are the only way to get the unemployment rate down and keep it down.

Certainly we could have more stimulative shotgun-type approaches to the whole economy in 1 year, but then we would have to reverse later and lose the benefits.

The CHAIRMAN. Maybe I should not have used "macro" as if it were working in just one way. I am talking about macroeconomic policies of stimulus. And you would agree with your two colleagues that we would be better off with macroeconomic policies currently of somewhat less overall stimulus and instead rely more on structural policies which, among other things, costs less per job produced.

Mr. JORDAN. Right; I agree.

The CHAIRMAN. There is an apparent disagreement which I would like to get at between Mr. Dornbusch and Mr. Klein. Mr. Klein has said that tinkering around with domestic interest rates, making them higher than they otherwise would be for sound domestic reasons, is a good idea because of the international position of the dollar.

You said something like that, did you not?

Mr. KLEIN. I think I said that monetary policy options are very restricted now because of the dollar position, and I think it is very important that we maintain the dollar. I would say that there is more

danger in the dollar depreciation, that we have undergone already than is revealed in the trade-weighted exchange rate change, because OPEC nations don't buy heavy amounts in Canada and Mexico, and they are indexing against areas where they buy goods. Those are the areas where we have had very heavy dollar depreciation. And the whole world activity complex would look very different if there were major shifts in oil prices.

The CHAIRMAN. If it were not for international considerations, you would welcome a relatively low schedule of interest rates in this country for their beneficent effect on capital investment, on housing, and similar activities. Would you not?

Mr. KLEIN. Again, that is an area where structural policies could be introduced.

As an example, one could have interest rates subsidization in housing markets, very selective structural-type policies.

The CHAIRMAN. Well, in departing from your view, which I find very congenial, on the effect of a reasonably low structure of interest rates in this country for domestic reasons, let me turn to foreign considerations. Have you taken into account the charts presented by Mr. Dornbusch that show that in the last year or two there is really not much connection between the U.S. level of interest rates and short-term capital movements? Also have you taken in account what seems to me to be a commonsense observation: That foreigners really are quite wacky and get in and out of the dollar for reasons which can best be described as zany? Should we do that which is by your own admission wrong with our own economy, namely, have higher interest rates than would otherwise be the case, in order to humor the nuttiness of foreign lenders?

It would seem to me a risky course.

I would like to have you expatiate on that a bit.

Mr. KLEIN. You see, I believe the dollar would have been under much greater pressure, given the really outside trade balance that we have had, the deficit, and the current account deficit, were it not for some favorable capital flows.

Now, the capital flows from abroad are subject to a number of considerations, political stability in America versus political stability abroad. If the French elections turn sour later this month, there will be some capital outflows. Many things are influencing the capital flows. The dollar has held up reasonably well, I believe. And I would not dispute the charts.

Nevertheless, I think we still have an option in keeping the dollar from getting worse by keeping what capital flows we have already coming and perhaps inducing more.

The possibility of direct investment, like the Volkswagen plant in Pennsylvania, are numerous on the scene, and I think that they would be very helpful in some of our external problems.

I think that the dynamics of a very rapidly falling exchange rate are ill-understood and a very dangerous thing to play around with. The side effects, particularly the oil effects, are very serious. For that reason, I think we have a very strong obligation in doing whatever we can to maintain stability of the dollar.

The CHAIRMAN. My skepticism derives, in part, from my own observation that in recent years, for instance, the Federal Republic of

Germany practically bought up the State of South Carolina at a time when German exchange rates were a great deal higher than those prevailing in South Carolina.

There are so many other factors that I would hate to give the new Chairman of the Federal Reserve Board, who will be before us the day after tomorrow, the idea that he is going to win brownie points around here by raising interest rates so as to help the dollar.

We should continue with this.

Professor Dornbusch?

Mr. DORNBUSCH. I wonder if I could take up a couple of the points Professor Klein has made.

I think there is no doubt that interest rates will do something for the dollar. The question is whether they could sufficiently reverse the trend.

First, with respect to oil, I think that the oil producers are quite well indexed. The inflow into the United States for placement in the United States has been less than one-third, so that means that the remainder must be in other developed capital markets. I assume it is in Switzerland and in Germany and in England. Those are the appreciating currencies.

Then, to some extent, we overestimate the losses to the oil producers. Of course, they have been investing in dollar assets. They have been losing money on those investments but they have money in other currencies making gains.

But, more importantly if you look at the dollar, you ask yourself, "Is it going to depreciate once more by that much, or is it going to come back?"

Well, a lot of people say it is very low now, and it may perhaps be already undervalued. It is not a time when you start shifting your assets into Swiss francs.

The further the dollar declines, the more the probability that it will go back, and I think that the dollar now is at the point where we would not expect large shifts of capital out of U.S. assets.

I would note, too, that for direct investment in the United States, the current exchange rate together with the labor-cost developments in the United States, make the United States an excellent place to invest in, compared to Switzerland or Germany. It is a first-rate investment.

Last, on the question of the rapid decline, I agree that we know very little about the effects, but I think they are not terribly dramatic as we have seen in 1973-74, where we had very large swings in the exchange rate on the order that we have seen in the last months. The increased alarm now comes from people who have money in dollars, including central banks, and they are taking losses; not losses in the real values, but book losses. And there is pressure for the United States to share in that.

If that argument is correct, then it is very much overstated. I think we should worry much more about the fact that the stock market is so disastrously low than the dollar.

Finally, when we say we should use high interest rates to keep the dollar up, of course, that doesn't come without a tradeoff. If we have high interest rates, we shift the mix of aggregate demand even more adversely away from investment, and I think that is not a policy the United States should follow, even from an international point of view,

because we need the investment to restore competitiveness and exploit the advantages that the real depreciation gives us. And I think we need the productivity growth that comes from investment to reduce inflation.

So, I don't really see a strong case to use high interest rates for the dollar. For one, we don't even know how high they would have to be. It may be we would have to create enough of a recession for foreigners to believe that inflation in the United States would come down, but I don't even then see that would bring in the capital flows.

So, I am very skeptical of the argument that increased U.S. interest rates would be a safe way of stabilizing the dollar without having major inconveniences on the domestic scene.

The CHAIRMAN. Let me ask Mr. Klein. A foreign mark or Swiss franc or a yen invested in the stock market on Wall Street is quite as good for our balance of payments, is it not, as an equivalent amount of foreign currency invested in a U.S. Treasury bill or a fixed-interest bond?

Mr. KLEIN. We want the capital flow. There may be a difference in direct investment, because that creates jobs. But it doesn't really matter.

The CHAIRMAN. You see, there is one trouble with raising interest rates higher than God ordained they should be raised from the domestic standpoint, and that is that you scare the hell out of the stock market and more people leave it. As the stock market goes down, you may lose more on people shying away from the stock market than you gain from coupon clippers investing in fixed-income securities.

Mr. KLEIN. Well, none of us do very well in forecasting the stock market, and if one were to believe the financial journalists these days, the slide of the dollar is contributing to the slide of the market. It is very difficult to say which is the causal factor in this situation.

The CHAIRMAN. All we do know is that the Dow Jones is lower than it was 12 years ago, and enthusiasm is minimal.

Thank you all very much.

I will now turn to Congressman Henry Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

I have some questions for Mr. Dornbusch, because of my particular role on this committee and on the subcommittee.

The aspect of intervention that you mentioned, where, if it is so successful, you lose money, is it not true that we pay interest on the borrowed marks, for example, and eventually buy them back in the open market with deflated dollars, and even though the swap arrangements that do exist may take care of some of those losses, is it not true that the losses nevertheless are fairly substantial? And do you have any idea what those would be to the Federal Reserve in the last few weeks or months?

I believe you mentioned \$30 billion last year.

Mr. DORNBUSCH. That was a comment on the accumulation by foreign holders.

Mr. GONZALEZ. Do you have any idea as to the extent of the losses or the range of the losses?

Mr. DORNBUSCH. If I can come, first, to the institutional arrangements, it is true that most of the foreign official dollar holdings are held in Treasury bills and therefore pay 6½ percent, which compen-

sates considerably the foreign holders for some of the dollar depreciation.

Now, on the losses, I have seen two sets of numbers, one set by Milton Freidman, that argue that there were consistently large losses on the order of, I believe, \$100 million a year. I find that is a large number, but that is in a Newsweek column, I believe.

I think Gov. Henry C. Wallich of the Federal Reserve Board testified before the Senate 2 weeks ago that the gains were \$25 million last year. Those are the only two sets of numbers I have seen, and I really have no idea what the order of magnitude is.

Mr. GONZALEZ. I did not get that last figure.

Mr. DORNBUSCH. \$25 million.

So, one says they were large losses, and the other says last year there was a gain, but I am not aware of what, in fact, the figures are or how they are made.

Mr. JORDAN. If I may comment, I believe the Federal Reserve reported an exchange loss due to exchange transactions of \$145 million in 1977.

Mr. GONZALEZ. In 1977. But you don't have any idea about what it would be, say, the last 6 months?

Mr. JORDAN. Well, the majority of their losses for last year would have occurred in the latter part of last year. Under a swap arrangement, the United States and the foreign partner share the exchange loss 50-50. Consequently, the amount of the loss in recent weeks, for instance, or since they announced the massive intervention potential beginning January 4, would depend upon how much of the intervention was conducted by us and by them. To the extent that it was conducted by foreign central banks, there is no exchange loss to the United States. To the extent that it was done by the Federal Reserve, the swaps eventually have to be reversed; and if we have to buy back the foreign currencies at a higher rate, then that loss will be shared.

Mr. GONZALEZ. One other question, more practical and more bothersome because of its immediate implications. I have had letters from some of our service families stationed in Germany, for example, and apparently they are suffering a lot more than the people back home realize because of the loss of the value of the dollar and because most are living on the economy in Germany.

What, if anything, can we do to rectify that? Now, I know we have maintenance of value with the international monetary institutions, but what about our own citizens, hapless citizens, that live in these countries and are really suffering?

The letters I get are disturbing, and very little is being said about that, if anything. Do you have any ideas or comments? What could we do from the legislative standpoint to try to tide over these families?

Mr. DORNBUSCH. I take it you want to adjust for local prices, as you do with U.S. civil servants abroad?

Mr. GONZALEZ. Do you know of any policy that our Government—and this would be an administrative matter, I am sure, probably concentrated in the Defense Department. But do you have any information as to the detrimental aspect of the depreciation?

Mr. KLEIN. One simple device, of course, would be to pay them in local currency, estimated to give some level of living. It would cost the U.S. Government more, but it would address their problem.

I think other American institutions that function abroad, certainly in scientific research centers abroad, follow a policy of no loss, no gain. An American traveling abroad shall be protected from loss of real income, either by local inflation or unfavorable exchange rates. And those kinds of things can be calculated.

This is a difficult calculation, and it has to be revised fairly frequently, but a fairly simple policy in the case of the military personnel would be to pay an equivalent amount in local currency.

Mr. DORNBUSCH. I take it the State Department uses exactly the arrangement that Mr. Klein outlined, and they have the indexes available, so if they wanted seriously to do that, I don't see much of a technical problem. You have a chart for all cities of the world, and you find the total, and you compensate by a commensurate increase in dollar payments.

Mr. GONZALEZ. The State Department does do that, you say, with respect to its employees?

Mr. DORNBUSCH. Certainly. AID does it. I am sure the State Department must do it.

Mr. GONZALEZ. Well, I am glad to hear that, because that must be a recent development. I know, in reading Robert Murphy's memoirs, he referred to the fact that they were underpaid, and when this kind of situation was confronted, they made up in their pay for the losses. So, I am glad to hear that, and it would be, then, I think, appropriate to find out if the Defense Department has or should enact such a policy.

There is just one final question, particularly to Mr. Jordan, because you make reference to these two base years, 1972-73. Why is it that I don't seem to see any reference—well, in anything I have seen from economists—to the inflationary growth or spurt in 1973 to the rather bad or defective stabilization, Economic Stabilization Act, and its administration and its controls and its removal. The first part of 1973, remember phase 3½, if I remember correctly, that is when we had a tremendous, sudden, and quick increase on our price levels. And also, I have seen very little reference to the inflationary phenomenon because, first, of the devaluations in 1971 and 1972, and then the rather imprudent removal as well as the imposition of the stabilization program. I find no reference to that. Everybody that mentions the causes or anything talks about the velocity of money or currency in the market and expansionary policies of the Government, but nobody has specifically referred to these two things as prime factors. And yet, it seems to me that, remembering that period, that cause and effect seem to be clear.

Now, I am just a layman, and I am wondering if I am in error and just haven't read enough, or whether there is, indeed, such an absence.

Mr. JORDAN. I think you have to distinguish between an ongoing inflationary process and a change in reported transactions prices and what that does to the price indexes.

Monetary growth in 1972 was very rapid. The price indexes under the phase 2 control program indicated an inflation rate of slightly less than 3 percent, something that very few economists believed was real. It was because, in a sense, the control program effectively controlled the price indexes. It did not necessarily effectively control inflation.

We simply weren't measuring it very well. A lot of distortions began to occur in the economy. They were most visible in the foreign and in the agricultural sectors.

You remember the stories about the drowning of baby chicks and the slaughtering of calves, and so on, followed by the lapse of the control programs going into phase 3 and phase 3½, and so on. The breakdown was the inevitable consequence of the pressures that were being built up by monetary stimulus in an environment of controls. The controls might have worked under phases 1 and 2, if monetary stimulus had not become excessive in 1972.

But that is a problem with controls. You may get a relaxation of the diligence of monetary authorities in pursuing their primary objective of price stability. I think that is what happened in 1972. The controls had to break down. The price indexes, in a sense, played catch-up, they jumped up to where they otherwise would have been anyway if they had not been held down artificially in 1972. So, you saw an acceleration in the reported rate of inflation to get up to the higher level of prices.

That was warranted by underlying conditions. Then, late in 1973, you had the sudden, sharp increase in oil prices, which sharply raised energy prices relative to all other prices. Because of the weighting given to energy in the price index, as you moved into 1974, a reported further acceleration in the rate of inflation occurred, raising the indexes to the higher level of prices associated with more expensive energy.

Mr. GONZALEZ. But had you not had the quadrupling in oil prices, would you not have had the cumulative effect, anyway, of that clumsy removal?

Mr. JORDAN. In 1973—for most of 1973, I agree. But I think that the further acceleration of inflation in 1974 would not have been nearly so severe, or it might have subsided in 1974—as was generally expected at the time. Late in 1973, there was a general forecast of declining inflation, and declining interest rates in 1974, and the bond markets actually rallied briefly; the stock market rallied on the expectation of lower inflation and lower interest rates.

It turned out to be wrong, because people were misreading the effects of the oil price increase. And so we had to go through a very difficult, unpleasant period in 1974.

All of that was a very, very high price to pay to correct some imbalances that had been built up in the economy.

Mr. DORNBUSCH. I would like to agree with Mr. Jordan on the monetary expansion in the early seventies, as the cause for the price increase once the controls were relaxed.

It is a textbook example for monetarism, unlike the remaining part of the seventies. You mentioned the depreciation as one of the causes. I think the early seventies were a period of worldwide inflation, and the United States was by no means out of line with the rest—although, of course, the depreciation may have contributed to it.

And, finally, I agree entirely, too, that the timing of the price increases—as opposed to the average level over 1971 to 1974—was affected by the controls, but not the cumulative increase in the level of prices.

Mr. GONZALEZ. Thank you, very much.



The CHAIRMAN. Thank you.

Mr. Steers?

Mr. STEERS. I would like to address my question to any one, or all three, of you. It relates to the continuing pile up of OPEC dollars, both those that have already accumulated, and those which I presume will continue to accumulate.

Is there, in your opinion, the likelihood that this pile up will force further devaluation of the dollar—possibly by non-OPEC nations who fear further devaluation, and want to get out before it is too late?

Mr. KLEIN. Well, in the past there have been some runs on currencies that have been thought to be related to OPEC shifting of funds. I think, particularly, when sterling was under pressure, about a year and a half ago or so, it was thought to be Nigerian funds being withdrawn from sterling balances on a massive scale.

Something like that could very well happen. I think the principal issue is to make investments in the non-OPEC world attractive to this large overhang, and particularly to make our own investment attractive.

Second, there is a big possibility of increasing our exports. Exports have been very good, in terms of magnitude, to OPEC nations. Their ability to absorb imports has been bigger than a lot of people thought at the beginning of this whole episode, and larger sales to OPEC as well as larger attraction of capital investment are probably the only way we have to deal with this situation.

But, there will always be a certain overhanging potential for speculative runs.

Mr. STEERS. Well, you say an “overhanging potential”; do you really believe that it will continue to just “overhang”? Or, won’t there be a further erosion of the dollar?

Mr. KLEIN. Well, I think not necessarily a steady erosion, but I think the real danger is that there could be very sudden shifts. You have to assume, in a situation like this, that a great deal of the OPEC money will be shifted on political grounds, and not on the basis of the underlying situation.

I think that really is the biggest danger in this situation.

Mr. STEERS. Mr. Jordan?

Mr. JORDAN. I find it useful to look at what happened to the oil prices and the stocks of dollar-denominated assets acquired by the OPEC countries in the following way. Prior to October of 1973, the prices of a barrel of oil and a bag of wheat on world markets were roughly the same. One barrel of oil equaled one bag of wheat.

The OPEC countries said: We are going to change the terms of trade. From now on, one barrel of oil is going to equal four bags of wheat, or equivalent commodities, but we only want two of them now, in the form of increased exports from us to them—their imports—and they wanted claims to the other two bags in the future. That is represented by their acquisition of dollar-denominated assets of one form of another—equities, land, hotels, or bonds.

Over the period since 1973 they have increased their current exports from us, but also we’ve increased our current exports of their output—oil—and we continue to give them claims to our future output.

That means that we haven't really, as a Nation, fully paid the price of the oil price increase, yet. The wealth transfer from us to the oil exporting countries has not really been paid, in the sense of reduced standards of living of the American consumers. Real output growth in the future is going to have to be faster to meet the higher export demand that their portfolio represents, or our standards of living—what the American consumer's or worker's income will buy—are going to go down.

He is going to feel like he is working harder, producing more, but not enjoying the fruits of his labor—unless we increase our investment and our ability to expand output to meet that increased demand for output.

Mr. STEERS. Well, do you really see any prospect for the dollar not to decline further, in view of what you have just said?

Mr. JORDAN. I think it has probably declined too much—I think the dollar is currently undervalued. That is an opinion.

Professor Klein. I agree with your statement about the shifts, for political reasons or whatever. I think what is happening to our equity market, the stock market in this country and the dollar in foreign exchange markets, are exactly the same; that there is a deterioration in confidence about the prospects for investing in real long-lived assets in America; that the after-tax, after-inflation returns are perceived to have gone down. And, once that process stops and people either stabilize in that expectation or start to revise up their expectation of returns from investing in this country, then both our equity market will improve and the dollar will improve relative to other countries.

But that will only happen once the perception, or the fears of inflation in the future, stabilize or maybe improve.

Mr. STEERS. Mr. Dornbusch, will you pull your microphone to about 3 inches from your mouth—not a foot? Because I haven't heard much of what you have said, to be honest with you.

Mr. DORNBUSCH. Well, I disagree slightly with the prospects for the return on capital in the U.S. economy. Because, for an asset holder, of course, one would have to ask: What else could she hold? And you don't really want to think of French stocks, or of British stocks. The prospects in those economies—both economic and political—are much less promising than in the U.S. economy.

I think what is happening in the foreign exchange market is that speculation has turned short term. You cannot really go after fundamentals if you are not certain that, in the next 1 to 4 months there isn't a further depreciation that may offset the real gains that you expect on trends that are very modest compared to what can happen in the exchange market.

So I think, for that reason, it is true that we have to create an atmosphere of more stability in setting out more clearly what the pattern of the U.S. continued recovery would be. But I don't think it is true that the U.S. assets have a lower expected return than those in the rest of the world.

I think if we can get the stock market up, then we will have the capital inflows.

Mr. STEERS. Thank you, Mr. Chairman. That is all I have.

The CHAIRMAN. Thank you, Mr. Steers.

Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

I enjoyed reading and listening to the comments today, and I hope that we can have a better understanding, and be ready to question thoroughly the new Chairman of the Federal Reserve Board.

One of the problems has been that last year, exclusive of OPEC, we had a 22-percent increase in foreign trade. What is the impact of that increase on devaluation?

Mr. KLEIN. Do you mean the increase in our imports?

Mr. VENTO. That is right.

Mr. KLEIN. Well, it is certainly the case that the big deficit on the current account, and the big deficit on the merchandise account, have been instrumental in pushing the dollar down.

It is a complicated process. There are other factors—inflation rates, and growth rates, and interest rates, on a relative basis—but if we had not had the OPEC increase—you can't subtract the whole \$45 million—but I suppose if it can be said that, at old oil prices of 1973, which is wishful thinking, we would have been—other things unchanged—close to balance.

Under that situation, I think the trade accounts would not have been responsible for the kind of dollar depreciation we have. That is an unreal situation because, if you did not have those oil prices, you would have a lot of other things changing at the same time.

Mr. VENTO. What you are saying, I think, Professor Klein, is that we should not try to leverage our changes in terms of devaluation, solely out of the 22 percent increase in imports?

Mr. KLEIN. No. Because we had good exports.

Mr. VENTO. I think most of us probably agree with that, but it is a significant rise as compared to what we have exclusive of OPEC, which is sort of painted as being the only problem. And I guess that it is not.

What is the likelihood of the Japanese, or the Western Europeans—West Germany, specifically—increasing their gross national product, or productivity this year, so that they become consuming? Isn't it, in essence, a real problem?

What is going to happen? What is the scenario going to be this next year? If we read the statistics, it hasn't been good. Historically, they have made some promises this year. What can we realistically expect? What do you expect in terms of models that you might be developing for this year?

Mr. KLEIN. Well, as I implied in my statement, world trade growth, and world production growth, were on the low side in 1977. They were below beginning-of-the-year expectations, and certainly below the pronouncements at the London summit of May of the major nations.

The prospects for the coming year, in my opinion, are somewhat better. That is to say, the growth in world trade ought to be somewhat larger in percentage terms in 1978 than in 1977. And, the growth rate in some countries that had restrained or difficult problems last year, will probably be somewhat better.

Everybody in the forecasting fraternity has been pushing very hard for higher growth rates in Germany and Japan. I would continue to argue along those lines, but I think the most sensible policy is to have a concerted reflationary movement among five or six other countries,

in addition to Germany and Japan. I would consider the low countries, United Kingdom, Canada, Australia, as possible candidates helping to stimulate the world economy and obtain somewhat better growth among those larger nations.

We will certainly help our exports a little, and make a small contribution to our trade position. However, the best hoped for prospects for next year don't put us in trade balance.

Mr. VENTO. Mr. Dornbusch?

Mr. DORNBUSCH. I would like to add some remarks. I agree broadly with what Professor Klein has said. I think one of the problems for our trade prospects comes from the fact that the stimulation in countries like Germany and Japan is mainly public-sector construction that has very little direct impact on U.S. exports.

There will be induced spending that would benefit us, but that really means that—

Mr. VENTO. It is well insulated, I guess.

Mr. DORNBUSCH. Quite well insulated directly, and one assumes administratively, so that is the first qualification that the effect on U.S. exports, even if the real income expands, will be quite a bit out.

The other is the problem of coordinating the recovery. If a country like Canada is to expand, they really have to wait to see the actions in the rest of the world. Because if they went ahead, their exchange rate would depreciate and add to the inflationary problems.

So those countries that could profitably expand, along with Germany and Japan, certainly think of the United Kingdom, in that context and France, won't until they really see the action. And Germany has been very reluctant—except for announcements.

But last on the medium-term trade position of United States, I really don't see a very large improvement, either from the proposed energy measures of the United States, or from the depreciation.

The world recovery will do something, but I think we won't get rid of the oil problem altogether. That will leave a residual problem, and I think we are facing growing competition from LDC's that, in the last 5 years, have really managed to go into manufacturing products. They are cost competitive now. They have to pay off debt. They will have to reduce their current account surpluses, and they will do it by promotion of exports.

Whether they are totally competitive, or they will rebate value-added taxes, or otherwise, I think the exports will show up and that will be a problem for the U.S. trade balance, once we go beyond the cyclical position.

Mr. JORDAN. I would like to add a few comments.

Your original question was on the relation between the trade deficits with the nonoil countries, and the devaluation of the dollar.

Our increased demand for foreign imports to us, if that had been matched by foreign demands—either for our exports or their demand for our securities—earning assets such as bonds, equities, or whatever—then we would not have had the devaluation, or the depreciation, of the dollar.

For the future, the solution to the deterioration in the dollar's value lies in either increased foreign demand for our exports, our reduced demand for their exports, or their increased demand for earning assets in this country—a portfolio effect.

Of last year's increase in the trade deficit, about \$1½ billion was associated with the higher price of coffee. This year we are not going to have that. Our total coffee bill is going to be less than last year, by quite a bit, maybe less than 1976. That is a positive.

The higher quantity of steel coming into this country costs us an additional \$2 billion or more last year. The conservative estimates are that we will have \$1 billion less in foreign steel costs this year. Optimists say it could be much greater than that because of the effect of trigger prices and the effect of appreciation of other currencies.

As far as Germany and Japan, they have had very substantial monetary and fiscal stimulus late last year, partly related to their intervention on the foreign exchange market. We have yet to see the lagged effects of that on their domestic economies. Even if it is not as strong as some people might desire, they pay for all of their raw materials—their inputs to production—in dollars. Japan imports 98 percent of its oil. They pay in dollars. The price of oil to them has gone down 25 percent. It is the same thing as if Saudi Arabia cut the price of oil to Japan.

They have a benefit from that. Everything they buy—the copper ore from the Philippines, iron ore from Australia—is all paid for in dollars, and it is all a lot cheaper to the Japanese now.

If there is any price effect there at all, they are going to be increasing their demand for the imports from all of these other countries. Those countries, in turn, are the ones, in large part, that have been lagging in their demands for U.S. exports—especially for machine tools and intermediate capital goods—and the United States is going to be very competitive on capital goods markets this year.

Countries like the Philippines and Australia are going to be able to afford to buy more from us. So, the prospects really are very good.

Mr. VENTO. One other point you touched on. I paid close attention to your remarks, Professor Dornbusch, on the intervention in terms of devaluation and the concern about it. I don't know if that theory is agreed to but, obviously, they were doing it for other reasons. They were going to protect their own competitiveness by becoming involved. If I understand properly what you are saying, is that we still pay the price but in a different way, and that it would be the height of folly now to go back and buy that money back by floating a large loan on which we pay interest, which, in essence, they have bought to eliminate the competition with U.S. products which have a lower price.

And I don't know what the others here—Professor Klein or Mr. Jordan—feel about that. I do understand your position correctly, do I not?

Mr. DORNBUSCH. Yes.

Mr. VENTO. And I am interested in what their reaction is to that. I find that to be a very interesting observation, and I am wondering if that is shared by the others here.

Mr. JORDAN. I don't think it really should be viewed, as it often is, as an "us versus the foreigners" kind of thing.

An exchange rate change influences domestic import competing industries as well as domestic consumers in the countries on both sides of the transactions. It is sort of an irony that with the dollar declining

relative to the Germans, they are unhappy about it and we are unhappy about it, as though we are both losers from it.

And what is happening is that their export industries are becoming less competitive relative to the United States because of their appreciation, even though their consumers are benefiting, but it is less observable. Our import competing industries, steel and auto companies, for example, are benefiting by the decline of the dollar, but that effect also is not as readily observable as the adverse effects—

Mr. VENTO. Excuse me. Insofar as they intervene against the dollar, though, we don't necessarily benefit. I think they are doing it for quite the other reason, are they not?

Mr. JORDAN. To benefit their exporting industries. And so our import competing industries don't benefit as much as if the foreigners did not intervene to that extent. And by the same token, the effect on our consumers of higher costs of foreign goods is not the same as if they did not intervene.

Mr. VENTO. Well, there seems to be a real problem in this country with regard to demand, control over inflation. Professor Dornbusch has touched on a subject and some of the things I think politically are very hard to live with, that we ought to keep the value of the dollar high, and we can go through a whole scenario here that makes a good campaign slogan, but not always very good economics. That becomes a concern as we try to deal with this particular issue.

Well, I think we could go on quite a while. I know I have exceeded my time, but I have just one other question which really relates back to the quarterly reporting to the House and Senate.

What would have been the impact, for instance, in terms of the monetary targets if they had been followed last year—in other words, if we had stayed within the bounds of those monetary amounts, those monetary targets, the growth targets that were set here for us in wonderful charts last year at about this same time, Mr. Chairman, and what would be the likelihood if we actually followed those growth rates this year? What would be the impact on us in this economy? What would happen in the economy if we had followed those growth targets?

Mr. JORDAN. I think we would have less concern about inflation in the future than we now do. We would not have the dilemma that, unfortunately, I think the Federal Reserve is going to face as we move through the spring months.

A year ago we had a very nice situation of not having to face up to an unpleasant short-run tradeoff. Now that is no longer the case. I think interest rates would be lower now, both long and short term, if monetary growth had been less than it was. If we had not had the kind of excessive monetary growth that occurred, I think that equity prices—the stock market—would be a lot stronger. If people had not observed the Federal Reserve substantially exceeding their monetary growth targets, they would not now have to contemplate the implications of some sort of a tightening move to correct those excesses. That is what the stock market is discounting, and that is what has got the market scared.

Mr. VENTO. The effect on unemployment you said was—

Mr. JORDAN. I think unemployment would not have been substantially different than it is.

Mr. VENTO. What would our growth have been without that increase?

Mr. JORDAN. The growth of real GNP from fourth quarter to fourth quarter was 5.9 percent, which was the highest rate that we have experienced in some time. Nominal income growth, as I mentioned in my statement, was the highest that we have had since 1950. They would have probably been somewhat less. But now the growth of real output is going to be less at some point in the future than it would have been if we had had slower money growth. Certainly, it would have been somewhat less than in 1977. But now it is going to be less sometime in 1978 or in 1979 as we correct the excesses that have been built in.

Mr. VENTO. In other words, if we had followed that pattern, all the benefits would have been attained?

Mr. JORDAN. We would have had a more stable past.

Mr. VENTO. And some additional benefits in terms of inflation and long-term planning; that is what you're suggesting?

Mr. JORDAN. Very definitely.

Mr. VENTO. Professor Klein?

Mr. KLEIN. Yes. I look at the same numbers and come out with quite different conclusions. But if the monetary growth had been somewhat lower last year, and indeed in between the two bands of your committee's charts, I think we would have had slightly higher rates of interest, and with some time delay that might have had a restraining effect on capital formation. Investment was not too bad, very close to 9 percent real growth last year. It would have had some effect on housing, although this sector has long time delays; we would not have seen very much of it in 1977.

I don't really believe that we would have seen a very different inflation rate. The real swing factors in our inflation rate last year were, as I said in my paper, the severe cold weather of the early months which caused people to shift to a very heavy fuel mix and very heavy imports of fresh fruits and vegetables—higher priced fresh fruits and vegetables—and a big swing in the summer months to almost flat inflation rates in our price indexes, because agricultural prices were low, and that was related not to money supply growth but to worldwide harvest conditions. Agricultural prices are enormously important in determining our Consumer Price Index and the swings in it.

So I think I would interpret the movement of inflation in this country in real terms and not in monetary terms last year. Had we had those higher rates, though, higher rates of interest associated with a more restrained growth in money supply, then there would be a spillover effect to the coming year, and in terms of the time delays in capital formation decisions, we would be in for a little more trouble than we are having at the moment.

Now, in the projection that I distributed this morning, there is a tendency for an upward drift in short rates, a little bit in long rates as well. The  $M_1$  figures on that tabulation are just about in line with the upper range of your committee's targets for  $M_1$  growth, so that the slightly higher levels of  $M_1$  last year, if projected with current policies in place, don't lead us to a very excessive growth rate in the coming year.

I would say that, all in all, monetary policy has been about on target, if you take a longer view than just 1 year and if you think of continuing present policies into the near-term future.

Mr. VENTO. Thank you.

I know I have way exceeded my time here.

The CHAIRMAN. Well, if Professor Dornbusch has something to answer, surely he may.

Mr. DORNBUSCH. I would just say that I don't think monetary policy was excessively stimulative. There is a direct effect from money growth to inflation. Inflation is made out of aggregate demand and accidents. So if the Open Market Committee went out and reduced the monetary growth rate, we really would not see a decline in the rate of inflation in the near term. We would first have to go through a reduction in housing construction, and the main channel would be interest rates.

To know what would have happened on the interest rates under a tighter monetary growth, we can look at Professor Klein's chart and see what he has said would happen to interest rates this year. I think the proposed monetary growth is on the tight side, and interest rates will be rising, and with the conventional lags it will reduce investment spending and, in effect, housing construction.

Mr. VENTO. I will look at this point and comment, Professor, about your comments concerning demand and inflation—and apparently you don't feel that holds true necessarily for availability of dollars. Although I think what you are saying is in an aggregate sense, that demand as such does not have the correlation with inflation that is attributed to it necessarily, but you are qualifying that in the sense that you say there definitely is some relationship between the availability in terms of monetary supply and interest rates so that in that case demand does have an impact.

Is that accurate?

Mr. DORNBUSCH. The linkages are between money, interest rates, and spending, and the further linkage between the spending relative to capacity, utilization, and inflation. But there is no direct effect from money on inflation independent of the state of aggregate demand, and I think that is amply demonstrated.

Mr. VENTO. Well, Mr. Chairman, if I might be permitted, I have just one more question, it is just more really of a statement, but that is with respect to foreign investment in the United States.

I appreciate Mr. Jordan's comments about it is not us and them, because I think that holds true, especially with regard to foreign investment in this country.

If I recall correctly, historically we have done very well in terms of gathering capital resources from Britain and from all over the world to build this country into what it is today. I am not really very concerned about the fact that we can get OPEC capital back in here, because I think it does tend to cause the type of growth that we need to keep going, to keep the engine going, in terms of the world economy. And I don't think the hope for Japan or Western Europe is very good in terms of GNP overall growth unless they see us growing at the same time, because their growth is so dependent upon exports to this country. And if we have an economy here which is in essence static, their



likelihood of committing to more production and to more growth is really a major disincentive, not just for them but for the world economy. And I don't know that all of us and all of our study and you and your expertise—and it is of a very high caliber—have put together the answers to all of these questions.

But I just wanted to finish by saying I wanted to thank the committee for putting up with my long questioning and for your responses.

Thank you.

The CHAIRMAN. Thank you.

I want to express my gratitude to the panel for a really brilliant contribution to our deliberations.

Two days from now, you know, the new Moses will come down from Mount Sinai with the tablets and tell us what the monetary aggregates may be. In advance of that let me ask you, Professor Klein, if you would prefer a target band of 5 to 7 percent rather than the present 4 to 6½ percent for  $M_1$ ?

Mr. KLEIN. Right.

The CHAIRMAN. Professor Dornbusch, what would you prefer?

Mr. DORNBUSCH. Five to seven and a half.

The CHAIRMAN. Mr. Jordan, if my understanding is right, you said that you could sit still for the present 4 to 6½ percent if they really stuck to it, but if you are going to go to 4- to 6½-percent target and then wild deviations on the up side—would it be right to say that you would sooner have an honest 5 to 7 percent than a fraudulent 4 to 6½ percent?

Mr. JORDAN. Definitely.

I would be just as concerned about shortfalls to the 1- or 2-percent range for some reason as an overshoot into the 8- to 9-percent range.

The Fed should set a target and hit it.

The CHAIRMAN. I conclude with my plaudits to a superb panel. Thank you very much.

We will stand in adjournment until 10 a.m. Thursday morning.

[Whereupon, at 12 p.m., the committee adjourned, to reconvene Thursday, March 9, 1978.]



## QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

THURSDAY, MARCH 9, 1978

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,  
*Washington, D.C.*

The committee met at 10 a.m. in room 2128 of the Rayburn House Office Building, Hon. Henry S. Reuss, presiding.

Present: Representatives Reuss, Moorhead, St Germain, Gonzalez, Minish, Annunzio, Hanley, Mitchell, Blanchard, LaFalce, Spellman, Tsongas, Derrick, Hannaford, Allen, Lundine, Cavanaugh, Oakar, Mattox, Vento, Barnard, Garcia, Stanton, Wylie, Rousselot, Hansen, Hyde, Kelly, Leach, Steers, Evans of Delaware, Caputo, and Green.

The CHAIRMAN. Good morning. The House Committee on Banking, Finance and Urban Affairs will be in session for its dialog with the new Chairman of the Federal Reserve Board.

Some weeks ago, I was called by the Vice President, who announced that the selection had been made—which he was very proud of—for Chairman of the Federal Reserve. I said, “That is great; who is he?” Mr. Mondale replied that his name was Miller.

“That is marvelous,” I said. “We have not had a Milwaukee brewer as Chairman of the Fed at any time in history.” He then set me straight.

After a little historical research, I think the President made an extremely wise decision, and I think the Nation is very fortunate. We are fortunate, in that one of the ablest and most respected members of our committee, Congressman Fernand J. St Germain, of Rhode Island, is a neighbor and friend of the new Chairman of the Federal Reserve Board.

Mr. St Germain, I know you would want to make a little personal statement, so I recognize you for that.

Mr. ST GERMAIN. Thank you, Mr. Chairman. I hope you won't hold me to “little,” because it is a most unusual opportunity for me to introduce the most unusual man to the committee as the new Chairman of the Federal Reserve Board.

It is an honor for me this morning to present formally to this committee the new Chairman of the Federal Reserve Board. Today's headlines on our Nation's economy represent some awesome challenges for this man as the new Chairman of the Board, as well as for each and every one of us.

I have some thoughts, as a result of knowing him and listening to him, as to why he accepted this challenge, and I feel that they will tell a lot about why he is the man for the job.

Recently, I heard Mr. Miller speak to a group of bankers from the State of Rhode Island at a reception here in Washington, and he told us why—at the summit of a lengthy successful business career—he decided to accept the President’s invitation to become the Chairman of the Fed.

In many ways, it was a simple reason. The strength of our economic system is being sapped by uncertainty and indecision; but, Mr. Miller believes in our system. He feels a debt to a society and a system which means a great deal to him. He believes he can help to restore the vitality of our economy.

When you have those beliefs, clear, simple, and strong, you also have a responsibility to serve, and that is why he chose to take up that responsibility. Increasingly he sees the people and the leaders of our Nation taking a morbid fascination in the negative—and missing the positive: The enormous strength that we can build upon. He said and I quote:

We talk about unemployment and forget that we have the highest employment in our history. We focus on the battered dollar, yet we fail to note that it is still the world’s currency. We worry about our economy and our ability to produce, and forget that we have the highest GNP in history. We turn our attention to scandals or problems in one industry or another, and forget the vitality and creativity and productivity that continue to make us the envy of the world. We forget the positive.

As we look at the challenges facing us, we should all take a vow that for just 1 year we will stress the positive in our economy, and in our Nation—just for 1 year, let us look at what we have going for us. It is a far more imposing list than any catalog of troubles and if we can just once start focusing on the positive, we will find that list of troubles shrinking.

That is what Mr. Miller said to his colleagues from Rhode Island the other evening.

I think we all share his convictions, and his faith in America.

We have all read, as well, about his achievements in his personal life. His contributions to the Rhode Island community over the years—despite the fact that he headed up a corporation that had 64,000 employees, and 180 major facilities here and abroad—he was actively involved at all times in civic and national affairs.

He has concerned himself with urban problems, and the problems of unemployment and of minorities.

He has been the chairman of the President’s Committee for HIRE that works to find job opportunities for Vietnam veterans. In the sixties, he was on the President’s Committee on Equal Employment Opportunity, and the Chairman of its Industry Advisory Council.

He has been a director of the Coalition of Northeastern Governors, an advisory group to the Governors. In Rhode Island, he has exercised vigorous leadership in several major projects important for the revitalization of that State.

He is a man of unusual energy, superb intelligence, and very high moral standards. And, you know, I hope that many of you will also get to know his partner—his wife—who is a most unusual lady, as well. And, as the old adage goes, “behind every man, there is a woman who is responsible for his success,” and in this instance it certainly holds true.

To each and every one of you, my colleagues on this committee, this is one of the very proudest days in my life and in long service on this committee, to introduce Bill Miller to you.

You know, he served in the Coast Guard, and the motto of the Coast Guard is "Semper Paratus," always ready, and he has always been ready.

He has just weathered some unusual storms, but he came through them with flying colors. And we are very happy for that.

I would just conclude, Mr. Chairman, by saying to you and the members of the committee, and to everyone here assembled, that perhaps we should give him a little hand because today, believe it or not, is also his birthday

Happy birthday, Mr. Miller.

[Applause.]

The CHAIRMAN. Thank you very much, Congressman St Germain, for your eloquent remarks. I associate myself with every syllable of them, and I am sure every member, on both sides of the aisle, does likewise.

I have prepared a somewhat lengthy 10-page opening statement of my own. I gave Chairman Miller a copy of its yesterday and it is available to the press. Under the rule, and without objection, I would ask that it be inserted, in full, in the record. At this point, I would just briefly like to sum up the opening statement and then we shall hear from our witness.

I, too, want to welcome you, Mr. Miller, as the new Chairman of the Federal Reserve.

The Federal Reserve Reform Act of 1977, which became law last November, requires a somewhat greater precision of statement from the Federal Reserve in these dialogs than was true in the past.

Specifically, it asks that the Federal Reserve take into account—and I am quoting—"past and prospective developments with respect to production, employment, and prices."

The committee report on the legislation makes clear that this requires some discussion on matters of fiscal policy, monetary velocity, and interest rates.

Last year, growth of the basic money stock came to 7.4 percent, the highest since 1972. Looking back upon it, it does not appear to have been excessively high and it did serve to fuel a healthy rate of growth, without exacerbating inflation.

Projections are for a somewhat slower real GNP growth rate in 1978. Consequently, in my view, a rate of money growth similar to last year's would imply a more moderately expansive monetary posture. Such a policy may well be just what we need.

I also hope that you will be able to comment on the relationship of the new targets to the previously announced targets for the first and second quarter of 1978.

As you no doubt know, to meet the target for 1978 for this first quarter, money growth would have to be less than 1 percent per year in the present quarter. This would seem to me a calamity, that none of us wish to advocate.

Over a longer horizon, another question of targets arises. The Economic Report of the President calls for a rate of growth of real GNP of between 4.5 and 5 percent this year and next, and a progressive reduction of unemployment to between 5.5 and 6 percent in the same time.

Your colleague on the Board of Governors, Henry Wallich, recently, in a speech, concurred that they are reasonable goals, and that they can be reached. I would hope that you would find yourself in agreement with Mr. Wallich on that point. For the period beyond 1979, however, the President and Governor Wallich, part company.

The President's Council of Economic Advisers looks for an unemployment goal that will continue falling to 4 percent by 1983. Governor Wallich, for his part, denies that possibility, and favors what he instead calls a soft landing, meaning sustained growth rates of real GNP between 3 and 3¾ percent from 1980 onward, with little or no decline in unemployment from the level of about 5.5 percent.

We, of course, will be interested—if not this morning, as soon as possible—in your views on that question.

Finally, the relationship between monetary policy and the international value of the dollar has become a matter of intense concern to us all.

Members of this committee, including myself, are watching intently the intervention in which our country is now engaged in trying to bet the \$20 billion or so that we may have to fool around with against the trillions of dollars that are amassable by speculators on the other side.

[The complete opening statement of Chairman Reuss follows:]

OPENING STATEMENT OF CHAIRMAN HENRY S. REUSS  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
U.S. HOUSE OF REPRESENTATIVES  
AT HEARINGS ON THE  
CONDUCT OF MONETARY POLICY  
BY THE FEDERAL RESERVE

It is a pleasure to welcome you, Mr. Miller, as the new Chairman of the Federal Reserve, to our first hearing pursuant to the Federal Reserve Reform Act of 1977.

1. This Act requires that the Federal Reserve present a more complete statement than in the past of the basis on which monetary policy has been formulated and the objectives toward which it is directed. In the words of the Act, the Federal Reserve shall report its targets for the growth of the monetary and credit aggregates, "taking into account past and prospective developments with respect to production, employment and prices." Thus, a statement of the rate of growth of real Gross National Product, of the rate of unemployment, and of the rate of inflation that you believe is compatible with the target ranges of monetary growth you are announcing is now a formal requirement of the reporting system.

The Committee Report on this legislation further noted that to meet this requirement would "require discussion of such matters as fiscal policy, monetary velocity, and interest rates." In par-

particular, as the legislative history of the Federal Reserve Reform Act of 1977 makes clear, a discussion of future trends in interest rates should be part of the Federal Reserve's quarterly report to Congress. In the Report (No. 95-774), I noted that since moderate long-term interest rates are stated as a goal of monetary policy, it is necessary for the Federal Reserve to present their view of prospective developments in interest rates. My colleague, Congressman Stanton, the ranking minority member, agreed "that in his view, as in that of Chairman Reuss, it is 'implicit' that interest rates be taken into account in the quarterly dialog, when moderate long-term interest rates are stated as a goal of monetary policy." (p. 5) We are not, of course, asking you to reveal your short-term targets for the Federal funds rate. Rather, you should tell us whether or not you expect interest rates, both short-term and long-term, to rise or fall, and whether the Federal Reserve expects that its planned money growth path will tend to accommodate or to oppose this trend.

2. Last year, growth of the basic money stock came to 7.4 percent. This figure, while the highest since 1972, was not excessive in context; it served to fuel a healthy rate of growth without exacerbating inflation. If anything, the Federal Reserve leaned slightly against the wind of economic growth in the latter part of the year.

Projections are for a somewhat slower real GNP growth rate in 1978. Consequently, a rate of money growth similar to last



year's would imply a moderately more expansive monetary posture. Such a policy may be just what we need. Not pushed to excess, it would lower interest rates, encourage investment, and help us meet some of the important capital needs that may otherwise face us as bottlenecks a year or so hence. It would offset the bias toward consumption which has characterized policy in recent years. To keep the economy on a moderate overall expansion, we could offset such monetary encouragement with a little fiscal restraint -- perhaps achieved by substituting a cost-effective direct attack on structural unemployment for some of the Administration's proposed tax cuts, as I have long advocated. Incidentally, your views on structural unemployment, and how we fight it, I find very similar to my own.

Your statement of the Federal Reserve's target growth bands for the year ahead will say much about the Federal Reserve Board's attitude toward such a trade-off of monetary ease and relative fiscal restraint. I hope the target band will be high enough to permit such a possible policy blend. Even if it is not, I would like your reaction, and that of the Federal Reserve, to this idea.

3. I wish you would also comment on the relationship of the new targets to the previously announced targets for the first and second quarters of 1978.

Last Summer and Fall, as you know, the actual money supply jumped far above the upper target band. Since this did not accompany any fall in interest rates, but rather a rise, it is my view

that unusually strong credit demands, not an unusually eccentric monetary growth policy, was the cause of the divergence. But there is a consequence that remains to be dealt with. Since such rapid money growth took place last Summer and Fall, the targets set in 1977 for periods ending for the first two quarters of 1978 are now unrealistic. To meet the target for 1978, first quarter, money growth would have to be less than one percent per annum in the present quarter. It would have to be less than five percent per annum over the first two quarters of this year if the targets for second quarter 1978 are to be met. I do not advocate such recessionary growth rates, and I hope you agree.

The Federal Reserve Reform Act, of course, does not require that any particular set of targets for the monetary aggregates be met. However, it will be a matter of great interest to this Committee if the targets for the first and second quarters should now be disregarded, and we would appreciate your so saying.

4. Over a longer horizon, another question of targets arises. The Economic Report of the President for 1978 calls for a rate of growth of real GNP of between 4.5 and 5 percent this year and next, and a progressive reduction of unemployment to between 5.5 and 6 percent in the same time. In a recent speech, your colleague on the Board of Governors, Henry Wallich, concurred that these are reasonable goals and can be reached. I trust I do not presume too much in presuming that you are also broadly within this consensus.

For the period beyond 1979, however, the President and Governor Wallich part company. The budget projections presented in the Economic Report are for unemployment to continue falling to 4 percent by 1983. The Council of Economic Advisers admits this is a difficult goal: "for it would imply that actual GNP would exceed our present estimates of potential GNP". Nevertheless, with the aid of suggested structural and labor market policies, the Council of Economic Advisers prepares to do battle with this objective in mind.

Governor Wallich, for his part, denies the possibility of achieving 4 percent unemployment, "in the absence of an incomes policy of a sort that so far the nation has shown no willingness to apply". Mr. Wallich favors what he calls a "soft landing": sustained growth rates of real GNP between 3 and 3 3/4 percent from 1980 onward, with little or no decline in unemployment from the level of about 5.5 percent.

Where, in your own view, do the limits to the "art of the possible" lie? With what perspective on the prospects for long-range real GNP growth and employment do you plan to guide monetary policy over the next few years? How, if required to do so, would you plan to bring Federal Reserve monetary policy into the broader canvas of a unified economic strategy?

5. Discussion of long-range economic objectives leads to another important issue: the appropriate format and subject mat-

ter for Congressional oversight of monetary policy. This Committee takes its responsibilities on this question very seriously. We worked hard to pass the Federal Reserve Reform Act of 1977, to tighten the links between Federal Reserve reporting of long-range monetary targets and the discussion of real economic objectives -- maximum production and employment, stable prices, and moderate long-term interest rates -- which the operation of monetary policy is designed to achieve. In the past, getting forthcoming and open discussion of these questions has not always been easy. I am confident that we can start today to put our interchange on a less adversary, more open, and more informative basis than we have had in the past. The Humphrey-Hawkins bill, currently under debate in the House, will conduce toward this end.

6. Finally, the relationship between monetary policy and the international value of the dollar has become a matter of intense concern.

By law, the Federal Reserve may intervene in foreign exchange markets only at the direction of the Treasury. By long-established principle, intervention is called for only in response to "disorderly market conditions". In August, 1975, after joint hearings, the Subcommittees on International Economics of the JEC and on International Trade, Investment and Monetary Policy of the Banking Committees agreed on the following recommendation:

The United States monetary authorities should intervene in exchange markets only to combat or pre-

vent the emergence of disorderly conditions.  
Intervention should not attempt to influence  
the trend of exchange rate movements.

Lately, the Federal Reserve has intervened repeatedly to support the dollar. Although it may be possible to maintain that on each such occasion "disorderly conditions" prevailed in the context of that day's trading, these conditions have shown a decided tendency to recur. Each time, the dollar's fall is made more severe, not less so, by the past efforts of the Federal Reserve and foreign central banks to support the dollar.

I want to distinguish two issues here. First, there is the use of swap agreements -- under which the Federal Reserve borrows foreign currency from allied governments and uses it to purchase dollars, with repayment stretched out over weeks and months. The FRB now has swap lines totalling \$20 billion with Germany, Japan, Great Britain, and a few others. Perhaps -- and you can enlighten us on this point -- some of those lines are now exhausted?

Swaps are an appropriate counter to truly disorderly market conditions. If disorder is the problem, intervention will be short-lived and successful. Swaps cannot, however, stall a declining trend. Twenty billion dollars, cast into a \$500 billion market, can be lost in an afternoon. Speculators know that intervention cannot go on forever: so today's rise merely ups the stakes and the pressure for tomorrow's fall. The policy, in sum, is costly

and ineffective.

I would specifically like your comments on the following questions:

- 1) With whom does the Federal Reserve have swap agreements and in what amounts?
- 2) To what extent have those agreements been used since January 1?
- 3) Of the swaps effected, what portion have now been repaid?
- 4) What has been the net profit or loss on each transaction? (I understand that these are then shared with participating foreign governments.)
- 5) What evidence is there that the swaps have contributed to a stronger dollar over the past ten weeks?

Incidentally, I would appreciate from you, if not this morning, as soon as you review your testimony, a definition of "disorderly markets". I have a dark suspicion that disorderly markets are what happens when central banks intervene; when central banks fail to intervene, markets are not "disorderly". Cannot we do better than this?

The second issue is the manipulation of domestic interest rates -- the Federal funds rate and the discount rate -- to support the international dollar. On January 6, such a policy was explicitly invoked to justify a rise in the discount rate from 6

to 6.5 percent. International objectives are also implicated in the rise of the Federal funds rate from 6.56 percent in December to 6.78 percent today. The Treasury bill rate leaped 42 basis points from December levels in the second week of January, and has maintained this high level ever since. Over the same time, the basic money stock has declined about \$900 million. Are these the causes or effects of Federal Reserve use of domestic credit markets to support the dollar? If so, was this also done under explicit Treasury instruction?

I hope the answer is no. For such a policy, unlike swap agreements, does indeed work. Higher interest rates attract foreign capital, if there are not offsetting movements in foreign interest rates. Higher interest rates also slow our economy, including our demand for oil imports, which improves our balance of payments and hence relieves the real pressure on the dollar. The result: a healthy dollar and a sick economy.

In current conditions, the Federal Reserve should refrain from interest-rate intervention. If surplus countries want to hold the dollar up, let them lower their interest rates: such action tends to expand their economies, whereas if we do it the effect is contractionary. For our part, we should concentrate on real problems: controlling our use of oil and stepping up our exports. The Federal Reserve should abandon at once any use of domestic monetary policy in support of exchange rate objectives. Such objectives, under present circumstances, are inconsistent with the objectives prescribed by law for monetary policy: maximum production and employment, stable prices, and moderate long-term interest rates. I look forward to your assurance that in the future the Federal Reserve will adhere to these objectives and refrain from pointless, ill-fated foreign adventures.

The CHAIRMAN. From this, you may well gather that I am not interventionists' most hearty enthusiast. I think this gives some sense of what is on the minds of most of the members of this committee.

We now, under the rule, and without objection, will receive in full your statement into the record, and ask that you proceed in any way you would like.

Before that, however, I wish to recognize our distinguished ranking minority leader, Congressman J. William Stanton of Ohio.

Mr. STANTON. Thank you, Mr. Chairman.

And Mr. Miller, I had my prepared remarks here to personally welcome you, and not only by myself but on behalf of the minority. Regrettably, not too many of us are here, yet, but I am sure that they will be coming along in a couple of minutes.

I want to repeat that though, and to extend you a warm welcome, and wish you the best in your new position.

One cannot move from one Chairman to another quite so quickly, though, without just a couple of remarks about our past Chairman. And I am sure that you would agree, and I think it would probably put it in the best light, Mr. Chairman, if I would inform the committee that here this afternoon in the House we are putting a joint resolution forward to express our appreciation to Dr. Burns.

I am joined in this by my colleagues, on a nonpartisan effort, and with Lud Ashley and all the members.

The CHAIRMAN. And would you add my name to the list?

Mr. STANTON. We will be coming back to the committee, and we are glad to have your support, Mr. Chairman—I knew, of course, it was there. The resolution reads:

To express the appreciation of the Congress of the United States to Dr. Arthur F. Burns.

Whereas Dr. Arthur F. Burns has concluded 8 years as Chairman of the Federal Reserve Board, a position ranked by many observers as second only in importance only to the Presidency itself; and

Whereas Dr. Burns has served under five Presidents and has served them and the American people faithfully and well; and

Whereas Dr. Burns, by his tireless efforts to protect the integrity of the American dollar both at home and abroad, and by his counsel and advice in improving the international monetary system, has gained unequaled universal respect among the free nations of the world; and

Whereas Dr. Burns, as Chairman of the Federal Reserve has acknowledged to a greater degree than any of his predecessors that the Board is independent and a creature of Congress, and has also fought long and hard to show the wisdom of keeping monetary policy decisions in the hands of our central bank; and

Whereas Dr. Burns, as an individual, blessed with high moral personal standards combined with a keen sense of humor, and by his courteous, thoughtful and forthright personality, has won the friendship and admiration of individual Members of Congress and the American people; and

Whereas Dr. Burns has served this Nation in various capacities since 1930—as President and Chairman of the National Bureau of Economic Research, as chairman of the President's Council of Economic Advisers from 1953 to 1956, as a Member of the President's Advisory Committee on Labor-Management Policy from 1951 to 1966, as Counsellor to the President in 1969, and as Chairman of the Federal Reserve Board from February 1, 1970 through March 8, 1978. Now, therefore, be it

*Resolved by the Senate and House of Representatives of the United States of America in Congress assembled*, That the Congress herewith expresses its appreciation to Dr. Arthur F. Burns for his long superb service to the United States of America and its people and does further express the hope that Dr. Burns will continue in his role as senior statesman in economic affairs, reflecting his qualities of economic integrity and stability.



Now, Mr. Miller, Dr. Burns is gone, and you are with us, and I know that I can only express the sentiments that we heard at your swearing in yesterday. I was sitting next to a Senator, and after your fine remarks, he turned to me and he said, "I am glad he is not running as a politician in my State."

And I would only forewarn you that we enter these hearings, which we have set up, of course, by law, and having had an opportunity to read your fine opening statement, that you will fully come to realize, of course, that the questions you hear either from me or from the chairman reflect personal opinions, not necessarily, in most cases, of the Banking Committee.

I hope that Chairman Reuss would not push his five questions that he has included in his opening statement, of which you and I received a copy yesterday. These intervention operations are kind of like a poker game, and I think to divulge the information that has been requested would put our players in an international banking game of foreign exchange transactions in a position of putting all of his chips and his cards face up on the table, so that all of the participants in the game could play with our chips without our players having to guess blind about what the other players do.

This morning, the Washington Post carried a story about the intervention of the Fed, which has reached a record, and it gives details. I hope perhaps, Mr. Chairman, that maybe reports such as this, giving information only 6 weeks old, will satisfy your requirements without pressing for information right up to the minute which, if divulged, in my opinion, could produce self-defeating and possibly self-destruction reactions to the foreign exchange markets.

If Congress really wants to do something to improve the position of the dollar, we should direct our efforts to controlling inflation and a reduction of expenditures resulting in a prospective budget this year of at least \$62 billion.

Mr. Miller, we welcome you, and good luck.

The CHAIRMAN. Thank you, Mr. Stanton.

Mr. Miller, would you now proceed?

#### **STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. MILLER. Mr. Chairman, I want to thank you for your welcome. And Congressman Stanton, I certainly appreciate your kind remarks.

As I said yesterday, Arthur Burns is one of those people who truly is a legend in his own time, and I am pleased and gratified to know that you are planning this joint nonpartisan resolution to give recognition to his great service.

In connection with my own transition at the Federal Reserve, Dr. Burns has been of tremendous help, which is just another demonstration of his unique qualities and character. He has been totally supportive and has greatly eased my way into my new assignment.

I have the good fortune to be assuming the position of Chairman of the Federal Reserve and to have my own Congressman here from my own district to welcome me. It is fortunate that Congressman St Germain is on this committee. And Mr. Congressman, I am grateful

for your remarks. I know that you mean them from the heart, and I appreciate them greatly, and I thank you.

I would also like to express to this committee, Mr. Chairman, my personal appreciation that so many of you did attend the swearing-in ceremony yesterday. I was very pleased that there was the interest and willingness to do so, because I do believe we have the opportunity to work together in some important areas, and I think that that demonstration of interest in the process of succession at the Federal Reserve bodes well for a good working relationship in the future.

As you know, this is my first official appearance before any congressional committee. It is very propitious that it should be before this committee, and I am pleased that it worked out that way.

Of course, we had scheduling problems, and it may have been that the chairman had an arrangement with Senator Proxmire to delay my confirmation until after the Budget Committee or the Joint Economic Committee hearings so I could testify here first; if so, it worked. But I am finally here.

Mr. Chairman, with your permission, I would like to read the official report that is being filed today with this committee. It carries out, as you know, the responsibility of the Federal Reserve, the Board of Governors, and the Federal Open Market Committee to report and consult with this committee on the monetary aggregates, taking into account the prospects for production and inflation, and the economic outlook for the country.

I don't know if this statement sets a precedent, but it is, I understand, the shortest ever delivered on this subject. I don't know whether that will be favorably received or not. Since my nature is to be brief, we may have even shorter reports in the future.

But I do say how pleased I am to be here, and that I do look forward to participating in these sessions in the future.

During the past year, the Federal Reserve continued to pursue the objective of fostering financial conditions consistent with expansion of economic activity and moderation of inflationary pressure. Gross national product—the broadest measure of economic activity—rose  $5\frac{3}{4}$  percent in real terms during 1977, about the same rapid pace as we experienced on average in the earlier stages of the current recovery. However, the rate of inflation remained disturbingly high.

Very recently, sales and production have weakened, but this seems to reflect mainly—if not entirely—the temporary effects of the unusually severe winter weather and the coal strike. While prolongation of the strike could lead to more extensive economic disruption, basically our economy is strong, and the year 1978 should see continued expansion in economic activity at a moderate pace and a further reduction in the unemployment rate. At the same time, recent trends provide little basis for optimism with regard to an abatement of inflationary pressures.

The brisk increase in production last year made it possible to reduce unemployment significantly despite further large growth in the size of the Nation's labor force. In the past 12 months, the jobless rate has fallen more than a percentage point. Total employment has risen by more than 4 million, and the proportion of our population that is employed stands at the highest level in the postwar period.

The advance of production and employment during the past year was broadly based, with most of the major sectors of aggregate demand registering good gains. Consumer spending followed an uneven course during 1977, but for the year as a whole growth was substantial by historical standards. Residential construction continued to provide considerable impetus to expansion, with single-family housing starts reaching an exceptionally high level and multi-family building also posting appreciable gains from earlier depressed levels.

Business fixed investment expanded somewhat more rapidly in 1977 than in earlier years of the recovery, although such investment continued to lag well behind its performance in previous cyclical up-swings. The pace of governmental spending—at both the Federal and the State and local levels—also picked up last year.

As domestic activity expanded rapidly, our imports of goods from abroad continued their steep climb, boosted by our increasing appetite for imported oil. Meanwhile, the sluggish performance of economic activity in other major industrial countries limited the demand for our exports. As a result, our trade deficit deepened from about \$10 billion in 1976 to more than \$30 billion in 1977.

The widening of the trade deficit contributed importantly to the downward pressure on the exchange value of the dollar over the past several months. The Federal Reserve, in cooperation with the Treasury, has taken steps to counter disorder in foreign exchange markets and to emphasize U.S. concern about the integrity of the dollar. But the key to a sound dollar and a stable world financial system lies ultimately in the resolution of some of our fundamental, longer range economic problems. In particular, we must establish an energy policy that promises to reduce our reliance on foreign sources of petroleum; we must create a better climate for business investment, so as to enhance labor productivity and to increase our international competitiveness; and most importantly, we must make progress toward the restoration of domestic price stability.

One of the great disappointments of the past year has been the lack of progress in reducing the pace of inflation. Wage increases have continued to outstrip gains in output per hour worked; unit labor costs in private industry have again risen substantially; and prices have been trending upward at about a 6-percent annual rate.

Prudent monetary management is, of course, an essential ingredient in the control of inflation over the longer run. Too much money growth would add to inflationary pressures and would tend to encourage still larger increases in wages, costs and prices.

Confronted with very strong demands for money and credit this past year, the Federal Reserve took actions to moderate monetary growth and to help insure that inflationary forces would not get out of hand. Although interest rates have risen, domestic financial markets have remained supportive of economic growth. Supplies of credit have been ample, with the total volume of funds raised in the Nation's money and capital markets approaching \$400 billion in 1977—a record both in dollar terms and as a percentage of GNP.

In the household sector, mortgage loans accounted for the bulk of an unprecedented increase in indebtedness. Families sought mortgage

credit not only to finance the purchase of homes, but also to fund other expenditures and to add to their holdings of financial assets.

Meanwhile, consumer installment credit grew very rapidly, especially during the first half of the year when sales of new cars were strongest.

Borrowing by nonfinancial business firms also rose sharply in 1977. The volume of new publicly offered bond issues fell off somewhat from the preceding year, as many of the larger, higher rated companies had completed the restructuring of their debt in 1975 and 1976. But lower rated firms continued to place large quantities of bonds privately with life insurance companies and other lenders. And companies of all types tapped financial institutions for increased amounts of mortgage and term loans, as well as for short-term credit.

Governmental demands for credit in 1977 remained exceptionally large by historical standards. Borrowing by State and local units surpassed previous levels by a wide margin. A substantial portion of the increase in tax-exempt bond issuance was for the advance refunding of debt obligations incurred in prior years when interest rates were higher, but States and municipalities also borrowed large amounts for current and future capital outlays. At the Federal level, the outstanding volume of Treasury debt rose by the third largest amount in history, as a consequence of the U.S. Government's large budget deficit. Financing of the continued Federal deficit contributed to upward pressures on interest rates last year—a year in which private credit demands were especially strong.

In an environment of briskly expanding economic activity and credit demands, the monetary aggregates also tended to grow more rapidly last year. The public's demand for  $M_1$ —currency and checking account balances—strengthened considerably, and growth in this measure of money accelerated. Over the year as a whole,  $M_1$  grew about 7½ percent, as the chairman pointed out, well in excess of the range established by the Federal Reserve. The broader monetary aggregate— $M_2$  and  $M_3$ —grew at rates near the upper end of the ranges that had been adopted by the Federal Reserve in early 1977.

Knowing that a sustained, rapid monetary expansion would threaten a buildup over time of inflationary pressures, the Federal Reserve began in early spring to be less accommodative in its provision of reserves to the banking system. The adjustment of policy was a cautious one, in view of the possibility that the burst of monetary expansion that had developed might reflect simply a transitory swing in the public's demand for cash balances. But as relatively rapid monetary expansion continued, the Federal Reserve gradually exerted increasing restraint in the provision of bank reserves relative to the strong demands for them.

As a result, the Federal funds rate—the rate banks pay to borrow reserves from one another on an overnight basis—rose about 1¾ percentage points from April to October. Subsequently, as you know, in early January, the discount rate was increased to 6½ percent and the Fed funds rate was moved slightly higher to help stabilize conditions in the market for dollars on international exchanges.

Overall, since last April short-term market rates of interest have risen about 2 percentage points. Intermediate- and long-term yields

have also risen, with increases largest in the market for Treasury securities, where rates have adjusted upward by  $\frac{3}{4}$  to  $1\frac{1}{2}$  percentage points over the past 10 months. These increases in interest rates on long-term securities may well have reflected some increase in the inflation premium, as investors reacted to the lack of progress in reducing inflation. Nevertheless, despite the increase of the past year, most short-term rates are still less than 1 percentage point above their levels at the beginning of the present economic expansion in early 1975, and corporate and municipal bond yields are significantly below their levels then.

Growth rates for all the monetary aggregates have slackened appreciably, on average, in the last few months. Growth in  $M_2$  and  $M_3$  has slowed in part because the rise in interest rates on market instruments has made them more attractive to some savers than interest-bearing deposits at banks and thrift institutions. At the same time, however, demands for loans at depository institutions have remained strong. Under the circumstances, these institutions have had to supplement their deposit flows by borrowing and by reducing their holdings of liquid assets.

Although these pressures may be causing depository institutions to become a bit more cautious in their lending policies, credit supplies still appear to be ample. Moreover, the financial condition of the key nonfinancial sectors remains generally strong. It is true that household debt burdens, as measured, for example, by the ratio of consumer and mortgage loan repayments to disposable income, are historically high, and they deserve careful monitoring. But to date, there has been no rise in delinquency rates, so that families appear thus far to be handling their increased indebtedness well. Businesses added further to their liquid assets last year, and corporate balance sheets on the whole appear to be strong, although there is considerable variation from firm to firm. And State and local governments, with record operating surpluses in 1977, appear in the aggregate to enjoy a healthy financial position.

Thus, financial conditions remain supportive of expansion in economic activity. As 1977 drew to a close, aggregate demands for goods and services were strong. As I noted earlier, severe winter weather and the coal strike have caused some steep declines in economic indicators recently. However—assuming a reasonably prompt resumption of activity in the coal industry—we can expect favorable underlying trends soon to reassert themselves.

Growth of employment and income has been substantial over recent quarters, and consumer confidence has remained high. Consumer spending, therefore, should grow at a reasonably good pace, and would be bolstered later this year by the proposed tax cuts.

In the business sector, new orders for nondefense capital goods have continued the uptrend that began about 3 years ago, and presage further expansion in business fixed investment.

In addition, the rate of inventory accumulation is likely to accelerate in coming months; inventory investment has slowed in the fourth quarter, and stocks are lean in many product lines. Moreover, with prospects for our exports improved by the likelihood of stronger economic growth abroad this year, it appears that our foreign trade deficit will not deteriorate further.

Overall, it is the Federal Reserve's judgment that trends in the national economy favor continued expansion at a moderate rate in economic activity and a further reduction in the rate of unemployment over the course of 1978.

There is, however, less reason to be sanguine about progress in curbing the rate of inflation. Food and material prices have risen substantially in recent months. And labor costs continue to rise at a relatively rapid rate.

The decline in the value of the dollar on international exchanges is another cause for concern. It not only contributes to upward pressures on domestic prices but also threatens to erode business confidence here and abroad.

The monetary growth ranges that were adopted by the Federal Open Market Committee at its February meeting are expected to prove consistent with continued expansion in economic activity, as well as with a gradual winding down of inflation over the long run.

For the year ending with the fourth quarter of 1978, the  $M_1$  growth range was set at 4 to 6½ percent. A range of 6½ to 9 percent was established for  $M_2$ , which includes, in addition to  $M_1$  time and savings deposits other than large CD's at commercial banks. And a growth range of 7½ to 10 percent was adopted for  $M_3$ , which includes, besides  $M_2$ , deposits at nonbank thrift institutions.

The ranges for  $M_1$  and  $M_2$  are identical to those that the committee previously had adopted for the year ending in the third quarter of 1978. The range for  $M_3$ , however, has been adjusted downward by one-half percentage point in light of the higher level of market interest rates now prevailing and the apparent effect of these rates in retarding growth in time and savings deposits at thrift institutions. All of the ranges adopted by the FOMC anticipate a deceleration of monetary expansion from the growth rates actually recorded in 1977. Progress over time in this direction is necessary to insure the ultimate achievement of reasonable price stability.

Specification of growth rates for the aggregates is, of course, subject to considerable uncertainty. The rate of growth in money needed to support economic expansion depends in part on changes in the velocity of money, that is, on the rate at which the public uses the existing stock of money to finance transactions. In recent years, regulatory changes and financial innovations have encouraged increases in the velocity of  $M_1$  by enabling the public to economize on demand deposits. However, the retarding effect of such changes and innovations on the demand for  $M_1$  apparently diminished in 1977, when  $M_1$  growth accelerated.

Thus far in 1978, growth in  $M_1$  has been quite moderate, but it is far too early to say whether this marks a slower trend in growth or is simply a transitory development in a highly volatile series.

The behavior of the broader aggregates— $M_2$  and  $M_3$ —will be affected in the year ahead by the constraint placed on the ability of depository institutions to attract funds under existing regulatory ceilings on deposit rates.

Banks have adjusted to the recent marked slowing of inflows of deposits subject to rate ceilings in part by offering increased amounts of large-denomination time deposits, which are not subject to ceilings.

Some of these deposits, mainly large-denomination deposits issued in nonnegotiable form, are included in  $M_2$  and  $M_3$ ; they have tended to sustain growth in these aggregates, especially  $M_2$ , in recent months.

There are other factors that may work to sustain growth in the broader aggregates in the years ahead. To some extent, the recent slowdown in inflows of savings and also small-denomination time deposits may represent a one-time shift of highly interest-sensitive funds; if so, once the shift has been completed, deposit growth should strengthen somewhat.

Moreover, the fact that longer term time certificates, which are subject to heavy penalties for early withdrawal, account today for a larger share of interest-bearing deposits—especially at thrift institutions—suggests that overall deposit growth should be less volatile than in the past.

Nonetheless, if heavy demands for money and credit should place further upward pressure on market interest rates, deposits subject to regulatory rate ceilings will be placed at a substantial competitive disadvantage. In such a circumstance, growth in  $M_2$  and  $M_3$  could fall short of the ranges. Upward adjustments in the ceiling rates on some or all categories of time deposits may be required to avoid a potential distortion in the flow of credit through our financial system, to promote equity for small savers, and to insure the availability of loans to home buyers and others who rely on institutional sources of credit.

We recognize, however, the considerable uncertainties surrounding the shorter run relationship between growth rates of the monetary aggregates, on the one hand, and the behavior of output and prices on the other. The Federal Reserve will continue, therefore, to maintain a vigilant and flexible approach, putting the longrun performance of the economy above the pursuit of any fixed monetary growth rates.

Economic and financial developments in the current year, it should be noted, will depend to an appreciable extent on governmental policies beyond the province of the Federal Reserve. The outcome of legislative action on energy policy and on taxation will have a considerable influence on the strength of business investment and on international confidence in the dollar. So, too, will this Nation's ability to find a way to reduce the upward wage-price pressures that continue to plague our economy.

Thank you, Mr. Chairman.

[Chairman Miller's prepared statement follows:]

**Statement by**

**G. William Miller**

**Chairman, Board of Governors of the Federal Reserve System**

**before the**

**Committee on Banking, Finance and Urban Affairs**

**House of Representatives**



I am pleased to appear today, for the first time, to present the Federal Reserve's report on the conduct of monetary policy. This will also be our first report since passage of the Federal Reserve Reform Act of 1977, which originated in this Committee and which wrote into law the monetary oversight hearings that had been held quarterly in recent years. These hearings have provided a useful forum for discussion of economic and financial conditions and monetary policy. I have no doubt that they will continue to do so, and look forward to participation in them.

During the past year, the Federal Reserve continued to pursue the objective of fostering financial conditions consistent with expansion of economic activity and moderation of inflationary pressures. Gross national product--the broadest measure of economic activity--rose 5½ per cent in real terms during 1977, about the same rapid pace as we experienced on average in the earlier stages of the current recovery. However, the rate of inflation remained disturbingly high.

Very recently, sales and production have weakened, but this seems to reflect mainly--if not entirely--the temporary effects of the unusually severe winter weather and the coal strike. While prolongation of the strike could lead to more extensive economic disruption, basically our economy is strong, and the year 1978 should see continued expansion in economic activity at a moderate

pace and a further reduction in the unemployment rate. At the same time, recent trends provide little basis for optimism with regard to an abatement of inflationary pressures.

The brisk increase in production last year made it possible to reduce unemployment significantly despite further large growth in the size of the nation's labor force. In the past twelve months, the jobless rate has fallen more than a percentage point. Total employment has risen by more than 4 million, and the proportion of our population that is employed stands at the highest level in the postwar period.

The advance of production and employment during the past year was broadly based, with most of the major sectors of aggregate demand registering good gains. Consumer spending followed an uneven course during 1977, but for the year as a whole growth was substantial by historical standards. Residential construction continued to provide considerable impetus to expansion, with single-family housing starts reaching an exceptionally high level and multi-family building also posting appreciable gains from earlier depressed levels. Business fixed investment expanded somewhat more rapidly in 1977 than in earlier years of the recovery, although such investment continued to lag well behind its performance in previous cyclical upswings. The pace of governmental spending--at both the Federal and the State and local levels--also picked up last year.

As domestic activity expanded rapidly, our imports of goods from abroad continued their steep climb, boosted by our increasing appetite for imported oil. Meanwhile, the sluggish performance of economic activity in other major industrial countries limited the demand for our exports. As a result, our trade deficit deepened from about \$10 billion in 1976 to more than \$30 billion in 1977.

The widening of the trade deficit contributed importantly to the downward pressure on the exchange value of the dollar over the past several months. The Federal Reserve, in cooperation with the Treasury, has taken steps to counter disorder in foreign exchange markets and to emphasize U.S. concern about the integrity of the dollar. But the key to a sound dollar and a stable world financial system lies ultimately in the resolution of some of our fundamental, longer-range economic problems. In particular, we must establish an energy policy that promises to reduce our reliance on foreign sources of petroleum; we must create a better climate for business investment, so as to enhance labor productivity and to increase our international competitiveness; and most importantly, we must make progress toward the restoration of domestic price stability.

One of the great disappointments of the past year has been the lack of progress in reducing the pace of inflation. Wage increases have continued to outstrip gains in output per hour worked; unit labor costs in private industry have again risen substantially;

and prices have been trending upward at about a 6 per cent annual rate.

Prudent monetary management is, of course, an essential ingredient in the control of inflation over the longer run. Too much money growth would add to inflationary pressures and would tend to encourage still larger increases in wages, costs, and prices.

Confronted with very strong demands for money and credit this past year, the Federal Reserve took actions to moderate monetary growth and to help ensure that inflationary forces would not get out of hand. Although interest rates have risen, domestic financial markets have remained supportive of economic growth. Supplies of credit have been ample, with the total volume of funds raised in the nation's money and capital markets approaching \$400 billion in 1977-- a record both in dollar terms and as a percentage of GNP.

In the household sector, mortgage loans accounted for the bulk of an unprecedented increase in indebtedness. Families sought mortgage credit not only to finance the purchase of homes, but also to fund other expenditures and to add to their holdings of financial assets. Meanwhile, consumer instalment credit grew very rapidly, especially during the first half of the year when sales of new cars were strongest.

Borrowing by nonfinancial business firms also rose sharply in 1977. The volume of new publicly offered bond issues fell off somewhat from the preceding year, as many of the larger, higher-rated

companies had completed the restructuring of their debt in 1975 and 1976. But lower-rated firms continued to place large quantities of bonds privately with life insurance companies and other lenders. And companies of all types tapped financial institutions for increased amounts of mortgage and term loans, as well as for short-term credit.

Governmental demands for credit in 1977 remained exceptionally large by historical standards. Borrowing by State and local units surpassed previous levels by a wide margin. A substantial portion of the increase in tax-exempt bond issuance was for the advance refunding of debt obligations incurred in prior years when interest rates were higher, but States and municipalities also borrowed large amounts for current and future capital outlays. At the Federal level, the outstanding volume of Treasury debt rose by the third largest amount in history, as a consequence of the U.S. Government's large budget deficit. Financing of the continued Federal deficit contributed to upward pressures on interest rates last year--a year in which private credit demands were especially strong.

In an environment of briskly expanding economic activity and credit demands, the monetary aggregates also tended to grow more rapidly last year. The public's demand for M-1--currency and checking account balances--strengthened considerably, and growth in this measure of money accelerated. Over the year as a whole, M-1 grew about  $7\frac{1}{2}$  per cent, well in excess of the range established

by the Federal Reserve. The broader monetary aggregates--M-2 and M-3--grew at rates near the upper end of the ranges that had been adopted by the Federal Reserve in early 1977.

Knowing that a sustained, rapid monetary expansion would threaten a build-up over time of inflationary pressures, the Federal Reserve began in early spring to be less accommodative in its provision of reserves to the banking system. The adjustment of policy was a cautious one, in view of the possibility that the burst of monetary expansion that had developed might reflect simply a transitory swing in the public's demand for cash balances. But as relatively rapid monetary expansion continued, the Federal Reserve gradually exerted increasing restraint in the provision of bank reserves relative to the strong demands for them.

As a result, the Federal funds rate--the rate banks pay to borrow reserves from one another on an overnight basis--rose about  $1\frac{1}{2}$  percentage points from April to October, reaching a level of about  $6\frac{1}{2}$  per cent. And the discount rate at Federal Reserve Banks was raised in two steps to 6 per cent by late October. Subsequently, in early January, the discount rate was increased to  $6\frac{1}{2}$  per cent and the Fed funds rate was moved slightly higher to help stabilize conditions in the market for dollars on international exchanges.

Over-all, since last April short-term market rates of interest have risen about 2 percentage points. Intermediate- and long-term yields have also risen, with increases largest in the market for Treasury securities, where rates have adjusted upwards by  $\frac{1}{2}$  to

1½ percentage points over the past 10 months. These increases in interest rates on longer-term securities may well have reflected some increase in the inflation premium, as investors reacted to the lack of progress in reducing inflation. Nevertheless, despite the increases of the past year, most short-term rates are still less than 1 percentage point above their levels at the beginning of the present economic expansion in early 1975, and corporate and municipal bond yields are significantly below their levels then.

Growth rates for all the monetary aggregates have slackened appreciably, on average, in the last few months. Growth in M-2 and M-3 has slowed in part because the rise in interest rates on market instruments has made them more attractive to some savers than interest-bearing deposits at banks and thrift institutions. At the same time, however, demands for loans at depository institutions have remained strong. Under the circumstances, these institutions have had to supplement their deposit flows by borrowing and by reducing their holdings of liquid assets.

Although these pressures may be causing depository institutions to become a bit more cautious in their lending policies, credit supplies still appear to be ample. Moreover, the financial condition of the key nonfinancial sectors remains generally strong. It is true that household debt burdens, as measured, for example, by the ratio of consumer and mortgage loan repayments to disposable income, are historically high, and they deserve careful monitoring. But to date, there has been no rise in delinquency rates, so that families appear thus far to be handling their increased indebtedness

well. Businesses added further to their liquid assets last year, and corporate balance sheets on the whole appear to be strong, although there is considerable variation from firm to firm. And State and local governments, with record operating surpluses in 1977, appear in the aggregate to enjoy a healthy financial position.

Thus, financial conditions remain supportive of expansion in economic activity. As 1977 drew to a close, aggregate demands for goods and services were strong. As I noted earlier, severe winter weather and the coal strike have caused some steep declines in economic indicators recently. However--assuming a reasonably prompt resumption of activity in the coal industry--we can expect favorable underlying trends soon to reassert themselves. Growth of employment and income has been substantial over recent quarters, and consumer confidence has remained high. Consumer spending, therefore, should grow at a reasonably good pace, and would be bolstered later this year by the proposed tax cuts. In the business sector, new orders for nondefense capital goods have continued the uptrend that began about three years ago, and presage further expansion in business fixed investment. In addition, the rate of inventory accumulation is likely to accelerate in coming months; inventory investment had slowed in the fourth quarter, and stocks are lean in many product lines. Moreover, with prospects for our exports improved by the likelihood of stronger economic growth abroad this year, it appears that our foreign trade deficit will not deteriorate further.



Over-all, it is the Federal Reserve's judgment that trends in the national economy favor continued expansion at a moderate rate in economic activity and a further reduction in the rate of unemployment over the course of 1978. There is, however, less reason to be sanguine about progress in curbing the rate of inflation. Food and material prices have risen substantially in recent months. And labor costs continue to rise at a relatively rapid rate. The decline in the value of the dollar on international exchanges is another cause for concern. It not only contributes to upward pressures on domestic prices but also threatens to erode business confidence here and abroad.

The monetary growth ranges that were adopted by the Federal Open Market Committee at its February meeting are expected to prove consistent with continued expansion in economic activity, as well as with a gradual winding down of inflation over the longer run. For the year ending with the fourth quarter of 1978, the M-1 growth range was set at 4 to 6½ per cent. A range of 6½ to 9 per cent was established for M-2, which includes, in addition to M-1, time and savings deposits other than large CD's at commercial banks. And a growth range of 7½ to 10 per cent was adopted for M-3--which includes, besides M-2, deposits at nonbank thrift institutions.

The ranges for M-1 and M-2 are identical to those that the Committee previously had adopted for the year ending in the third quarter of 1978. The range for M-3, however, has been adjusted

downward by  $\frac{1}{2}$  percentage point in light of the higher level of market interest rates now prevailing and the apparent effect of these rates in retarding growth in time and savings deposits at thrift institutions. All of the ranges adopted by the FOMC anticipate a deceleration of monetary expansion from the growth rates actually recorded in 1977. Progress over time in this direction is necessary to ensure the ultimate achievement of reasonable price stability.

Specification of growth rates for the aggregates is, of course, subject to considerable uncertainty. The rate of growth in money needed to support economic expansion depends in part on changes in the velocity of money--that is, on the rate at which the public uses the existing stock of money to finance transactions. In recent years, regulatory changes and financial innovations have encouraged increases in the velocity of M-1 by enabling the public to economize on demand deposits. However, the retarding effect of such changes and innovations on the demand for M-1 apparently diminished in 1977, when M-1 growth accelerated. Thus far in 1978, growth in M-1 has been quite moderate, but it is far too early to say whether this marks a slower trend in growth or is simply a transitory development in a highly volatile series.

The behavior of the broader aggregates--M-2 and M-3--will be affected in the year ahead by the constraint placed on the ability of depository institutions to attract funds under existing regulatory ceilings on deposit rates. Banks have adjusted to the recent marked

slowing of inflows of deposits subject to rate ceilings in part by offering increased amounts of large-denomination time deposits, which are not subject to ceilings. Some of these deposits, mainly large-denomination deposits issued in non-negotiable form, are included in M-2 and M-3; they have tended to sustain growth in these aggregates, especially M-2, in recent months.

There are other factors that may work to sustain growth in the broader aggregates in the year ahead. To some extent, the recent slowdown in inflows of savings and also small-denomination time deposits may represent a one-time shift of highly interest-sensitive funds; if so, once the shift has been completed, deposit growth should strengthen somewhat. Moreover, the fact that longer-term time certificates, which are subject to heavy penalties for early withdrawal, account today for a larger share of interest-bearing deposits--especially at thrift institutions--suggests that overall deposit growth should be less volatile than in the past.

Nonetheless, if heavy demands for money and credit should place further upward pressure on market interest rates, deposits subject to regulatory rate ceilings will be placed at a substantial competitive disadvantage. In such a circumstance, growth in M-2 and M-3 could fall short of the ranges. Upward adjustments in the ceiling rates on some or all categories of time deposits may be required to avoid a potential distortion in the flow of credit through our financial system, to promote equity for small savers,

and to ensure the availability of loans to home buyers and others who rely on institutional sources of credit.

We recognize, however, the considerable uncertainties surrounding the shorter-run relationship between growth rates of the monetary aggregates, on the one hand, and the behavior of output and prices on the other. The Federal Reserve will continue, therefore, to maintain a vigilant and flexible approach, putting the long run performance of the economy above the pursuit of any fixed monetary growth rates.

Economic and financial developments in the current year, it should be noted, will depend to an appreciable extent on governmental policies beyond the province of the Federal Reserve. The outcome of legislative action on energy policy and on taxation will have a considerable influence on the strength of business investment and on international confidence in the dollar. So, too, will this nation's ability to find a way to reduce the upward wage-price pressures that continue to plague our economy.

The CHAIRMAN. Thank you, Chairman Miller, for a superb debut. I am going to confine my remarks to one comment which I hope you will not think is ungracious, and one question which I hope you will like.

The comment is this. You were sworn in as chairman of the Fed at 2:43 yesterday afternoon, according to my watch. You have not had an opportunity to meet with the Federal Open Market Committee. So far as I know, you have not had a formal opportunity even to meet with your six colleagues on the Federal Reserve Board. You have had something less than 24 hours to prepare your paper. I think you have done remarkably well at being able to get up here at all this morning. I congratulate you.

Having said that, however, it is my duty to point out that you can do better.

In the first place, the law requires that the Fed—and I am quoting: “take into account past and prospective developments with respect to production, employment, and prices.” This means quantitative estimates. That is what we have been getting from Dr. Burns, and it is really necessary for us to have them in order to do our job.

The legislative history also requires discussion on such matters as fiscal policy, monetary velocity, and interest rates.

We respect the independence of the Fed. If the Fed has cheers for the fiscal policy of the administration, let us hear them; if it has suggestions for their improvement, let us hear those, too. Only thus can we achieve our job.

Third, I do have difficulty with the action apparently taken by the Federal Open Market Committee in lowering the band for  $M_3$ —that is, cash, checking accounts, and importantly, deposits at savings and loans and mutual savings banks.

The action taken by the Federal Open Market Committee in lowering the range from 8 to 10½ percent to 7½ to 10 percent, to me that spells higher interest rates mandated by the Fed. To me that spells a blow at the housing market which displays increasing signs of fragility.

Fortunately, in just a few days, on March 21—that is a week from Tuesday—there will be a meeting of the Federal Open Market Committee which also includes the full membership of the Board of Governors of the Federal Reserve System. I would welcome it, if just as soon after that March 21 meeting you would provide us with a written statement which more nearly conforms to the exacting requirements of the law. I would hope, too, that the gentlemen assembled would take a look at that action in lowering the target on  $M_3$ . I am fearful of the consequences of what has tentatively been done, and in any event, let us have a record before us which shows who of the 12 voted what way, and if there are dissenters, and I would not mind seeing a few, have them give us the reason for their dissent. I would hope then that with that additional statement from you we could fill in some of the gaps.

And let me say again, I think you did a remarkable job in the time given you, and these comments of mine are not intended to be ungracious.

Do you think you would be able to accommodate us after March 21?  
Mr. MILLER. I would be very pleased to.

Mr. Chairman, I do thank you for your comment. I would point out that I have not participated in a board meeting or in an FOMC meet-

ing. I thought it would be improper to do so until I was officially sworn in.

As you know, the FOMC is made up of the seven governors and five presidents of the Reserve Banks, and its action on the aggregates is based upon a review of the staff's presentation on economic performance and projections.

In the past the Federal Reserve has not had a procedure—or perhaps one is not possible—where the FOMC can itself adopt a specific quantitative measure of the future outlook for production, for GNP, and for other developments. It may be necessary that such projections presented to this committee reflect my personal analysis and summary of the situation—that may be necessary because of the difficulty for a committee to vote on projections.

The CHAIRMAN. I understand perfectly. In fact, that is the way Chairman Burns did it.

And as the record many times discloses, he would give his views as his own. We would be very pleased indeed to have yours on such matters rather than in the more collegial form.

Mr. MILLER. I would be pleased to do that.

The CHAIRMAN. And we are very grateful.

Now, on my question.

The Chairman of the Federal Reserve, as you know, must fit his recommendations into a complex economic environment, taking into account the administration's objectives, the Federal budget, the need for jobs, and the inflationary situation. It is widely accepted that general macroeconomic policies alone, among which monetary policy plays a central role, cannot bring us to the President's goal of 4.0 to 4.4 percent unemployment by 1983 without generating intolerable inflationary pressures. What I feel is needed, in addition to traditional policies, is a large-scale program aimed at reducing structural unemployment—by as many as 1 million persons over the next few years.

Clearly, if a program on so large a scale is to work, it must involve a meaningful public-private partnership. One way to achieve this might be to expand on the work already undertaken by the National Alliance of Businessmen, about which you, as an outstanding past leader of that group, know a great deal. We could have, for example, a nationwide network of local business councils, non-profit organizations with federally-funded staffs, who would help match private-sector jobs with the hard-core unemployed, and direct a much expanded program of federally funded training subsidies where they are most needed.

Would you be willing to lend your support, your leadership abilities, and your special knowledge and qualifications in this area to such an endeavor? What, in your view, would be the most effective way of putting it together? Do you feel that the Federal Reserve, with its many local contacts, might be of help? Would not such an effort to create a meaningful public-private partnership to reduce structural unemployment cost less per job created, and have a more enduring impact, than primary reliance on traditional across-the-board tax reduction, and would it not make easier your job of coordinating monetary policy with overall macroeconomic objectives?

Mr. MILLER. Mr. Chairman, I do appreciate your question, because I agree with you completely: Macroeconomic policies will not be

able to produce the reduced level of unemployment that all of us seek as a national goal without unleashing a degree of inflation that would be self-defeating. In fact, we could unleash inflationary forces that would bring us right back to high unemployment. So I think you are absolutely correct in saying that if we rely upon macroeconomic policies, we are going to have enormous difficulties and perhaps not achieve our unemployment goal.

I agree with you, also, that our technique, therefore, should be to target in and address specific programs to the structurally unemployed; we do have very taxing problems and very difficult ones to overcome, because of the special social and demographic changes that have occurred.

Your suggestion of local business-government partnerships and training councils is, I think, an excellent approach. If the attack on structural unemployment is to be successful, I feel that we do need such a partnership of the public and private sector, as you indicated.

The jobs, ultimately, will have to be in the private sector, if we are going to succeed. If we continually shift resources into the public sector, I think we will shrink our economic base—again, with self-defeating consequences.

So I would concur that, if there is a way to stimulate the employment of those who are disadvantaged and those who are caught in the isolated traps of structural unemployment through some such public-private partnership, it would be of great advantage.

Something along these lines, as you know, is now being worked by the National Alliance of Businessmen and the administration. There is also provision in the President's fiscal year 1979 budget for funds to do some of this. It had not occurred to me that the Federal Reserve might have a role in this, but I would certainly be delighted to lend whatever assistance I could to such an effort because I think it is a very important one. I don't know what the appropriate role for the Federal Reserve Board and reserve banks would be. But I will certainly be openminded and willing to look at what we might do, because I think this is a very, very important mission.

The CHAIRMAN. Well, I am delighted at your answer.

Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman, and welcome, Chairman Miller. We are very pleased to see you, and I think your first appearance has been a stellar one, sir.

Mr. Miller, on page 8 of your testimony you state that local governments in the aggregate appear to enjoy a healthy financial condition.

There is one notable exception to that with which I have been concerned recently and in recent hearings, and that is New York City.

We have received testimony that if the present Federal aid is not continued or some form of Federal aid, that New York City may face bankruptcy.

Have you given any consideration to the national and international implications of such an event?

If you have not, sir, and would prefer to answer that for the record, I would be very happy to have you do so.

Mr. MILLER. Mr. Moorhead, I think I can answer now.

I have, personally, given consideration to this matter—as we all have, as interested citizens and as a person who has had facilities and

reasons to do business in that city in the past. The Federal Reserve has been doing studies on New York City's outstanding securities, how they are held by banks, and the impact of default. I would think that New York's default or bankruptcy would have wide-ranging implications.

I do not think that New York's bankruptcy would cause a serious or lasting problem for the banking industry; I think that no doubt could be handled. But I think the effects on markets and on interest rates for municipal securities would be unfortunate, and should be avoided if at all possible.

Mr. MOORHEAD. Thank you, sir.

On another subject, on page 2 of your testimony you said that business fixed investments continued to lag well behind its performance in previous cyclical upswings.

And then on page 3 you state that we must create a better climate for business investment.

Are you in general agreement with the administration's program for promoting business investment, and would you like to make any additional suggestions that we might consider?

Mr. MILLER. Mr. Congressman, it seems to me that the tax package contains reductions on an order of magnitude that is probably the most that should be considered—given the interrelations of that tax package with deficits and with rates of inflation, and given its impact on the economy, generally.

I would personally like to see more of that package concentrated on policies that would generate fixed business investment. Business investment is anti-inflation investment; it is a job-creating investment. And, as we expand, if we don't start soon to place more emphasis in this area, we are going to run into bottlenecks and we are going to continue to trigger more inflation.

So I would like to see more emphasis on business investment, using whatever resources are available and whatever the Congress feels is appropriate in the way of tax reductions. I would like to see the tax package targeted a little bit more than it is toward generating this kind of investment.

Personally—and this is personally—I do believe that more emphasis on higher rates of depreciation would, perhaps, be one of the most effective ways to stimulate investment. This approach defers taxes; it does not reduce taxes. And, to the extent that it stimulates investment, it is an approach with its own ability to generate revenues and increased business activity.

So, I would think some more emphasis along those lines would be desirable.

Mr. MOORHEAD. Turning now to the question of inflation, I quite agree with you that excessive monetary growth would add to inflationary pressures and—however, you give us little encouragement, as a matter of fact. On page 9 you say that you can't be sanguine about the progress in curbing inflation.

Do you have any suggestions for us along the line of curbing inflation?

I realize that your position is: You are going to try to prevent a worsening of the situation. Is there anything you can suggest to us to improve the situation?



Mr. MILLER. Since the President nominated me to the Federal Reserve on the 28th day of December, developments have, I would say, worked a little against us on the inflation front. So I am more concerned about inflation today than I was then.

Curbing inflation is therefore going to have my very, very high priority. The Federal Reserve is examining its options, but, as you know, many of the possible remedies are not within the jurisdiction of the Federal Reserve; they relate to activities other than monetary policy.

The President, in his economic package, has proposed elements of moderation. I think we are going to have to focus stronger and harder on them, and see if we can find the will—not only in the private sector but in the Government sector—to begin to take some steps to show that we are serious. If we don't take those steps, I am afraid that the consequences will be ones that none of us will like. The sooner we realize that inflation is a very serious matter, the sooner we can begin to control it.

Now, I have taken quite a cut in salary as my contribution to fighting inflation; what are you in Congress going to do? [Laughter.]

Mr. MOORHEAD. My time has expired.

The CHAIRMAN. Mr. Stanton?

Mr. STANTON. It is time to change the subject.

Mr. Miller, the chairman of our committee made some suggestions to you that will, without a doubt, lengthen your next statement before our committee, and probably the previous statements were a little bit longer, too, because we always looked forward to not only hearing a report on monetary policy but to hearing what the monetarists and the monetary policy leaders think of the effect of fiscal policy, what it has on this monetary policy. I would only point out that it is a two-way street, and I would hope in the future you would take every opportunity that you so wish, to show that effect and what it means.

The colloquy that you had with the chairman on unemployment made me think that this afternoon—well, not this afternoon, but within a few minutes, we will be back onto a bill called the Humphrey-Hawkins bill, and I had a question or two, but I hesitate to ask them if you are not at all familiar or if you don't want to comment on the bill.

Shall I take a shot at it and see if you can comment?

Mr. MILLER. Sure.

Mr. STANTON. The crux of the bill, as it affects monetary policy, is in section 108, title I, and this is the procedure in which the monetary report of the Federal Reserve would come to Congress.

Now, in the original bill, which was sort of open ended, and none of us knew exactly what it meant, there was a statement somewhere that this should be turned over to Congress and Congress shall do with it as it sees fit and so forth.

The chairman of our committee took that and made some improvements, because what he has done now, in an amendment that will be offered this afternoon, is really direct that report to our committee rather than Congress in general, and we would then have our comments about it.

After the chairman made that change, Mr. Ashley and I were to add an amendment originally that—to the effect of—language that is

before this committee now, as far as these hearings, and it is sort of a policy of the Congress—that would simply state: Nothing in this act shall be interpreted to require that policies proposed by the Board of Governors of the Federal Reserve be followed if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be followed because of changing conditions.

This is in the language of our present hearings, and the chairman has accepted our amendment, and so we will have a full committee amendment which we are in agreement on going to the floor here this afternoon.

And my question to you is: With this language and protection, as we want to keep the independence, which the President spoke about yesterday, of the unique position of the Fed—do you think this language is sufficient, or do you approve of the language?

Just so we could have your thoughts on that. I would appreciate it.

Mr. MILLER. Congressman Stanton, I was pleased with Chairman Reuss' statement about structural unemployment because I think it reflected a recognition that there is no way to mandate a monetary policy—a prudent monetary policy—to reduce unemployment to a level that may, perhaps, be a very wise objective from the point of view of national policy.

It is still my view that the Humphrey-Hawkins bill, in reflecting that national policy, should continue to emphasize that price stability is a part of that package, and that we must be cautious because of the interaction of these conflicting objectives.

I would also say that one of the geniuses of our monetary system is its flexibility, and I would think that any language in the bill that could be interpreted to destroy that flexibility would not be in the national interest.

I think the language that you have just cited would be very desirable; it is an excellent choice of words to make clear that there is no intent to lock the Federal Reserve into policies that would be against the national interest and that we must be allowed to retain the ability to be able to respond to what is going on in the real world, day to day and hour to hour.

I also would add that this committee is conducting an effective dialog with the Federal Reserve in the consultation on monetary policy, and it would seem to me that it would be unnecessary to layer on any additional structures. It seems to me we have a good operating structure now, and the reporting responsibilities are where they properly belong.

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Stanton.

I note that there is a rollcall, and without objection, we will stand in recess for 7 minutes.

Mr. ANNUNZIO. Mr. Chairman, point of order before you recess.

We will probably be going into the 5-minute rule, and under that rule I don't think we are going to get permission to sit. I am just wondering if you would ask for unanimous consent for those of us that have some questions, and if we are not sitting, we would like to submit those questions for the record.

I have already written to Chairman Miller. I have received an answer from him. But I want further answers to the problems that confront my subcommittee.

The CHAIRMAN. Yes. I am embarrassed by the time constraints under which we are operating, and I would certainly want to yield to the sense of the meeting.

It is agreeable with those numerous members who have not had a chance to inquire of Chairman Miller personally that their questions and supplementaries may be put to him in writing with the understanding that replies will be made by March 21, which is 10 days off, and is the date of the next Federal Open Market Committee meeting?

If there is one single objection to that, I will not order it. Is there objection?

Mr. DERRICK. Reserving the right to object, apparently, we are going to run into more of the same today as we had yesterday, and I think it is going to be very impractical to try to continue at this point. I will not make an objection, but I would suggest that we adjourn now for the day.

The CHAIRMAN. The Chair would like to get a sense of the meeting on the following. The Chair would like to propose that we now adjourn this hearing and that we have heard and welcomed Chairman Miller and that we have heard his willingness to respond to any questions put to him in writing within the next few days, as promptly as possible, and to get us an answer as close to March 21 as possible; that Chairman Miller further has agreed that following the March 21 Federal Open Market Committee meeting there will be a further supplementary written report; and it would be this chairman's intention that if nobody requested a further personal appearance by Chairman Miller, we could then lock the proceedings up and take whatever action is dictated.

You have heard the proposed proposition. Is there objection to that procedure?

Mr. ROUSSELOT. Mr. Chairman?

The CHAIRMAN. Mr. Rousselot.

Mr. ROUSSELOT. Could you restate what you are proposing.

The CHAIRMAN. I ask unanimous consent that we now adjourn; that members have a reasonable time to present in writing to Chairman Miller any questions they may have.

Mr. ROUSSELOT. He may spend the next 2 weeks just answering questions and he has other jobs to perform.

The CHAIRMAN. Let me put the proposition then, if there is objection—I ask unanimous consent that we now adjourn; that members have a reasonable time to put questions in writing to the Chairman; that the Chairman, Mr. Miller, will endeavor to answer those questions expeditiously, having in mind the fact that March 21—

Mr. KELLY. Mr. Chairman, reserving the right to object—

The CHAIRMAN [continuing]. Having in mind the fact that March 21 is the next meeting of the Federal Open Market Committee; and at that time, with all of the evidence before us, if any one member feels that a further hearing is required, the Chair will then, without question, recall Mr. Miller.

Is there objection ?

**Mr. KELLY.** Mr. Chairman, reserving the right to object; what is the reason we could not attempt to proceed today ?

The CHAIRMAN. Because the general flavor of things on the floor yesterday leads me to believe that my request for permission to proceed under the 5-minute rule would be greeted with derision. So I am not even going to try to do that.

Is there objection ? [No response.]

If not, thank you very much, Mr. Miller.

**We now stand adjourned.**

[Whereupon, at 11:15 a.m., the committee adjourned, subject to the call of the Chair.]

# QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

MONDAY, APRIL 10, 1978

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,  
*Washington, D.C.*

The committee met at 10:07 a.m. in room 2128 of the Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, St Germain, Gonzalez, Annunzio, Mitchell, LaFalce, AuCoin, Derrick, Hannaford, Allen, Lundine, Pattison, Cavanaugh, Barnard, Stanton, Brown, Wylie, Rousselot, Hansen, Kelly, Grassley, Leach, Evans of Delaware; and Caputo.

The CHAIRMAN. Good morning, ladies and gentlemen and Chairman Miller.

The House Committee on Banking, Finance and Urban Affairs will be in order for continuation of its quarterly hearings on the conduct of monetary policy.

Chairman Miller, welcome back for this continuation.

I first want to thank you for your comprehensive letter of March 29, answering the majority of the questions that were left hanging; and under the rule and without objection, that letter will be received in full into the record.

[The letter referred to with attached record of policy actions of the Federal Open Market Committee held on February 28, 1978, may be found in appendix II.]

The CHAIRMAN. In that letter you gave, for the first time, your written estimates for the rate of real growth, unemployment and inflation which you expect in the year ahead. Your assessment differs in some particulars from that of the administration. Perhaps today during the course of the questions you will be able to give us some of the reasoning behind that difference.

Several other questions that I raised in my opening statement on March 9 have not yet been fully discussed. These concern:  $M_3$ , that form of money which consists largely of the deposits made by savings and loans customers in their institutions.

There I expressed distress, you will recall, that the Fed—before you joined it, I was glad to report—at its February 28 meeting, singled out  $M_3$ , of all things, to cut down on; the bands on  $M_1$  and  $M_2$  were kept uniform, but on  $M_3$ , upon which the housing of the Nation depends, that was cut down.

I did not like the looks of it. I asked the Open Market Committee to reconvene and take another look at it, and get your input. Let us dis-

cuss that right now. The Open Market Committee did reconvene. Was my uneasiness about what they had done conveyed to you then?

Mr. MILLER. Yes, Mr. Chairman, and the FOMC will be meeting again next week, at which time new ranges for the aggregates will be developed for the coming 4 quarters. At that time the ranges will all be reconsidered, and we hope to be reporting back on them in April. That report will be to the Senate Banking Committee, but certainly we will send a record to you.

The CHAIRMAN. Will you convey, with redoubled urgency, my feeling that of all the dogs that do not deserve to be kicked around, it is the housing one?

Mr. MILLER. I think the——

The CHAIRMAN. It is outrageous. I do not know what they thought they were doing.

Mr. MILLER. The members of the FOMC, I believe, felt—and I am not sure of this, because as you point out I wasn't there; and also they are now thinking about the matter in hindsight—I believe they felt at that time that, with the higher level of interest rate, there was a slowing of flows of funds to thrift institutions.

I think those ranges reflect the realization that that was beginning to happen, which is very much of concern. I am sure the members of the FOMC were influenced somewhat by the actual trends in that direction. This is something I am sure we will discuss further this morning.

The CHAIRMAN. Convey to them further that projections frequently carry the seeds of their own destruction, and, that if they project a lower rate of  $M_3$  and then start raising ceilings on regulation Q and on everything else, they are going to get precisely the disintermediation which they are wringing their hands about avoiding.

Mr. MILLER. I will certainly convey your message to them, Mr. Chairman.

The CHAIRMAN. I had hoped that that message was going to be conveyed at the March 20 meeting. Was it?

Mr. MILLER. Yes, sir. But preparation had not been made at that time to set new ranges. This will be done at the meeting next week.

The CHAIRMAN. There was no vote on March 20?

Mr. MILLER. No, sir.

The CHAIRMAN. Hence, of course, you did not vote on it.

Mr. MILLER. Right.

The CHAIRMAN. In the minutes of the meeting of February 28—that is when the deed was done and happily it was the day before you were made Chairman of the Fed, so you were not there—I note on page 20, that two members actually believed they had not “done in” housing enough, and that reducing the  $M_3$  growth range, which was done, should have been done with even more fiendish vigor. Who were those two citizens?

Mr. MILLER. I am not aware of who they were, because the minutes that I have are the same that you have, and I do not feel it appropriate for me to be privy to information from that meeting, since I was not confirmed until a few days later, as you know.

The CHAIRMAN. Would you ask one of your associates to call and find out who those people were? After all, we are residents in a responsible democracy. When decisions which vitally affect the housing in-

dustry are made, we, the Congress, have a right and a duty to know who is doing what. I do not see any reason why that information cannot and indeed, at this very moment, is probably being made public.

Mr. MILLER. Mr. Chairman, I think it has been the procedure of the FOMC—again I am learning about it—but I understand the procedure has been such that, in order to provide full freedom for discussion and to avoid the possibility of inhibition of expressions of viewpoints, the names of members who express those viewpoints are generally not made available. They were made available in the fuller records that were released many years later.

Those memoranda of discussion, of course, have been suspended recently; I hope that they will be reinstated so that there will be a historical base for analyzing decisions.

I do think that if we started bringing to this committee the name of each person who expressed a viewpoint, there is the danger that the members will begin to speak for your consideration. They will restrain themselves from sharing frankly their views, which may be at variance with the great majority of the FOMC members, and may, indeed, as in this case, not be reflected in the final committee action.

So I hope you will bear with us and recognize we do not want to begin a procedure that would, perhaps, undermine the very way in which the FOMC is able to act objectively and get a collegial decision and find a consensus after the fullest kind of dialog.

The CHAIRMAN. I really cannot understand that, because here in the committee we make our decisions in open forum. If my friend, Mr. St Germain, and I disagree on something, we sound off, give our reasons, good or bad, and let the truth come out.

I do not see why a board, five members of which are not even democratically selected, should have the cloak of anonymity thrown over it until we are all dead. So, I want to record myself as completely out of sympathy with the secrecy cloak of the Fed.

No one is going to jump on someone because he made a statement with which we disagree. We will disagree with it, but I do not see why he should be immune from criticism.

So convey—speaking just for myself—my utmost outrage at this violation of democratic process and my hope that, under the new administration, it will be put into the trash can, where it so richly deserves to reside.

I have a few other questions which were raised in my opening statement. We still do not have the Federal Reserve comments on fiscal policy and on prospective developments in interest rates and velocity. We still do not have the Fed's judgment on the need to revise or abandon now unrealistic money growth targets still in effect for the next few quarters.

Every day we read in the Nation's press that, whoops, sorry, but vital matters like  $M_1$  and  $M_2$  have been badly misguessed by the 800 economists working for the Federal Reserve. This does not endow us with great confidence in the process by which those decisions are made. I think it is high time we looked at the whole statistical basis.

We would like your view, too, on appropriate long-term goals for reducing unemployment, goals which, as you know, I am heartily in accord with, and have frequently commended before and do so again this morning.

We want your comments on the appropriate format for monetary policy oversight, and particularly, we would like your view on the future scope of intervention in foreign exchange markets in support of the dollar. I suspect that there may reside some genial differences between us. I think the Fed does more harm than good by trying to rig the dollar market under the guise of quieting disorderly conditions. I think it is a failure so far, and I really would like to know about it.

Earlier, we had an opportunity for questions from Mr. Moorhead, and I think, Bill Stanton had his time at bat. So we will start out this morning where we left off, Mr. St Germain.

Mr. ST GERMAIN. Thank you, Mr. Chairman. I welcome the Chairman back again.

Chairman Miller, by now, hopefully the Fed has had an opportunity to analyze and review the President's new urban policy. What I would like to know is how you and the Fed feel that this policy, if enacted more or less in its entirety by the Congress, will impact on general economic conditions and monetary policy.

Second, assuming the program is enacted basically along the lines as presented by the President, how does the Fed feel, or how does it plan, rather, to accommodate the urban policy?

It could be you would like to give us a few remarks on that at this time and expand for the record. I would understand if that were the case.

Mr. MILLER. Congressman St Germain, I am pleased to comment on the urban program. I am sure that all of us are concerned about the plight of our central cities. There is a long history as to why there has been pressure on the central cities and why they have lost some of their vitality as important parts of our economic structure.

Part of the reason, of course, has been the very change in the nature of cities which, in ancestral times were places of defense; later, of ceremonial activity; and then of mercantile activity. In the Industrial Revolution, they became the centers of production, where the necessary labor forces could be readily available.

But, in the era of the postindustrial revolution, we have seen the dispersal of production facilities away from the cities; and we have seen the influx of those persons displaced from agrarian activities into the cities. And the resulting mismatch of jobs and people has created a tremendous difficulty.

Generally, I think the urban program presented by the President is a good one. It has been noted that it has no one centerpiece of policy; in many ways, I think that is a benefit, because there is no one simple solution to urban problems, but rather a series of answers that address themselves to the reestablishment of a balance.

There are only a limited number of things that can be done to rehabilitate cities and to create employment for the people who reside there. One is to transport urban dwellers who are unemployed to places of employment each day and return them. But that creates an enormous logistic problem and it doesn't work.

Another is to physically move people from the cities to other areas where they can be near opportunities for employment. But this also is a massive undertaking, and we do not have the structure for doing it.

A third possibility is to bring jobs back to the cities, to make the opportunity for employment available.



I think the program presented gets at a great number of problems. It will do a great deal to bring us back to where a mix of activities in the city—transactional business, production, financial activities, service industries, entertainment, cultural activities—can mesh into a vital whole.

So I commend the program. I believe that it shows some prudence in its financial commitments. It is neither meant to be a cure-all, nor is it meant to be an expensive solution through massive injection of money. But it appears to be addressed to solving a whole series of structural problems and to creating incentives that should go a long way toward making progress in this regard.

The CHAIRMAN. Thank you.

Mr. ST GERMAIN. Thank you. Dr. Burns—Dr. Miller.

Mr. MILLER. Neither Dr. Burns nor Dr. Miller is here!

Mr. ST GERMAIN. What I meant to say was, Dr. Burns, back in 1974, wrote to banks in agricultural districts, expressing the concern of the Fed with the crunch for capital for feedlot operators in the Midwest. He urged that Federal Reserve officials make clear to those banks in their districts that there was an obligation to meet the local credit needs of those cattle operations. Now I am wondering, has the Federal Reserve given any thought or has it done anything in the area of sending the signals to the banks, serving urban areas, that they too, like banks in the agricultural areas, which were referred to in 1974, have a clear obligation to serve local needs, including inner-city banking efforts?

Mr. MILLER. We are fortunate that Congress has helped in this regard: the Community Reinvestment Act is now law, and it does provide that banks shall have an obligation to meet the credit needs of their communities.

The Federal Reserve, along with the other bank regulatory agencies, has commenced a series of hearings across the country—the last of which, I believe, will be in New York on April 20—in order to gain a more widespread understanding of how these responsibilities of banks might be met. The inputs we have received from people in all walks of life have so far been extremely helpful, and from this process will come regulations which I think will go a very long way toward clarifying the responsibilities of banks in the communities where they operate, where they draw their capital.

And I believe we will find that our action does contribute positively toward supporting the urban programs that are now being presented to you.

Mr. ST GERMAIN. Well, I say that my subcommittee is planning to hold hearings, as well, on this as soon as the agencies have completed their hearings. No doubt we will be asking you for your contributions and reaction, as a result of the hearings that you and the other agencies, well, you, the Fed, and the agencies have held on this topic.

One last question.

Prior to the Easter district work period, I, in a press release, stated my intent to introduce legislation which I did, indeed, introduce on Wednesday last, which would remove the prohibition of payment of interest on demand deposit accounts. It seems to me that the new regulation the Fed has had comments on which would permit automatic transfer accounts is just another step at circumventing this

prohibition and, for that reason, I felt that we should address the problem directly. For many years now there have been overt methods employed by financial institutions to get around this and the regulatory agencies have looked the other way.

Now, of course, the Fed has this proposed regulation.

My legislation would, in fact, remove the Federal prohibition entirely and give checking account powers to all financial institutions. Has the Fed had an opportunity to look at that particular legislation as contrasted to the regulation, its proposal at this time?

Mr. MILLER. Mr. St Germain, I hope that I can soon stop repeating what I am about to say.

The automatic transfer proposal was initiated just before I became Chairman, but it will soon come before the Board for final determination. I hope that, in making a determination about that proposed regulation, we will do nothing at the Fed that would tend to circumvent the direction of Congress or the laws.

Today, as you know, the mechanism of banking is evolving through the natural forces of the market.

New techniques have been developed for consumers to gain better access and better returns from their own banking resources. We have seen the development of NOW accounts in New England; we have seen the development of telephone transfers from savings accounts.

If savings moneys can be transferred by telephone or by walking into the bank every day or by sending a list of instructions, then one might say it follows logically that transfers can be left to a standing order. This regulation, I hope, would be only consistent with serving the consumer and serving the needs of banking, rather than intended in any way to circumvent the will of Congress.

Having said that, I will say that, as you know, the Federal Reserve has supported the concept of NOW accounts nationwide through legislation. Although we have not discussed this at the Board, my personal opinion is that the Federal Reserve would support your own proposal, because it would offer a uniform and equitable opportunity for all of the depository institutions to compete fairly, and it would also provide additional service and additional opportunity for income to consumers.

Mr. St GERMAIN. I will admit that I anticipated your answer. However, I wanted to take the opportunity to bring it out into the public eye a little more and just make one further comment. That the intent here in allowing all institutions to have demand deposit accounts that would pay interest would be to do so without the differential.

I think that is an important point.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California, Mr. Rousselot.

Mr. ROUSSELOT. Thank you, Mr. Chairman. Mr. Chairman, we are appreciative that you are here so soon after your last appearance and your willingness to subject yourself to questioning by Congress. I was most interested in your letter of March 29 to the chairman of this committee and found it to be helpful. I have quoted from it several times since.

My question relates mostly to the econometric model of the Federal Reserve Board. My understanding is that you have your own econometric model which you use from time to time, and in the past we have not been privileged to know what its projections might be.

As you know, in Budget Committees of the House and Senate and several other committees of Congress subscribe to the services of various econometric models.

Would it be your thought that maybe it would be helpful to share with us from time to time projections that come from your econometric models, since as a Board you make judgments which may in part be based on the model, and since your whole system, I am sure, uses it from time to time?

Mr. MILLER. Mr. Congressman, let me give you what I think is the range of possibilities. I am sympathetic to your need, and my letter was intended to be responsive to the matter of making available to this committee and to Members of Congress more quantitative projections.

I am sympathetic to your need to know what we are trying to accomplish—in some way other than in generalities.

Mr. ROUSSELOT. We would like to know on what assumptions about the economy your judgments are based, and we would like to have the benefit of the model in making certain judgments of our own concerning economic issues.

Mr. MILLER. And what we base our judgments on. Let me give you the range of possibilities. If we should conclude that the best alternative is to present to you our staff models, the problem, as I see it, is that inevitably the staff would begin to shape the model for its public value rather than for its value in presenting the hard economic realities that we need to consider at the FOMC. I would hope that staff members could remain completely uninhibited, even by the prospect that their work would be subject to scrutiny other than the scrutiny of those to whom they are accountable for their work.

Having said that, I will offer two other choices. One is for the FOMC—it has never been able to do this—but for the FOMC to develop some method of making its own judgment about the information presented and shaping its own projections. It is hard to get 12 people to agree to anything and that creates a problem, although this alternative should be considered.

The other alternative is for the Chairman—having seen and worked with the staff data, and having listened to the comments and inputs of all members of the FOMC—to reduce this information to his personal projection and to bring you what I hope would be an educated judgment of how all those factors, comments, inputs, regional viewpoints could be synthesized into something that would be helpful to you. I have done this in my letter; perhaps the method can be improved in the future.

I must confess to you that the ranges I have given to you are not the ranges presented by the staff. They are, however, ranges which, since we met, I have had a chance to discuss with some members of the FOMC. I think they are consistent with the general consensus of the FOMC, although there may be individuals who would be above or below the ranges.

I hope, as we work together, that I can develop something that is useful to you and yet allows us to keep our staff as an internal source of information, whose opinions are not colored by a desire to speak to you rather than to speak to us.

Mr. ROUSSELOT. I appreciate your comments. The reason I think it would be helpful is that I know that the Budget Committees and many

of our committees here in Congress subscribe to several outside econometric model services, and many of our judgments are made on the basis of those models. I also believe it would be helpful to us, especially in this committee when we are discussing monetary policy issues with you as you come up to appear before us every 6 months, to know how much of a part of the Fed's own econometric model plays in the judgments that you make.

So I appreciate the comment and also appreciate your response to the chairman of our committee.

The CHAIRMAN. The gentleman's time has expired.

Mr. ROUSSELOT. That is certainly unfortunate.

The CHAIRMAN. The gentleman from Texas, Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

Mr. Chairman, dollar depreciation obviously contributes to our inflation, or at least the experts seem to think so. However, more dangerous than that, it could lead to such things as OPEC demanding payment in something other than the dollar unit, as for instance China announced last week, in which the news reports indicated that China was demanding payment in Swiss francs rather than dollars. Or it could lead to OPEC valuing its oil in some other unit.

Now, this could lead to panic. On the other hand, it could also lead to a price rise by OPEC. Either way, it seems to me extremely urgent to do something to protect the dollar. I am not going to follow up at this time on the intervention question that the chairman raised, because I raised that question the first time when we had the first hearing, from Professor Dornbusch, I believe.

Do you believe that a tight monetary policy would be one key step to take now in protecting the dollar?

Mr. MILLER. Congressman Gonzalez, the issue you raise is a very serious one, and I concur with you that the depreciation of the dollar against some key currencies has, even in the last 6 months, fed in a significant amount of inflation and potential inflation to our economy. It does create other prospective difficulties for us—such as its effects on the method of pricing oil, and such as its effects on international money markets and the flow of capital—which could upset our economy or could have an adverse impact on it.

I think the real solution, however, is not just to use monetary policy, but to look at the fundamental reasons which cause the problem. The fundamental reason for the dollar's decline is the large deficit in trade and in current accounts that we have incurred: a large one in 1976; an unprecedented, record one in 1977; and a continuing trend of such deficits in 1978.

Therefore, it seems to me that we need to look at the fundamentals and at least to make a change in the trend in those deficits in order to strengthen the dollar. One of the ways to do that is to reduce our dependency upon foreign oil. One of the best ways to do that is to have an energy bill from Congress as soon as possible so that we can establish a baseline in our policy. And if it is not a perfect law, at least it will be one from which we can learn and make adjustments and move forward to try to reduce this very heavy dependency on imported oil.

In 1973, we imported 8½ billion dollars' worth of petroleum and petroleum products; last year, \$445 billion—which, of course, was a major contributor to our \$30-plus billion deficit last year.

The second thing that influences the value of the dollar is inflation. Those who hold dollars look at the realities: that 6-percent inflation means that the value of the dollar in 12 years will be 50 cents and that the value of a dollar in 24 years will be 25 cents. Inflation reduces the purchasing power of those holding dollars; and that does create problems.

The decline of the dollar feeds inflation, and inflation feeds the decline of the dollar; so we have a serious problem, which is related to our oil import problem.

Monetary policy under these circumstances must be prudent; it must strike a balance between the degree to which, on the one hand, the dollar could be aided, and the degree to which, on the other hand, our economy would be slowed, creating problems of underutilized resources and unemployment.

So, we have a very tough dilemma. Because of that dilemma, it is our preference and belief that the national interest would best be served by attacking the problem, first, with an oil policy and, second, with a strong anti-inflation program, rather than relying so heavily on monetary policy.

Mr. GONZALEZ. However, in your testimony the last time, March 9—you thought that this foreign trade imbalance would show no further deterioration.

However, the month of February shows the largest of all, \$4.5 billion.

Mr. MILLER. Mr. Congressman, the trade figures in February were a disappointment. And if we continue to have trade deficits at the rate we had for the first 2 months of this year, we would have a much larger deficit for the full year. And that is of concern to me; the information in February was somewhat unexpected. I am convinced that we have an even more serious problem than I expected a month ago, which makes it more urgent that we have an energy bill and more urgent that we have a strong anti-inflation program.

It also makes it urgent that we try to stimulate opportunities for exporting American goods to help close this gap.

You know, there has been a good deal of discussion about our trade deficit in which two components of it have been noted. One is oil imports, which is on everybody's list of what creates the problem. The other is relative growth rates between our economy and the economies of other industrialized nations, the argument here being that when we have a higher relative growth rate than other countries our economy absorbs many imports in addition to oil because we need them to keep our economy growing at that high rate. Moreover, we cannot export as much because of the lower growth rates elsewhere.

As you know, there has been considerable discussion of this issue; some of the EEC countries have been meeting recently to discuss whether they have any prospects for adjusting their growth rates to help close some of that gap.

But I think correcting the trade imbalance takes a number of efforts. The problem of oil imports must be addressed, and a change in the relative growth rates would be helpful so that there is less disequilibrium in trade.

But it is also important that we bring down our inflation rate.

Mr. GONZALEZ. Mr. Chairman, I am very disturbed, because you depend—

The CHAIRMAN. The gentleman's time—

Mr. GONZALEZ. I just want to complete this, that is all, Mr. Chairman.

The CHAIRMAN. Very well.

Mr. GONZALEZ. Then I am afraid we are open to a karate punch, which is what I am afraid of now.

Mr. MILLER. If we do what, sir?

Mr. GONZALEZ. If we are going to wait on this mission represented by the so-called energy bill pending now, I am afraid we are leaving other options that I feel something is demanded now to avoid a karate punch.

Mr. MILLER. As you know, I have felt the first step is to have an energy bill. I have felt that, in the absence of an energy bill in the very near term, other actions should be taken.

Mr. GONZALEZ. I ask unanimous consent that I may be permitted to offer in writing four questions for the record.

The CHAIRMAN. Is there objection?

Hearing none, the gentleman is accorded that privilege.

[The questions submitted by Congressman Gonzalez, and answers from Chairman Miller, may be found in appendix I.]

The gentleman from Illinois, Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman. I want to join the other members of the committee in welcoming Chairman Miller back to the committee. I want to commend him for his appearances, two occasions now before our committee, his straightforwardness, his candid and open answers.

And I am hoping that that will continue on his part.

I think the committee enjoys answers that are straightforward, especially in language that we can all understand.

Mr. MILLER. That is the only language I know, Mr. Annunzio.

Mr. ANNUNZIO. Chairman Miller, like all of my colleagues, I was at home for the Easter recess. And one of the major problems, at least everywhere I went, I was confronted with was the cry of inflation. I represent a district that is predominantly middle class. The average voter in my district is about 50 years old or over, many people living on fixed income. We hear so much about unemployment and other issues. But the burning question in their mind is inflation. The high prices. Now it is permeating their pocketbooks and their style of living so that as all of us know, inflation has reached a point where it absolutely defies textbook solutions.

I know that the idea of wage and price control is not something that any of us like to think about. But I am wondering if the economy continues on its present course, would you and your colleagues favor a wage and price control program?

Mr. MILLER. Congressman Annunzio, I would not favor direct wage and price controls. And I know of no one in the government who would. The reason is very simple. I don't think they will work. Our experience has shown that, in this very large, dynamic economy with its inherent characteristics of large private inputs and options, direct wage and price controls work only in periods of national emergency, such as in wartime, when there is a completely unified viewpoint.

Our experience trying them this decade, during a period of serious inflation but without such a national emergency, was very unfortunate. We saw distortions, and we saw the breeding of additional inflationary forces that we are still fighting today.

So I would be completely opposed to direct wage and price controls. I am in favor of making inflation our No. 1 priority in terms of domestic policy, because it is as insidious a force as your constituents have informed you. As I mentioned at our last meeting and as I have said since, even from the time I was nominated on December 28 until today, it is pretty apparent to me that inflation has become a more difficult problem than I anticipated.

Therefore, it deserves tremendous attention. It deserves a marshaling of all the resources of leadership and action we have to counter it. And it requires that we must all discipline ourselves and give the inflationary impact of what we do much greater consideration in our decisionmaking.

Mr. ANNUNZIO. Thank you, Chairman Miller, but I should mention that absent the national emergency, having reached that proportion, I want to go on record this morning stating that as far as I am concerned inflation is not only our No. 1 priority to be resolved, but it has reached a point of national emergency. And for years this committee has passed legislation giving the President of the United States the authority to use wage and price controls as a standby measure, I appreciate your answer.

You feel it is not a national emergency. But when you talk to the people, as far as they are concerned it is a national emergency, and I do feel that the administration must seriously think about some kind of a policy to bring our economic system back into order.

Mr. Chairman, I have just one more question. Chairman Miller, another question that has concerned me for some time is about regulation Q. As my colleagues know, I have proposed on many occasions that regulation Q be made a permanent regulation. I am tired of year after year regulation Q being held hostage. The last several years I have sponsored legislation trying to get it extended to 2 years. I think the most we ever got it extended was 1 year.

Now, at least in my opinion, one of the best ways of insuring an adequate mortgage money supply is the maintenance of this quarter of 1 percent differential allowed the savings and loan industry.

I would like to know how you feel about this differential or whether or not it is important to grant some type of such benefit to S. & L.'s in order to insure mortgage money?

Mr. MILLER. Congressman Annunzio. I share your emphasis on the need for adequate capital resources to finance our housing needs. I think that is critical. I know that the thrift institutions and the S. & L.'s have performed a great function in many parts of the country in this regard. I also know that we have seen improvement in the fundamental stability of those sources of capital, both because of the greater dependence today than we have seen in the past on longer term deposits in those institutions, and because of the availability of backup resources from nondeposit sources of funds. Those are all encouraging things. As to the differential, it is my understanding that there is a task force working on this problem now and that the Federal Reserve is participating in it with other bank regulatory agencies. Perhaps

when I have heard all of the inputs from those sources, I can better answer your question.

But I will say, categorically, that I think it's essential that we maintain a financial structure that accommodates the housing industry that is the key to our economic progress.

Mr. ANNUNZIO. My time has expired and I thank the gentleman.

Mr. MILLER. Thank you.

The CHAIRMAN. The gentleman from Florida, Mr. Kelly.

Mr. KELLY. Thank you, Mr. Chairman.

I yield to my colleague for 1 minute.

Mr. BROWN. You talked about the energy problem and the potential for a legislative solution. You said if that did not occur, you would then advocate other actions. What other actions were you alluding to?

Mr. MILLER. It seems to me that petroleum importation has become too critical to sustain our own economic well-being, and that our dependence on foreign oil has become excessive; this has created the problems I mentioned.

In the absence of congressional action, it seems to me that the President could well give consideration to direct action on imports, either through some sort of fee—which he is authorized to impose under certain circumstances—or through a quota.

If we come to that, I have expressed myself publicly as preferring the fee approach. But I think that in a few weeks, if we do not expect to have congressional action, the President might well consider that initiative on his own. That initiative wouldn't have to last forever; it could be an approach to be in force only as long as legislation hasn't come forward from Congress to address the problem.

Mr. BROWN. But, Mr. Chairman, the thing that bothers my mind, and appears to be almost an intellectual schizophrenia, is you can talk about imposing a \$5-per-barrel fee or even higher, I have heard, in order to effect conservation, I presume, and you some way walk the tightrope of saying that wouldn't be inflationary but will effect conservation.

But if you give the producers that \$5 per barrel, that is going to neither effect conservation and it will be inflationary.

How can you possibly walk that line?

Mr. MILLER. In the first place, I think any program that lets market forces loose to solve our problem—by creating incentives for development of new sources, or by shifting to old sources, or by reducing or conserving our use of energy—any of those things will add to the unit cost of energy. Unless we offset that with a reduction of our utilization of energy, there will be a new addition to cost which will be inflationary.

But let me assure you that the alternative is even more inflationary. The decline of the dollar since last September will add about three-quarters of 1 percent to the inflation rate in this country by the end of this year. A \$5-per-barrel crude oil tax would add less; and if it returned the dollar to where it was last September, we would be even better off.

So, in terms of the tradeoffs in this very complicated area, if we continue to be at the mercy of oil exporting nations and make no significant progress in reducing our dependence, we are faced with inflationary pressures from petroleum in any case; and we are faced with problems with the dollar that add more inflation.



It is not an easy task, but if we could agree that inflation is so serious that it is an emergency—I think I can agree with Congressman Annunzio on that—then it is important that we take some steps which will not be popular with everyone. But I think these are steps that we have to take, medicine we have to take.

If we fail to have the courage to take these steps, then I think the inflationary forces we have been predicting may turn out to look low. If that is true, we will have far more problems in sustaining our growth and providing the employment levels we want.

Mr. BROWN. Mr. Chairman, I have more than used up my time. I just would like to say that an import fee doesn't cause any kind of incentive for greater production of oil and gas in this country; the incentive for increased oil and gas production is increased profitability.

I have never seen a tax provide production or profit to any concern.

Thank you, Mr. Kelly.

Mr. KELLY. I would like to ask you this question. The difference in the growth rate between the United States and our trading partners has been to a very large measure due to the artificial stimulation of the economy; isn't that true?

Mr. MILLER. No; I wouldn't say artificial—

Mr. KELLY. In either event, the stimulation to the economy was the result of buying jobs, creating jobs.

Mr. MILLER. I would put it in a little different perspective, because so many things have happened in the last 10 years and many shocks to our economic system have been incurred.

Mr. KELLY. Have we been trying to stimulate the economy? Has the Government been doing that?

Mr. MILLER. Certainly the actions of the Government have been stimulative in the last few years.

Mr. KELLY. Has that been the purpose of it, to stimulate the economy?

Mr. MILLER. I don't know. I would have—

Mr. KELLY. Was that the announced purpose?

Mr. MILLER. I would have to ask each of you how you perceive it. I think one of the purposes was to—

Mr. KELLY. Excuse me, Mr. Miller. I didn't ask you how we perceive it. I asked was it the announced purpose of the Government to artificially stimulate our economy by Government expenditures; was that the purpose of it?

Mr. MILLER. I think Government expenditure levels have been a part of an economic program that was stimulative and was so intended.

The CHAIRMAN. The time of the gentleman has expired.

Mr. MILLER. I am not sure I understand the question. Obviously deficits are stimulative, but I am not saying Congress voted deficits to be stimulative. They may have voted deficits because they wanted to reduce the high level of unemployment, for example.

Mr. KELLY. The administration announced that it wanted to stimulate the economy; is that not so?

The CHAIRMAN. The gentleman from Maryland.

Mr. MITCHELL. Mr. Chairman, will you note the time that is being given to me so I can be sure to get my 5 minutes with no intrusions?

Mr. Miller, let me comment briefly on two things. No. 1, I do not share your enthusiasm for the urban policies proposed by the admin-

istration. I know that the mayors and the Governors must make some soothing sounds about it because they are to be the recipients of it. But it is inadequate, it is underfunded, and it will not have the impact we desire. I state that very flatly. I am primarily concerned with this proposed policy because of the lack of attention given to the unemployment problem. I think there is a growing feeling in Congress, in this country, and hopefully in the administration, that white America is back to work but black America is not. Nevertheless, you say, let's start restraining, moderating our policy, and leave blacks pretty much where they are in the unemployment picture. I must make that comment because that is the way I feel.

It is clear that the urban policies proposed by the President will not have the kind of impact that many of us desire.

The second comment is with reference to Chairman Reuss' earlier discussion about the Federal Open Market Committee's secrecy. I share the chairman's concern. Why should there be double standards? Chairman Reuss is right. We in Congress are required to have open sessions, open discussions. I see no reason why the deliberations of the Federal Open Market Committee ought to be closed and held in secrecy, as you indicated.

The CHAIRMAN. Would the gentleman yield very briefly?

There may be a way out of this dilemma. Chairman Miller has suggested that it might inhibit the freedom of action of the Federal Reserve Board of Governors if they were required to state their reasons. We have on our committee, a subcommittee chaired by the gentleman from Illinois, Mr. Annunzio, which has evolved a device for protecting the anonymity of witnesses, and I would ask the gentleman from Illinois if he and his staff would be able to devise masks of some sort—

Mr. MITCHELL. Mr. Chairman—

The CHAIRMAN [continuing]. For Federal Reserve members who are afraid to state in open court—

Mr. MITCHELL. Mr. Chairman, with all due respect to the Chair, I would wish that that question would be put to him after I finish. I have so little time to propound some questions.

The CHAIRMAN. I will not impose further.

Mr. MITCHELL. I appreciate the kindness of the Chair.

Some feel that if the money is restrained, Mr. Miller, interest rates, especially short-term rates, will rise. That is generally the thinking. However, we had a different kind of phenomenon last year. As you know,  $M_1$  growth accelerated to nearly 8 percent, and short-term interest rates jumped about 2 percentage points.

My question thus is: Will restraining money growth increase or decrease interest rates, including short-term rates?

Mr. MILLER. Of course, the answer depends on the rate of growth of the economy. Last year, the rate of growth of  $M_1$ —7.8 percent—was faster than the FOMC had established in its ranges. But nonetheless, with the  $5\frac{3}{4}$  percent real growth of the economy, the result was some increase in short-term interest rates.

If the economy had grown at a slower rate, I would say interest rates would not have increased. So it was the interrelationship of the rate of growth of money and the growth rate of the economy that produced this effect.

I might comment on your observations, because I agree with them. I think we cannot be satisfied and cannot be complacent about the problem of unemployment. The rates of unemployment for many groups of Americans, certainly black Americans, and certainly many other disadvantaged Americans, is far too high.

As we have discussed before, however, there is a limit to what macroeconomic policy can do to improve that picture. We need, I think, to have a complete economic program which includes some targeted programs for structural unemployment.

I would make just one other important comment to respond to your issue on the urban program.

Mr. MITCHELL. Would you hold for just a moment on that, because I wanted to raise a question about the macroeconomic approach on unemployment.

Mr. MILLER. Certainly.

Mr. MITCHELL. As you know, 4 million jobs were created in 1977, and though the white rate of unemployment decreased, the black rate remained the same. In fact, it actually increased for black teenagers and for some others. The most recent statistics from the Department of Labor indicate that that black unemployment continues to increase.

Recognizing the limitations of the monetary policy approach, what, if anything, specifically would you try to do to help ameliorate that situation?

Mr. MILLER. We would try to seek solutions that do not leave monetary policy as the sole counterforce to our inflation problem. My message has been—and my message today clearly is—that the inflation situation is so serious that it will impact and threaten the opportunity for jobs for all Americans. The burden of inflation certainly will fall heavily on those who need jobs the most.

If inflation continues, regardless of monetary policy, interest rates will rise for long-term capital. There will be a slowdown in housing; there will be a slowdown in business; there will be a slowdown in the economy; and there will be an increase in unemployment resulting from inflation.

If the Federal Reserve is left to deal with the problem alone, it has one of two choices: It can try to act soon to restrain the forces of inflation by restricting the growth of the monetary aggregates, in which case the economy would slow down early and, perhaps, moderately; or it can increase the rate of growth of the money supply to finance the higher levels of inflation—can open the printing presses to pay the price of inflation—in which case inflation will accelerate, economic dislocation in 2 or 3 years would be very substantial, and there would be even greater unemployment and greater distress.

So we have a very serious dilemma. That is why we are trying to encourage our economic counterparts in the Federal Government to take a strong hand against inflation: so that we can, in monetary policy, maintain conditions for growth.

That is what we—

Mr. MITCHELL. My time is up. I see where you are coming from. You needn't say more. The essence is fight inflation, make that the No. 1 priority. Fight inflation by reducing fiscal spending, reducing stimulus, thus leaving blacks pretty much where they are. That is the pattern.

Thank you very much, Mr. Chairman.

Mr. MILLER. No, even in my own outlook for the year, you will notice that I contemplate further reduction in unemployment. I contemplate that only by getting inflation under control can we have conditions for growth in the economy that would get us to the lower unemployment levels we all want.

If we fail to control inflation, then we will have—whether we like it or not, regardless of what we do—a slowdown in the rate of growth.

The CHAIRMAN. The gentleman from New York, Mr. LaFalce.

Mr. LaFALCE. Thank you, Mr. Chairman.

Mr. Miller, there is presently before the Fed a proposal that would permit the creation of a domestic-international banking branch. It would require a change in regulation Q and regulation D, insofar as interest on short-term deposits are concerned, and reserves on those deposits.

It is a rather technical process. If you are familiar with it, I am wondering as to your present thoughts on it.

Mr. MILLER. This is the domestic-international banking facility?

Mr. LaFALCE. Yes.

Mr. MILLER. I think it's an intriguing idea.

Mr. LaFALCE. The entire Euro-dollar market is outside the United States: London, Cayman Islands, Bahamas, and so forth, and the jobs attendant with it. It just seems to me as if it is an excellent proposal, and that the requisite changes in the Fed regulation are necessary before we can bring those jobs back here.

Mr. MILLER. Congressman LaFalce, I think that it is an intriguing idea that deserves consideration. I have studied it only briefly so far. I would have no objection to taking a harder look at it. I think we have to be careful and be sure that it will accomplish what is intended, and that it will not create some leak in the dike for domestic banking to creep in somehow.

And the segregation of the activity—

Mr. LaFALCE. We already do regulate under regulation M certain overseas operations. While it is a problem, it is certainly one I think we can deal with. I hope you wouldn't approach the problem with the perspective of: How can we deal with it?

I might go on to the second question—and I have three, so I hope you will be brief on the second one.

I am concerned with the apparent exodus of banks from the Federal Reserve System; and the usual refrain from the Fed is: Let us have interest on reserves. It seems to me we need some total approach to the problem. We have to understand the problem better, and then need some total approach to it. I am wondering what you are contemplating along those lines.

Mr. MILLER. I think there are several ingredients necessary to a comprehensive solution. First, because of the burden of membership, we need to find some method for compensating for sterile reserves. That, of course, would lessen the burden on member banks.

I would like to couple that approach, however, with the establishment of explicit pricing for Federal Reserve services. I believe ultimate equity depends upon having those who use the services pay for them; it is not fostered by just having a pool from which some people get benefit and some don't.

The third ingredient I think is needed is some way to shelter the Treasury from any loss of revenue from paying interest on reserves. The Federal Reserve might have to make up the difference in revenue for a couple of years to ease the transition.

And a fourth aspect is whether, once we have explicit pricing and some form of compensation to the banks for their required reserves, we don't also want to look at opening up access to some Federal Reserve services on a broader basis. Member banks would be the only ones entitled to direct access to the discount window; but perhaps nonmembers could use some of the other services of the Federal Reserve to assure that there is a competitive environment for arranging the best payments mechanism we can.

Mr. LAFALCE. Very good. I will be looking forward to your explicit discussion and presentation of those proposals.

Mr. MILLER. Thank you.

Mr. LAFALCE. Now my last question: We have twin evils in this society of ours, unemployment and inflation. You have stated your opinion that at the present time inflation should be our No. 1 priority.

I happen to concur with that at this point in time. Take that concept in concert with the fact that the Federal Reserve is a creation of Congress, that it is independent of the executive branch of Government, although it must work in cooperation with it of course, and answer this question: What do you contemplate the role of the Federal Reserve to be concerning executive legislative initiatives such as social security bill, the minimum wage bill, the Humphrey-Hawkins bill—do you think it should be within your province to speak out on these executive legislative initiatives insofar as they impact problems as you perceive them within our society, particularly the No. 1 problem of inflation?

Mr. MILLER. Mr. Congressman, I want to clarify my position. It is my position that we must attack the problems of unemployment and inflation together, because I believe they are interrelated. We cannot have full employment if we don't have low inflation, and we cannot have low inflation if we don't have full employment; these goals are related.

My only point is that we have made some good progress in the last 12 months on the jobs front, but we are off target on the inflation front. So we have to give it more focus, more emphasis, and more priority, but not lose sight of the fundamental goal of full employment and prosperity and sound values in our system.

The role of the Federal Reserve in the broader economic sphere is, I think, manifold. One of our jobs, of course, is to counsel and to express to the other economic policymakers in the Government our views on the matters you point out, so that as policies are shaped, we have a chance to make our suggestions and evaluations known; and I think we have open channels for doing so.

I am sure we will have an opportunity to make our inputs as policies are shaped. I think we have a second obligation, and that is to speak with candor on our views of the proposals after they are developed.

And, hopefully, our persuasive ability will be such that many of the proposals will be consistent with our views. On others, perhaps, we will make additional suggestions or adjustments; or we may find

some proposals that we think are incorrect. So I think our role is, first, to be an internal source and collegial voice in developing policies; and, second, to be an independent voice on the adoption and implementation of policies.

Mr. LaFALCE. I would just wonder if you have any comments on the present proposals in Ways and Means to roll back some social security increases we enacted last year, and on the Humphrey-Hawkins bill that the Senate still has to consider in the future.

Mr. MILLER. Those are pretty big questions. I don't know if the chairman is going to give me time to answer them right now or not.

The CHAIRMAN. Because we have many members who have not had an opportunity to ask questions, and the gentleman's time has expired, if Chairman Miller would be good enough, when he goes over the transcript, give the complete answer to Mr. LaFalce's question.

Mr. MILLER. Certainly. I would be glad to.

[Chairman Miller subsequently submitted the following information for inclusion in the record at this point:]

Thank you for the opportunity to comment on the social security tax increase and the Humphrey-Hawkins bill which has passed the House and is pending in the Senate.

Increases in social security taxes are a two-edged sword. On the one hand, they directly increase the costs of production and contribute to inflation. At the same time, higher social security taxes reduce workers' take-home pay, thereby eroding their total purchasing power and probably increasing their future wage demands. Because inflation is a serious threat to continuing economic expansion, careful consideration must be given to the proposals pending before the Ways and Means Committee. However, a simple, temporary rollback of these tax increases, or some other quick fix designed to ameliorate the near-term inflation problem, is not enough. The increases in social security taxes were enacted because of an underlying tendency for long-term benefit disbursements to outrun program revenues, an unacceptable state of affairs for all parties. A more appropriate approach would be to reconsider the entire existing social security program, including eligibility criteria, benefit levels, and benefit escalation.

Since I have already responded to Congressman AuCoin's question concerning the Humphrey-Hawkins bill, there is only one additional comment I wish to make at this time. The bill, as passed by the House, mandates the development of five-year projections and the adoption of long-term goals partly based on such projections. Given the track record of economic forecasts during the 1970's, I fear that such forecasts may be seriously misleading, and create additional undesirable rigidities in Federal Reserve macroeconomic policymaking.

The CHAIRMAN. The gentleman from Iowa, Mr. Grassley.

Mr. GRASSLEY. Thank you, Mr. Chairman.

Mr. Miller, I have a general question or two dealing with the independence of the Fed. I think the independence of the Federal Reserve System is very closely connected with the maintenance of a sound monetary policy in this country, so you understand then what direction I am coming from when I ask these questions.

Previous Fed Chairmen and previous administrations usually met to discuss general matters, at breakfast, or other meetings, particularly with the Secretary of Treasury of those administrations.

My first question to you is: What kind, how often and in what environment do you have discussions with administration officials; and are these discussions any compromise of the principles of independence of the Fed?

Mr. MILLER. I will answer in reverse order. I think there is no compromise of the independence of the Fed in carrying on discussions with other officials in the Government who are interested in economic

policy. There is none because we continue to use these discussions only as a basis for considering matters of mutual interest and policies of mutual concern.

I do meet with the Secretary of the Treasury once a week if we are both in town. Our staffs tend to meet once a week. These meetings may not involve me; they may just involve some of our staff working on technical aspects or coordination of our activities. We act as fiscal agent for the Treasury and do a lot of other things with the Treasury.

I usually meet periodically with the Chairman of the Council of Economic Advisers. And I also meet occasionally with the officials in other agencies of the Government who are dealing with economic issues.

As you probably know, on occasion the President asks for a number of us to come in and sit down with him and discuss economic matters; that may, I think, be a continuing procedure.

Mr. GRASSLEY. From that standpoint, I would detect that your relationship with the administration doesn't depart too much from what we have been told have been the patterns of previous administrations and previous chairmen.

Mr. MILLER. I know of no difference. I have really picked up the agenda that was established by Dr. Burns.

Mr. GRASSLEY. Are you taking any new and/or different actions to insure the independence of the Fed as it might be within your power to do so?

Mr. MILLER. I don't know of any action that is necessary. Our commitment to independence is absolute. I think there is no one in the Federal Reserve who is not fully committed to the concept of independence. I detect, in the arrangements that have been made since I succeeded Dr. Burns, no evidence of efforts to subvert that independence. I do not think our discussions entangle us or require us to become silent supporters of something in which we don't believe. So I haven't found any forces at work that seem to require a new initiative as far as independence.

Mr. GRASSLEY. This final question would probably give you an opportunity to sum up what you have previously said. But is the independence of the Fed in any danger from either political pressure from this administration or from the Congress?

Mr. MILLER. I don't detect it at this time. The President has stated over and over again that he believes in the independence of the Fed. He has stated that, at the time that I was nominated and at the time I was sworn in. There was a slight slip when I was sworn in giving us constitutional blessing, but I know it is only the Congress that has created the Fed, not the Constitution—although perhaps that is an amendment we should look into. [Laughter.]

Mr. GRASSLEY. I would at this point yield the balance of my time to Mr. Kelly.

Mr. MILLER. I didn't finish answering his question last time, correct?

Mr. GRASSLEY. Mr. Kelly.

Mr. KELLY. I thank the gentleman for yielding.

Mr. Chairman, I would like to pose two questions to Mr. Miller in the event he doesn't have time to answer, and ask that he answer for the record.

One of these questions is does the Fed have authority to make direct loans to the city of New York in order to solve their financial problems,

and are you contemplating anything in this area and to what extent has the Fed given consideration to the New York problem. Does the Fed have plans to finance New York City in the event the Congress decided not to? What rationale would you have for why the Fed would undertake the risk when the marketplace would not and the investors there would not voluntarily do so?

The other question I have is, you have indicated that you commend the President's urban policy. One of the things the administration is going to do is to solve the problems of the city. The problem of the city primarily is that it is losing its jobs. In the recent past, 85 percent of the new jobs in the private sector in the United States have been created in the South and in the West. The northeast and the north-central part of the United States has either been losing jobs or growing more slowly. The jobs are fleeing that part of the country because of high taxes, high utilities, industrial wages and union control.

Now, isn't the administration simply financing inefficiency when they pour money into a political and social solution such as the President's urban policy rather than trying to solve the problems of inefficiency that have caused the distress?

The CHAIRMAN. The time of the gentleman has expired. If it is agreeable with Chairman Miller—

Mr. MILLER. I will be happy to answer those for the record, yes, sir.

[Chairman Miller subsequently submitted the following material for inclusion in the record at this point:]

In response to your first question, municipalities, along with other types of institutions that are not members of the Federal Reserve System, may obtain credit directly from Federal Reserve Banks under certain conditions specified by the Federal Reserve Act. However, these statutory conditions and the regulations established to administer them set rather narrow limits on the scope of such borrowing.

Paragraph 13 of Section 13 of the Act authorizes Federal Reserve Banks to lend for periods of up to 90-days directly to individuals, partnerships and corporations—subject to whatever restrictions are imposed by the Board of Governors—so long as the borrowing is secured by U.S. Treasury securities or by the fully-guaranteed obligations of a Federal agency. For this purpose the term "corporation" includes State and local governments.

Paragraph 3 of Section 13 of the Federal Reserve Act permits the Federal Reserve to make emergency loans to individuals, partnerships, and corporations under terms that accept a broader range of collateral than paragraph 13. However, the statutory language for these loans sets other conditions that constrain their use. They can be made only in "unusual and exigent circumstances"; they must be approved by not less than five members of the Board of Governors; the Federal Reserve must obtain evidence that the borrower is unable to secure adequate credit accommodations from other lending institutions; and the loans must be endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank. In short, more limitations on these loans are cited in the statute itself than in the case of paragraph 13 loans.

Emergency loans made under these provisions of the Federal Reserve Act would thus be at a higher rate than the basic discount rate and would typically have to meet several criteria. Other credit sources would have to be exhausted; unusual and exigent circumstances would have to exist; the borrower would need to be solvent and to have adequate collateral; the borrower's need would be for short-term accommodation and his basic financial position would have to permit early repayment; and the borrower would need to show that failure to obtain Reserve Bank credit would risk a significant economic and financial impact on the surrounding area, the region, or the nation.

Some members of Congress have suggested that Section 14(b) of the Federal Reserve Act provides the Federal Reserve with a more explicit mandate to provide broad financial support directly to New York City. The language of 14(b) states that a Federal Reserve Bank has the power to: ". . . buy and sell, . . .



bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, . . . such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board:". There is nothing in the Federal Reserve Act or its legislative history, however, to suggest that this provision contemplated the purchase of municipal securities as a means of aiding financially distressed communities.

The System's largest purchases of municipal notes under this authority occurred during the 1914-1917 period before the establishment of a formal or centralized Federal Open Market Committee. This was an era in which open market operations were not used as an important instrument of monetary policy. Some purchases of municipal warrants were made by individual Reserve Banks as a means of providing these banks with a source of income, but not to assist financially troubled communities.

Examination of Board records indicates that a few purchases of municipal obligations took place up to 1933 essentially as an accommodation for members banks that were experiencing liquidity problems at a time when authority to lend to banks through the discount window was more limited than it is now. In no instance were purchases made by Reserve Banks to provide assistance to financially distressed municipalities. Since 1933, the Section 14(b) authority to purchase municipal warrants has not been used.

The practical basis for Federal Reserve lending to municipalities and other nonmember institutions is thus quite limited. The System can be a lender of last resort on a short-term basis when unusual and exigent circumstances exist, and certain other criteria are met. Whether any such loan is appropriate depends, of course, on conditions at the time of loan application, including an evaluation of the borrower's ability to repay, the likely financial and economic impact of a failure to obtain System credit, and the adequacy of available collateral. Most importantly, with regard to the possibility of a loan to New York City, the Federal Reserve would have to assess the risk that a precedent would be set, making it difficult to avoid lending to a large number of similar borrowers. If such lending were undertaken, the Federal Reserve would inevitably become enmeshed in the tasks of monitoring loan compliance, judging the eligibility of competing prospective borrowers, and allocating credit among those units. Coping with political pressures generated by this process is not the proper province of the Federal Reserve and could seriously interfere with the effective management of general monetary policy.

You also asked whether the President's urban policy would result in "financing inefficiency" rather than solving the fundamental problems of the cities.

The President's urban policy does not involve large new outlays of funds. Rather, it largely attempts to simplify and to redirect existing Federal programs to secure the maximum benefit from local public and private resources. As I see it, this is a suitable purpose for a sound urban program; this is, not to distort decision of business firms as to where they should locate, but to promote policies that help in the orderly movement of workers and jobs to more efficient areas while minimizing the social costs of such changes.

The competitive disadvantage to business firms of high taxes, wages, and energy costs is a serious problem for many areas of the country. In general, the Federal government should not promote policies that distort firms' decisions to adjust to such cost differentials. When employment opportunities shift, we want to encourage people to move to those jobs. However, there are social costs involved in rapid and massive locational changes. The areas receiving new migrants frequently have to construct new housing, sewer systems, and schools. Community services of all types often become strained.

However, the burdens are usually more troublesome for communities losing population and jobs. The existing social capital often becomes under-utilized and then decays. As President Carter has suggested, our existing cities and towns are valuable national assets. Their social capital can be utilized, rehabilitated, and complemented so that it can make private investment more profitable. Federal expenditures on roads, dams, and other public works have done much to increase private investment in the South and the West. Why incur the costs of investing in new social capital when useful assets are already in place? The problem of the mature economies in the North and Mid-West are further compounded by the fact that our migration often involves the loss of skilled workers while the unskilled workers remain behind. The proposed urban

policy is aimed at encouraging public and private investment in lagging economic areas in a way that fully utilizes these remaining physical and human resources.

In addition, there is a human element to be considered. Many workers have strong attachments to their homes and families where they now live. These attachments imply that labor market adjustments to economic incentives in new areas frequently occur with a long lag. We should pursue policies that encourage and help younger workers to migrate to growing areas. At the same time, it is important to help those who remain in slower growing regions by providing meaningful economic opportunities.

The CHAIRMAN. The gentleman from Oregon, Mr. AuCoin.

Mr. AuCOIN. Thank you, Mr. Chairman.

Mr. Miller, you indicated to the gentleman from New York that you would respond to his questions for the record. It turns out that his questions and mine are almost identical.

I came here anxious to hear your point of view, that inflation was the No. 1 problem, because I happen to agree with that, and I compliment you for the answers you gave to Congressman Mitchell. Given the No. 1 priority that should be assigned to inflation and given the emergency nature of that problem and I emphasize the term "emergency," does it make sense to you for the Congress to pass a Humphrey-Hawkins bill that puts a specific target for unemployment rates but speaks only in broad terms of what our objectives ought to be on the inflation side? Does that kind of legislation make sense to you given the emergency priority you have put on inflation?

Mr. MILLER. I would prefer, Mr. Congressman, to see a more explicit reference to the inflation side in the Humphrey-Hawkins bill. If you recall, the previous legislation on this issue that still is very important is the Employment Act of 1946. In that act, we established a national policy of full employment without citing a specific level; the definition of full employment was left to circumstances as they developed.

But that act also has language, often forgotten, that explicitly provides that full employment will be achieved by creating conditions for investment and growth in the private sector of the economy, and with price stability. I think those principles ought to be reaffirmed, and that if we are going to set specific numbers for employment, it would be well to look also at some explicit objective for inflation.

Mr. AuCOIN. So to that extent you see a defect in the Humphrey-Hawkins legislation processing through the Congress?

Mr. MILLER. I see a preference in terms of the process and conditions under which Humphrey-Hawkins would operate. I see that it could work without a specific number on inflation, but I would prefer to have that target. I think the number would have to be developed in the Congress, and I think you can't overlook that it would have to be developed each year.

Mr. AuCOIN. Given the emergency priority that you assign to inflation, do you think it is wise to roll back the social security tax increase that Congress recently passed? This is after all, in a way, a tax on labor which is going to be passed along through the economy and reflect itself in higher prices.

Mr. MILLER. The social security tax increase that we have already had, and the one that will go into effect in January, certainly adds to costs. Since we have a cost-push inflation, anything we could do to eliminate or reduce those costs would be helpful in the fight against

inflation. I hope the Congress will address the issue of a reduction in the increase in social security taxes, but only in conjunction with either adjusting the benefits or finding a means for funding them that does not leave us with a constant, underfunded situation or that does not merely add to the Federal deficit, because that is also inflationary.

Mr. AuCOIN. Would you support general funding?

Mr. MILLER. I would prefer not to use general funds for social security. It would seem to me that some of the thoughts about a temporary tie-in to the COET tax, or something like that approach to funding social security, should be studied. I don't know if it is the right solution or not, but it should be studied—if it were temporary and if we believed that over, say, a 2-year period the Congress would address some fundamental reforms in the social security system.

It may be desirable to find such a temporary linkage to give time. I would hope that if there were, say, a 2-year period for Congress to look at social security, we might consider some of the options for private funding of social security benefits—moving it out of the Government system, which is cost ineffective, and perhaps letting people buy the same benefits in a competitive arena. It might turn out to be a lot cheaper.

Mr. AuCOIN. Are you prescribing a reform of the social security system by which social security then would become optional?

Mr. MILLER. No; by which it could be contracted in or contracted out of the public system.

Mr. AuCOIN. So one could opt to purchase from the private sector if one had means to do so, and one could stay within the public sector, the public finance program if he were not able to go the other direction?

Mr. MILLER. It seems to me that is one possibility. Pension funds which are already in existence, might be a vehicle for providing the same benefits at a much lower cost. One can see the possibility of maintaining a public system for those who don't have an alternate mechanism.

Mr. AuCOIN. Don't you see a weakness that you might create with the system itself if you allow some people to opt out?

Mr. MILLER. No; I don't think so. The British are going in this direction.

Mr. AuCOIN. The British are going many directions that I wouldn't want this country to follow.

Mr. MILLER. This is one they have gone into directly. Maybe it is part of the reason that their inflation is beginning to drop.

Mr. AuCOIN. My time has expired.

The CHAIRMAN. The gentleman from South Carolina, Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Chairman Miller, on a relative scale of zero to 10 in the area of inflation, where would you put the energy crisis that we now face and where would you put the continued deficit financing by the Federal Government?

Mr. MILLER. I would put them both in the high part of the scale of zero to 10. They are different kinds of problems, yet I would put them both in, say, the 80 percentile range of importance in fighting inflation.

Mr. DERRICK. So you think they are equally important?

Mr. MILLER. Yes; I really do. The energy problem will build up and will continue to erode our economy if we don't start the process of independence. We can't correct our dependence on foreign petroleum products in a hurry. But unless we start the procedure, we are going to have the continuing threat of inflationary pressures for a long, long time. That is why it is such a high priority.

On the other hand, we do have more ability to make choices in solving the problems of our deficit. That is, the discipline imposed by spending and taxing. I think that with the fourth year of expansion underway, and with the deficit projected to be larger than in the current fiscal year, one would say there is a high order of importance to bring discipline into that area.

Mr. DERRICK. Two questions, on each one of these areas, as to the deficit. Would you care to comment on any specific areas that the Congress might address in the budget?

Mr. MILLER. Well, I would—

Mr. DERRICK. On the revenue side.

Mr. MILLER. Well, on the revenue side—

Mr. DERRICK. Excuse me.

Mr. MILLER. On the revenue side, Congress is considering a tax cut that would add about \$25 billion—actually when you net it out, I think it is slightly less than that—to the deficit.

There, my own preference would be to adjust that tax cut a little toward more incentive for fixed business investment, because I think that if we are going to have a tax cut, more of the flows ought to go in the direction of job-creating investments that would be anti-inflationary in their impact. So I would like to see more emphasis in that direction.

Particularly, I would like to see more emphasis on faster writeoffs or higher depreciation allowances for fixed investment, because I think this will stimulate investment and do more for our economy long term than just increasing consumer demand.

I also feel that it is very important that the aggregate net reduction not be increased, and that, if anything should be considered, it is perhaps coming out on the skinny side of the proposal.

Mr. DERRICK. You are all for these business incentives, as an alternative for the tax cut?

Mr. MILLER. Looking at the proposed allocation between business and individuals, I think I would weight a little more of the tax cuts, toward incentives that would create investment. I am not saying that I would therefore increase the amount allocated to a reduction of corporate income taxes, because while a reduction of corporate income taxes does improve a corporation's ability to invest, it doesn't insure that there will be an investment. On the other hand, a higher depreciation level means the tax is cut only if there is, in fact, an investment.

Mr. DERRICK. What you are really speaking of is an accelerated investment tax credit.

Mr. MILLER. That is, of course, a form of forgiveness of tax. Higher rates of depreciation are a deferral of taxes.

I prefer deferral of tax through faster writeoff rather than an increase in the amount of tax credit. I think it is more efficient; I think the Treasury comes off better per dollar of tax incentive.

Mr. DERRICK. I have one more I want to slip in here, please. On the matter of energy—do you see rationing as a final alternative, if we don't get a handle on the energy situation?

Mr. MILLER. Congressman Derrick, I hope not.

Mr. DERRICK. Well, I hope not too.

Mr. MILLER. I think rationing is an extreme that we shouldn't have to come to.

We have adopted a policy so far where, by whatever means, we are providing all of the energy resources needed. And while we have had a dislocation or two, because of weather, we have basically had all the energy we wanted. We haven't really tried to use rationing as a technique, because it is so inequitable and results in such distortions. I think the better approach is to use the market system and to price energy in terms of Btu's on a basis that promotes the use of the kinds of energy that are most plentiful and most efficient. One of the reasons that I am less enthusiastic about quotas for restricting importation of petroleum than I am about a fee is that there are problems of how to administer a quota, and some of the possibilities are akin to rationing and that bothers me.

Mr. DERRICK. Thank you very much.

The CHAIRMAN. The Congresswoman from New Jersey, Mrs. Fenwick.

Mrs. FENWICK. Thank you, Mr. Chairman. My questions have been answered, specifically, the budget deficit, but I want to ask the Chairman whether or not the higher taxes and particular the social security taxes, and the rise in minimum wage, have not fostered higher unit costs, because they do foster demand for higher wages, quite understandably. I got a letter from a man who got a \$20-a-week raise of which he received \$8.67 by the time the Government was through with him. This is really beyond bearing, and makes a barrier to employment.

I think the higher minimum wage creates a barrier to employment also, particularly for the structurally unemployed.

We have no less-than-minimum wage for young people, 16 or 17 years old, who might otherwise be employed. The minimum wage simply makes it not economic and sensible for business to employ them. I think that we have an effect here on inflation with these Government-imposed costs which foster unemployment.

I share with my colleagues from Maryland an absolute horror of the tragedy of unemployment. I think we have done everything we can to encourage businessmen to buy machines instead of employing people. We have done it deliberately with Government action.

I am so afraid my 5 minutes will go.

I was interested in the proposal that we lift our oil to the OPEC price. Why isn't that going to be immensely inflationary?

Why suddenly would we go up to \$13 or \$14 or even higher, if OPEC goes higher? Isn't that a tremendously inflationary prospect for business and everybody, and a terrible cost to the consumer?

It troubles me very deeply. Then, finally, double taxation of dividends. Don't you think if perhaps we made business pay profit tax on everything, except what they pay out in dividends, that we would have a more equitable tax in that each individual receiving the dividend would then pay according to ability to pay. We might get more equity

capital too, instead of debt capital, for businesses which wanted to expand?

Mr. MILLER. I will comment as long as the Chairman gives me time on those matters. I agree with you, many of the things the Government has done and the Congress has done are, indeed, inflationary, including some that you mentioned.

With the high rate of unemployment among teenagers, and the apparent phenomena that once a person is beyond age 24 the probabilities of employment are much higher, it would make sense to maintain a lower minimum wage—perhaps even a differential—for teenagers. Experience shows that young people who, perhaps still live at home, and who get some employment and get into the world of work and learn to understand it, do work their way into more useful jobs, more creative jobs, more valuable jobs, very quickly; and a lower minimum wage would help them get started.

On the oil tax, I must say that, yes, any market force that allows the product to rise in price in the face of scarcity, brings about the long-term reduction of inflation, because it forces us to shift away from that resource and find alternative ones. If we don't do that, we are merely living in a dream world; the shortage makes the price higher anyway, but we have never made the shift and never developed a new system.

We must remember that our economy, our Nation, has been blessed with an open continent with unlimited, boundless resources. Therefore, we built an economy based on inefficient use.

Mrs. FENWICK. Right.

Mr. MILLER. The Japanese and Europeans had shortages and no local sources to tap, so they built automobiles that were lighter.

Mrs. FENWICK. I understand. It is so clear.

Mr. MILLER. We have to force ourselves in the direction of making the shift.

Mrs. FENWICK. In that regard, I have been hoping that we would have a 5-percent automatic mandated drop in imported oil—a quota. We might then bend our minds a little more constructively to conservation and to replacing oil with alternate sources of energy.

But you don't approve. You think the quota system would be difficult to administer?

Mr. MILLER. That is an alternative, and I am not opposed to it. I just can see that it will have more administrative burdens and lots of problems.

I wouldn't want to reject it. But my intuition tells me that a fee would be a simpler and more direct and more effective way of going.

Mrs. FENWICK. My time has expired. Could you just give us a word on double taxation of dividends?

Mr. MILLER. Yes. I think we do need to look at the reform of our tax system. I agree with the President that many features of it are unattractive and are not working well. I think some integration of the structure, so we don't have double taxation on dividends, is needed. As to how we go about it, I am open minded. We also need to look at taxation of what we call capital gains. Sometimes it is good to try to apply the same sort of taxing theory to one form of income as we apply to other forms of income, but the result has been to dry up capital, to impair the incentive to invest. That has reduced the creative

force for jobmaking. In that sense, we aren't doing ourselves much of a favor.

I think we have to look at the taxation of capital if we do, in fact, want to create rewards for doing what we should do.

Remember, the nations that have been growing faster and providing fuller employment than the United States are ones that invest more of their GNP in fixed investment. The Japanese invest about 25 percent and the Germans over 20 percent; we invest about 9 or 10 percent.

Mrs. FENWICK. I know.

Mr. MILLER. So we do need to look at this matter seriously. I do not believe that would be antiemployment; it would be proemployment. And it would be pro-people. Any system that encourages the normalization and investment of capital to create jobs and wealth is in favor of people.

Mr. STANTON. The gentleman from California.

Mr. HANNAFORD. Mr. Chairman, I appreciate your candor and durability both. I have one more question. It relates to what you were just discussing. The other day in a discussion, you mentioned and discussed at some length structural inflation. I assume this is energy, food and fiber, wage escalatory clauses, and so on. I have two parts to the question.

One, could you assign a portion of our inflation rate to that matter? Would it be half our inflation rate or such a matter?

Second, and most importantly, it bothers me, related to what you have just said, that we are taxing illusory income in capital gains, in dividends that don't exist, because of the structural—which implies a measure of permanence to—inflation. This is a disincentive to save, to invest. Perhaps that is part of the problem of the stock market, and an incentive to consume and to buy tangible things, land and gold, and so on.

If we have this more or less permanent nature to inflation, does this not call for a somewhat general reappraisal of our tax structure, so we tax only real effective interest rates and real effective income instead of this illusory income, about 6 percent of which is washed away by inflation?

Mr. MILLER. Congressman Hannaford, I think you are absolutely correct. As long as we have this inflation and it continues to persist, we have a tax structure that is working to validate the inflation. Those who are receiving income on their capital are receiving part of the interest as a return of the purchasing power of their capital. The longer they lend it out, the higher their interest rate has to be in order to get back their purchasing power. We are taxing capital.

Mr. HANNAFORD. We are taxing up the interest rate.

Mr. MILLER. Therefore, we are driving up inflation, and regardless of what the Federal Reserve does, this will result in higher long-term interest rates. Neither you, nor the chairman, nor myself, nor anyone else is going to lend money at 25 years even for an important investment, if at the end of 25 years we expect to get back 25 cents of our dollar, and in the meantime, to have had the interest taxed away at very high rates.

So you are absolutely correct. I can't give you a number on how much of our inflation is now structural, because a lot of our inflation was started by, first, unfunded expenditures for Vietnam—the failure

to pay for the war; and second, fuel and food price rises that resulted from dramatic changes.

Now what we are seeing is cost push inflation that goes in the other direction: about 50 percent of American wage earners and other income recipients now have their incomes indexed to changes in the CPI.

Now, if we create a system in this country where there is no penalty for inflation, then we will have inflation. If we create a system where there is no penalty for inflation, and we have inflation, we will destroy economic vitality, because we will destroy the capital base. And there can be no economic growth and there can be no jobs without savings, investment, and productivity. It is just as simple as that.

Mr. HANNAFORD. But, essentially, we are discouraging saving and investment.

Mr. MILLER. Absolutely.

Mr. HANNAFORD. By taxing inflation?

Mr. MILLER. Absolutely.

Mr. HANNAFORD. We are encouraging consumption?

Mr. MILLER. We have run our economy on a philosophy of consumption.

Mr. HANNAFORD. Purchase of land and some of these other things that are having explosive increases in cost. Thank you.

Mr. MILLER. Yes.

Mr. HANNAFORD. I yield the balance of my time.

The CHAIRMAN. The gentleman from Tennessee, Mr. Allen.

Mr. ALLEN. Thank you, Mr. Chairman. Chairman Miller, summarizing what you have said, I take it you consider that energy policy is the No. 1 thing of importance if we are to get any handle at all on inflation, which you consider as the No. 1 problem that we should address.

Asked about wage and price control, you took the conventional position that this administration and others have taken, that you would be opposed to wage and price control. Yet there is one area in which the Federal Reserve can have an important effect.

That is in monetary policy and interest rates. Follow me in seeing if you agree that, in addition to wages chasing prices, and prices chasing wages, that most economists fail to take into account in this inflation the amount of interest that is included in the price of everything we buy.

For example, we start with the producers of the raw material, farmers, mine operators, most of them operate on borrowed capital, and they have to pay interest on that borrowed capital. And they have a markup that they have to charge when they sell their products to the processors.

So, the interest is marked up and compounded by that markup. Then it goes to the processors. And the processors, too, largely are operating on borrowed capital. And they have to pay the price that includes compounded interest from the original source of raw materials.

And they must add to that their own interest charges and add to that their markup. And from there it goes from the processor to the wholesaler who also operates on borrowed capital, and who also has a given amount of markup that he must require in order to come out and make a profit.



Then from the wholesaler, it goes to the retailer who also is operating on borrowed capital, and must add into the price of what he charges, the interest rate plus markup.

Then we finally come to the consumer. And if he buys, as many people in my district have to buy, on monthly payment plans, he has to pay 18 percent interest more. Over a period of time.

Now, do you not consider that in viewing this problem of inflation, that interest rates and the monetary policy controlled by the Federal Reserve bank are a vital factor to be considered? I have not heard any of that discussed here today. That is, the part that interest plays in the price, the ever-escalating prices, of what we are having to pay for what is being produced in our services and commodities on the market today.

Mr. MILLER. Yes, the interest rate is, of course, a factor. And interest rates are much influenced by inflation. All studies have indicated that the real cost of money is—plus or minus—in the 3-percent range, and that the difference between 3 percent and the interest rates paid at all those stages of production in the economy that you mention is inflation. Depending upon the creditworthiness and type of credit the real cost of money is somewhere around 3 percent for long-term capital. It is also clear to me that there is no way to solve the problem by reducing the cost of interest without creating more inflation, and thereby working against yourself.

Those who have savings and have the means to make long-term investments or lend money for long-term investments will not do so at low rates in an inflationary environment. If the Government or the Federal Reserve tries to manage the rates to bring them down, to make interest rates cheaper, we will both fuel inflation and dry up capital, because as we have seen in many other nations, when inflation is a persistent worry and there isn't any assurance that capital is secure, that capital will fly.

It will go into gold; it will go into real goods; and it will no longer go into investment in productive capacity. And the result of that is a snowballing effect; you would create a worse problem.

So as true as what you say is, there is no way to wash out that interest cost except by getting inflation under control. As soon as we bring down the rate of inflation, the rate of interest will drop; and as soon as the interest rate drops, costs will drop; and then we can bring inflation down more and bring costs down more. So, we need a program that starts that ratcheting off of the inflation rate at a half a percent a year until we are down to zero, or as near to it as we can get.

Mr. ALLEN. My time is up, but I would comment that the Federal Reserve has increased its rate at the discount window by approximately 2 percent in the past 12 months. At the same time, inflation has accelerated.

Mr. MILLER. Yes. I don't know what would have happened had the Federal Reserve not done so. I suspect that the inflation rate today would be much higher, and therefore our problem an even more serious one.

The CHAIRMAN. The gentleman from Iowa, Mr. Leach.

Mr. LEACH. Chairman Miller, coming from an agricultural district, I have a couple questions regarding your import fee proposal and its impact on agriculture. The administration has come out with very few

figures indicating exactly who will be paying any type of petroleum sales tax.

We have heard some comments that a tax might fall heavier on lower class people than higher class. However, 16 percent of all petroleum is consumed in the agricultural sector. A higher crude oil fee, in effect, means that the American farmer is going to be facing substantially higher costs of production.

Would you favor any type of agricultural exemption in terms of a passthrough on an oil import fee?

Mr. MILLER. To be perfectly frank, I have not considered the question, and therefore I am not sure I can answer you. I suppose my reaction would be that if we started exempting one sector of the economy, there would be political pressures to exempt them all.

I suspect if we really want to solve the problem, we are going to have to create some penalty for the consumption of products which are in short supply or develop alternate kinds of supplies of energy.

I suspect I would be very reluctant to see an exemption; one can make a case for exemption of everyone, so one shouldn't exempt in the first place.

Mr. LEACH. Let us pursue this, again from an agricultural perspective. Net farm income in 1977 was 50 percent lower in real terms than in 1973. We have also seen farm debt increase to \$120 million, about double the 1973 level.

Would you comment on the state of the farm economy from a banking point of view? In Iowa over half of our banks have over half their assets extended in agricultural loans. For farmers higher petroleum costs imply substantially higher costs of production. Do you think this has, or should have, any impact on the administration's agricultural proposals?

The CHAIRMAN. It is the Chair's intention, it now being 5 of 12, to, of course, recognize the 4 or 5 members who have not yet had a chance to inquire. The Chair would hope that we could finish at 12:30 or so, and thus allow ourselves and Chairman Miller to go about our business.

Is there any objection to that proposed course of conduct?

Chairman Miller, does that sound all right with you?

Mr. MILLER. Yes, sir, Mr. Chairman.

We have been concerned about the status of banks that are in agricultural finance, and the point you make is well taken for several reasons; not only because of the change in farm income, but also because, in the inflationary period of a few years ago, there was a good deal of bidding up of farm land. The psychology of continuing inflation led to the financing of a lot of properties and created unduly heavy debt burdens. This was, perhaps, unwise.

While we are concerned about it, I think we have both a banking network that can handle it, and, of course, the backup of the discount window and other lending procedures that will, I believe, cushion any problems.

Of course, the Federal Reserve window is available only to members or available to other banks only through members. Our viewpoint is that the situation is less satisfactory than we would like, but it is not one that should be of real concern.

Mr. LEACH. Does this mean that you would pledge the discount window in the event of an agricultural catastrophe?

Mr. MILLER. I think we have always been standing by in all areas. The purpose of the discount window is to provide liquidity to banks when there is some sort of squeeze—if it is necessary to restructure loans, or to change amortization schedules. The purpose of the discount window is to create liquidity in the banking system so that we do not have any kind of interruptions in its soundness.

Mr. LEACH. Thank you very much. I appreciate your concern for agriculture.

The CHAIRMAN. Has the gentleman concluded?

Mr. LEACH. Yes.

The CHAIRMAN. The gentleman from New York, Mr. Lundine.

Mr. LUNDINE. Mr. Chairman, I was fascinated by your previous discussion of the relative specificity that we should put on our establishment of policy goals with regard to unemployment and inflation. Do you think it might be helpful for Congress to adopt a fairly comprehensive anti-inflation policy, establishing specific goals for reducing inflation and setting forth in some detail the specific means that might be utilized to achieve those goals?

Mr. MILLER. My first preference, always, is to persevere and also to retain as much flexibility as possible. So my instincts are against legislation that establishes quantitative levels.

None of us, I believe, can project what the conditions of the Nation will be 10 years from now, none of us sitting in this room could predict what would be wise and prudent and appropriate then. Circumstances may change and the numbers we lock in may not be the ones we would like.

In the 1990's, for example, there will be a shortage of labor in the United States. We now think we have very serious unemployment problems, and we do. But by the 1990's, we will have a shortage of labor. So, our problem will be entirely different. Inflation may be a different kind of animal at that time, and unemployment may be of a different dimension. And I think we should bear that in mind.

When Congress legislates specific numbers, the numbers are very hard to change later. I would prefer either for Congress to legislate numbers for a limited number of years—for example, to legislate for what we see over the next 5 years—or to say that each year we will set a 3-year horizon. That way we wouldn't lock ourselves in 20 years from now only to find ourselves with guidelines that are not appropriate under completely new circumstances in the world.

So I like to have flexibility and a living system.

Mr. LUNDINE. Might we also do that by some sort of a formula which takes last year's inflation rate and adjusts for productivity, in order to arrive at a specific goal?

Mr. MILLER. Yes, that is a possibility. But I think you see what I am getting at.

Mr. LUNDINE. Yes.

Mr. MILLER. I am not objecting to having strong goals and strong targets for what we want to accomplish, but I hate for people in 1978 to affect those who may be having different kinds of problems in 1992.

Mr. LUNDINE. Absolutely. Turning to money supply, the revised estimates for growth of 1977 basic money supplies were 7.8 percent  $M_1$ , of course, 7.8 percent. That is 1.3 percent above the top band 6.5 Fed target range given the Congress earlier.

We have had testimony, and eminent economists have said that the Fed could come within a half a percentage point of that target if it wanted. Now, I recognize that in your letter to Chairman Reuss, of March 29, you indicated that the relative monetary aggregates are far from precise. But how serious is the Fed really in achieving " " targets, and is such a wide differential really explainable?

Mr. MILLER. I cannot speak for the past. I think there have been some technical problems in recent years. Over the last 10 years we have seen a period of unprecedented economic dislocations: the financing or failure to finance the war in Vietnam is one; the wage and price controls of 1971, 1972, 1973 are another; the increase in the price of oil and the boycott is another; and the working of that phenomenon into food and a series of worldwide crop failures are another. In the process, interest rates became much higher than we had ever experienced in our adult lifetimes.

As a result, a whole new system for cash management and for the use of the payments and settlements mechanism grew up which changed the velocity of money. So, all of these things made it more difficult to manage the money supply than would have been the case in more tranquil times.

Having said that, I will tell you what my purpose is. My purpose is to tell you that the ranges for the aggregates have been established by the FOMC, and that we will work extremely hard to see that we live within those ranges. And if we cannot live within those ranges, we will come back and give you new ranges so you know where we are going. That is my purpose.

You will judge me later as to whether we have accomplished that.

Mr. LUNDINE. Thank you.

The CHAIRMAN. The gentleman from New York, Mr. Pattison, whom I will appoint chairman pro tempore. I will be back in 5 minutes.

Mr. PATTISON. Thank you.

Mr. MILLER. You are in charge of your own stopwatch.

Mr. PATTISON. I will take unlimited time.

Mr. Chairman, I know from the Wharton index of capacity utilization that we have now made a rather steady climb up to somewhere above 90 percent, both in manufacturing and—manufacturing, mining and utilities. I guess that would indicate that the effect of deficit, budget deficit, would be more serious than it would have been a year ago, when capacity was somewhere in the 1980's.

I would like you to comment on that.

And also in relation to that, I would be interested in your comments on such things as the tuition tax credit which now seems to be pushing hard on us, as to whether that would be wise, quite aside from the virtues of it or merits of it, from an inflationary standpoint.

Mr. MILLER. You are certainly correct that the longer we go in an economic expansion and the more of our capacity we utilize, the more risk there is in a stimulative budget if we are trying to continue to bank the fires of inflation.

So far the budget deficits, per se, have not necessarily worked themselves through in a way that has contributed to inflation, but I think we are at the point where we have to be really concerned about that.

As I have said, I am somewhat disappointed that, in this fourth year of expansion, we expect to enter the next fiscal year with a higher

deficit than in the current fiscal year. That is, I think, an unfortunate trend, and one that I hope we will work to change.

When we come into a period of high utilization, we always run the risk of bottlenecks and, therefore, of price pressures.

But I might comment on a couple of other things. One is that productivity is lagging, as it often does in an expansion. But productivity is critical in creating jobs, and so we have got to be serious about it.

One aspect of productivity is the better use of human resources, which creates a more stable environment; and down the learning curve a greater output per man-hour is realized.

But there also needs to be capital investment. The longest period of peacetime expansion we experienced in this country with price stability was 1961 through 1965. In that period we had a doubling of fixed-business investment, and at the beginning of that period we introduced new incentives for business investment—tax credits, and liberalized depreciation. We had a boom in business investment; we had full employment, price stability, and increasing real incomes.

At this stage, I believe that, because of the high rate of capacity utilization and because of the lagging productivity, we need to create the incentives to start building the capital stock back up. That will not only provide jobs, but will increase productivity and give us a chance to work against inflationary forces.

Mr. PATTISON. I fully agree with that, but I would like you to just very briefly comment on tuition.

Mr. MILLER. Thank you. I have to say that many of the proposals before Congress are meritorious. No doubt the tuition credit idea is meritorious as a form of tax relief; but it is inflationary.

Because it is inflationary, I don't believe we can afford it at this time.

Mr. PATTISON. Thank you very much. With that, I will yield 5 minutes to the gentleman from Nebraska.

Mr. CAVANAUGH. Thank you.

Mr. PATTISON. Those are the second bells of a live quorum. We have 10 more minutes. We can do Mr. Cavanaugh. I understand we are going to go to 12:30 p.m. We will either miss the live quorum or—

Mr. CAPUTO. I will go and come back.

Mr. PATTISON. Fine. The gentleman from Nebraska.

Mr. CAVANAUGH. Thank you.

Mr. Chairman, I am pleased that you have consented to return to the committee today due to the briefness of the time we had with your previous testimony before the committee. I have read that testimony, as well as your testimony before the Budget Committee on March 15, and your letter of March 29; and I am still unclear as to what your personal goals are in terms of the economy and in what context the monetary targets of the Open Market Committee were arrived at.

The only references to projections in terms of unemployment or inflation that I can find in any of those documents is in your letter of March 29. Those do not seem to be projections so much as anticipations.

Could you explain upon what projections the monetary targets of the Open Market Committee were arrived at in terms of inflation, unemployment and fiscal, the level of fiscal deficit?

Mr. MILLER. Congressman Cavanaugh, the process of the FOMC is as follows. We have a briefing from the staff, who give their assess-

ment of the outlook in the key areas of performance of the economy. The members of the FOMC are from various parts of the country, and they are experienced in what is happening in various markets.

They canvass information from their own boards of directors, from those who are bankers as well as those from other industries. And so we have inputs not only from the staff, but from these regional sources.

The members of the FOMC listen to all of this information and make their own assessments; and then, as a collegial body, they establish the various ranges for the monetary aggregates and give a directive to the trading desk at the Federal Reserve Bank of New York as to how to operate in the market to create the conditions for aggregate growth that are consistent with their view.

It is very hard for 12 people to agree on one set of economic projections. So what I have done in my letter is to indicate—after having heard the most recent development of projections by the staff and listened to all of the inputs—what seems to me to be reasonably to be expected from fourth quarter of last year to fourth quarter of this year. These are not my targets; this is an indication of what I think would be the range of probabilities absent—

Mr. CAVANAUGH. Mr. Chairman—

Mr. MILLER. My target, personally, is always to have less inflation and less unemployment and, if necessary, to have higher growth to get there. But, of course, that is a wish rather than a probability.

What I have given, instead, is my assessment of what I think will actually happen.

Mr. CAVANAUGH. Mr. Chairman, are you saying that the Federal Reserve has not set the monetary targets based upon aggregate economic targets in terms of growth, unemployment and inflation?

Mr. MILLER. The FOMC considers the direction of the economy and the aggregate levels that will be able to maintain the performance of the economy while countering inflationary forces. They are not trying to create a model and run the aggregates to get there. They are trying to look at the state of the economy—at the possibility of price actions and employment actions and production actions—and, based on their assessment of velocities, trying to adjust the monetary aggregates in order to achieve certain economic targets, within a range—that part of your statement is correct.

Mr. PATTISON. The gentleman's time has expired. The Chair will ask that the committee will adjourn for 5 minutes, awaiting the return of the chairman and the other members who wish to continue questioning.

[Recess.]

The CHAIRMAN. The committee will be in order again. There are a few additional questions that now-absent members want to ask, but I have one little one.

First of all, let me say, at the near completion of the hearings this morning, that I think I speak for every member of our large committee, when I say that you have earned our respect.

Mr. MILLER. Thank you.

The CHAIRMAN. I think you have handled yourself beautifully.

Now to go from the sublime to the ridiculous. We have a little exchange, of course, about the Miami, Fla., office of the Fed.

Mr. MILLER. Yes.

The CHAIRMAN. That was a problem you inherited. Last March, long before your time, the Fed adopted a guideline which said—I am reading from it:

Candidate sites for analysis should not be limited to traditional city center locations but rather should encompass a wide range of possibilities—including suburban and industrial park properties. Sites which permit future lateral expansion, minimum excavation, large floor areas, adequate surface parking, and sufficient exterior maneuvering space for loading facilities on the building perimeter should be given priority consideration.

Pursuant to that, within the last year, and in defiance of the uniform wishes of the city fathers of Miami, the association of commerce, labor and everybody else, while there was a desperate need for a Fed office in the central city to do something about employing minority groups and other poor people who needed jobs and could have received them there, somehow or other the Fed ignored these needs and instead followed the guideline I just cited. So the decision was made before you ever got there to hunt down these new Fed installations miles and miles out to create new suburban sprawl someplace in the hinterland of Florida.

I objected to that under the pre-Miller Federal Reserve, and then seeing you on the scene, and knowing the noble job you have done in helping to keep Textron in Providence, R.I., in other ways recognizing the needs of the central city, I made a bold move to write you a letter asking you to reconsider. You very nicely replied to me on March 15, 1978.

Under the rule, without objection, I ask that the correspondence from me to you of March 8 and the correspondence from you to me of March 15 be included in the record.

[The correspondence referred to follows:]

HENRY S. REUSS, WIS., CHAIRMAN  
 EDWARD W. PATTISON, N.Y.  
 HERMAN BADILLO, N.Y.  
 MARY ROSE OAKAR, OHIO  
 JAMES M. HANLEY, N.Y.  
 JOHN J. CAVANAUGH, NEBR.  
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 STEWART B. MCKINNEY, CONN.  
 MILDRED FENWICK, N.J.

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON THE CITY  
 COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
 OF THE  
 NINETY-FIFTH CONGRESS  
 604 HOUSE OFFICE BUILDING ANNEX 1  
 WASHINGTON, D.C. 20515

March 8, 1978

The Hon. G. William Miller, Chairman  
 Board of Governors of the Federal Reserve System  
 Federal Reserve Building  
 Constitution Avenue, N. W.  
 Washington, D. C. 20551

Dear Chairman Miller:

I trust that under your leadership the Federal Reserve System will show new concern for the critical problem of unemployment in our urban centers. One of the first steps you could take to evidence this concern would be to withdraw the Board's March, 1977 anti-city guidelines for the location of Federal Reserve facilities, and reverse the subsequent decision to locate a new Miami branch facility in the suburbs rather than downtown.

The March, 1977 location guidelines provide:

Candidate sites for analysis should not be limited to traditional city center locations but rather should encompass a wide range of possibilities—including suburban and industrial park properties. Sites which permit future lateral expansion, minimum excavation, large floor areas, adequate surface parking, and sufficient exterior maneuvering space for loading facilities on the building perimeter should be given priority consideration.

While the opening phrase of the guidelines implies that there is to be a choice between central city and suburban locations, the actual criteria specified make it clear that, with some fortuitous exceptions, only suburban sites can be considered.

At a time when the General Services Administration is drafting a new Executive Order for the President that will emphasize more than Executive Order 11512 of February 27, 1970, the need to retain and locate Federal facilities in central cities, it is highly inappropriate for the Federal Reserve Board to be taking the opposite tack. As we all know, Federal policies working at cross-purposes have been one of the underlying causes of urban distress.



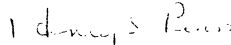
The Hon. G. William Miller  
March 8, 1978  
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Your active leadership of efforts to revitalize downtown Providence, Rhode Island is a matter of record. Miami, Florida is also seeking to preserve and bring new vigor to its downtown business district. Yet, the Federal Reserve Board, overruling the recommendation of the Atlanta Federal Reserve Bank, has chosen a suburban location for the Miami branch facility, which will provide a new impetus to sprawl patterns of development.

It will be said that too much has been spent on the suburban site to reverse the decision now. Such an argument is specious. Ground-breaking has not yet taken place. And if constructed as planned, the facility's hidden costs to the people of Miami will be felt for decades to come. At a minimum, I urge you to halt further work on the site until you personally have had a chance to review the costs and benefits of the suburban and downtown locations.

As for the Board's location guidelines, I am sure you will wish to ask their speedy revision, so that the Governors of the Federal Reserve System can be brought into step with the Administration on urban policy.

Sincerely,



Henry S. Reuss  
Chairman



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

~~Mar~~ch 15, 1978

The Honorable Henry S. Reuss  
Chairman  
Committee on Banking, Finance  
and Urban Affairs  
House of Representatives  
Washington, D. C. 20515

Dear Mr. Chairman:

Thank you for your letter of March 8 commenting on the Board of Governors' site location policies for new facilities and which expresses concern over the decision to construct the new Miami Branch building in the west Dade area.

As you know, I have been concerned with urban revitalization for years and believe the Federal Reserve should promote this goal whenever there is a reasonable opportunity consistent with its responsibilities. However, in the Miami situation there was a lack of flexibility in available downtown sites and the analysis of the Atlanta Reserve Bank and the Board showed a considerable extra cost for construction and for operations.

Let me contrast this decision by noting that a site has been approved for the Baltimore Branch in the center of town, where a site of sufficient size was available for efficient construction and future expansion. Planning for new downtown construction in San Francisco and modernization and enlargement of downtown offices in Oklahoma City and Omaha have also been approved. In Richmond, Philadelphia, Boston, and Minneapolis, new buildings were constructed in downtown locations, and, in some of these cases, within redevelopment areas.

I am advised that the Board's building guidelines for new facilities are not administered mechanically, but are designed to lead to the construction of the most efficient structures possible considering the purpose of the building. Federal Reserve Branch functions, as you may know, are largely high volume production-type

The Honorable Henry S. Reuss  
Page Two

operations, and are especially amenable to low rise buildings for efficiency. The intent of the guidelines is to select sites for building construction that are large enough to accommodate current operational requirements and future expansion.

I hope we have an early opportunity to visit on matters you believe most important between the Congress and the Federal Reserve.

Sincerely,

A handwritten signature in black ink, appearing to read "Bill". The signature is written in a cursive style with a large, sweeping initial letter.

The CHAIRMAN. While in your reply to me, unfortunately from my point of view, you pointed out that you had done the right thing in Baltimore—the city branch there which our friend, Congressman Parren Mitchell, I know, feels very grateful for; and in Omaha, putting something down there for which our friend, Congressman Cavanaugh, I am sure, wells up with gratitude, too—you did not yield on Miami.

You said that, “\* \* \* considerable extra cost for construction and for operations” appears to be the case in that out-of-town site, as opposed to the Miami site. You also did not say anything about my request that you withdraw what, I consider to be, a very ill-advised policy guideline of March 1977.

I have two comments. One, my staff, with all due respect to the staff of the Federal Reserve, believes that the staff of the Federal Reserve is dead wrong, and that it is not going to save any money to put the Miami branch out in the hinterland. Could our staffs get together and see who is right on that before the—

Mr. MILLER. I would be delighted.

The CHAIRMAN [continuing]. Bulldozers start bulldozing?

Mr. MILLER. I would be very delighted, and I certainly will be pleased to reconsider that guideline. I am hopeful we won't have this problem come up again. I am hopeful that we can be supportive of the whole urban rehabilitation and revitalization that is being undertaken. I hope the Fed can do its part. I would be pleased to do both things you ask, Mr. Chairman.

The CHAIRMAN. That is great.

Mr. MILLER. Both things—to review our guideline and see what the facts are about Miami.

The CHAIRMAN. My staff will be available to sit down with yours. You have answered my second question before I asked it. I think it is particularly important that you take a look at, and I would hope remove with a pair of tongs, and dump it in the wastebasket that March 1977 location guideline, because it directly violates the President's urban policy statement of March 28, which of course came after your letter to me. The President said, in so many words, “Put Federal installations in the cities.”

So I really think there is a marvelous face-saving opportunity for the Fed. As you know, I will join you in a hollow square any time the executive branch threatens your independence and wants you to print money out of hand. But, when it comes to independence in matters of where we put our Fed installations, I really think there ought to be solidarity, so I am delighted to have your answer.

Mr. Barnard, were you given an opportunity?

Mr. BARNARD. Not yet.

The CHAIRMAN. You are now recognized.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Chairman, I want to compliment you on your endurance today. You have done an outstanding job with regard to all those questions.

I have a very simple question. I would like for you to respond to a question, if possible, both from your experience as chief executive officer of Textron, and now as Chairman of the Board of the Federal Reserve System.

Are we witnessing the demise or at least severe crippling of the free enterprise system?

Mr. MILLER. We are witnessing a threat to the private enterprise system. That is of deep concern to me. We see, too often, I think, that our solution—and the leaders of private enterprise have been somewhat guilty of this themselves—is to look to Government intervention and not to rely upon market forces.

We have some great assets in our private enterprise system. First, is that it is undoubtedly the most effective system ever invented. It produces better goods and services for more people at lower cost than any other system ever devised. And, second, it is an economic system that gives freedom of choice in how we work, where we work, and what we do; it is impossible to enjoy personal freedoms without that system. Inflation, and the trend to solve it with more and more public input, are a threat to our system. Eighty percent of the goods and services in this country are still produced by the private sector.

We need to maintain and enhance that. We need to reduce, slowly the percentage of GNP represented by the Federal sector and to increase that represented by the private sector.

Mr. BARNARD. Thank you very much.

Mr. MILLER. And congratulations on an outstanding Masters tournament in your district.

Mr. BARNARD. Well, thank you.

The CHAIRMAN. Mr. Caputo.

Mr. CAPUTO. I would just like to say: There have been a series of events which damaged chances of new legislation for New York City by June 30. I am sure you are aware there was a \$700 million State tax cut enacted in the last 15 days, a large pay increase for middle management, followed by a 6-percent increase, plus productivity wage increase, for the transit authority, technically a State agency.

Discoveries of new dollars by the city management seems to particularly offend Members of Congress. A present deadlock in negotiations with the city employees, discussions of somewhere between \$600 million and \$800 million a year costs for the settlement out of a \$14 billion budget does not seem like a lot, but it particularly offends Members of Congress.

On top of that, we have a congested congressional calendar of 10 weeks to do something. I spoke with you at breakfast with the Monetary Policy Subcommittee last week. My concern is that the Fed started out and estimated cash flow requirements for the city in the event of a strike. Obviously cash outlays go down abruptly. Certain forms of government revenues dry up, like State aid to education is predicated on school attendance. But I would think there would be substantial change in the cash flow of the city in the event of a strike.

I also believe that under existing law the Fed has authority to make loans to municipalities. In the event Congress does not act to give the Treasury authority, your organization would be the only place in the Federal Government where something could be done. I would want to question whether you have had a chance to look into this since I asked you about it last, and whether you have specifically considered a condition you would want to impose upon the city in the event you used the authority to provide financing, short-term or long-term, to the city government.

Mr. MILLER. Congressman Caputo, I really thank you for bringing this to my attention the other day. Prior to our discussion, my concern was to be sure that the Federal Reserve was equipped to deal with any liquidity problems of banks who hold municipal securities, or any problems that might arise because customers of banks hold such securities.

I do not think the problem would be so much a failure to realize on those securities as it would be some delay in realizing on them.

But since you raised the matter, we have been looking at what alternative plans or authorities or programs the Federal Reserve might have, and what policies it might pursue. I think I have to say honestly that I start off with a reluctant attitude because it is important that New York City solve its own problem, and not feel that there is someplace to go and get more relief rather than facing up to the actions that it must take.

I really hope very much that New York City can solve its problems and can convince the Congress and the Treasury that it has a sound plan that will work it back to self-sufficiency; I hope we do not have to come into the picture. But I will certainly follow up and be prepared to know what we can do and to evaluate the alternatives very carefully.

I thank you for bringing the matter to my attention.

[Chairman Miller subsequently submitted the following material for inclusion in the record at this point:]

Municipalities, along with other types of institutions that are not members of the Federal Reserve System, may obtain credit directly from Federal Reserve Banks under certain conditions specified by the Federal Reserve Act. However, these statutory conditions and the regulations established to administer them set rather narrow limits on the scope of such borrowing.

Paragraph 13 of Section 13 of the Act authorizes Federal Reserve Banks to lend for periods of up to 90-days directly to individuals, partnerships and corporations—subject to whatever restrictions are imposed by the Board of Governors—so long as the borrowing is secured by U.S. Treasury securities or by the fully-guaranteed obligations of a Federal agency. For this purpose the term “corporation” includes State and local governments.

Paragraph 3 of Section 13 of the Federal Reserve Act permits the Federal Reserve to make emergency loans to individuals, partnerships, and corporations under terms that accept a broader range of collateral than paragraph 13. However, the statutory language for these loans sets other conditions that constrain their use. They can be made only in “unusual and exigent circumstances”; they must be approved by not less than five members of the Board of Governors; the Federal Reserve must obtain evidence that the borrower is unable to secure adequate credit accommodations from other lending institutions; and the loans must be endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank. In short, more limitations on these loans are cited in the statute itself than in the case of paragraph 13 loans.

Emergency loans made under these provisions of the Federal Reserve Act would thus be at a higher rate than the basic discount rate and would typically have to meet several criteria. Other credit sources would have to be exhausted; unusual and exigent circumstances would have to exist; the borrower would need to be solvent and to have adequate collateral; the borrower's need would be for short-term accommodation and his basic financial position would have to permit early repayment; and the borrower would need to show that failure to obtain Reserve Bank credit would risk a significant economic and financial impact on the surrounding area, the region, or the nation.

Some members of Congress have suggested that Section 14(b) of the Federal Reserve Act provides the Federal Reserve with a more explicit mandate to provide broad financial support directly to New York City. The language of 14(b) states that a Federal Reserve Bank has the power to: “. . . buy and sell, . . . bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district,

political subdivision, or municipality in the continental United States, . . . such purchases to be made in accordance with rules and regulations prescribed by the Federal Reserve Board;”

There is nothing in the Federal Reserve Act or its legislative history, however, to suggest that this provision contemplated the purchase of municipal securities as a means of aiding financially distressed communities.

The System's largest purchases of municipal notes under this authority occurred during the 1914–1917 period before the establishment of a formal or centralized Federal Open Market Committee. This was an era in which open market operations were not used as an important instrument of monetary policy. Some purchases of municipal warrants were made by individual Reserve Banks as a means of providing these banks with a source of income, but not to assist financially troubled communities.

Examination of Board records indicates that a few purchases of municipal obligations took place up to 1933 essentially as an accommodation for member banks that were experiencing liquidity problems at a time when authority to lend to banks through the discount window was more limited than it is now. In no instance were purchases made by Reserve Banks to provide assistance to financially distressed municipalities. Since 1933, the Section 14(b) authority to purchase municipal warrants has not been used.

The practical basis for Federal Reserve lending to municipalities and other nonmember institutions is thus quite limited. The System can be a lender of last resort on a short-term basis when unusual and exigent circumstances exist, and certain other criteria are met. Whether any such loan is appropriate depends, of course, on conditions at the time of loan application, including an evaluation of the borrower's ability to repay, the likely financial and economic impact of a failure to obtain System credit, and the adequacy of available collateral. Most importantly, with regard to the possibility of a loan to New York City, the Federal Reserve would have to assess the risk that a precedent would be set, making it difficult to avoid lending to a large number of similar borrowers. If such lending were undertaken, the Federal Reserve would inevitably become enmeshed in the tasks of monitoring loan compliance, judging the eligibility of competing prospective borrowers, and allocating credit among those units. Coping with political pressures generated by this process is not the proper province of the Federal Reserve and could seriously interfere with the effective management of general monetary policy.

The CHAIRMAN. Mr. Evans, did you have a question ?

Mr. EVANS of Delaware. Thank you, Mr. Chairman.

Let me say at the outset that I have enjoyed very much being here. Mr. Chairman, I appreciate tremendously the important task that you have accepted, and the responsibility. I am impressed with your candor. I am very impressed with your quiet yet positive approach to helping to solve some of the problems we have.

But I am concerned that people talk about inflation, not yourself, sir, but people talk about inflation, talk about unemployment, talk about the problems that we have in unemployment, especially among teenagers, minority groups, and yet our actions are very inconsistent in terms of reaching the goals that we all want to achieve of trying to reduce unemployment and do something about inflation.

I am more and more convinced that Government is part of the problem rather than part of the solution to that problem. And I would like to just discuss a few things about the Carter tax reform proposal, if I may, because you have identified inflation as the No. 1 issue today.

We have talked about the balance of payments and problems there. We have talked about unemployment. We have talked about monetary policy. You have identified capital formation as very crucial to productivity. And it is.

But you cannot have capital formation unless you have confidence. That is an intangible. But in order to have confidence, it seems to me that you need to be able to determine with some degree of pre-

dictability where the administration is going to stand. I just do not understand the President's emphasis on the "three-martini lunch." I never have had three martinis at lunch.

Mr. MILLER. If you did, you would not be able to do anything after lunch, I am sure.

Mr. EVANS of Delaware. Right, not after lunch, either. But eliminating the alternate means of computing capital gains, it seems to me, is a disincentive to capital formation. The approach of the Carter administration as far as domestic international sales corporation seems to me to be a disincentive as far as employment and as far as jobs are concerned. I would just like to have your comments.

Mr. MILLER. Well, it is true that many things that have been done by the Government—certainly in all good will—have created inflationary forces. There is no question that those actions should be reversed. I think it is easy to understand this question of confidence a little more if we look at it in the context of where we are now.

I continue to refer to the last 10 years because these last 10 years have been as dynamic in change and magnitude of change as any I have ever seen in my life. I won't recite again the liturgy of events, but the result is not only a heritage of inflation, but also some serious breakdown in esteem for institutions as a result of Watergate.

We certainly do have—all of us have—a somewhat more cynical view of our essential institutions. That is a temporary phenomenon, because those institutions are representative of the American people, and they will recrystallize and they will strengthen.

But in the meantime, there is a certain fracturing of the process by which decisions are made in Government. There is a certain tendency to lose discipline in governmental managements. We tend to refer to this as lack of confidence in Government.

I don't think that is really true. It is just a natural aftermath of some very dramatic events. The American people in their hearts and in their minds are confident people; they are optimistic people. And I think we are going to see a rebuilding of confidence in institutions, and in the process of Government.

And this process starts with gaining confidence in ourselves. If each individual in this room and each individual in America would say something positive about every problem he faces for the next 12 months—take the attitude that there are no problems but only opportunities to do better—you would be amazed after 12 months at how much confidence we would have in ourselves and in Congress and in the President and in our country, and how much progress we would make.

Mr. EVANS of Delaware. Could I proceed for 1 minute, Mr. Chairman?

The CHAIRMAN. Is there objection?

Hearing none, Mr. Evans, please proceed.

Mr. EVANS of Delaware. I, too, have great confidence in this country, and I think there is nothing we can't overcome working together. I think we have overcome Watergate; we will overcome Korea, or anything else we have here in America. But I do think it is awfully important for the Government to be consistent, consistent in its proposals, rather than counterproductive and sometimes inconsistent.



My point of view here is just to bring that up so that we can develop together a solution to these problems. I congratulate you, Mr. Chairman, on the fine job that you are doing, and I hope that the pipeline you have to the White House is a good one, and that the ears over there will be open rather than plugged.

Mr. MILLER. Thank you.

The CHAIRMAN. The time of the gentleman has expired. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

It is very good to have you here this afternoon. I think your essay on confidence is tremendous. However, I sat on the Joint Economic Committee last Friday morning and heard Dr. Shiskin report that there is a little improvement in employment, a little decrease in unemployment; but at the same time output stood still, which means that from a productivity and inflationary standpoint, it was bad news rather than good.

We didn't have as many people in the labor force in the month of March as we had before, and anyone that's studied those statistics over the years knows that when you don't have many people going into the labor force this month—you will next month and to the extent you get them, unemployment can jump since entrance into the labor force has as much of an impact on unemployment figures as do people becoming employed, because that is the ratio, of course, that develops the figure.

But I will try to be confident, nevertheless, Mr. Chairman. The thing that I am interested in is, to the extent that you can tell us, what you have done, what do you expect to do, and how critical is the value of the dollar problem.

Mr. MILLER. The value of the dollar has been a difficult problem. It's been brought about by fundamental imbalances of the last few years. It's been brought about because of large deficits in our balance of trade and payments, unprecedentedly large ones.

Those deficits have been fueled by our excessive dependence upon imported oil and oil products, and by an ambition or aspiration for this country to go back to a fuller use of its capital resources, at a rate which has accelerated its requirement for imported materials and products.

Because we have had this pattern both in our growth rate and dependence on oil, we have run up deficits which have created an excessive supply of dollars in the hands of foreigners; and these holdings have bid dollars against other currencies, creating dislocations.

We in the Federal Reserve and in the Treasury, as you know, have intervened in the market to be sure that any relative change in currency value would be orderly, that we wouldn't see any conditions which would upset financial markets. And we have done this with the belief that we should simultaneously address the fundamental issues. If we in the United States take action as to energy, and if we take action as to inflation—not with the idea that we can solve the problems overnight, but that we can start back in the right direction—if we show progress in the right direction, the dollar will be strong and sound, and will appreciate.

If we do not address the fundamentals, then our bridging actions and intervention will be of limited effectiveness, because they can

only cushion the changes that will take place in any event. It is my conviction that we can address the fundamentals. We can change the trends, and we can establish the dollar as sound and worthy currency and as a key to the international monetary system.

Mr. BROWN. Then you don't look upon your intervention as having any real significance other than adjusting temporary distortions; is that correct?

Mr. MILLER. It seems to me all you can do with bridging actions is to make sure that change in the value of currency is orderly. Once there is a decline in the relative value of our currency, our goods become cheaper in foreign markets: we may be able to export more; but the sad thing is that the rate of current growth in imports is quite high, and that their price goes up. That, in turn, allows domestic prices to go up in a competitive way, and the whole cycle is inflationary.

So decline of the dollar is a problem, not only because of the general importance of the currency in such matters as pricing oil, but also because it feeds in as an inflationary force and works against us.

Mr. BROWN. Mr. Chairman, we have blamed energy for our balance-of-trade-deficit problem. I think we have overemphasized the significance of our energy imports. They still don't equal a third of our deficit problem, do they?

Mr. MILLER. Oil imports last year were \$45 billion, and our balance-of-trade deficit was \$30-plus billion. Incidentally, in 1973 our imports of oil—

Mr. BROWN. I mean with respect to total imports.

Mr. MILLER. Our total imports in 1977 were about \$150 billion.

Mr. BROWN. So \$45 billion would be less than a third.

Mr. MILLER. Yes.

Mr. BROWN. So we are talking about somewhere between a quarter and a third.

Mr. MILLER. Yes.

Mr. BROWN. Since our imports of petroleum products only constitute a quarter to a third of total imports, you have to look at total imports if you are looking at where the deficit is.

Mr. MILLER. That is right.

Mr. BROWN. It is very nice to blame the deficit all on one commodity, but we know that isn't true.

What was our balance of trade deficit with West Germany last year?

Mr. MILLER. I think our deficit with the Federal Republic of Germany was about \$1.2 billion.

Mr. BROWN. What would you think, Mr. Chairman, if there was in connection with our European theater common security efforts, we were going to embark upon a program that would involve almost, let us say anywhere from \$1 billion to \$2 billion more in purchases there? Would that bother you?

Mr. MILLER. If you are talking net additional purchases, that would be a concern, because it works in exactly the opposite direction—

Mr. BROWN. If we were going to commence purchasing those things we are not purchasing now, assuming the rest of the situation is the same that would be almost doubling our present balance of trade deficit with West Germany.

Wouldn't that be of some criticality to you?

Mr. MILLER. It would. But Congressman Brown, I would have to be careful not to answer you out of context, because if you are talking additional purchases by the Defense Establishment, these may be the basis for sustaining continued purchases from the United States. So you have to look at the net effect.

If we are selling \$1 billion from this side and spending \$1 billion over there, that nets to zero. So I would have to look at the net effect. As you know, there are usually tradeoffs on these decisions as to military equipment; and I am not familiar with the particular problem you mention.

Mr. BROWN. But assuming all that you say to be true, wouldn't you think there couldn't be a less timely time to do it?

Mr. MILLER. Well, if it resulted in a net increase in our purchases abroad, it is bad timing. That is why I have to know the net effect; if we are going to sell some F-16's to make up for it, then it is fine. We would create jobs for the suppliers of engines and aircraft assemblers and we would make up for the purchases very rapidly and help our employment situation.

Mr. BROWN. Are you suggesting there should be then a tradeoff, that there should be an increase in the consumption or purchase of our goods if we are going to purchase theirs, as a tradeoff, right?

Mr. MILLER. Yes, and as you know—

Mr. BROWN. If that doesn't exist then you would be disturbed.

Mr. MILLER. I would be concerned. As you know, because the maintenance of strategic forces in Europe is important to our security, but does cost us money, in the past there have been counterpurchase arrangements. Usually, we have been the net gainer on purchases for weapons systems. Purchases from the United States have been an offset to the costs of our maintaining forces abroad. Maintaining forces in Europe becomes a far more costly situation because of inflation. Can you imagine what happens to our Armed Forces living in Germany with the change in value of the deutsche mark? So that problem concerns me.

All the things that work in the direction of worsening the deficit and, therefore, worsening the problem of the dollar do concern me. I don't mean to duck your question, because I agree with you.

I also don't want to imply, though, that we shouldn't make tradeoffs. If we can gain some sales by making some purchases, let us do that, too.

And we may have to look for some relief for our military personnel because we cannot allow the kind of pressure on their family budgets that takes place with their need to purchase, on the local market, items that are priced in deutsche marks.

Mr. BROWN. Mr. Chairman, one final thing. Would you not see this as somewhat inconsistent?

If there was pressure being applied by the defense establishment in the Federal Republic of Germany to, say, purchase German equipment having the kind of impact we have been discussing here upon the dollar, while at the same time the Economic Ministry and others are saying that we should get the dollar back on a sound basis.

Mr. MILLER. Yes; I think there is a kind of interesting problem. In a sense, many other nations would like to see the U.S. growth rate continue so it can continue to import their products into this country.

At the same time they are very critical of the value of the dollar, which implies we would have to change the level of importation.

So, there is a certain aspect here of trying to have it both ways. We can't continue to be the source of economic growth for another country by importing from it unless we can also sell back. So we do have that kind of problem; I agree with you 100 percent.

Mr. BROWN. Thank you.

My time has expired.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Mr. Chairman, I want to compliment you for an excellent performance and I might say that I find much in which to find consonance in your views. I noticed a publication from the Federal Reserve Bank in St. Louis, which says that the monetary basis is expanding a great deal faster than  $M_1$ .

Moreover, there has been almost no growth in checking deposits over the last few months while currency component of  $M_1$  has been accelerating. Can you give me an explanation for this buildup in the public holdings of currency?

Are they socking it away, is the money going abroad or what? But this now amounts to about \$400 for every man, woman and child in the United States.

What implications does this have or do you see other monetary and fiscal policies of the immediate future?

Mr. MILLER. It's a phenomenon that is interesting to me. Mr. Axilrod, who is staff director for Monetary Policy for the Board, reminds me that in terms of the nominal growth of the economy, the growth in currency in circulation is not really out of line. In terms of currency as a component in  $M_1$ , I think it has grown because of the slower growth in demand deposits; and that, of course, may well be related to new payment mechanisms that are available to depositors. I think you should be aware, and we should all be aware, that  $M_1$  is going to change in importance to us in the next year, as consumers gain access to readily spendable cash that is not in a demand deposit form. We are going to see  $M_1$  change somewhat. This may be a healthy change if, as a result, consumers do actually increase their own return on their idle money.

Mr. WYLIE. Well, on page 8 of this report published March 31, 1978, I notice that the currency component has increased very steadily over the past few months whereas the demand deposit component has remained relatively flat. That was the thrust of my question.

Mr. MILLER. I think you are absolutely correct.

Mr. WYLIE. As to whether people are putting it in the sock or whether that money is going out of the country, going abroad. You might want to expand on that but that brings me to another question. This is a good place for me to ask something about the International Banking Act of 1978, which the House passed on Thursday.

The CHAIRMAN. 367 and 2.

Mr. WYLIE. 367 and 2.

I know there is a difference of opinion on the thrust of that. The Chairman reminded me it passed 367 to 2. Former President Lyndon Johnson once said that if you pass a bill by more than one vote you have probably given up too much. That is where I come out on this bill. This is not the bill I would submit that the Federal Reserve

Board suggested to us or Dr. Arthur Burns suggested to us some time ago.

I have the feeling there is a chance for a difference of opinion here, that we may have worked some 3 years and harmed the Nation.

But in any event, we did pass it.

I think also it proved that the State regulators are more persuasive than I first thought and maybe they have a more persuasive constituency than the Federal Reserve Board or they have a larger constituency.

But what I would like is, it seems to me as if it is difficult for you to control monetary policy with the rapid increase in foreign deposits in the United States, and with little or no control by the Federal Reserve over those foreign deposits. And does the bill, which we passed on Thursday, address that problem sufficiently in your opinion, and if you are not familiar with the bill, maybe you would want to answer for the record.

Mr. MILLER. I would be happy to answer, because I think the Federal Reserve would have preferred some improvements in the international banking bill, as it passed the House. I appreciate your support.

I wish you'd been more effective in persuading Mr. Brown to help us, but—

Mr. WYLIE. Thank you. I wish I had been more effective, too.

Mr. BROWN. Will the gentleman yield?

Mr. WYLIE. Yes, I would be glad to yield.

Mr. BROWN. Mr. Chairman, I would respectfully suggest that you have got a lot more legislation today than you would have had if Mr. Wylie's views had prevailed in submitting that to the House floor.

Now, you have still got another body to work in and I think you have a better—

Mr. WYLIE. I refuse to yield further. I didn't want to get into an argument here.

But I appreciate what you have said and your support and I have a feeling that the future will show that we were more right on Thursday than is now apparent.

With that I thank you, Mr. Chairman. My time is up.

Mr. MILLER. Thank you again for your support. We will work on a couple of matters that we think will improve the bill, but we do appreciate the gains we have made.

After all, we will have some further control. One of the main things I am personally concerned about is the multi-State branching limitation, which is what the State supervisors worked so hard against. My reason is simply this: a foreign organization can buy a major U.S. bank, operate through the State, and then establish branches in many other money centers and operate a national banking system; our own domestic banks can't do that.

Mr. WYLIE. Precisely, correct and maybe siphon off some of our American dollars.

Mr. MILLER. And take deposits and make loans overseas. I hate to see us back into a new banking pattern without understanding what we are doing. I hope this will be thought about a little more. Maybe the Senate will see that that could become a problem. I, at least, would prefer to restrict foreign branch banking at this point, until we look at the issue much harder.

If Congress, after really seeing the implications, still feels it is proper to permit this for foreign banks but not U.S. banks, then it could take this action.

Mr. WYLIE. Yes, it is hard for me to understand why we as a Congress allow foreign branch banks a competitive standing over our own U.S. banks, but in any event. I am sorry we are a little late, because I lost my seniority position, but I am glad to have this chance to talk to you again.

Thank you, Mr. Chairman, for a very impressive performance.

Mr. MILLER. Thank you.

The CHAIRMAN. I would just add before closing, Chairman Miller, that to me a very, very important part of the international banking bill is the section which gives the monetary authority to the Federal Reserve to publish reserve requirements. That section is largely the handiwork of the gentleman from Michigan, Mr. Brown.

I think he was right on track and would you not agree that in that important portion of the total at least the Fed is reasonably well satisfied?

Mr. MILLER. We are very pleased and very much appreciate the very overwhelming vote in favor of that section. That is a very important step, and we are very glad to have the authority because it is a necessary part of monetary control. But it is part of the problem of unfair competition to allow major foreign banks to operate in this country without reserve requirements.

So, I thank you for that.

The CHAIRMAN. Did you want to add anything?

Mr. BROWN. Well, Mr. Chairman, I just would say, Chairman Miller, that one thing, I don't think the Fed has been terribly notable for in the years that I have served in the Congress is the ability to check the political pulse of the Congress. And all I am saying is that I respectfully suggest, you got much more than you would have had by the very action that you condemn.

Mr. WYLIE. As I said before, State bank regulators are more powerful than we thought.

Mr. MILLER. Yes.

Mr. BROWN. You know, you had the bill written once before pretty much as the Fed wanted, and it got nowhere. I think now it has a chance to receive action in the other body, and a move toward the Fed position can be accomplished.

Mr. MILLER. Wonderful.

Mr. BROWN. But without the vehicle, there would be nothing there to improve.

Mr. MILLER. You are correct. We must certainly learn to read pulses better; maybe we will need some new pulse readers.

Mr. BROWN. I don't think it is a matter of reading, I think it is a matter that in the past, the Fed hasn't wanted, many times, to believe that which was obvious to everyone else. And you know, being right oftentimes isn't as important as being President.

Mr. MILLER. Thank you for drawing us out of our shell and getting us to these meetings with one another because in this way we can learn and be instructed. Next time we will be more alert.

Mr. BROWN. I would remind you to go back and check some of your predecessors, that I was the champion of the Fed's position on the so-

called audit bill. And there again, there was a failure to recognize political reality. Upon that occasion, I found myself almost in Mr. Wylie's position.

Mr. WYLIE. Almost.

The CHAIRMAN. In conclusion, I would just somewhat disassociate myself from the remarks of my friend, Mr. Brown. I think the Fed has, over the years I have been here, been quite successful in its legislative relations. I would not want anything that he has just said to encourage you to become even more overwhelmingly successful in the years ahead.

Anyway, you have delivered yourself nobly this morning. We are very grateful. We learned a lot. I think we shall all become better friends.

We shall now stand in adjournment.

I will have questions to submit in writing to you on some of the international problems of monetary affairs and you can include your answers to them in the record.

Mr. MILLER. Thank you very much, Mr. Chairman. Thank you for your courtesies this morning. I appreciate the opportunity to be here.

The CHAIRMAN. We now stand adjourned.

[Whereupon, at 1 p.m., the hearing was adjourned, subject to the call of the Chair.]

[The following letter containing questions submitted by Chairman Reuss re Federal Reserve intervention in the foreign exchange market and the System's swap arrangements with Chairman Miller's answers follows:]



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

May 2, 1978

The Honorable Henry S. Reuss  
Chairman  
Committee on Banking, Finance  
and Urban Affairs  
House of Representatives  
Washington, D. C. 20515

Dear Chairman Reuss:

Thank you for your letter of April 12 regarding Federal Reserve intervention in the foreign exchange market and the System swap arrangements.

For your convenience, I have repeated each question and followed it with my response:

1. In my opening statement of March 9, I asked you to provide this Committee with a definition of "disorderly markets" -- that mysterious condition under which central bankers intervene in foreign exchange markets. Can you now supply such a definition?

Answer: The determination of whether a foreign exchange market is disorderly is in the last analysis a matter of judgment. Several years ago the Federal Reserve prepared a statement identifying the characteristics of disorderly markets, and this statement still represents our view:

Disorderly markets have certain features in common: exaggerated rate or price movement, wide spreads in quotations, a stifling of the intermediary role of professional dealers, and an unresponsiveness of prices and orders to the fundamentals operating at the time. Disorderly markets are by their nature unstable; in the absence of some stabilizing influence, disorder can increase to the point at which the market ceases to function.



2. On March 7, the first day of our hearings on the Conduct of Monetary Policy, Professor Rudiger Dornbusch of the Massachusetts Institute of Technology testified: "I am not aware of any evidence in support of the view that intervention has in fact -- and on average -- smoothed exchange rates relative to their trends and thus created an atmosphere of increased certainty. . . . I would therefore argue strongly that the Federal Reserve should desist from all and any kind of intervention". Would you comment on this remark?

Answer: Direct evidence that intervention operations have smoothed exchange rate movements is difficult to obtain, since it would require determining what exchange rates would have prevailed in the absence of intervention. There is, however, indirect evidence in the fact that the System has realized profits each year on its foreign exchange intervention operations under the regime of floating exchange rates. The profit criterion is one measure of the success experienced by the Federal Reserve in smoothing exchange rate movements, although, as you know, it is not the only relevant criterion.

3. The Federal Reserve press release of March 13 lists the banks with which the Federal Reserve now has reciprocal currency arrangements and the amounts of each:
  - a. To what extent have those arrangements been used since January 1: how many days and in what amounts?

Answer: As reported in our quarterly report, System drawings in January on German mark swap lines occurred on 10 days and amounted to \$451 million equivalent; System drawings in Swiss francs occurred on

one day and amounted to \$19 million equivalent. According to our established procedures, data on drawings and repayments in the February-April period will be published in the June Federal Reserve Bulletin.

- b. Of the swaps effected, what portion have not been repaid?

Answer: None of the swap drawings during January were repaid in that month.

- c. What has been the net profit or loss on each swap transaction over the last year?

Answer: We do not normally assemble the data on profits and losses transaction by transaction. For the calendar year 1977, however, we realized total profits of \$4.9 million on transactions related to current operations, i.e., excluding transactions connected with repayments of pre-August 1971 Swiss franc swaps.

- d. What evidence is there that the swaps have contributed to a stronger dollar over the past year?

Answer: There is little empirical evidence on the effects of intervention, whether financed by swap drawings or from existing balances. System intervention has been for the purpose of countering disorderly conditions. In recent months, when the dollar has been under downward pressure, such intervention may have helped prevent the dollar from falling to unrealistically low levels. But intervention has not been intended to keep the dollar exchange rate at levels above those justifiable by fundamental economic conditions.

- e. Are negotiations underway or in prospect to extend swap agreements with any one?

Answer: There are no negotiations underway to extend System swap agreements.

Please let me know if I can be of further assistance.

Sincerely,



APPENDIX I

THE FOLLOWING ARE QUESTIONS SUBMITTED BY MEMBERS OF THE COMMITTEE TO FEDERAL RESERVE CHAIRMAN G. WILLIAM MILLER, ALONG WITH THE CHAIRMAN'S ANSWERS



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

April 20, 1978

The Honorable Henry B. Gonzalez  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Gonzalez:

Enclosed are responses to the questions posed in your letter of April 11. A copy of these answers has been sent to the Committee staff for inclusion in the record of the hearing on April 10.

Please let me know if I can be of further assistance.

Best regards,

Sincerely,

*(Signed) G. William Miller*

Questions forwarded by Congressman Gonzalez and responses furnished by Chairman Miller to be included in the April 10 hearing.

Question #1

Professor Rudiger Dornbusch of MIT told this Committee on March 7, "I am not aware of any evidence in support of the view that intervention has in fact -- and on average -- smoothed exchange rates relative to their trends and created an atmosphere of increased certainty. I would, therefore, argue that the Federal Reserve should desist from all and any kind of intervention."

Would you comment on this?

Answer: The Federal Reserve's objectives in intervening are not to influence the trend in exchange rates, but simply to counter disorderly markets. In trying to counter disorder, the Fed has attempted to see that there is good "two-way" business in the exchange market so that when there is large selling of dollars by private holders, the System may purchase dollars (i.e., sell foreign currency) and likewise reverse its activities when private holders are rapidly buying dollars. Indeed the System has generally attempted to achieve a position of zero net intervention over an extended period of time so as not to alter fundamental trends.

While it is difficult to determine what short-run exchange rate fluctuations would have been in the absence of central bank intervention, it may be noted that the System has realized profits each year on its foreign exchange operations related to intervention under the regime of floating exchange rates. The earning of profits by selling foreign currency at a time when prices were high and subsequently purchasing it back at lower prices suggests that the Federal Reserve may have moderated fluctuations in exchange rates which would have occurred without official support.

Question #2

Your predecessor felt that it is urgent to prevent the further decline of the dollar. He was willing to go so far as to recommend some dramatic step like disposing of our gold stock, to show our determination to maintain a strong dollar. Do you share his sense of urgency, and what steps other than market interventions would you take to keep the dollar from depreciating further?

Answer: It is an urgent matter to adopt policies that will strengthen the U.S. economy. A healthy economy that invites confidence in the future will lead to a stronger dollar. Intermediate bridging measures can help prevent unwarranted depreciation of the dollar while such confidence is being built, but can never substitute for the actions needed to create sound fundamentals on which a strong dollar can be based.

We must reduce the rate of inflation. Controlling and reducing government deficit would contribute to reducing our rate of inflation. Secondly, we need a sound energy policy, which is chiefly the responsibility of Congress. If Congress fails to act, the Administration should take the less desirable but necessary measures that I have recommended elsewhere. An effective energy policy and a reduction in the rate of inflation would contribute to confidence in the U.S. economy, prompting the investment we need for sustained growth. Because I feel that a strong dollar depends upon a strong economy, I would not suggest that we reduce our rate of economic growth to improve our trade balance, but rather look favorably on the efforts of our trading partners to achieve a sound rate of growth in their economies.

Question #3

In your testimony of March 9 you stated your belief that our foreign trade deficit will not show further deterioration. However, the recently announced \$4.5 billion deficit for February is the largest monthly deficit. Are you still confident that the trade deficit will be no worse this year than in 1977?

Answer: In my testimony of March 9, I said "with prospects for our exports improved by the likelihood of stronger economic growth abroad this year, it appears that our foreign trade deficit will not deteriorate further." In light of the very large U.S. trade deficits recorded in January and February of this year, it is reasonable to question whether the trade deficit for all of 1978 can be held to the rate of 1977.

You will note that in my March 9 statement I linked prospects for the U.S. trade balance to prospects for a recovery in our exports. In this connection, the results recorded for January and February were somewhat disappointing because they revealed a reduction in our non-agricultural exports from the fourth quarter of 1977.

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Question #4

We speak of gold as being demonetized. Yet, there is still a strong attachment to gold, and it seems to move up or down with currencies.

If gold has been demonetized, why are we holding so much of it at Fort Knox, and in the vaults of the New York Fed?

Answer: The Second Amendment to the International Monetary Fund's Articles of Agreement, which came into force on April 1, 1978, provides for a gradual reduction in the role of gold in the international monetary system. The Secretary of Treasury has stated that it is U.S. policy to sell gold from time to time, and on April 19 the Treasury announced a schedule of gold auctions to be held in 1978.



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

March 22, 1978

The Honorable Frank Annunzio  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Annunzio:

I am pleased to furnish my answers to the two questions you transmitted to me via staff at the hearing before the House Banking Committee on March 9.

I have provided the House Banking Committee with a copy of this letter and the enclosure for inclusion in the record of the hearing.

With best regards,

Sincerely,

(Signed) G. William Miller

Enclosure



(The following are written questions from Congressman Annunzio to Chairman Miller, along with the Chairman's answers.)

Question #1 Submitted by Congressman Annunzio to Chairman Miller on March 9, 1978

Mr. Miller, shortly after you were nominated by President Carter as Chairman of the Board, I wrote to you concerning a Board proposal that would allow member banks to transfer funds from customers' checking accounts to savings accounts, in effect creating interest on demand deposits. I pointed out in my letter that it was my feeling that the Board was legislating rather than regulating and that this area was one that should be left to the Congress.

You replied, in your letter to me, that you have not taken any part in the deliberations leading up to the decision and that you would study the matter at a later date. I wonder first if you now have a position on this matter and secondly I wonder if under your term as Chairman, the Board will continue its Walter Mitty dream that it is a legislative rather than a regulatory body. I am deeply concerned that time and time again Congress enacts laws or fails to enact laws and the Board does not agree with the position of the Congress, and through regulation, either nullifies the laws or creates a law when none exists. I would suggest that if the members of the Board want to legislate, then they ought to resign from the Federal Reserve System and run for Congress. I note that Dr. Burns will soon be unemployed and perhaps he might set a precedent for the Board by running for Congress, and then he could legislate through the front door rather than the back door.

I would appreciate your comments on this, particularly as to whether or not the Board will implement its NOW accounts by regulation proposal.

Answer: Since becoming Chairman, I have reviewed some of the issues raised by the automatic transfer of savings proposal. You have questioned the Board's regulatory authority in this area. Prior to public announcement of the proposal, I understand that the Board carefully considered the effects such a service could have. In deciding to announce this matter for public comment a second time, the Board indicated that the proposal represented an additional convenient way in which a depositor may withdraw his or her funds from a savings account. In the area of deposit accounts, Congress has

given the Board the authority to define terms, establish rate ceilings and prescribe rules regarding the manner in which deposits may be withdrawn. At present, a depositor at a bank or savings and loan association may withdraw savings deposits by telephone or use a savings account to pay bills directly through the use of third-party transfer services. The automatic transfer feature would eliminate the oftentimes cumbersome requirement that the depositor actually make a telephone call to the bank to transfer funds.

The proposal does not result in the payment of interest on demand deposits since the proposal requires that the funds to be transferred remain subject to the bank's ability to require the depositor to provide a 30-day notice prior to withdrawal. This reservation of the right to require 30-days notice is what presently distinguishes savings deposits from time deposits. In addition, the proposal requires that the depositor forfeit interest earned during the previous 30 days on the funds transferred. This may assist in preserving the distinction between demand and savings deposits.

The automatic transfer proposal would not, in fact, authorize NOW accounts since separate savings and checking accounts must be maintained by the depositor who desires to make use of the service. Under the proposal, a depositor would not be permitted to write checks against his or her savings account but rather could only draw checks against a separate checking account maintained at the bank. The Board's proposal, therefore, can be distinguished from NOW accounts, which permit depositors to write checks directly against interest earning accounts.

Thus, the Board believes that this proposal is clearly within its regulatory authority. Let me assure you that on this or any other issue the Board will be sensitive to the limitations of its authority and will exercise all due care in not exceeding its jurisdiction.

With respect to the substance of the transfer proposal, the Board has received voluminous public comment. I have not formed a final opinion on the advisability of moving ahead with the proposal and will not do so until I have weighed very carefully the comments received.

Question #2 Submitted by Congressman Annunzio to Chairman Miller on March 9, 1978

Mr. Miller, legislation is soon to go before the full Senate which is labeled a Truth in Lending Simplification law. I am deeply concerned, as Chairman of the Consumer Affairs Subcommittee of the House, that this bill is not a Christmas tree bill that we all are familiar with in this body, but rather a Halloween bill in that it is costumed as legislation to help small businessmen.

The legislation contains a provision that would forgive many Truth in Lending crimes committed by lenders in the amount of hundreds of millions of dollars. It also contains a Hitler clause which states that if the magnitude of the crime is so great that requiring repayment would affect the solvency of the business, that no restitution need be made.

In short, a business which only breaks the law a little bit would be punished but a business that stole millions of dollars from consumers would get away Scot free.

I would like to know if, as the new Chairman of the Federal Reserve Board, you favor this soft approach to financial criminals.

Answer. My time at the Board has been so short that I have not had time personally to study the question you have asked, whether a financial institution's safety and soundness should be taken into account in determining whether adjustments in customers' accounts should be required whenever Truth in Lending violations are discovered. I have been informed that the Board did not make any recommendations with respect to this issue in the course of the Senate Banking, Housing and Urban Affairs Committee's consideration of the Truth in Lending simplification bill.

Enclosed is a copy of material published in the Federal Register by the Board and the other regulatory agencies seeking public comment on several Truth in Lending enforcement policy questions. I am told the subject is addressed in this material. The Board has not reached final decisions on these issues. I will be reviewing this matter and taking into account the comments we have received, including the views you have expressed, as this issue is given further consideration by the Board.



# FEDERAL RESERVE

press release

This release has been issued on behalf of the following Federal regulatory agencies:  
 Comptroller of the Currency  
 Federal Deposit Insurance Corporation  
 Federal Home Loan Bank Board  
 National Credit Union Administration  
 Board of Governors, Federal Reserve System

For immediate release

October 18, 1977

Uniform guidelines for the enforcement of the Truth in Lending law and its regulatory rules were proposed for public comment today by the five Federal agencies that regulate banks, thrift institutions and credit unions.

Comment should be sent by November 21, 1977 to Interagency Enforcement Policy -- Regulation Z, Washington, D.C. 20219.

The joint notice of the proposed guidelines said they are intended to "promote improved and uniform enforcement of the Truth in Lending Act through corrective action, including reimbursement, for borrowers who have been overcharged or otherwise harmed by violations of the Act."

The Truth in Lending Act was passed in 1968, and, at the direction of Congress, the Federal Reserve Board wrote rules -- Regulation Z -- to implement it. The Act calls for disclosure of the true costs of credit extended for consumer purchases.

The Truth in Lending Act was the first of a dozen Federal consumer credit protection laws enacted in the last decade. These acts, and regulations spelling out their meaning and what may and may not be done under them, have created a new body of law so large and complex that provision of standard criteria for their enforcement has become necessary.

Consequently, the five Federal agencies have joined in proposing uniform guidelines for enforcement of Truth in Lending and Regulation Z

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and they expect to issue further enforcement guidelines for other consumer credit protection laws and regulations.

The agencies joining in today's proposal are the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board and the National Credit Union Administration.

In a statement accompanying their enforcement proposals the agencies said:

"It is felt that coordination among the agencies is desirable in order to bring about uniformity in the administrative actions that will be taken when violations of the Act are detected....It is administratively impossible to fashion an appropriate remedy for every type of violation. The guidelines...outline the corrective action the agencies intend to require when violations...have caused measurable monetary injury to customers.... It should be emphasized that it will continue to be the policy of the enforcing agencies that...prospective correction of any violation will be required -- that is, creditors will be required to take whatever action is necessary to insure that the violation does not recur....

"The guidelines are not intended to substitute for...administrative authority any of the agencies has to enforce the Act, nor are they intended to foreclose the customer's right to bring civil action to recover for violations of the Act."

The agencies said willful and knowing violations will be brought to the attention of the Department of Justice. The guidelines may be modified by the agencies to be responsive to specific circumstances, and they will be reviewed and modified as continued special examinations of financial

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institutions for compliance with the consumer credit protection laws yields more information.

"In all cases," the joint statement added, "the financial condition of the creditor and the cost of corrective action will be considered in applying the guidelines."

In connection with a number of their proposals, the agencies cited specific questions on which they would particularly like to have comment.

In part, the guidelines propose corrective actions that would be required when violations of key provisions of the Act are discovered. These guidelines are listed, beginning with Guideline 4, under the heading Corrective Action for Specific Violations. They include:

Violations Involving Improper Disclosure of the Annual Percentage Rate or Finance Charge (total cost of credit to a customer) (No. 4):

The agencies distinguish several types of violations involving the Annual Percentage Rate (APR) and the finance charge. They are:

1. Where the APR is understated<sup>1/</sup> and the finance charge is either correct or not disclosed:

--The creditor would be allowed to charge no more for the credit than the understated APR indicates, and must take action to ensure this.

2. Where no APR is disclosed and the finance charge is either correct or not disclosed:

Alternate 1: The creditor would calculate what APR is actually being charged and take action to ensure that the customer does not pay more than that, reduced by one-quarter of one per cent in the case of a first mortgage loan or one per cent in all other cases.

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<sup>1/</sup> "Understatement" of the APR or finance charge means an APR or finance charge that is less than what the customer is actually paying, resulting in an overcharge. See definitions Nos. 18 and 19 in the guidelines.

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Alternate 2: Whatever rate is disclosed on the loan note or conditional sales contract would be considered the "disclosed" APR and the customer could be charged no more than that.

3. Where the APR is correctly disclosed but the finance charge is understated, the creditor would be required to pay the difference between the actual and the understated finance charge to the customer.
4. Where both the APR and the finance charge are understated, the creditor would be required to take the corrective action appropriate to whichever of the understatements caused the largest overcharge.
5. No reimbursement would be required when no finance charge is disclosed and the APR is correct. The agencies feel that customers are more likely to be misled by misstatement of the finance charge than by no disclosure of it.

Additionally, the agencies proposed three types of actions for correcting an understated APR. These are:

- A lump sum rebate and reduction of the amount of each remaining payment;
- Reducing the number of remaining payments;
- Reducing the amount of each remaining payment.

The agencies said each of these is administratively feasible and all would lower the actual rate paid by the customer to the level of the understated APR.



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Violations Involving the Improper Disclosure of Credit Life, Accident, Health or Loss of Income Insurance(No. 5). The Act allows premiums for such insurance to be excluded from the Finance Charge if the customer is clearly and conspicuously informed that the insurance is optional. If the customer wants the insurance, the customer must sign and date an affirmative statement to that effect. The agencies proposed that if there is no written disclosure that the insurance is voluntary it should be treated as having been required, and its cost must be included in the finance charge.

If the disclosure was made but the cost of the insurance was not stated or the customer did not sign a statement saying it was desired, the agencies proposed that the customer should be given another chance to accept or reject the insurance. If the customer wants to cancel the insurance, the creditor would be required, under alternative proposals, to (1) refund some or (2) all of the premiums paid. The agencies said their alternative proposals for partial or entire refunds were made in light of the facts that even if the customer in the end rejects the insurance, some benefits were received while it was in force.

Other guidelines constitute proposed general policies, dealing with such matters as the difference in treatment of intentional and unintentional violations, how far back in time corrective action should reach and minimum amounts for which correction should be required.

Intentional Violations (No. 1):

The agencies defined intentional violations as (1) those an enforcing agency can reasonably determine to have been knowingly committed, permitted or approved by a creditor's managerial personnel or board of directors, or (2) a violation that an enforcing agency determines to have

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resulted (a) from a deliberate or sustained ignorance of, or indifference to, the law on the part of the creditor's management, including the board of directors, or (b) a deliberate or sustained omission concerning, or misrepresentation of, the requirements of the Act in the creditor's policies and procedures.

All intentional violations resulting in an overcharge would require corrective action, regardless of the dollar amount involved.

Unintentional Violations (No. 2):

(1) All unintentional violations resulting in an overcharge would require corrective action if the overcharge, or the estimated average overcharge per customer, is one dollar or more.

(2) Where the overcharge or estimated average for a type or class of loan is determined to be less than one dollar:

A -- Generally, no corrective action is to be required.

If, however, in the discretion of the agencies, the aggregate amount is considered substantial, a corrective action may be required.

B -- Corrective action is to be required

in the case of any customer accounts identified in a sampling of the creditor's practices as having been overcharged by one dollar or more.

In a discussion section following Guideline No. 2 the agencies said they were trying to strike a balance between harm to the customer and cost of corrective action programs to creditors who violate Truth in Lending requirements unintentionally. "Therefore," they said, "the agencies propose that in cases of unintentional violations, if an examiner, by sampling or some other

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technique, detects a type or a class of loan for which the overcharge is one dollar or more, corrective action will be ordered for that type or class of loans. Creditors...will be given the right to produce their own average overcharge estimates."

Period for which Corrective Action is Required (No. 3):

Alternate Proposal 1: Corrective action shall be required for all violations since July 1, 1969 (date when Truth in Lending became effective).

Alternate Proposal 2: Corrective action would be required for all violations within the scope of the Guidelines occurring within one year prior to the date of examination of a creditor by an enforcing agency.

In discussing these alternatives the agencies said they have determined that the statute of limitations for civil remedies in the Truth In Lending Act does not control administrative enforcement of the Act, such as proposed under the Guidelines. However, they said, they are concerned about requiring creditors to take corrective action for violations back to 1969 since retroactive enforcement has only recently been required by the agencies. On the other hand, they said, they recognize that any time limitation will cut off some customers from relief for losses.

The statement of the agencies, and their proposed guidelines, are attached.

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DEPARTMENT OF THE TREASURY  
COMPTROLLER OF THE CURRENCY  
Regulation Z

JOINT NOTICE OF PROPOSED STATEMENT OF ENFORCEMENT POLICY

AGENCIES: The Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration

ACTION: Proposed Statement of interagency enforcement policy  
- Regulation Z.

SUMMARY: This proposed statement of enforcement policy sets forth uniform guidelines which the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration propose to use to enforce the Truth in Lending Act and Regulation Z. It is intended that specific, standardized guidelines will promote improved and uniform enforcement of the Truth in Lending Act through corrective action, including reimbursement for borrowers who have been overcharged or otherwise harmed by violations of the Act. Realizing the value of public participation in the formulation of these guidelines, the agencies are requesting comments on these guidelines and have designated specific issues for comment.

DATES: Comments must be received on or before November 21, 1977 (30 days from publication in the Federal Register).

ADDRESSES: Written comments should be addressed to:

Interagency Enforcement Policy - Regulation Z  
Washington, D. C. 20219

FOR FURTHER INFORMATION CONTACT: Mark Medvin, Federal Reserve Board, 202-452-2412; Thomas Vartanian, Comptroller of the Currency, 202-447-1884; Peter M. Kravitz, Federal Deposit Insurance Corporation, 202-389-4427; Harry W. Quillian, Federal Home Loan Bank Board, 202-376-3556; Harry J. Blaisdell, National Credit Union Administration, 202-254-8760.

SUPPLEMENTARY INFORMATION: This document is intended as a statement of the guidelines that the federal regulatory agencies involved propose to use in enforcing the Truth-in-Lending Act and Regulation Z.

It is felt that coordination among the agencies is desirable in order to bring about uniformity in the administrative actions that will be taken when violations of the Act are detected. To that end, the agencies have developed a set of proposed policy guidelines for measuring and correcting the conditions resulting from certain violations of the Truth in Lending Act.

It is administratively impossible to fashion an appropriate remedy for every type of violation. The guidelines which follow outline the corrective action that the agencies intend to require when violations which have caused measurable monetary injury to customers are discovered. It should be emphasized that it will continue to be the policy of the enforcing agencies that, whenever any violation of the Act is detected, prospective correction of the violation will be required--that is, creditors will be required to take whatever action is necessary to insure that the violation does not recur. For example, a creditor which is found to be using forms that do not comply with the type size requirements will be required to obtain new forms which do comply. These guidelines, however, are intended to address the most serious types of violations, those which result in overcharges to customers. Based upon the expertise and experience acquired by the various agencies through examinations of lending institutions throughout the country and investigations of consumer complaints, several substantive violations which cause measurable damage to customers have been identified, and guidelines for correcting the conditions resulting from these violations are proposed.

These guidelines are not intended to substitute for any other administrative authority that any of the agencies has to enforce the Act, nor are they intended to foreclose the customer's right to bring a civil action to recover for violations of the Act. Further, where apparently willful and knowing violations are found, the agencies will notify the Department of Justice. The guidelines serve only to reflect the enforcement policies of the agencies and to specify the actions which the agencies feel are appropriate to correct the conditions resulting from violations which cause overcharges to customers. As guidelines, they may be modified in the discretion of the agency so as to be more responsive to specific or unique circumstances which may exist. As new examination data concerning the extent and type of violations are received, the guidelines will be reviewed and revised as appropriate. In all cases, the financial condition of the creditor and the cost of corrective action will be considered in applying the guidelines.

This statement of enforcement policy is proposed to announce formally and to solicit public comment on the course which the federal regulatory agencies involved propose to follow in enforcement actions. It is hoped that the publication of

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this proposed general statement of policy will promote uniformity of enforcement and provide notice to consumers and creditors of the type of action that can be expected when violations resulting in overcharges are found. Comments are requested on the entire proposal and specifically on the designated issues.

#### AUTHORITY

These guidelines are proposed pursuant to the enforcement authority contained in 15 U.S.C. 1607 and 12 U.S.C. 1818(b) in the cases of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency, pursuant to 15 U.S.C. 1607 and 12 U.S.C. 1464(d)(2) and 1730(e) in the case of the Federal Home Loan Bank Board, and pursuant to 15 U.S.C. 1607 and 12 U.S.C. 1786(e)(1) in the case of the National Credit Union Administration.

DRAFTING INFORMATION: The principal drafters of this document were Mark Medvin, Federal Reserve Board; Roberta Boylan, Comptroller of the Currency; Peter M. Kravitz, Federal Deposit Insurance Corporation.

#### PROPOSED STATEMENT

In consideration of the foregoing, the following statement of enforcement policy is proposed:

#### STATEMENT OF ENFORCEMENT POLICY

#### DEFINITIONS

1. "Act" means the Truth-in-Lending Act, 15 U.S.C. 1601 et seq., and Regulation Z, 12 CFR 226.
2. "Actuarial method based on scheduled payments" means a method of computing rebates of unearned finance charges in which the ratio of interest earned in a given period of time to the amount of the principal owed during that time is constant; the scheduled payment is allocated first to interest earned and the remainder is used to reduce principal.
3. "Annual percentage rate (APR)" means "annual percentage rate" as defined in 12 CFR 226.2(g).
4. "Corrective action" means a course of conduct to be undertaken by a creditor at the direction of an enforcing

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agency to correct the conditions resulting from past violations of the Act.

5. "Creditor" means a "creditor" as defined in 12 CFR 226.2(s) and which is supervised by an enforcing agency.
6. "Customer" means "customer" as defined in 12 CFR 226.2(u)
7. "Enforcing agency" means the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration.
8. "Estimated average overcharge" means the average amount each customer is overcharged for a specific violation within the scope of these guidelines, based on a sampling of similar types or classes of loan accounts by an examiner of an enforcing agency.
9. "Finance charge" means "finance charge" as defined in 12 CFR 226.2(w).
10. "Intentional violation" means 1) any violation which an enforcing agency can reasonably determine to have been knowingly committed, permitted or approved by managerial personnel or the board of directors of a creditor; or 2) a violation which, in the determination of an enforcing agency, resulted from a deliberate or sustained ignorance of or indifference to the requirements of the Act on the part of a creditor's management, including the board of directors, or a deliberate or sustained omission concerning or misrepresentation of the requirements of the Act in the creditor's policies and procedures.
11. "Lump sum method" means a method of adjustment for determining the amount that will be returned to a customer when a loan has been paid in full; the amount will be calculated in accordance with the maturity reduction method.
12. "Lump sum/payment reduction method" - means a method of adjustment under which a cash payment equal to the amount the customer has overpaid (including time value) will be returned to the customer and the remaining payments on the loan will be reduced to the level at which they would have been had the payments been computed at the understated APR at the outset.
13. "Maturity reduction method" - means a method of adjustment under which a loan will be restructured to reduce the number of payments that the customer is required to make to pay off the loan so that the customer will not pay at a rate in excess of the understated APR.
14. "Method of adjustment" - means a calculation to determine

the adjustment necessary to correct overcharges resulting from APR violations.

15. "Overcharge" means a charge imposed by the creditor in excess of charges disclosed or required to be disclosed in accordance with 12 CFR 226 and as computed in accordance with these guidelines.

16. "Payment reduction method" means a method of adjustment under which the amount of each remaining payment on the loan will be lowered so that the customer will not pay at a rate in excess of the understated APR.

17. "Reimbursement" means corrective action involving monetary adjustment for overcharges for other than APR violations.

18. "Understated APR" means a disclosed APR, rounded to the next higher one-eighth of one percent, which is less than the APR calculated in accordance with the Act.

19. "Understated finance charge" means a finance charge disclosed at a dollar amount which is less than the finance charge calculated in accordance with the Act.

20. "Violation" means a violation of the Act.

#### GENERAL POLICIES

##### 1. INTENTIONAL VIOLATIONS

All intentional violations of the Act by a creditor which result in an overcharge shall require corrective action regardless of the dollar amount of the overcharge.

##### 2. UNINTENTIONAL VIOLATIONS

(a) All unintentional violations which result in overcharges shall require corrective action if the overcharge or the estimated average overcharge per customer is one dollar or more.

(b) If the overcharge or the estimated average overcharge per customer for a type or class of loans is determined to be less than one dollar, no corrective action shall be required except as provided in paragraph (c) unless, in the discretion of the agency, the aggregate amount of all overcharges is considered substantial.

Alternate paragraph (b):

(b) If the overcharge or the estimated average overcharge for a type or class of loans is less than one dollar, no corrective action shall be required except as provided in paragraph (c).

(c) Where the estimated average overcharge for a type or class of loans is less than one dollar, any customer accounts



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identified in the sample which have been overcharged by one dollar or more shall be subject to corrective action.

## DISCUSSION

In many cases, the costs involved in the corrective action may be far greater than the amount of monetary damage suffered by the customer. The agencies believe that the imposition of a corrective action program on a creditor who had unintentionally violated the law may be unnecessary where there is negligible harm to any customer. Therefore, the agencies propose that, in cases of unintentional violations, if an examiner, by sampling or some other technique, detects a type of loan (e.g. mortgage, installment, open-end) or a class within that type of loan (e.g., all loans involving amounts financed greater than \$1,000) for which the overcharge or the estimated average overcharge is \$1 or more, corrective action will be ordered for that type or class of loans. Further, to afford creditors the opportunity to confirm or rebut the accuracy of estimated average overcharges they will be given the right to produce their own average overcharge estimates.

When estimated average overcharges are less than \$1 per customer but the total of all overcharges is substantial, it may not be equitable to allow the creditor to keep amounts to which it is not entitled. It has been suggested that, in these cases, each agency may exercise its discretion to order the creditor to use such amounts in a manner which would further the purposes of the Truth in Lending Act.

It should be noted that, where estimated average overcharges are less than \$1, any account in the sample which has been identified as having been overcharged \$1 or more should be reimbursed since the cost of identifying those accounts and computing the overcharge has already been incurred.

The agencies have advanced the estimated average overcharge proposal under the assumption that the costs involved in requiring corrective action for amounts less than \$1 would probably outweigh the benefits of such action and would be unnecessarily burdensome when the violation was unintentional. In the case of intentional violations, however, corrective action should presumably always be ordered because the creditor has inflicted financial harm upon its customers.

In distinguishing between intentional and unintentional violations of the Act, the agencies do not mean to equate "intentional" violations as defined in these guidelines with "willful and knowing" violations as defined in 15 U.S.C. 1611. However, if, in the determination of the agencies, an intentional violation was committed willfully and knowingly, the matter will be referred to the Department of Justice.

## Designated Issues

1. Is one dollar a reasonable minimum estimated average overcharge amount to trigger corrective action for unintentional violations of the Act?
2. Where the estimated average overcharge is less than the amount that would trigger corrective action, but the total

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of all overcharges is substantial, should corrective action be ordered? If so, in what form?

3. PERIOD FOR WHICH CORRECTIVE ACTION IS REQUIRED

Corrective action shall be required for all violations within the scope of these guidelines occurring since July 1, 1969. Alternate guideline 3.

3. PERIOD FOR WHICH CORRECTIVE ACTION IS REQUIRED

Corrective action shall be required for all violations within the scope of these guidelines occurring within one year prior to the date of the examination by the enforcing agency.

Discussion

The agencies have considered the time period for which corrective action will be required. One proposal is that corrective action should be required for all violations within the scope of the guidelines since 1969 when the Act became effective. Another proposal is that the creditor only be required to take corrective action for violations occurring within one year prior to the date of examination to maintain consistency with the one-year statute of limitations for Truth-in-Lending civil actions.

The enforcing agencies have concluded that the statute of limitations for civil remedies in the Act does not control administrative enforcement of the Act. The agencies are concerned, however, about the desirability of requiring creditors to take corrective action for violations occurring as far back as 1969 since retroactive corrective action has only recently been imposed by the agencies. On the other hand, it is recognized that a corrective action program which addresses violations occurring within any limited time frame will provide no relief for some customers who have suffered harm as a result of a violation.

Designated Issue

3. Should corrective action be required for violations occurring since July 1, 1969, when the Act became effective, or should it be limited to violations occurring within one year prior to the date of examination? Is any other time period appropriate? Should a longer time period be specified for long-term obligations (e.g. real estate loans) than for short-term obligations (e.g. auto loans).

## CORRECTIVE ACTION FOR SPECIFIC VIOLATIONS

4. VIOLATIONS INVOLVING THE IMPROPER DISCLOSURE OF THE APR OR FINANCE CHARGE

(a) Where there is an understated APR and the finance charge is either correct or not disclosed, the creditor shall take corrective action to insure that the customer's true cost of credit does not exceed the understated APR.

(b) Where no APR is disclosed and the finance charge is either correct or not disclosed, the creditor shall calculate the APR it charged the customer and shall take corrective action to insure that the customer's true cost of credit does not exceed the actual APR reduced by one-quarter of one percent in the case of first lien real estate transactions, and one percent in all other consumer credit transactions.

Alternate paragraph (b):

(b) Where no APR is disclosed and the finance charge is either correct or not disclosed, the rate disclosed on the note or conditional sales contract evidencing the transaction will be considered the "disclosed APR"; the creditor shall calculate the APR it charged the customer and shall take corrective action to insure that the customer's true cost of credit does not exceed the "disclosed APR". If no rate is disclosed on the note, the creditor shall calculate the APR it charged the customer and shall take corrective action to insure that the customer's true cost of credit does not exceed the actual APR reduced by one-quarter of one percent in the case of first lien real estate transactions, and one percent in all other consumer credit transactions.

(c) Where there is an understated finance charge and the APR is correct, the creditor shall reimburse the overcharge which is the difference between the actual and the understated finance charge.

(d) Where no finance charge is disclosed and the APR is properly disclosed, no reimbursement is required.

(e) Where there is an understated finance charge and an understated APR, the creditor shall take appropriate corrective action for the larger overcharge.

(f) Corrective action for understated APR violations will be made by a method of adjustment as defined in the guidelines.

## Discussion

## 1. APR Violations

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One of the most important items of information furnished to a borrower under the Truth-in-Lending Act is the Annual Percentage Rate (APR). The APR is a term of art which is described in 12 CFR 226.5. Essentially, it represents the true cost of the credit extended and reflects not only the rate of interest but also the total of certain other costs which the customer must pay as a condition of the extension of credit. Congress intended that the uniform disclosure of a rate would enable borrowers to shop for and compare consumer credit costs and make informed credit decisions.

Where the creditor discloses a rate but actually charges a higher rate, the affected accounts must be adjusted. For the purpose of calculating the adjustment, the disclosed APR will be rounded to the next higher one-eighth of one percent and termed the "understated APR". This tolerance recognizes the flexibility suggested by the rounding provisions found in 15 U.S.C. 1606 and 12 CFR 226.5 and would not unfairly discriminate against creditors which try to disclose the exact APR as a service to their customers rather than utilize the method of rounding permitted by the Act and Regulation Z to disclose less precise rates.

Where the creditor discloses no APR to the customer, a serious breach of the creditor's responsibility under the Act has occurred. Technically, while it may be said that since no APR was disclosed, none can be charged, the agencies feel that that would be a windfall to customers and a severe hardship to creditors. On the other hand, those creditors who fail to make such important disclosures should be treated at least as severely as those who did make disclosures, even though inaccurately. Consequently, the agencies propose that in such a situation the actual APR should be computed and the creditor should be required to adjust affected accounts to reflect an APR which is lower than the actual APR by certain specified margins. Those specified margins will be based on a comprehensive data base compiled by the agencies after a review of a sufficient number of examination reports to determine typical APR disclosure inaccuracies found in various types of credit transactions. Based upon information which the agencies now have, it is proposed that the actual APR charged on first lien real estate mortgages should be reduced by one-quarter of one percent since that appears to be the most common margin of APR disclosure error. Further, until an even more comprehensive data base can be established through further examinations, all other credit transactions will be corrected by a reduction of one percent in the actual APR.

An alternate proposal is to consider the rate disclosed on the contract or note as the "disclosed APR" and to require corrective action if the actual APR is higher.

Another alternative, to adjust the APR and lower the finance

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charge to the lowest rate which was available in the market area at the time the loan was made, under the assumption that the customer might have obtained credit at another institution which provided that lower APR if the customer had been given the tools to shop for that credit, was not included in the proposal because adequate rate information on local markets is not readily available.

## 2. Specific Methods of Adjustment for APR Violations.

When the disclosed APR is less than the APR actually being charged, an adjustment of the loan will be required in order to bring the rate actually being charged down to the understated APR. Simply reimbursing the difference between the APR charged and the understated APR will not accomplish this goal since the effect of the overcharge increases as the length of time between the inception of the loan and the error adjustment date increases. The agencies have considered a number of methods of adjustment. Some are attractive for policy reasons but are administratively unacceptable because formulas and programs to enable creditors to make the adjustments are extremely difficult to develop and use. Three adjustment methods,<sup>1/</sup> all of which have the effect of lowering the actual rate paid by the customer to the understated APR and are administratively feasible, are proposed. The dollar adjustments for each method vary because the time periods over which the total adjustments will be made are different. The proposed methods are:

### (1) Lump sum/payment reduction

The remaining payments on the loan would be reduced to the level at which they would have been had the payments initially been computed on the basis of the understated APR, and a lump sum money adjustment equal to the amount that the customer has overpaid (including time value) would be returned to the customer.

Example: On a 12-month loan having an amount financed of \$1,000 and calling for 12 payments of \$100, where a \$120 total overcharge has been found and six payments have been made, the customer would receive \$61.83 in cash and each remaining payment would be reduced to \$90. The dollar adjustment to the customer under this method is \$121.83.

### (2) Maturity Reduction

The loan would be restructured in such a way as to reduce the number (not the amount) of required payments. The amount of each

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<sup>1</sup> The lump sum method defined in the guideline is proposed only for loans that have been paid in full. It incorporates the maturity reduction method.

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payment in the revised schedule (except the last) will remain the same as in the past.

Example: A loan having an amount financed of \$1,000 and requiring 12 payments of \$100 per month would be adjusted to require only 10 payments of \$100 per month and one payment of \$72.05 if the total overcharge resulting from an understated APR is \$120. The dollar adjustment to the customer under this method is \$127.95.

### (3) Payment Reduction

The amount of each remaining payment on the loan would be lowered so that the total finance charge does not exceed that permitted by the revised payment schedule and the understated APR.

Example: On a 12-month loan having an amount financed of \$1,000 and calling for 12 payments of \$100, where a \$120 total overcharge has been found after six payments have been made, each remaining payment would be reduced to \$79.25. The dollar adjustment to the customer under this method is \$124.50.

It is anticipated that, because of cost and administrative factors, only one adjustment method will be adopted. After a determination has been made as to the method of adjustment that will be required, technical assistance will be available from the agencies to creditors for making adjustments for APR violations.

The agencies recognize that all methods will require adjustments to the creditor's records and notification of changes to customers.

### 3. Finance Charge Violations

The agencies recognize that customers may be misled by understated finance charges even though the disclosed APR is accurate. In such situations, adjustment of the finance charge will be required. Reimbursement will be made by repaying to the customers the difference between the actual and disclosed finance charge.

Where the correct APR has been disclosed, but there is no disclosure of the finance charge, the agencies have considered various standards for corrective action. Although the finance charge is an integral part of the disclosure requirements, the Act assumes that its reflection in the APR is the essential tool contemplated by the disclosures. In all transactions subject to the Act the APR must be disclosed; however, in certain transactions no finance charge disclosure is required. Further, the agencies feel that misstating the finance charge is more likely to mislead a customer than omitting that disclosure, particularly since the finance charge can normally

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be computed from the other disclosures. Consequently, where the APR is correct and there is no disclosure of the finance charge, the agencies propose that no corrective action be required.

#### Designated Issues

4. Which method of adjustment (i.e., the "maturity reduction method", "the payment reduction method", or "the lump sum/payment reduction method") is preferable? Is any other method preferable?

Commentors should address: (1) any accounting problems associated with the various methods, (2) whether more than one adjustment method should be adopted, (3) if more than one method is adopted, who should determine which method to use (customer/bank/enforcing agency), and (4) the costs associated with the various options.

#### 5. VIOLATIONS INVOLVING THE IMPROPER DISCLOSURE OF CREDIT LIFE, ACCIDENT, HEALTH OR LOSS OF INCOME INSURANCE.

(a) If the creditor has not disclosed to the customer in writing that credit life, accident, health, or loss of income insurance is optional, the insurance shall be treated as having been required by the creditor and improperly excluded from the finance charge. The overcharge will result from an understated finance charge and, possibly, an understated APR. The creditor shall take appropriate corrective action for the larger overcharge. The insurance will remain in effect.

(b) If the creditor has disclosed to the customer in writing that credit life, accident, health or loss of income insurance is optional, but there is either no signed insurance option or no disclosure of the cost of the insurance, the creditor shall be required to send a written notice to the affected customers disclosing the cost of the insurance and notifying them that the insurance is optional and may be cancelled within 45 days to obtain a full refund of all premiums charged. If the creditor receives no response within 45 days, the insurance will remain in effect and no further corrective action will be required.

#### Alternate paragraph (b):

(b) If the creditor has disclosed to the customer in writing that credit life, accident, health or loss of income insurance is optional but there is either no signed insurance option or no disclosure of the cost of the insurance, the creditor shall be required to send a written notice to the affected customers disclosing the cost of the insurance and notifying them that the insurance is optional and may be cancelled within 45 days to obtain a partial refund of premiums charged. If the creditor receives no response within 45 days, the insurance will remain in effect and no further corrective action will be

required.

#### Discussion

The Act requires that premiums for credit life, accident, health, or loss of income insurance written in connection with any credit transaction be included in the finance charge unless the customer is clearly and conspicuously advised in writing that the insurance is optional. If the insurance is desired, the customer must sign and date an affirmative statement to that effect after having received written disclosure of the cost of the insurance. These requirements are imposed to insure that premiums which are excluded from the calculation of the cost of credit are voluntarily incurred by the customer.

Since voluntariness is the basis for excluding the insurance premiums from the finance charge, the agencies believe that if there is no written disclosure that the insurance is voluntary it should be treated as having been required and, therefore, improperly excluded from the finance charge. Corrective action will be ordered as discussed in the section on APR violations or in the section on understated finance charges, depending on which method is more beneficial to the customer.

If the optional nature of the insurance was disclosed in writing but either 1) the cost was not disclosed or 2) the customer did not sign the insurance option blank, the agencies believe that the creditor should be required to write to and inform the customer that the insurance was optional, disclose its cost, and offer to cancel the insurance if requested. In cases where the customer expresses a desire to cancel, the creditor should be required to refund some or all of the premiums paid. On the one hand, the customer has received benefit from the insurance coverage during the period it was in effect; on the other hand, the customer did not want the insurance. Alternate courses of corrective action are set forth in the guidelines.

If the required insurance authorization is signed but not dated, no corrective action need be taken since the lack of date disclosure is deemed to be of little significance in establishing whether the insurance was optional.

#### Designated Issue

5. Where the proposed guidelines require notice to customers that credit life, accident, health or loss of income insurance was optional and may be cancelled, should the entire premium be reimbursed if the customer cancels? If not, on what basis should a partial reimbursement be made?
6. VIOLATIONS INVOLVING THE IMPROPER DISCLOSURE OF PROPERTY



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INSURANCE, INCLUDING VENDOR'S SINGLE INTEREST INSURANCE

(a) If a creditor has not included the property insurance premium in the finance charge when required by 12 CFR §226.4(a)(6), corrective action will not be required.

(b) If an insurer providing vendor's single interest insurance has not waived its right of subrogation against the customer and the premium has been excluded from the finance charge, the creditor shall indemnify the customer for any loss incurred as a result of a subrogation action by the insurer.

## Discussion

The agencies believe that if property insurance is improperly excluded from the finance charge, the resulting situation should not be treated as an overcharge. Even required property insurance is excludable from the finance charge if the creditor discloses the cost of the insurance if purchased through the creditor and that the customer has the option to select the insurer. Based upon the agencies' review of examinations conducted up to this point, the agencies have not found evidence of abuse in this area as there is with credit life insurance. However, the agencies believe that borrowers might be harmed if the insurer has not waived its right of subrogation against the customer when vendor's single interest insurance is required since the insurer may sue the customer for amounts it paid to the creditor. Consequently, in that situation, creditors would be required to establish procedures to indemnify customers for any harm caused by that failure where the insurance has been improperly excluded from the finance charge.

7. VIOLATIONS CONCERNING PREPAYMENT PENALTIES AND REBATES

(a) Where the finance charge is computed on the outstanding balance and the creditor has not disclosed a prepayment penalty, none can be collected and those already collected are overcharges which shall be reimbursed.

(b) Where the finance charge is computed on the outstanding balance and the creditor has charged a prepayment penalty in excess of that disclosed, the difference is an overcharge which shall be reimbursed.

(c) Where the finance charge is precomputed and there is neither a disclosure that no rebates of unearned finance charges will be made nor a disclosure of the method of computing the rebates, the failure to rebate unearned finance charges is an overcharge. The amount of reimbursement shall be the rebate of unearned finance charges in the event of early payment of the obligation as specified under state law; if state law is silent, the actuarial method based on scheduled payments shall be used to determine the amount of the reimbursement.

(d) Where the finance charge is precomputed and a method of

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computing rebates of unearned finance charges has been disclosed but the actual rebate is less favorable to the customer, the difference between the actual and the disclosed rebate is an overcharge which shall be reimbursed.

## Discussion

Regulation Z, 12 CFR 226.8(b)(7), requires that the method of rebating unearned finance charges be disclosed, and if no rebate will be given, that fact must be disclosed. The regulation also requires disclosure of the amount of any prepayment penalties (12 CFR 226.8(b)(6)). The guideline is self-explanatory.

8. VIOLATIONS CONCERNING LATE FEES

(a) Where a creditor has disclosed the amount of late fees to be imposed in the event of late payment, any late fees collected in excess of those disclosed are overcharges which shall be reimbursed.

(b) Where a creditor has not disclosed the amount of late fees to be imposed in the event of late payment, none can be imposed and those already collected are overcharges which shall be reimbursed.

## Discussion

The guideline is self-explanatory.

9. ITEMIZATION OF MISCELLANEOUS FEES AND CHARGES

If a creditor has not itemized and disclosed the charges found in 12 CFR 226.4(b) and has not included them in the finance charge as required by that section, the resulting disclosure violation, by itself, shall not constitute an overcharge and corrective action shall not be required.

## Discussion

Regulation Z, 12 CFR 226.4(b), lists certain miscellaneous charges which may be excluded from the finance charge if they are itemized and disclosed to the customer. The agencies believe that if the charges are not itemized and disclosed, and are excluded from the finance charge, the resulting violation is only of a technical nature. The customer's ability to shop is not impaired since comparability of the APR and finance charge is not destroyed; the nature of the violation does not justify requiring corrective action.

## PUBLICATION FOR COMMENT

The Administrative Procedure Act does not require notice

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and solicitation of comment in connection with the establishment of statements of enforcement policy or guidelines (5 U.S.C. 553(b)), and it permits them to become effective immediately (5 U.S.C. 553(d)). However, in consideration of the agencies' desire to solicit public participation on these issues, they have elected to afford an opportunity for comment on these proposed guidelines. Comments should be addressed to: Interagency Enforcement Policy-Regulation Z, Washington, D. C. 20219.

Dated:

Stephen S. Gardner  
Vice Chairman of the  
Board of Governors of the  
Federal Reserve System

Dated:

John G. Heimann  
Comptroller of the Currency

Dated:

George A. Le Maistre  
Chairman, Federal Deposit  
Insurance Corporation

Dated:

Robert H. McKinney  
Chairman, Federal Home  
Loan Bank Board

Dated:

Lawrence Connell Jr.  
Administrator, National  
Credit Union Administration



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

March 15, 1978

The Honorable Mark W. Hannaford  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Hannaford:

Thank you for your letter of March 9 and your thoughtfulness during my transition. I am pleased to enclose responses to the questions contained in your letter.

I have furnished a copy of this letter along with the enclosure to the House Banking Committee for inclusion in the record of the March 9 hearing.

I am looking forward to working with you in the months and years ahead.

With best regards,

Sincerely,

(Signed) G. William Miller

Enclosure

(The following are written questions from Congressman Hannaford to Chairman Miller, along with the Chairman's answers.)

1. Many economists point to the lack of business capital investment as a primary factor contributing to high inflation and unemployment. As a matter of fact, we have had an expanding labor force and a declining population of investors. It is estimated that the reduction in the number of investors since 1969 has resulted in a loss of about \$103 billion in equity capital, and that this capital could have been used to create about four million new jobs in the private sector. What types of changes in capital gains taxation do you believe should be explored to generate business capital investment?

Answer. Changing the capital gains tax law would not, in my view, be the most effective way to encourage business investment spending. Measures that would directly reduce the cost of new capital, such as a further increase in the investment tax credit or a liberalization of depreciation rules, would probably have a greater impact on investment spending per dollar of lost revenue to the government.

A reduction of taxes on capital gains would tend to increase investment spending by encouraging greater savings and increasing the rate of return on investment. But more favored treatment of capital gains would apply to returns on already created capital goods as well as new investments. Thus, the Treasury would suffer revenue losses without achieving a commensurate increase in new business investment.

Despite the drawbacks, the Congress may want to explore possible changes in the capital gains tax law. Consideration might be given to permitting an investor holding an asset with a capital gain to shift into a new asset without incurring an immediate tax liability. This, of course, is the approach presently followed in the law when individuals change their home ownership. Another feature worth considering would be to allow the asset holder to adjust for the impact of inflation on the value of his asset before calculating his tax liability.

2. During the last session of Congress, I introduced legislation to reinstate detailed memoranda of discussion of the Open Market Committee and stipulated that these documents be released to the public after a three-year lag. Dr. Burns testified in support of this bill, and I would appreciate your views as well.

Answer. I have taken the opportunity to review Chairman Burns' testimony of November 17, 1977, regarding your legislation, H.R. 9465. Chairman Burns expressed sympathy for the concerns underlying this legislation and I share that sentiment. At the same time, I concur in Chairman Burns' judgment that certain amendments to the bill may be necessary in order to assure against premature disclosure of the memoranda and to avoid release of sensitive material relating to foreign governments or institutions. Chairman Burns expressed the view that mutually satisfactory amendatory language could be worked out and I know that preliminary discussions to this end took place at the staff level in December of 1977. I will direct members of the Board's staff to resume promptly contacts with your staff, with a view to achieving a mutually resolved position on this legislation.

## APPENDIX II

## LETTER FROM FEDERAL RESERVE CHAIRMAN G. WILLIAM MILLER WITH THE RECORD OF POLICY ACTIONS OF FOMC FEBRUARY MEETING



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

G. WILLIAM MILLER  
CHAIRMAN

March 29, 1978

The Honorable Henry S. Reuss  
Chairman  
Committee on Banking, Finance  
and Urban Affairs  
House of Representatives  
Washington, D. C. 20515

Dear Mr. Chairman:

In response to a question you raised at the February monetary policy oversight hearing about the slight downward adjustment in the longer-run range established for M-3, I am enclosing a copy of the policy record for the February FOMC meeting. That record summarizes the Committee's discussion of the longer-run ranges that were set for the one-year QIV '77 to QIV '78 period. You will see that the decision was unanimous.

I also indicated at the hearing that I would let you have my personal views, in quantitative terms, on projections of key economic variables that would be consistent with the ranges for the monetary aggregates set at the February FOMC meeting. At this time, I would anticipate a moderate expansion in real GNP over the year--with growth averaging perhaps in a 4 to 4½ per cent range from the fourth quarter of 1977 to the fourth quarter of 1978. In this assessment, I have assumed that there will be a tax cut of about \$25 billion effective in the fall of the year. Consistent with such a GNP projection, it is probable that the unemployment rate would decline to the 5½-6 per cent area by the fourth quarter of 1978. Because of continuing strong cost pressures, however, the average level of prices--as measured by the GNP implicit price deflator--seems likely to increase by around 6½ to 7 per cent over the same period.

While these projections reflect my views at this time, the economy is subject, as always--and particularly in today's climate, to unexpected changes and forces that cannot be anticipated in advance. Historical experience indicates that the linkage between growth in the monetary aggregates and in rates of change of

The Honorable Henry S. Reuss  
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production, employment, and prices is far from precise. Factors other than monetary policy importantly influence trends in economic activity and prices, and many of these are subject to substantial uncertainty--for example, the timing, magnitude and composition of any tax cuts; the behavior of Governmental outlays for goods and services; shifts in business and consumer confidence; economic developments abroad; OPEC pricing decisions; and world agricultural conditions. Thus, quantitative projections, though they may be a convenient indicator of the economic outlook, should be viewed as provisional and subject to considerable margins of error.

Projections of likely economic developments over the year ahead are, of course, quite separate and distinct from the nation's ultimate goals. We urgently need to make progress in lowering the rate of inflation, as well as to achieve further reductions in the unemployment rate. Recent experience, in my view, strongly suggests that the nation is experiencing more difficulty at present in containing inflation than it is in reducing unemployment.

Structural unemployment does remain as a major problem. I welcomed your comments on this subject at the hearing, and concur with your proposals to overcome structural unemployment through targeted programs rather than through reliance solely on monetary policy. I will be pleased to support this approach in any appropriate way.

I look forward to continuing our dialogue on monetary policy and trust that we will make further progress in enhancing public understanding of the policy process.

Sincerely,

A handwritten signature in black ink, appearing to read "Bill". The signature is written in a cursive, somewhat stylized font with a large initial "B".

Enclosure



RECORD OF POLICY ACTIONS  
OF THE FEDERAL OPEN MARKET COMMITTEE

Meeting held on February 28, 1978

1. Domestic policy directive

The information reviewed at this meeting suggested that retail sales, industrial production, and housing starts had been adversely affected in January by unusually severe weather. It appeared, however, that there had been little change in the underlying economic situation.

In the fourth quarter of 1977, according to estimates of the Commerce Department, real output of goods and services had grown at an annual rate of 4.0 per cent, down from a rate of 5.1 per cent in the third quarter. However, final sales in real terms had expanded at a considerably faster pace than in the third quarter, and the rate of business inventory accumulation had slowed sharply. The rise in average prices, as measured by the fixed-weighted price index for gross domestic business product, had stepped up somewhat to an annual rate of 5.5 per cent in the fourth quarter from 5.0 per cent in the third.

Staff projections for the year 1978, like those prepared just before the Committee's meeting in mid-January,

were based on assumptions that included reductions next fall in Federal income taxes. The projections continued to suggest that growth in real GNP would be sustained at a good pace throughout the year, although the over-all rate was somewhat below that anticipated earlier because of scaled-down projections for housing starts, auto sales, and total government purchases of goods and services. It was still expected that the rise in prices would remain relatively rapid and that the unemployment rate would decline moderately further over the year.

The latest projections suggested that growth in output would be less rapid in the first quarter of 1978 than had been expected earlier, in large part because of the adverse weather, but that the weather-related losses would be about made up later. Thus, it was expected that growth of consumer spending in real terms--which had been exceptionally rapid in the fourth quarter of 1977--would slow even more in the current quarter than had been anticipated and that expansion in business fixed investment and in residential construction also would fall short of

earlier expectations. It was anticipated that growth in consumer spending would pick up in subsequent quarters--particularly in the fourth quarter, following the reduction in personal income taxes assumed to take effect on October 1. Business fixed investment was still projected to expand moderately over the remaining quarters of 1978, owing in part to stimulative modifications of the investment tax credit that were assumed to be retroactive to the beginning of the year. It was now anticipated, however, that residential construction activity would begin to edge down after midyear in response to the less favorable mortgage market conditions that now appeared to be developing.

In January industrial production declined 0.7 per cent--about as much as it had risen over the preceding 3 months--as the unusually severe weather caused widespread absenteeism, reduced workweeks, and disruptions to supplies. Moreover, auto manufacturers curtailed assemblies in an effort to control dealers' inventories, and the ongoing strike of mineworkers reduced production of coal further.

Nonfarm payroll employment continued to expand in January, and after adjustment for strikes, the gain was in line with the monthly-average rise during the second half of 1977. Increases were again sizable in manufacturing, trade, and services. Because of the unfavorable weather, however, construction employment declined, and the average workweek of production workers in nonfarm establishments fell sharply. The unemployment rate edged down to 6.3 per cent from 6.4 per cent in December.

The total value of retail sales declined about 3 per cent in January, according to the Census Bureau's advance estimate, after having expanded 5 per cent over the preceding 3 months. Sizable decreases in January were reported for almost all major categories of stores, at least in part because of the weather. Unit sales of new domestic autos declined 10 per cent to the lowest rate since late 1976, when supplies had been limited by a strike in the auto industry.

Private housing starts fell from an annual rate of 2.2 million units in December to 1.5 million units in January.

Declines occurred in all regions of the country and were especially large in areas that had suffered major storms.

Manufacturers' new orders for nondefense capital goods fell 5 per cent in January after having risen about 9 per cent in December. However, the machinery component changed little in January after an increase of almost 8 per cent in December.

The index of average hourly earnings for private nonfarm production workers rose sharply in January, in part as a result of the increase in the Federal minimum wage from \$2.30 to \$2.65 per hour at the beginning of the year. Increases were especially large in trade and services, where adjustments in the minimum wage have tended to have more widespread effects.

The consumer price index for all urban consumers rose 0.8 per cent in January, almost twice the monthly-average increase in the second half of 1977. About two-thirds of the rise in January was attributed to price increases for foods and beverages and for housing, although prices advanced for all major categories of expenditures.

The increase in the wholesale price index for January--0.9 per cent--also was considerably more than the average rise during the second half of 1977. In January average prices both of farm products and foods and of industrial commodities advanced substantially.

In foreign exchange markets, after almost a month of calm, the dollar came under renewed downward pressure around mid-February, and its trade-weighted value against major foreign currencies declined about 1-1/2 per cent during the second half of the month. Almost all major currencies rose against the dollar; the largest appreciations were registered by the Swiss franc and the German mark.

The U.S. foreign trade deficit increased appreciably in the fourth quarter of 1977. It appeared that the dock strike, which halted containerized shipments through Atlantic and Gulf Coast ports between October 1 and November 29, had depressed recorded exports more than recorded imports. After allowance for the apparent effects of the strike, the deficit was still slightly larger in the fourth quarter than in any of the first three quarters of the year. A deficit of \$31 billion

(international accounts basis) was estimated for 1977 as a whole, up from \$9 billion in 1976.

At U.S. commercial banks, total credit expanded substantially in January, after having changed little in December. The January expansion, which was about in line with the average rate of growth during the fourth quarter of 1977, was attributable chiefly to a rebound in loan expansion. Growth in business loans and in loans to finance security holdings accelerated, and expansion in real estate and consumer loans apparently remained large. As in earlier months, banks financed a sizable part of the January increase in total loans by reducing their holdings of Treasury securities.

For nonfinancial businesses the January pick-up in loan growth was especially evident at smaller banks. Lending to nonfinancial businesses also rose somewhat at large banks during January, but it remained below the pace of late 1977, and these businesses managed a sizable net run-off of their outstanding commercial paper.

The narrowly defined money supply (M-1) expanded at an annual rate of 7-1/4 per cent in January, but data for early February suggested a decline from the January level. From the fourth quarter of 1976 to the fourth quarter of 1977, M-1 had grown 7.4 per cent, compared with 5.6 per cent in 1976 and 4.4 per cent in 1975.<sup>1/</sup>

Growth in M-2 picked up in January to an annual rate of about 8-1/4 per cent--from 5-3/4 per cent in December--reflecting some strengthening in inflows to banks of time and savings deposits other than negotiable CD's. From the fourth quarter of 1976 to the fourth quarter of 1977, M-2 had grown 9.6 per cent, compared with 10.9 per cent in 1976 and 8.3 per cent in 1975.

Deposit growth at nonbank thrift institutions continued to slow in January, and M-3 expanded at an annual rate of 8 per cent--about the same as in December. Over the four quarters of 1977, M-3 had grown 11.6 per cent.

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<sup>1/</sup> At the time of this meeting, revision of the measures of the monetary aggregates to reflect, among other things, new benchmark data for deposits at nonmember banks had nearly been completed. It was reported at the meeting that, according to tentative estimates, the benchmark adjustment would raise the 1977 growth rates of M-1 and M-2 by 0.4 and 0.2 of a percentage point, respectively.



At its January meeting the Committee had decided that operations in the period immediately ahead should be directed toward maintaining about the prevailing money market conditions, provided that the monetary aggregates appeared to be growing at approximately the rates then expected. Specifically, the Committee sought to maintain the weekly-average Federal funds rate at about 6-3/4 per cent, so long as M-1 and M-2 appeared to be growing over the January-February period at annual rates within ranges of 2-1/2 to 7-1/2 per cent and 5 to 9 per cent, respectively. The members also agreed that if growth in the aggregates appeared to be approaching or moving beyond the limits of their specified ranges, the operational objective for the weekly-average Federal funds rate should be varied in an orderly fashion within a range of 6-1/2 to 7 per cent. It was understood that very strong evidence of weakness in the monetary aggregates would be required before operations were directed toward reducing the Federal funds rate below the 6-3/4 per cent level.

Data that became available during the inter-meeting period suggested that growth in the monetary aggregates over

the January-February period would be well within the specified ranges. The Manager of the System Open Market Account, therefore, continued to aim for a Federal funds rate of around 6-3/4 per cent. Over the 6-week inter-meeting period, the funds rate averaged 6.76 per cent, and weekly averages showed only minor deviations from that level.

Other short-term interest rates also changed little on balance over the inter-meeting period, even though short-term credit demands remained relatively strong. Longer-term interest rates showed mixed changes for the period. Yields on State and local government bonds declined somewhat further, whereas those on Treasury, Federal agency, and corporate securities edged higher.

Interest rates on mortgages rose during January, and some tightening of nonrate terms was reported as well. In order to cover mortgage take-downs in the face of weakening deposit flows, savings and loan associations increased their reliance on advances from the Federal home loan banks and other nondeposit sources of funds. This contrasted with the typical pattern in January of reductions in borrowings.

In the Committee's discussion of the economic situation and prospects, the members agreed that the expansion in activity was likely to continue throughout 1978. Most members thought that the staff's GNP projection was reasonable, but two or three members believed that growth in real GNP would fall somewhat short of the projected rate. Several members emphasized that the degree of uncertainty with regard to economic prospects and projections had been increasing.

It was observed that at the current stage of this business expansion some deceleration in growth toward a rate that could be sustained for the longer term would be a desirable development. The comment was also made that some deceleration would be acceptable in light of the inflationary pressures in the economy and of recent developments in the foreign exchange markets.

Considerable concern was expressed that the rate of inflation might accelerate significantly as the year progressed. The comment was made that prospects for inflation had been inhibiting business decisions to invest in fixed capital, and

it was suggested that an acceleration would adversely affect confidence and would dampen expansion in spending of other kinds. Such price behavior, it was noted, would pose difficult questions concerning the appropriate role of monetary policy.

Two members expressed the view that over the year the rate of unemployment was unlikely to decline very much. Another member believed that a realistic objective for the unemployment rate now was considerably higher than it used to be, perhaps as high as 5-1/2 to 6 per cent.

One of the members who thought that the staff's projection for real GNP represented the most likely outcome nevertheless cited certain elements in the situation that could cause growth in output to fall short of the rates projected. He suggested, first, that the sizable decline in stock prices over the 6 weeks since the January meeting of the Committee indicated a continuing lack of confidence in prospects for business activity and profits, which could undermine the progress of the expansion. Like others, he agreed with the staff expectation that the economy would rebound from the

effects of the severe weather and the coal strike. Nevertheless, he was concerned about the possibility that the loss of income because of those developments, even though temporary, could have enduring effects on consumer demands and on the general course of the economy. With respect to the U.S. foreign trade position, he did not see clear signs of the sort of expansion in activity abroad that would significantly reduce the trade deficit. Another member expressed agreement with this view of prospects for the trade deficit, while a third was somewhat more optimistic.

One of the members who believed that growth in real GNP would fall somewhat short of the rate projected by the staff also believed that the shortfall would be concentrated in the second half of the year. In his view, growth in output would be buoyed until midyear by a rebuilding of inventories as well as by the recovery from the effects of adverse weather and of the coal strike. However, he thought that problems would develop later in the year in residential construction and in some other sectors of the economy. Another member expressed the view that the staff expectations for housing starts, even though scaled down since the January meeting, were still too high.

Several members commented that they agreed with the scaled-down projections for both housing starts and auto sales, and some noted that for several months they had viewed the staff projections for those sectors as too high. It was observed that the outlook for those sectors was still relatively strong and that demands were likely to be supported by adequate supplies of credit and a willingness of consumers to assume debt. With respect to housing, the tendency of consumers to perceive home-ownership as a good form of investment in a period of inflation also was mentioned as a factor likely to support demand.

It was observed in the discussion that the current business expansion--now about 3 years old--had developed some serious imbalances. U.S. merchandise imports were much too high relative to the behavior of the world economy. Business fixed investment was low in relation to growth in over-all production, and a few members expressed doubts of significant improvement during 1978. State and local governments were running a sizable surplus in their accounts, thereby draining purchasing power from the private sector. Outstanding consumer credit was high in relation to personal income. Wage increases

were high in relation both to improvements in productivity and to the level of unemployment. Corporate profits were low in relation to personal income and to costs of production. Prices of common stock were low relative to corporate profits. And the state of general confidence appeared to be unduly low in relation to the actual performance of the economy.

One member expressed the view that confidence was being adversely affected by the large deficit in the Federal budget. He added that the budget estimates were based on the assumption of continued moderate growth in economic activity, and that if a recession should develop the deficit could swell to such a size that it might take many years to return to financial stability. Another member noted that under present fiscal policies the Federal deficit apparently would remain substantial even if a state of high employment were reached.

At this meeting the Committee reviewed its 12-month ranges for growth in the monetary aggregates. At its meeting in October 1977, the Committee had specified the following ranges for growth over the period from the third quarter of 1977 to the third quarter of 1978: M-1, 4 to 6-1/2 per cent;

M-2, 6-1/2 to 9 per cent; and M-3, 8 to 10-1/2 per cent. The associated range for growth in commercial bank credit was 7 to 10 per cent. The ranges being considered at this meeting were for the period from the fourth quarter of 1977 to the fourth quarter of 1978.

In the Committee's discussion of the 12-month ranges, all but one member expressed a preference for retaining the existing range for M-1. This member suggested that the upper limit for M-1 be reduced by 1/2 of a percentage point and the lower limit be raised by a corresponding amount, yielding a range of 4-1/2 to 6 per cent. In the case of the broader aggregates, most members favored no change in the existing range for M-2 and a reduction of 1/2 of a percentage point in the range for M-3. Two members, however, preferred a reduction of 1/2 point in the range for M-2. One of them also suggested a reduction of 1 point, while the other advocated a reduction of either 1 or 1-1/2 points, in the M-3 range.

The nearly unanimous preference of members for retaining the range of 4 to 6-1/2 per cent for M-1 reflected several considerations. First, it was observed that any increase in the



6-1/2 per cent upper limit of the range could strengthen inflationary expectations, which already appeared to be intensifying, and could accentuate the current weakness of the dollar in foreign exchange markets. Second, because the rate of growth of M-1 in 1977--about 7-1/2 per cent--had significantly exceeded the upper limit of the Committee's earlier ranges, it was suggested that a decision now to reduce the range might lack credibility. Third, it was noted that if the actual rate of growth in M-1 during 1978 were to fall within a 4 to 6-1/2 per cent range, that would represent a significant slowing from the 1977 rate. Indeed, one Committee member observed that if--as seemed likely--some slackening were under way in the processes of financial innovation that recently had been facilitating economies in transactions balances, an unchanged rate of growth in M-1 could be interpreted as involving an increase in monetary restraint. Finally, it was suggested that current uncertainties regarding the economic outlook militated against an adjustment in the M-1 range. While Committee members found these considerations persuasive, it was observed in the discussion that further gradual reductions

in monetary growth ranges would be needed over time if growth rates consistent with general price stability were to be achieved.

Several Committee members noted that if during the coming year M-1 growth were to be constrained within a 4 to 6-1/2 per cent range and nominal GNP were to expand as fast as economic forecasters were generally projecting, an appreciable increase in the velocity of M-1 would be required. While they believed that such an increase in velocity might develop, they indicated that they would be prepared to accept M-1 growth rates that were relatively high with respect to the range if the increase in velocity fell short of the required amount. Other members stressed the importance of constraining growth in M-1 within the range specified.

The member who preferred the growth range of 4-1/2 to 6 per cent for M-1 based his recommendation on two considerations. First, by lowering the upper limit of the range, the Committee would be providing a further indication of its resolve to resist inflationary pressures and in the process perhaps help to provide some near-term support for the dollar. Second, by raising the

lower limit of the range, the Committee might offer some reassurance to those who had expressed concern that the Federal Reserve might not be sufficiently alert to the possibility of a softening in the economy later this year. Other members of the Committee took exception to this proposal. In addition to the arguments offered against a reduction in the upper limit of the M-1 range already noted, it was suggested that a narrowing of the range would imply much greater certainty than in fact existed regarding the precise rate of monetary growth appropriate under present circumstances.

In considering the longer-run growth ranges for M-2 and M-3, members took note of the sharp reduction in flows of savings to depository institutions that had occurred during recent months. It was suggested that part of the cutback in such inflows might reflect temporary factors, and that over coming months growth in large-denomination time deposits not subject to interest rate ceilings could well expand further, providing some offset to the continued slow growth expected in other deposits. It was noted that in the past the large-denomination deposit instruments of the types included in M-2 and M-3 had been issued primarily by

banks, but it was suggested that in the present circumstances thrift institutions might begin to make greater use of such instruments as a source of funds.

In view of these considerations, most members of the Committee were inclined to retain the existing range for M-2 and to reduce the range for M-3 by only 1/2 of a percentage point. The members recognized that the attainment over the coming year of growth rates for M-2 and M-3 within such ranges might require an increase in the regulatory ceilings on deposit rates. The two members who suggested some reduction in the M-2 growth range and a reduction of more than 1/2 of a percentage point in the M-3 range believed that under present circumstances the ranges favored by the majority were higher than those appropriately associated with a 4 to 6-1/2 per cent range for M-1.

At the conclusion of its discussion the Committee decided to retain the existing ranges for M-1 and M-2 and to reduce both the upper and lower limits of the range for M-3 by 1/2 of a percentage point. Thus, the new ranges, which applied to the period from the fourth quarter of 1977 to the

-21-

fourth quarter of 1978, were 4 to 6-1/2 per cent for M-1, 6-1/2 to 9 per cent for M-2, and 7-1/2 to 10 per cent for M-3. The associated range for growth in commercial bank credit remained 7 to 10 per cent. It was agreed that the longer-run ranges, as well as the particular aggregates for which such ranges were specified, would be subject to review and modification at subsequent meetings. It was also understood that short-run factors might cause growth rates from month to month to fall outside the ranges contemplated for the year ahead.

The Committee adopted the following ranges for rates of growth in monetary aggregates for the period from the fourth quarter of 1977 to the fourth quarter of 1978: M-1, 4 to 6-1/2 per cent; M-2, 6-1/2 to 9 per cent; and M-3, 7-1/2 to 10 per cent.

Votes for this action: Messrs.  
Burns, Volcker, Coldwell, Guffey, Jackson,  
Mayo, Morris, Partee, Roos, and Wallich.  
Votes against this action: None. Absent  
and not voting: Mr. Gardner.

In the Committee's discussion of policy for the period immediately ahead, it was suggested that recent developments in the foreign exchange markets militated against any marked easing of money market conditions at this time, and that the uncertainties

in the economic situation militated against any marked firming. All of the members favored directing initial open market operations during the coming inter-meeting period toward the objective of maintaining the Federal funds rate at about the prevailing level of 6-3/4 per cent, and a majority preferred to continue giving greater weight than usual to money market conditions in the conduct of operations until the next meeting. With respect to the range in which the funds rate might be varied if the February-March growth rates in the monetary aggregates appeared to be deviating markedly from expectations, most members advocated retention of the 6-1/2 to 7 per cent range agreed upon at the January meeting. However, two members suggested narrowing the range to 6-3/4 to 7 per cent, and one proposed widening it to 6-1/2 to 7-1/4 per cent.

The members did not differ greatly in their preferences for growth in the monetary aggregates for the February-March period; most favored ranges of 1 to 6 per cent for M-1 and 4-1/2 to 8-1/2 per cent for M-2. However, a few members were inclined to set the lower limit of the 2-month range for M-1 at zero, on the grounds that the acceptance of temporary weakness in the

monetary aggregates that might develop from time to time would improve the chances of holding average growth over the coming year within the longer-run range agreed upon earlier in this meeting. One of these members also suggested that, given the relative volatility of M-1 and M-2, a range for M-2 that was 4 percentage points wide might best be associated with an M-1 range 6 points in width; accordingly, he favored a 2-month range of 0 to 6 per cent for M-1. Another member suggested that the ranges for both M-1 and M-2 be narrowed to 3 percentage points, in order to achieve prompter adjustment of the funds rate to growth rates in the aggregates that were unduly rapid or slow.

At the conclusion of the discussion the Committee decided that operations in the period immediately ahead should continue to be directed toward maintaining prevailing money market conditions, as represented by the current 6-3/4 per cent level of the Federal funds rate. However, the members agreed that if growth in the aggregates should appear to approach or move beyond the limits of their specified ranges, the operational objective for the weekly-average Federal funds rate should be

varied in an orderly fashion within a range of 6-1/2 to 7 per cent. For the annual rates of growth in M-1 and M-2 over the February-March period, the Committee specified ranges of 1 to 6 per cent and 4-1/2 to 8-1/2 per cent, respectively. It was understood that in assessing the behavior of the aggregates, the Manager should give approximately equal weight to the behavior of M-1 and M-2. The members also agreed that in the conduct of day-to-day operations, account should be taken of emerging financial market conditions, including the conditions in foreign exchange markets.

As customary, it was understood that the Chairman might call upon the Committee to consider the need for supplementary instructions before the next scheduled meeting if significant inconsistencies appeared to be developing among the Committee's various objectives.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

The information reviewed at this meeting suggests that retail sales, industrial production, and housing starts were adversely affected in January by unusually severe weather. It appears, however, that there has been little change in the underlying economic situation. Employment increased



further in January and the unemployment rate edged down from 6.4 to 6.3 per cent. Both the consumer price index and the wholesale price index rose substantially. The index of average hourly earnings advanced sharply, as higher minimum wages became effective at the beginning of the year.

After a period of calm, the dollar came under renewed downward pressure around mid-February, and its trade-weighted value against major foreign currencies has declined about 1-1/2 per cent. The Swiss franc and the German mark have registered the most pronounced appreciations against the dollar.

M-1 expanded appreciably in January but declined somewhat in early February. Growth in M-2 picked up in January, reflecting some strengthening in inflows to banks of time and savings deposits other than negotiable CD's. Inflows to nonbank thrift institutions continued to slow. Market interest rates have changed little in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster bank reserve and other financial conditions that will encourage continued economic expansion and help resist inflationary pressures, while contributing to a sustainable pattern of international transactions.

Growth of M-1, M-2, and M-3 within ranges of 4 to 6-1/2 per cent, 6-1/2 to 9 per cent, and 7-1/2 to 10 per cent, respectively, from the fourth quarter of 1977 to the fourth quarter of 1978 appears

to be consistent with these objectives. These ranges are subject to reconsideration at any time as conditions warrant.

At this time, the Committee seeks to maintain about the prevailing money market conditions during the period immediately ahead, provided that monetary aggregates appear to be growing at approximately the rates currently expected, which are believed to be on a path reasonably consistent with the longer-run ranges for monetary aggregates cited in the preceding paragraph. Specifically, the Committee seeks to maintain the weekly-average Federal funds rate at about the current level, so long as M-1 and M-2 appear to be growing over the February-March period at annual rates within ranges of 1 to 6 per cent and 4-1/2 to 8-1/2 per cent, respectively. If, giving approximately equal weight to M-1 and M-2, it appears that growth rates over the 2-month period are approaching or moving beyond the limits of the indicated ranges, the operational objective for the weekly-average Federal funds rate shall be modified in an orderly fashion within a range of 6-1/2 to 7 per cent. In the conduct of day-to-day operations, account shall be taken of emerging financial market conditions, including the conditions in foreign exchange markets.

If it appears during the period before the next meeting that the operating constraints specified above are proving to be significantly inconsistent, the Manager is promptly to notify the Chairman who will then decide whether the situation calls for supplementary instructions from the Committee.

Votes for this action: Messrs.  
Burns, Volcker, Coldwell, Guffey, Jackson,  
Mayo, Morris, Partee, Roos, and Wallich.  
Votes against this action: None. Absent  
and not voting: Mr. Gardner.

Subsequent to the meeting, on March 10, nearly final estimates indicated that in February M-1 had declined and M-2 had increased relatively little. For the February-March period staff projections suggested that the annual rate of growth in M-1 would be below the lower limit of the 1 to 6 per cent range specified by the Committee in the next-to-last paragraph of the domestic policy directive issued at the February meeting. Growth in M-2 for the 2-month period was projected to be close to the lower limit of the Committee's range of 4-1/2 to 8-1/2 per cent for that aggregate. It appeared, however, that the weakness in the aggregates might reflect the prolongation of the coal strike and the severe winter weather and, therefore, might prove to be temporary.

During recent weeks the Federal funds rate had averaged about 6-3/4 per cent. In light of the behavior of the aggregates, the Manager would, under normal circumstances, have sought to reduce the funds rate within its specified range of 6-1/2 to 7 per cent.

Against that background, and in view of recent developments in foreign exchange markets, Chairman Miller recommended at a telephone conference meeting on March 10 that the Manager be instructed to continue aiming at a Federal funds rate of 6-3/4 per cent for the time being.

On March 10, 1978, the Committee modified the domestic policy directive adopted at its meeting of February 28, 1978, to call for open market operations directed at maintaining the Federal funds rate at about the prevailing level of 6-3/4 per cent for the time being.

Votes for this action: Messrs. Miller, Volcker, Burns, Coldwell, Eastburn, Jackson, Wallich, Willes, Winn, and Kimbrel. Votes against this action: None. Absent and not voting: Messrs. Baughman, Gardner, and Partee. (Mr. Kimbrel voted as alternate for Mr. Baughman.)

## 2. Authorization for foreign currency operations

Paragraph 1D of the Committee's authorization for foreign currency operations authorizes the Federal Reserve Bank of New York for the System Open Market Account to maintain an over-all open position in all foreign currencies not exceeding \$1.0 billion, unless a larger position is expressly authorized by the Committee. On January 17, 1978, the Committee had authorized an open position of \$1.75 billion.

At the meeting on February 28 the Committee authorized an open position of \$2.0 billion. This action was taken in view of the scale of recent and potential Federal Reserve operations in the foreign exchange markets undertaken pursuant to the Committee's foreign currency directive.

Votes for this action: Messrs. Burns, Volcker, Coldwell, Guffey, Jackson, Mayo, Morris, Partee, Roos, and Wallich.  
Votes against this action: None. Absent and not voting: Mr. Gardner.

On March 10, following the telephone conference held on that day, Committee members voted to approve a delegation of authority to Chairman Miller to negotiate an increase in the System's swap arrangement with the German Federal Bank of an amount up to \$2 billion if he determined that the detailed arrangements were satisfactory. The Committee also voted to approve a concurrent amendment to paragraph 2 of the authorization for foreign currency operations to raise correspondingly the amount specified there for the swap arrangement with the German Federal Bank. The Chairman approved an increase of \$2 billion on March 11. Accordingly, paragraph 2 of the authorization was amended, effective on that date, to read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

<u>Foreign bank</u>	<u>Amount of arrangement (Millions of dollars equivalent)</u>
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	4,000
Bank of Italy	3,000
Bank of Japan	2,000
Bank of Mexico	360
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	1,400
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Votes for this action: Messrs. Miller, Volcker, Burns, Coldwell, Eastburn, Jackson, Partee, Wallich, Willes, Winn, and Kimbrel. Votes against this action: None. Absent and not voting: Messrs. Baughman and Gardner. (Mr. Kimbrel voted as alternate for Mr. Baughman.)

This action, which enlarged the System's swap network with 14 central banks and the Bank for International Settlements to \$22.16 billion, was taken as part of the cooperative effort announced on March 13 by U.S. Secretary of the Treasury Blumenthal and Minister Matthoefer of the Federal Republic of Germany.





## APPENDIX III

BRIEFING MEMORANDUM PREPARED BY THE STAFF  
OF THE COMMITTEE ON BANKING, FINANCE AND  
URBAN AFFAIRS

HENRY S. REUSS, WIS., CHAIRMAN  
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 WILLIAM S. MOORHEAD, PA.  
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 JIM MATTOX, TEX.  
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 ROBERT GARCIA, N.Y.

U.S. HOUSE OF REPRESENTATIVES  
 COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

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 WASHINGTON, D.C. 20515

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 BRUCE F. CAPUTO, N.Y.  
 HAROLD C. HOLLENBECK, N.J.  
 S. WILLIAM GREEN, N.Y.  
 225-4247

## BRIEFING MEMORANDUM

Quarterly Hearings on The  
 CONDUCT OF MONETARY POLICY

March 7, 9 and April 10, 1978

Prepared by

The Staff of the  
 Committee on Banking, Finance  
 and Urban Affairs

Pursuant to the Federal Reserve Reform Act of 1977

P.L. 95-188

On March 7, 1978, the following witnesses appeared at 10:00 a.m.:

Professor Lawrence R. Klein  
Department of Economics  
University of Pennsylvania

Mr. Jerry Jordan  
Senior Vice President and Chief Economist  
Pittsburgh National Bank

Professor Rudiger Dornbusch  
Department of Economics  
Massachusetts Institute of Technology

On March 9, 1978, the following witness appeared at 10:00 a.m.  
and will appear again at 10:00 a.m. on April 10, 1978:

Mr. G. William Miller  
Chairman  
Board of Governors  
Federal Reserve System

REPORTING REQUIREMENTS UNDER THE  
FEDERAL RESERVE REFORM ACT OF 1977  
P.L. 95-188

The Federal Reserve Reform Act requires that the Board of Governors of the Federal Reserve System shall consult with Congress at quarterly hearings rotating between the House Banking Committee and the Senate Banking Committee. At the hearings the Federal Reserve is required to

- 1) provide their objectives and plans for ranges of growth of monetary and credit aggregates for the coming twelve months (In the hearing today, the twelve month period ends with the fourth quarter of 1978);
- 2) take "account of past and prospective developments in production, employment, and prices"; and
- 3) discuss past and prospective developments for long-term interest rates -- a requirement which, as the Committee Report notes, follows directly from the provision of the Act that establishes "moderate long-term interest rates as one of the objectives of monetary policy".

These reporting requirements will reveal a more complete picture of the Federal Reserve's monetary policy than would be provided by merely stating its monetary target ranges. Presumably, the Fed's projections will take into account the effect of its monetary policy on these important aspects of our economy -- production, employment, prices and interest rates.

#### MONETARY POLICY AND THE ECONOMY

The rate of growth of real Gross National Product (GNP) slowed progressively through 1977 as the recovery matured. The annual rate of growth from the previous quarter fell from 7.5 percent in the first quarter, to 6.2 percent in the second, to 5.1 percent in the third, to 4.2 percent in the fourth. Average GNP growth year-over-year came to 4.9 percent, down from 6.0 percent in 1976, but still about 2.5 percent higher than the average rate of growth in the European Economic Community.

### Money

A significant development in reported monetary statistics has occurred since the beginning of these hearings on the Conduct of Monetary Policy. On March 23 the Federal Reserve revised their money stock data for the 1975-77 period. Part of the revision was due to incorrect estimates of nonmember bank deposits amounting to a \$1.6 billion mistake in under-estimating those deposits at the end of 1977.

The new monetary estimates for 1977 show that the basic money stock, M-1, grew by 7.8 percent, not 7.4 percent as previously stated.

There have been two previous periods since World War II in which monetary growth grew at rates around 8 percent. Therefore, 1977 is one of the three periods of fastest monetary growth since World War II.

The two other periods of fast monetary growth were in 1969, when the annual rate of growth from the first quarter of 1968 to the first quarter of 1969 was 8 percent, and the period from the fourth quarter of 1971 to the second quarter of 1973, when the annual rates of growth rose as high as 8.5 percent.

### Velocity

The income velocity of money -- GNP divided by the money stock -- returned to near its long-term trend rate of growth of between 3 and 4 percent per annum in 1977. Chart 3 depicts this development.

### Interest rates

Short-term interest rates rose steadily over 1977. The Federal funds rate, tracked by the interest rate on three-month Treasury bills, jumped sharply in the fourth quarter -- from 5.9 percent in August to 6.56 percent in December. Since then it has continued to edge upward, to 6.78 percent last week, a rise of 217 basis points in thirteen months. Chart 4 traces the recent history of short-term interest rates, as well as the essentially stable level of the effective yield on new home mortgages.

Chart 5 shows the relationship of short-term interest rates -- the Federal funds rate, in this case -- to stock prices, measured by the New York Stock Exchange Composite Price Index. The relationship is highly inverse: falling interest rates mean rising stock prices, and vice versa. The reason is simple: short-term government securities are a liquid substitute for common stocks. When the Federal funds rate, the 3-month Treasury bill rate and other short-term interest rates rise, investors shift from stocks to higher-yielding government bills, causing stock prices to fall.

Charts 6 through 12 are designed to convey a quick overview of the state of the economy at the present phase of the business cycle.

#### Inflation

Chart 6 shows that inflation as measured by the Consumer Price Index stabilized in mid-1977, having risen sharply in late 1976 and early 1977. Currently the rate of inflation continues to hover between 6 and 7 percent per year.

#### Unemployment

Chart 7 shows that while average unemployment has declined by nearly a third from peak levels near 9 percent in 1975, with teenagers making strong gains in the second half of 1977, unemployment among blacks has not declined since the trough of the recession.

Chart 8 shows the continued steady rise of total employment.

#### GNP and Investment

Charts 9 and 10 show that while real GNP has been recovering uninterruptedly since early 1975, real Private Non-residential Fixed Investment has not yet surpassed its pre-recession high.

#### Capacity Utilization

Charts 11 and 12 show that, by the index prepared by the Wharton School of Finance, capacity utilization remains well below the inflationary levels attained in 1974, both overall and in the bottleneck-prone manufacturing, mining, and utilities sectors.

#### Outlook and Objectives

Due to the significant revision in monetary data estimates for 1977, one of the primary questions for monetary policy is, "How can we improve our monetary data?" Such improvements appear essential if the Federal Reserve is to conduct an appropriate monetary policy, and the Congress is to carry out its oversight responsibilities in judging that monetary policy.

A second question concerns the future path of monetary policy from the 7.8 percent level of 1977. Any attempt to pull monetary policy down too rapidly will induce a recession in the same manner as such a breaking of monetary policy following the period of monetary growth in 1968. The last half of 1969, monetary policy was very slow, and a recession followed in 1970. A similar breaking of monetary policy preceded the recession of 1974-1975.

A third question is "How serious is the Federal Reserve about achieving its targets?" The Fed was following a long range target path in 1977 with an announced upper limit of 6.5 percent. It missed by a wide margin, if we are to believe the latest estimate of 7.8 percent as the final revision. If the public, especially a participant in the financial market, is to believe that the Fed has control of the money supply, we must have improved performance from the Fed. Such an improvement must first begin with better statistics on monetary growth.

#### International Considerations

The cause of our currency decline remains, undoubtedly, our high deficit in the balance of payments (current account), which is itself due to high imports of oil and sluggish world demand for U.S. exports. Chart 13 shows the dramatic recent deterioration of the current account balance and of the balance of trade.

Conventional means of intervention -- swap agreements under which the U.S. borrows foreign currencies from other governments and uses them to buy dollars -- can alter the time path of exchange rate movements, but they cannot reverse the trend. At present, the Federal Reserve has \$20 billion in "lines" to foreign central banks that may be drawn upon for this purpose. In a market awash with over \$500 billion in footloose funds, \$20 billion does not make a very big dent. If, by Federal Reserve intervention, the dollar is boosted a little on one day, the effect is chiefly to give it further room to fall on the next. Since the borrowed currencies must then be repaid, the swap having failed, in depreciated dollars, the policy also loses money. Speaking to the National Press Club on March 2, President Carter recognized the essential futility of this approach, and declared his intention not to extend its use beyond the function it traditionally serves: to help re-establish order in disorderly markets. It would be interesting to hear Chairman Miller's opinion and intentions on this question.

(According to a 1975 joint report of the Subcommittee on International Economics of the J.E.C. and the Subcommittee on International Trade, Investment and Monetary Policy of the House Banking Committee:

Disorder emerges in exchange markets when for any reason dealers are unable to form reasonably firm expectations about direction or extent of exchange rate movements in the immediate future. In effect, fear overwhelms normal expectations upon which the ability to do business is based. Disorder is manifested by unusually wide spreads between bid and asked prices and by a severe drop in the volume of transactions from normal levels.

In practice, it is not likely that the Federal Reserve and Treasury adhere closely to this technical definition in deciding when to intervene. Most observers believe that the Fed bases its decision purely on judgment.)

Higher interest rates, by contrast, do act to improve our exchange rate -- but in a way few will find attractive. They attract foreign capital to our shores, increasing the demand for our currency and hence its price. But the effect is slower real GNP growth at home, as domestic borrowers feel the pinch of higher interest rates. Slower economic growth means fewer imports. Naturally, this means a lower current account deficit: hence a "healthier" dollar.

It is perhaps pertinent to point out that to use monetary policy in this fashion, under present circumstances, is in contradiction with the mandate of the Federal Reserve Reform Act of 1977, which directs the Federal Reserve to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production". Other things equal, higher interest rates for foreign exchange purposes imply a departure from this standard. As Chairman Reuss noted on the floor of the House:

Such moves merely transfer disorder from the foreign exchange markets to the domestic credit markets. While the short-term impact on the dollar may be dramatic, it soon may be offset by corresponding rises in interest rates in foreign credit markets, rather than yielding a permanent exchange rate adjustment. And the domestic impact of higher interest rates may be devastating: on the stock market, already slumping - partly in response to tightened monetary conditions - on business and investor confidence, on the level of investment and even on the health of the economy itself.

It would seem relevant to determine to what extent the Federal Reserve is now pursuing a policy of higher interest rates for exchange rate purposes, and to what extent it plans to continue to do so in the future.

Prepared by Banking Committee  
Staff

Robert Auerbach  
James Galbraith

In answer to Chairman Reuss' questions raised at the February 9th hearing, Chairman Miller submitted the following letter.

Attached

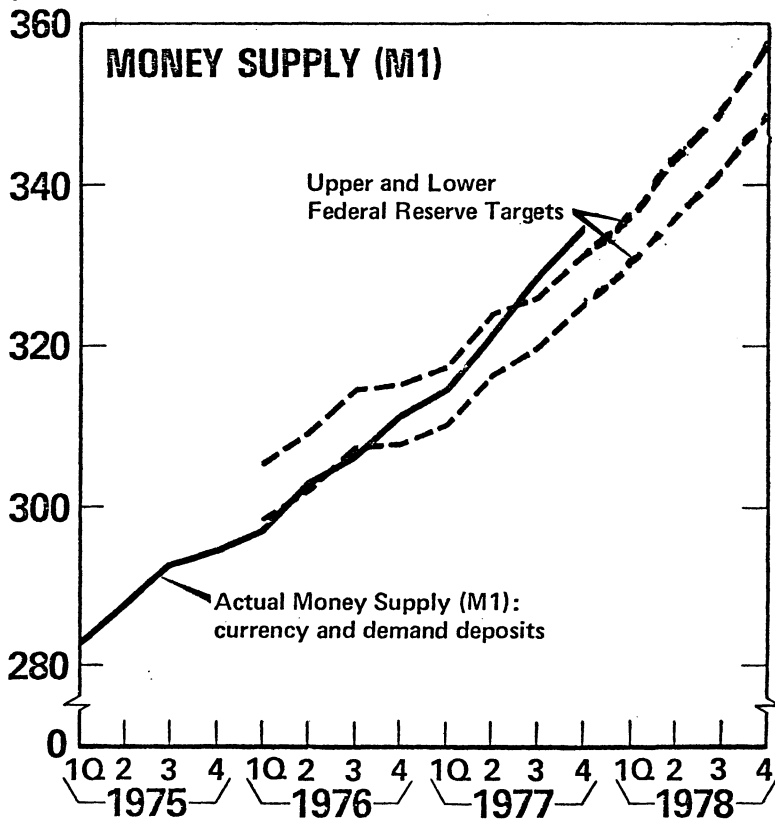
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CHART 1

# MONEY SUPPLY AND FEDERAL RESERVE TARGET RANGES (Quarterly Data)

\$ Billion



Note: The target range for 1st quarter 1976 was set for average M1 for March 1976.  
Actual M1 shown above is for the entire 1st quarter 1976 to provide consistency with other M1 observations.

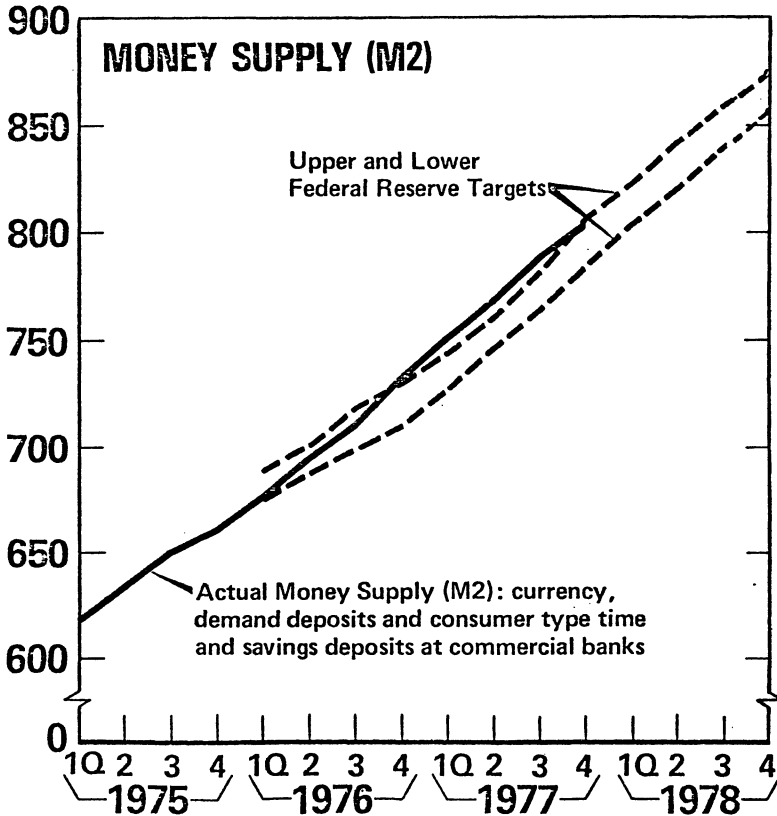
Data Source: Quarterly observations and target levels calculated from money supply series of the Board of Governors of the Federal Reserve System as revised in March 1978.

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CHART 2

# MONEY SUPPLY AND FEDERAL RESERVE TARGET RANGES (Quarterly Data)

\$ Billion



Note: The target range for 1st quarter 1976 was set for average M2 for March 1976. Actual M2 shown above is for the entire 1st quarter 1976 to provide consistency with other M2 observations.

Data Source: Quarterly observations and target levels calculated from money supply series of the Board of Governors of the Federal Reserve System as revised in March 1978.

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TABLE 1

FEDERAL RESERVE SYSTEM ONE YEAR TARGET RANGES AND ACTUAL  
GROWTH RATES FOR MONETARY AGGREGATES  
(Growth rates in percent)

Period covered	M1		M2		M3	
	Target	Actual	Target	Actual	Target	Actual
1. March 1975 to March 1976 . . . .	5.0 - 7.5	5.0	8.5 - 10.5	9.5	10.0 - 12.0	12.3
2. 1975:Q2 to 1976:Q2 . . . . .	5.0 - 7.5	5.2	8.5 - 10.5	9.5	10.0 - 12.0	12.0
3. 1975:Q3 to 1976:Q3 . . . . .	5.0 - 7.5	4.5	7.5 - 10.5	9.3	9.0 - 12.0	11.5
4. 1975:Q4 to 1976:Q4 . . . . .	4.5 - 7.5	5.7	7.5 - 10.5	10.9	9.0 - 12.0	12.8
5. 1976:Q1 to 1977:Q1 . . . . .	4.5 - 7.0	6.3	7.5 - 10.0	10.9	9.0 - 12.0	12.8
6. 1976:Q2 to 1977:Q2 . . . . .	4.5 - 7.0	6.6	7.5 - 9.5	10.7	9.0 - 11.0	12.4
7. 1976:Q3 to 1977:Q3 . . . . .	4.5 - 6.5	7.8	7.5 - 10.0	11.0	9.0 - 11.5	12.7
8. 1976:Q4 to 1977:Q4 . . . . .	4.5 - 6.5	7.8	7.0 - 10.0	9.8	8.5 - 11.5	11.7
9. 1977:Q1 to 1978:Q1 . . . . .	4.5 - 6.5	NA	7.0 - 9.5	NA	8.5 - 11.0	NA
10. 1977:Q2 to 1978:Q2 . . . . .	4.0 - 6.5	NA	7.0 - 9.5	NA	8.5 - 11.0	NA
11. 1977:Q3 to 1978:Q3 . . . . .	4.0 - 6.5	NA	6.5 - 9.0	NA	8.0 - 10.5	NA
12. 1977:Q4 to 1978:Q4 . . . . .	4.0 - 6.5	NA	6.5 - 9.0	NA	7.5 - 10.0	NA

M1 = private demand deposits plus currency.

M2 = M1 plus bank time and savings deposits other than large negotiable CD's

M3 = M2 plus deposits at mutual savings banks, savings and loan associations and credit unions

NA = not applicable.

NOTE: Actual growth rate data are based on money supply series of the Board of Governors of the Federal Reserve System as revised in March 1978.

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PERCENT

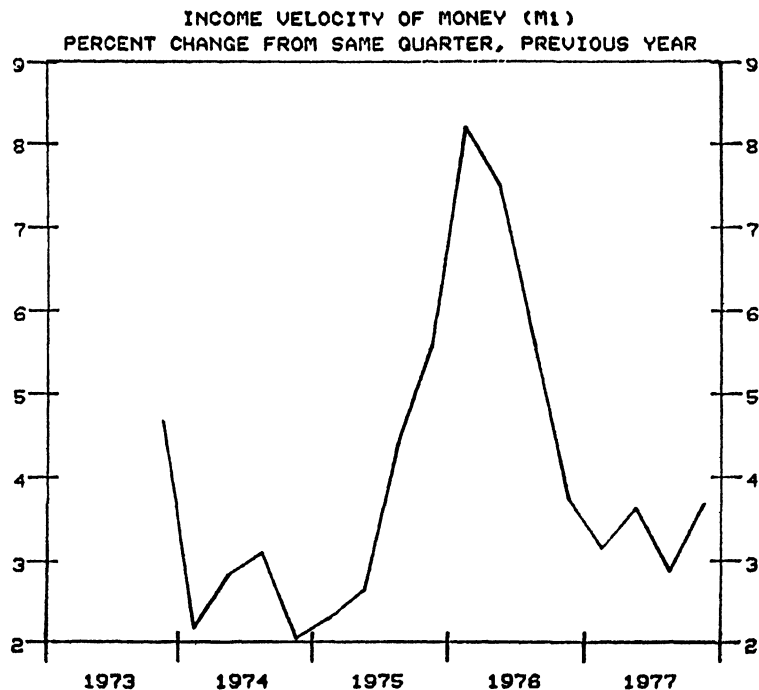


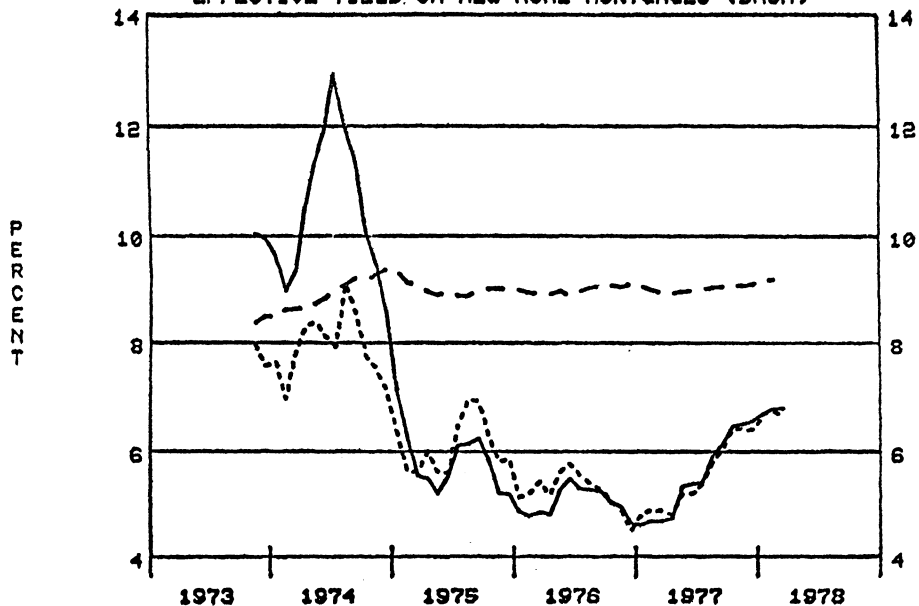
CHART 3

260

Data sources: Board of Governors of the Federal Reserve System and Department of Commerce, Bureau of Economic Analysis. 4/7/78

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**INTEREST RATES**  
**FEDERAL FUNDS RATE (LINE)**  
**AVERAGE YIELD ON 6 MONTH TREASURY BILLS (DOT)**  
**EFFECTIVE YIELD ON NEW HOME MORTGAGES (DASH)**

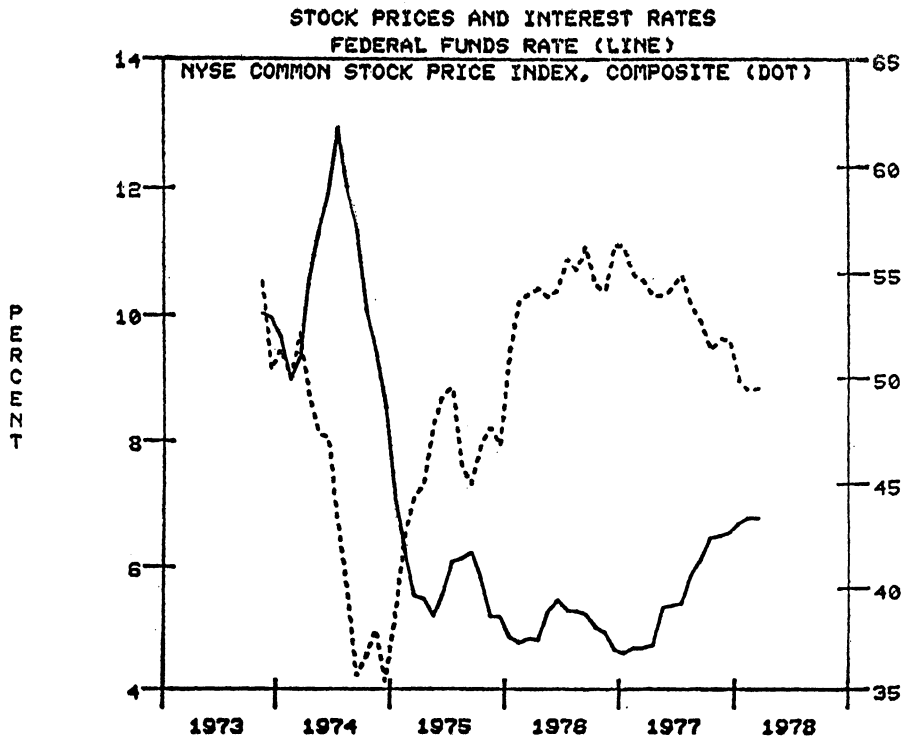


Data sources: Board of Governors of the Federal Reserve System, Department of the Treasury and Federal Home Loan Bank Board.

4/7/78

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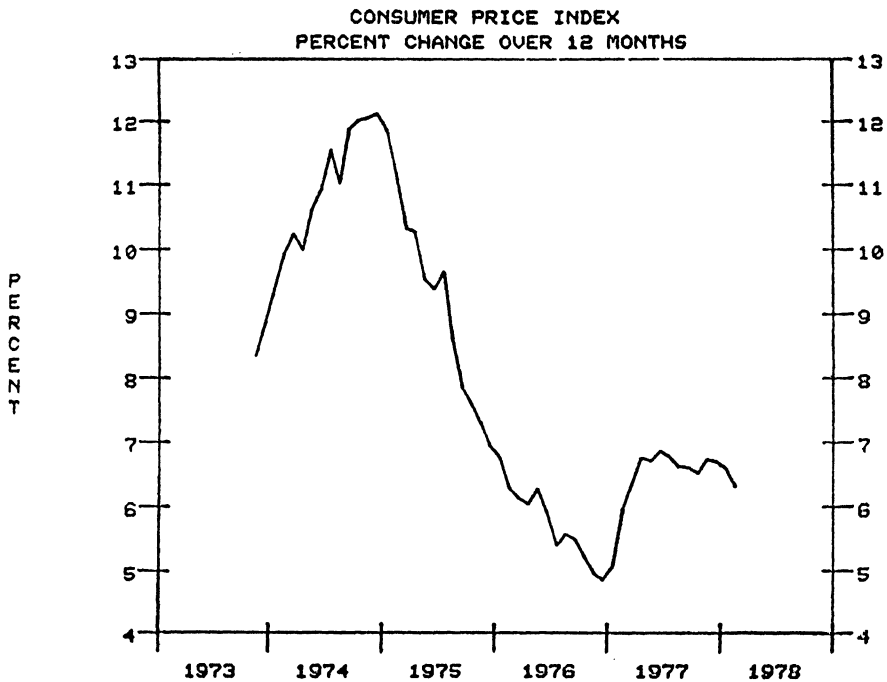
CHART 4



Data sources: Board of Governors of the Federal Reserve System and New York Stock Exchange. 4/7/78

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CHART 5

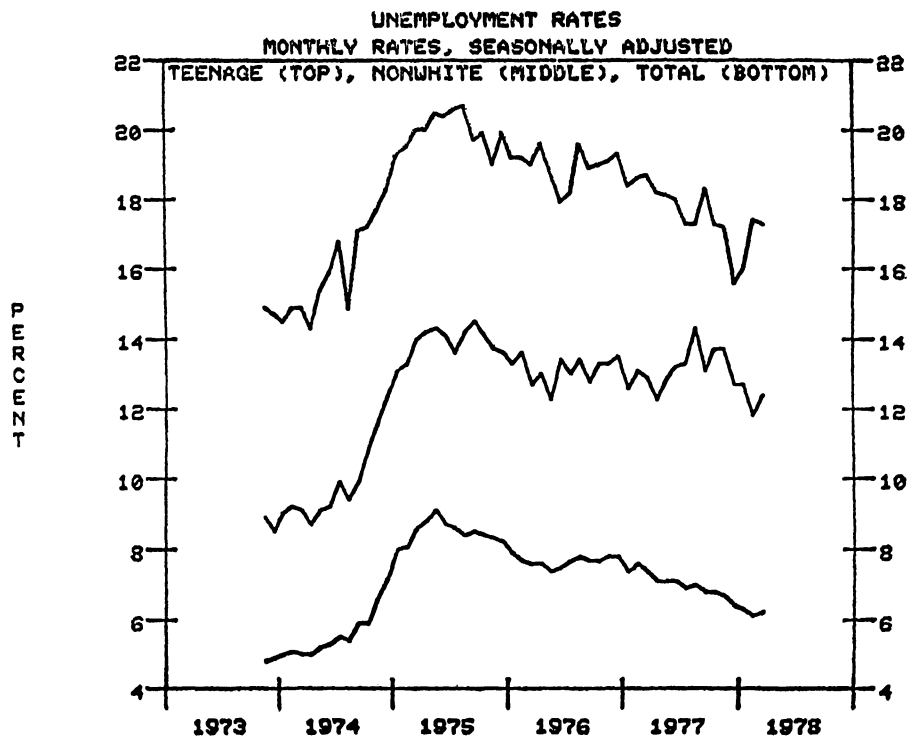


Data source: Department of Labor, Bureau of Labor Statistics.

4/7/78

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CHART 6



Data source: Department of Labor, Bureau of Labor Statistics.

4/7/78

CHART 7



TOTAL EMPLOYMENT, HOUSEHOLD SURVEY  
SEASONALLY ADJUSTED MONTHLY DATA

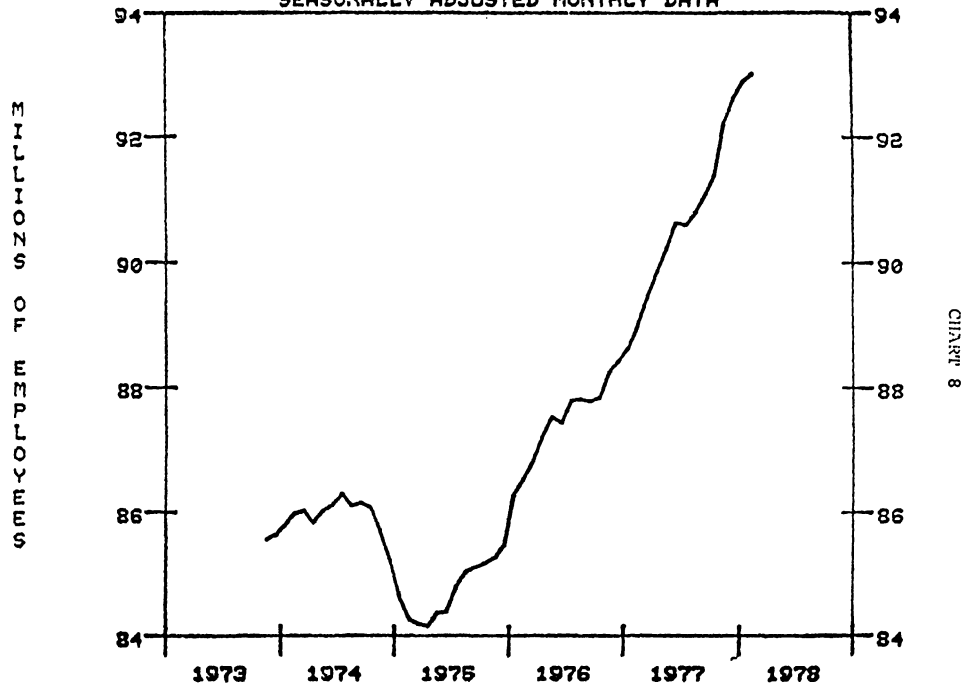
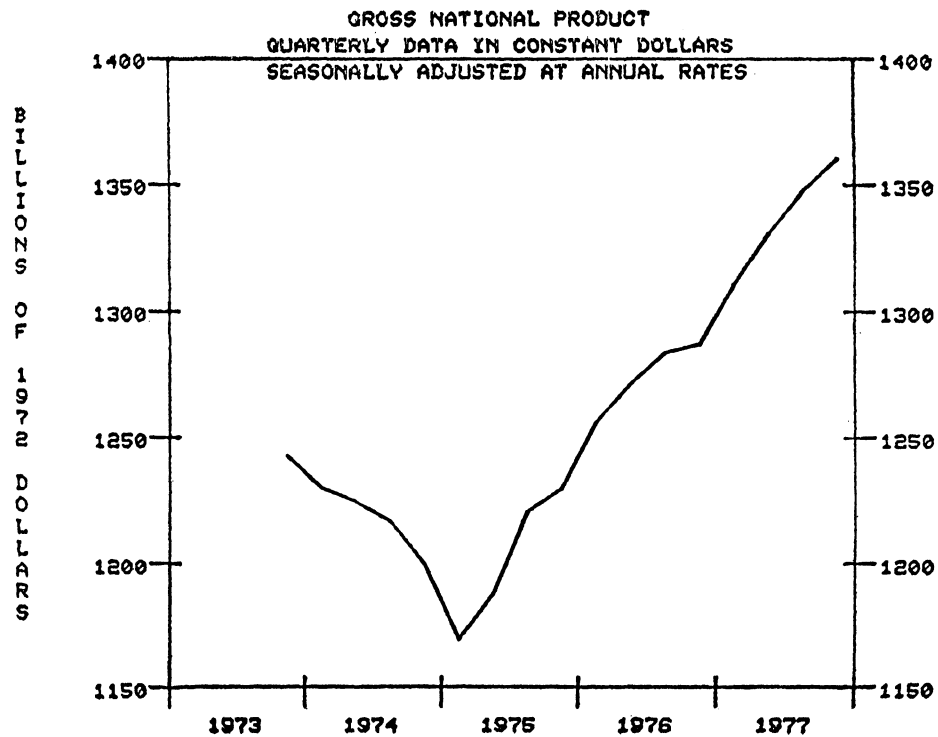


CHART 8

Data source: Department of Labor, Bureau of Labor Statistics.

4/7/78

Prepared by Congressional Research Service, Library of Congress.

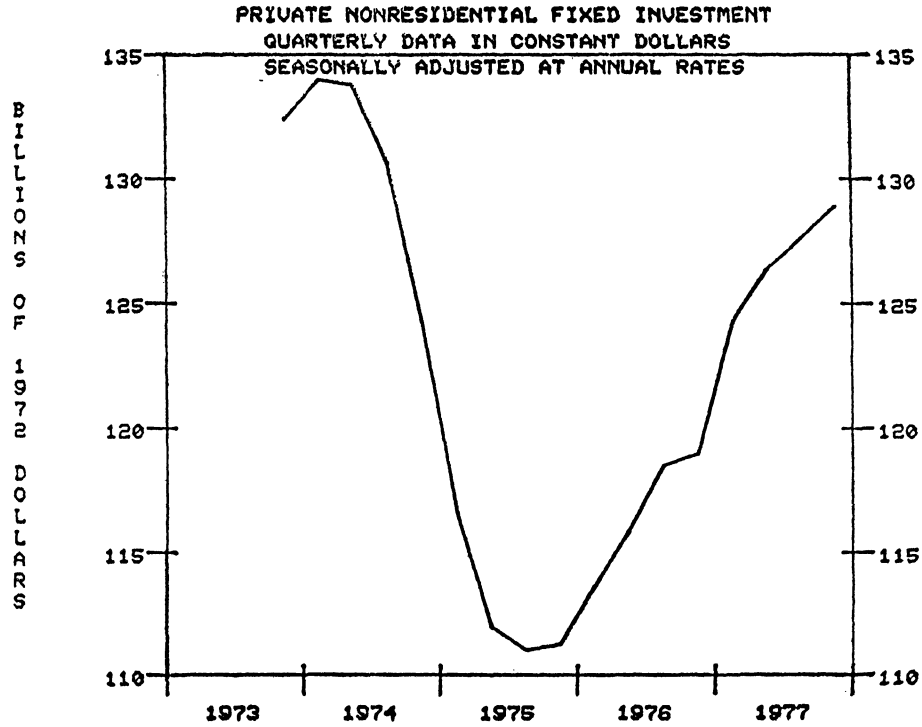


Data source: Department of Commerce, Bureau of Economic Analysis.

Prepared by Congressional Research Service, Library of Congress

4/7/78

CHART 9

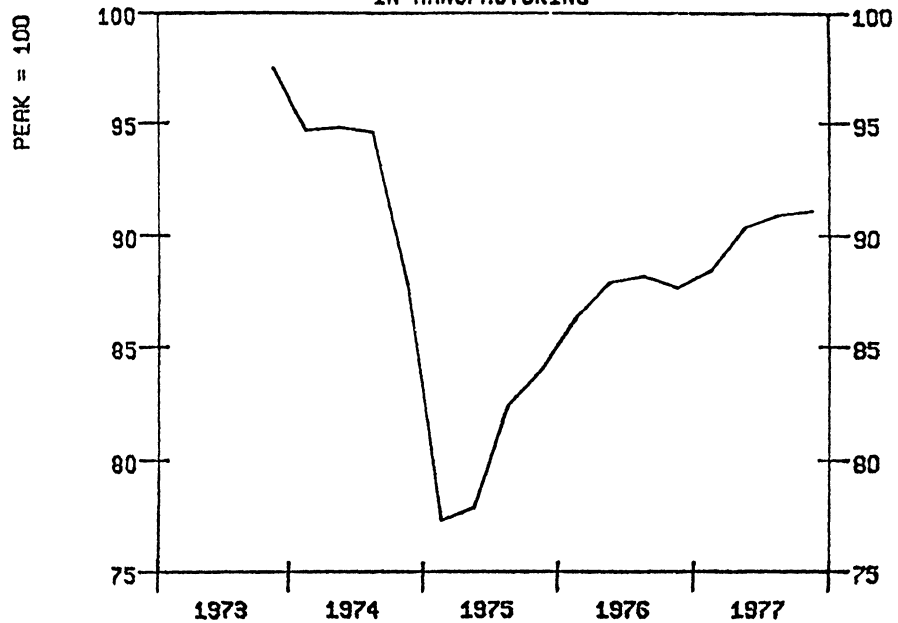


Data source: Department of Commerce: Bureau of **4/7/78**  
 Economic Analysis.

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CHART 10

WHARTON  
INDEX OF CAPACITY UTILIZATION  
IN MANUFACTURING

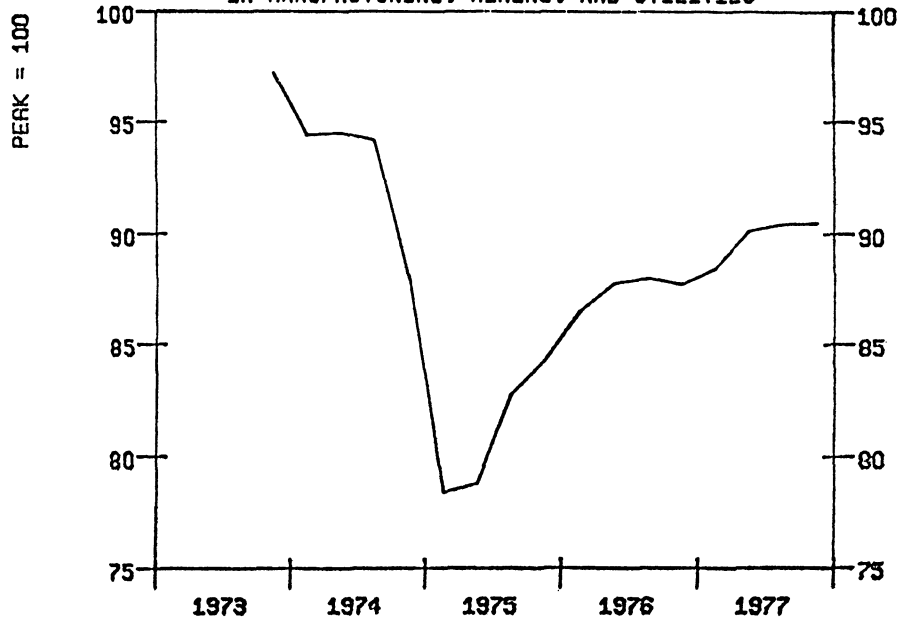


Data source: Wharton Econometric Forecasting Associates, Inc. 3/3/78

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CHART 11

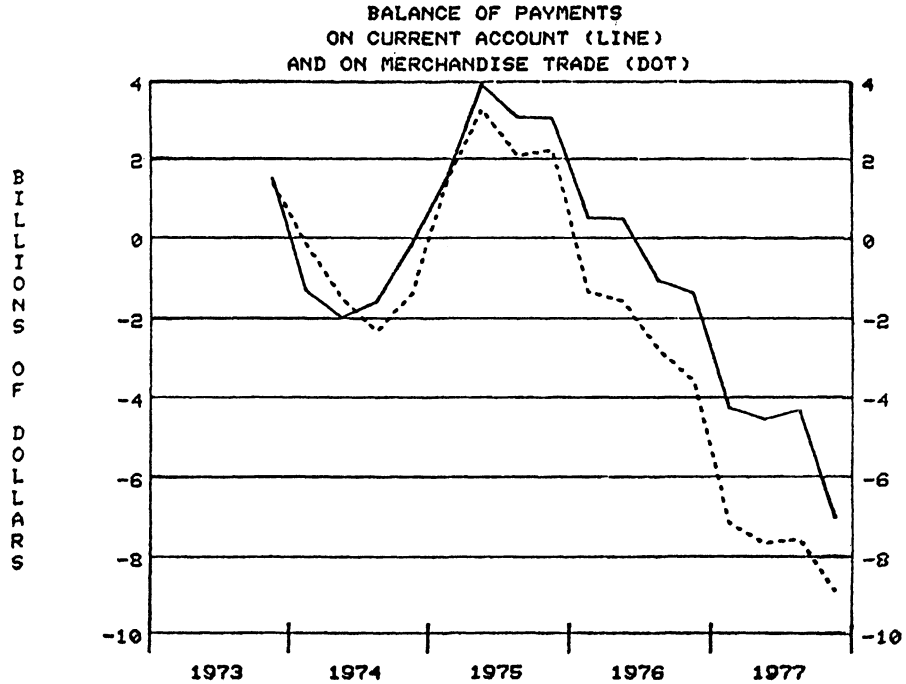
WHARTON  
INDEX OF CAPACITY UTILIZATION  
IN MANUFACTURING, MINING, AND UTILITIES



Data source: Wharton Econometric Forecasting Associates, Inc. 3/3/78

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CHART 12



Data source: Department of Commerce, Bureau of Economic Analysis. 4/7/78

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CHART 13