Outline of Statement by

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before the

Committee on Banking and Currency

House of Representatives

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I. Introductory Remarks.

A. Welcome the opportunity to comment on these two bills (H. R. 3160 and H. R. 3161).

1. These two bills could have extremely important effects on the functioning of financial markets, on the availability of credit to borrowers, and on the conduct of monetary policy.

2. Legislation of such fundamental importance should not be passed in haste. Careful deliberation and weighing of the issues is urgently needed.

B. I have not had time to study these bills and to reflect as much as I would like on their merits.

1. I learned of the two bills yesterday around 5 o'clock.

2. Today, I have spent the bulk of the day in a regular

monthly meeting of the FOMC -- deliberating with my colleagues from all over the U.S. on the appropriate course for monetary policy.

3. My comments, therefore, are based on a hasty reading of the proposed legislation -- which differs radically from H.R. 212, on which I testified at length on Feb. 6.

4. Since I had almost no time to study the bill, or even to discuss it with my colleagues, I assume that this Committee is in the same boat. I can't help but wonder whether this Commiteee has had the opportunity to consider carefully the goals it is seeking to accomplish and whether the proposed legislation would, in fact, promote them.

II. The First Bill -- H.R. 3160 (A Bill to Lower Interest Rates).

A. The aim of this bill seems clear enough. The authors of the bill are concerned, just as I am, about high and rising unemployment and declining economic activity.

1. The authors therefore wish to see conditions develop in financial markets that would be conducive to early and vigorous economic recovery.

2. They believe that lower long-term interest rates would contribute to that objective.

3. They therefore are preparing legislation to require the Federal Reserve to lower long-term interest rates during the first half of 1975, but they do not indicate how this is to be accomplished.

B. The question immediately arises whether the Federal Reserve can accomplish this. Let us first ask ourselves: Why are long-term interest rates high in the United States?

1. The reason is all too evident -- inflation got out of control over the last ten years; expectations of price increases have become built into wage contracts,

investment decisions, pricing decisions, and borrowing and lending decisions.

2. Lenders now expect to be repaid in a depreciated currency, and they hold out for interest rates high enough to give them some real reward.

3. Borrowers, in their turn, offer little resistance to high rates because they expect to repay debt in dollars of smaller purchasing power.

4. Long-term rates in the U.S. are thus extremely high by historical standards. But other industrial countries have also been suffering from inflation; and except for Switzerland, their long-term interest rates are even higher than ours.

C. What could monetary policy do to get long-term interest rates down in a hurry?

1. The experience of 1970 indicates that the capacity of the Federal Reserve to influence long-term interest rates is very limited. Let me give a recent illustration.

   a) At the very start of 1970 monetary policy shifted to a more expansive posture to cushion recessionary forces.

   b) Short-term rates declined promptly and markedly.

   c) But long-term rates kept advancing, and soared to new peaks in late June and early July, and then declined only 1-1/2 percentage points.

   d) The chances of doing much better now are small, since the rate of inflation is considerably higher than it was in 1970.

2. In my judgment, the course of monetary action most likely to contribute to a substantial and lasting decline in long-term interest rates would be to pursue a moderate rate of monetary expansion until inflation is brought to an end. This is a long-run prescription. It presumably is not what this bill has in mind.

3. There is, however, no escape from reality. The fact is that the Federal Reserve can have significant direct influence on short-term interest rates only. Our influence over long-term rates is marginal and could be perverse. If we took steps to lower short-term interest rates much further than we already have -- and let me remind you that we have brought down these

rates very sharply -- we would have an explosive expansion of money and credit. But this would be a self-defeating policy: inflationary pressures would be expected to intensify soon, and long-term rates would thus shoot up to even higher levels.

4. Now, it may be that the authors of this bill believe that the Federal Reserve can drive down long-term interest rates by purchasing long-term securities, while selling short-term securities to prevent excessive expansion of money and credit. Any such effort would, I believe, have negligible effects on the long-term interest rates.

   (a) The volume of long-term debt issues coming to market is enormous. Currently, around $3-1/2 billion in corporate and municipal debt securities are being marketed each month.

   (b) This volume could increase many times over if the cost of long-term financing were reduced relative to the cost of short-term funds; and such a market development would tend to raise long-term rates.

(c) Furthermore, private lenders would be discouraged from supplying long-term capital by any significant decline in long-term rates relative to short-term rates, and this too would work in the direction of raising long-term rates.

(d) These are simple facts about how free markets function and they must not be overlooked.

D. The constructive direction in which to look for ways to lower long-term interest rates is not by turning to the F.R., but in improving the conduct of fiscal policy.

1. In FY 1976, the budget proposed by the Administration has a devicit of $52 billion.

(a) If off-budget agencies are included, the deficit to be financed goes up to $62 billion.

(b) If borrowing by Government-sponsored enterprises is included, the figure rises to $69 billion.

(c) If the Congress does not adopt the $17 billion in expenditure cuts recommended by the President, deficit rises further to $86 billion.

(d) If the tax action now under consideration by the House Ways and Means Committee passes in lieu of the President's program, the figure may rise still further to, say, $96 billion.

(e) And if revenues fall short of those projected by the Administration, or if expenditures in some areas exceed present estimates, or if new programs are undertaken, the deficit in the forthcoming fiscal year could exceed $100 billion.

2. Deficits of this magnitude are bound to put enormous strains on the money and capital markets. The single, and by far the most beneficial, step that Congress could take to lower long-term interest rates would be to curb Federal expenditures and demonstrate prudence in tax actions to stimulate the economy.

E. Let me say in conclusion;the Federal Reserve is entirely sympathetic with the aim of getting long-term interest rates down.

1. This bill, however, could have the opposite effect -- for it would tend to undermine the capacity of the F.R. to pursue its independent judgment, diminish confidence in Government, and therefore raise the premium that lenders require for buying long-term securities -- particularly those of lower quality.

2. In short, the bill asks the Federal Reserve to accomplish things that are beyond its capability. I cannot emphasize too strongly that monetary policy cannot be guided by any simple rule, nor is it appropriate to define the objective of monetary policy in terms of any single financial variable -- whether it be the money stock or long-term interest rates.

III. Turn now to H.R. 3161 -- "A bill to bring about an improved allocation of credit."

A. The specific aims of this bill are not clear to me. The bill is shot through with ambiguities. Let me illustrate.

1. First, the language of the bill seems to imply that "noninflationary uses" and "national priority uses" of credit are synonymous. But from the standpoint of the national welfare, there may well be good reason to favor one use of resources over another, even though the two uses would contribute equally to price pressures.

2. Second, the distinction between inflationary and non-inflationary uses of credit is not clear.

   a) Any increase in borrowing, to the extent that it generates increased spending for goods and services, adds to upward pressures on prices.

b) Some increases in spending, however, add eventually to the supply of goods and services -- a as well as adding immediately to aggregate demand.

1. Thus, borrowing to audment inventories increases the supply of goods available for sale promptly. On the other hand, the addition to supply that results from investment in long-lived capital assets comes only after a considerable time lag and is therefore more inflationary in the short-run.

2. Am I therefore to conclude that H. R. 3161 would require that preference be given to investment in inventories over investment in new plant and equipment? Or again, are investment in oil-drilling equipment to be discouraged because no new productive fields may be discovered?

3. The bill specifically lists five categories of national priority uses: (1) essential and productive capital investment, including technological innovations and investment which increase competition; (2) normal operations of established business customers in order to overcome lack of adequate working capital; (3) low and middle income housing; (4) new and existing small business and agriculture; State and local governments.

   a) Does this listing imply that the authors of the bill wish to deny instalment credit to consumers who want to buy new autos, despite the slump in auto sales? I rather doubt it, but the meaning is not clear.

b) Do the authors wish to shut off consumers from access to credit at department stores and other retail outlets, despite the sluggishness of consumer buying? Again, I doubt it, but again the meaning is not clear.

c) Do the authors wish to discourage construction of houses and apartments for upper income groups now, even though total housing starts are down by about 60% from their peak in early 1973? I would have to guess here.

d) Or what about credit to finance our export trades? Is this, too, to be cut off or reduced at the present time? I do not know.

4. In short, there are numerous and troublesome ambiguities in the bill.

5. Furthermore, and this is a more basic point, I know of no evidence that there are today shortages of credit for credit-worthy borrowers. Nor do I believe that our credit resources are being squandered to any appreciable degree on wanton or speculative enterprises. I, therefore, fail to see the purpose of the legislation. I do not understand what the authors of this bill expect to accomplish by reducing the access of some, perhaps many, borrowers to needed credit facilities.

B. If the aims of this bill are unclear, so also are its means.

1. Two sections of the bill -- the section pertaining to supplemental reserve requirements and that pertaining to the voluntary affirmative action program -- apply only to insured banks.

a) This limitation would severely restrict the effectiveness of a credit allocation program.

b) For there are many other sources of credit to which borrowers could turn if their needs for funds were not being met by the banking system. Controls would have to be comprehensive if they are to be effective.

2. The first section of the bill seems to recognize this difficulty, since it provides the President with virtually unlimited authority to regulate extensions of credit by any bank, any insurance company, any department store, or any other lender, to any consumer, any business firm, any homeowner, any farmer, or anyone else.

a) I seriously doubt whether the authors of this bill really contemplate turning over to the Executive -- or any agency of Government -- such an enormous degree of possible control over the economy.

b) I might add, incidentally, that I am informed, that although this bill gives such enormous power to the President, the counsel of the Administration in this matter has not been sought -- more specifically, that the Secretary of the Treasury apparently has not been invited to testify on this bill.

C. I have already testified on the use of supplementary reserve requirements to allocate credit. I want to emphasize once again the strong opposition of the Board to this regulatory device.

1. As I indicated in my previous testimony, supplementary reserve requirements on bank assets would seriously weaken the capacity of the Federal Reserve to control the growth of the monetary aggregates. Differential reserve requirements on assets would introduce yet another element of uncertainty in the link between bank reserves and the monetary aggregates.

2. There is every reason to believe, moreover, that efforts to use reserve supplements and credits at banks to reallocate credit flows would set off myriad adjustments in other lending markets -- adjustments that would tend to frustrate the intended effects of the program, as I have previously explained.

3. Also, this Committee should consider carefully the high administrative costs and problems that would be encountered in any serious effort to implement a supplemental reserve program effectively and equitably.

IV. Concluding Remarks:

A. My reactions to these two bills are not entirely negative.

B. In some respects, these two bills are an improvement over the earlier bill discussed in my testimony of February 6.

1. H.R. 3160 does not set specific quantitative targets for the money stock. This is clearly an improvement.

2. Another improvement, at least from the standpoint of the Federal Reserve, is that direct authority to allocate credit in H.R. 3161 is given to the President rather than to the Federal Reserve. The Board

would hope that the President -- if he were required to implement this legislation -- would see fit not to saddle the central bank with major decisions in the field of credit allocation.

3. The supplementary reserve requirement section of the bill has been broadened to include all insured banks.

4. Unlike H.R. 212, the present bill also leaves intact the Credit Control Act.

5. Provision is made in this bill, furthermore, for relying on a voluntary program. The voluntary affirmative action program contemplated in this bill has some ideas that may be worth pursuing further.

C. In closing, I must nevertheless warn the Committee that H.R. 3161 would provide the Government with enormous powers over the use of credit. It envisages a comprehensive intrusion of the Federal Government into private credit markets. Implementation of the bill could undermine the market system and wreck all chances for economic recovery.

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