FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES

NINETY-THIRD CONGRESS

SECOND SESSION

JULY 16, 17, 18, 30; AUGUST 7, AND 8, 1974

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CONTENTS

Hearings held on—	Page
July 16, 1974	1
July 17, 1974	77
July 18, 1974	165
July 30, 1974	249
August 7, 1974	489
August 8, 1974	289
"Report on Federal Reserve Policy and Inflation and High Interest Rates," submitted to the House Banking and Currency Committee by Dr. Robert Weintraub, staff economist, July 12, 1974	31

STATEMENTS

Balles, John J., president, Federal Reserve Bank of San Francisco	97
Burns, Hon. Arthur F., Chairman, Board of Governors of the Federal Reserve System	251, 289
Eastburn, David P., president, Federal Reserve Bank of Philadelphia	121
Francis, Darryl R., president, Federal Reserve Bank of St. Louis	166
Hayes, Alfred, president, Federal Reserve Bank of New York	78
Mayo, Robert P., president, Federal Reserve Bank of Chicago	194
Meiselman, David I., professor of economics, Virginia Polytechnic Institute and State University	337
Morris, Frank E., president, Federal Reserve Bank of Boston	209
Weintraub, Dr. Robert, staff economist of the House Banking and Currency Committee	5
Wright, John Winthrop, president, Wright Investors' Service, Bridgeport, Conn	516

ADDITIONAL QUESTIONS

Questions Submitted by the Chairman and Members of the Committee to the Federal Reserve Witnesses Along With Their Replies

I. Chairman Wright Patman, concerning the Federal Reserve's Securities Portfolio	349
II. Hon. Leonor K. Sullivan, requesting comments on the staff recommendations made by Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee on July 16, 1974	361
First recommendation	361
Second recommendation	367
Third recommendation	370
III. Hon. John H. Rousselot, concerning possible efforts to influence and coordinate testimony of the Federal Reserve bank presidents	373
IV. Hon. John H. Rousselot, concerning effect of the action taken by the Federal Reserve to supply the Franklin National Bank with $1.2 billion in emergency reserves	399
V. Hon. Fernand J. St Germain, concerning the viability of thrift institutions and housing in periods of inflation and high interest rates; and Hon. John H. Rousselot, on miscellaneous matters	409

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ADDITIONAL INFORMATION SUBMITTED FOR THE RECORD

Page

Balles, John J.:
- Prepared statement 101
- Response to questions of:
  - Chairman Wright Patman 354
  - Hon. Edward I. Koch 163
  - Hon. John H. Rousselot 376, 401
  - Hon. Fernand J. St Germain 411
  - Hon. Leonor K. Sullivan 363, 368, 370

Brimmer, Hon. Andrew F., member, Board of Governors of the Federal Reserve System, letter to Hon. Henry S. Reuss, dated August 5, 1974, commenting on legislation designed to empower the Federal Reserve Board to influence explicitly the sectoral distribution of bank credit 274

Brown, Hon. Garry, article entitled, "Burns Urges White House To Push Drive On Inflation, but Sees Long Battle Ahead," from the Wall Street Journal of August 7, 1974 334

Burns, Hon. Arthur F.:
- Letters to:
  - Chairman Wright Patman regarding questions about the Federal Reserve Board's responsibilities under the Bank Holding Company Act as they relate to the Franklin New York Corporation, the parent of the Franklin National Bank, and the acquisition of voting shares by Fasco International Holding, S.A. ("Fasco"), dated:
    - June 5, 1974 295
    - August 2, 1972 296
  - Hon. Henry S. Reuss, commenting on H.R. 15709, legislation amending the Federal Reserve Act to permit the Federal Reserve Board to allocate credit so as to serve national priority needs, dated July 29, 1974 271
- Response to questions of:
  - Hon. William A. Barrett 261
  - Hon. Ben B. Blackburn 279, 281, 285
  - Hon. Margaret M. Heckler 307, 310
  - Hon. Matthew J. Rinaldo 326
  - Hon. John H. Rousselot 396, 401, 407
  - Hon. Fernand J. St Germain 269, 414
  - Hon. Leonor K. Sullivan 264, 265, 366, 369, 372
- "Ways To Moderate Fluctuations in the Construction of Housing," summary report from the Federal Reserve Bulletin for March 1972 477

Eastburn, David P.:
- Papers submitted from the "Business Review" of the Philadelphia Federal Reserve Bank:
  - "Can Credit Controls Be Controlled," January 1972 447
  - "Federal Regulation of Stock Market Credit: A Need for Reconsideration," July–August 1974 465
  - "Federal Reserve Policy and Social Priorities," November 1970 425
  - "Interest Ban on Demand Deposits: Victim of the Profit Motive?", August 1972 455
  - "Should Housing Be Sheltered From Tight Credit," November 1970 433
- Prepared statement 125
- Response to questions of:
  - Chairman Wright Patman 356
  - Hon. John H. Rousselot 378
  - Hon. Fernand J. St Germain 412
  - Hon. Leonor K. Sullivan 364, 368, 371

Federal Reserve banks represented at hearings:
- Boston 209
- Chicago 194
- New York 78
- Philadelphia 121
- St. Louis 166
- San Francisco 97

Francis, Darryl R.:
- Prepared statement 170

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Federal Reserve Bank of St. Louis

Francis, Darryl R.—Continued
Response to questions of: Page
Chairman Wright Patman 357
Hon. Ben B. Blackburn 247
Hon. Lindy (Mrs. Hale) Boggs 245
Hon. Bill Frenzel 242
Hon. James M. Hanley 240
Hon. John H. Rousselot 379, 402
Hon. Fernand J. St Germain 413
Hon. Leonor K. Sullivan 364, 368, 371
Hon. William B. Widnall 247
Hayes, Alfred:
Prepared statement 83
Response to questions of:
Chairman Wright Patman 349
Hon. Henry S. Reuss 144
Hon. Matthew J. Rinaldo 153
Hon. John H. Rousselot 375, 399
Hon. Fernand J. St Germain 409
Hon. Leonor K. Sullivan 361, 367, 370
Mayo, Robert P.:
Prepared statement 200
Response to questions of:
Chairman Wright Patman 358
Hon. Ben B. Blackburn 247
Hon. Lindy (Mrs. Hale) Boggs 245
Hon. Bill Frenzel 241
Hon. James M. Hanley 240
Hon. John H. Rousselot 394, 405
Hon. Fernand J. St Germain 236, 413
Hon. Leonor K. Sullivan 365, 368, 372
Hon. William B. Widnall 246
Morris, Frank E.:
Prepared statement 213
Response to questions of:
Chairman Wright Patman 359
Hon. Ben B. Blackburn 248
Hon. Lindy (Mrs. Hale) Boggs 245
Hon. Bill Frenzel 243
Hon. James M. Hanley 240
Hon. John H. Rousselot 394, 405
Hon. Fernand J. St Germain 236, 414
Hon. Leonor K. Sullivan 365, 369, 372
Hon. William B. Widnall 246
Patman, Hon. Wright:
"Arthur Burns: In a Tight Money Squeeze," article from the Washington Post of August 8, 1974 300
"Bank Dominos," article from the Wall Street Journal of August 8, 1974 298
"Federal Reserve Readies Emergency Loan Plan," article from the Washington Post of August 8, 1974 299
"Internal Revenue Collections of Individual and Corporate Taxes, Selected Years, 1945–73" (table) 234
Letters to Chairman Arthur F. Burns:
Concerning the Federal Reserve Board's responsibilities regarding the Franklin National Bank and its holding company operations and the entry of foreign investment in the U.S. banking system, dated:
May 14, 1974 293
July 19, 1972 295
Regarding the Chicago Federal Reserve Bank's refusal to the committee's chief investigator to review various expenditures of the Federal Reserve Club of the Chicago bank, dated August 1, 1974 297

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Reuss, Hon. Henry S., letters from the Federal Reserve Board commenting on H.R. 15709, legislation which would amend the Federal Reserve Act to permit the Federal Reserve Board to allocate credit so as to serve national priority needs:
Chairman Arthur F. Burns, dated July 29, 1974 ---------- 271
Gov. Andrew F. Brimmer, dated August 5, 1974 ---------- 274
Weintraub, Dr. Robert, response to question of Hon. William S. Moorhead on "Why are Federal Reserve policymakers for the most part wary of Cagan's findings?" ---------- 29
Wright, John Winthrop, prepared statement ---------- 491

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FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES

TUESDAY, JULY 16, 1974

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:20 a.m., in room 2128 Rayburn House Office Building, Hon. Wright Patman [chairman], presiding.

Present: Representatives Patman, Barrett, Sullivan, Reuss, Moorhead, Stephens, St Germain, Gonzalez, Minish, Annunzio, Rees, Koch, Cotter, Mitchell, Moakley, Boggs, Widnall, Stanton, Brown, Williams, Wylie, Heckler, Crane, Frenzel, and Rinaldo.

Also present: Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee.

The Chairman. This morning we open hearings on monetary policy with particular emphasis on how that policy affects inflation and interest rates. These can be some of the most important hearings this committee has ever conducted, and they come at a time when the American public is deeply concerned about the mismanagement of the economy and is demanding action by its officials. Without question, we are in one of the worst periods in the economic history of this Nation, and the signs for the future are not encouraging. Raging inflation, the highest interest rates in history by far, and mounting unemployment, and yet we have no real plan to attack the problems.

The Federal Reserve System, with its vast powers, provides much of the key to our economic successes or failures. The Federal Reserve as a monetary manager must accept responsibility for economic conditions, and it is the responsibility of this committee, and for that matter the Congress, to hold this agency responsible.

But the Federal Reserve has been a master of the bureaucratic snow job. It operates behind years of carefully developed mythology, and today too many newsmen and columnists and too many Congressmen accept the pipe-puffing generalities as gospel.

In my opinion, and it will be supported by data that will be brought out during these hearings, the Federal Reserve has been the engine of our current inflation, and not the number one fighter against inflation, as some financial columnists have informed us in recent weeks. In this hearing, as in all previous hearings, the Federal Reserve Chairman, Dr. Arthur Burns, will pass the buck, blaming the Congress, blaming everyone but his own agency, which unfortunately has been allowed a free hand to operate as it pleases.

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This time I hope the members will press in and ask the critical questions, and not allow the personalities to stand in our way and to let the outlandish buckpassing go by us as the truth. This is our responsibility and the public expects action during this critical period of our economy.

Dr. Robert Weintraub, who joined the staff last year from the University of California, has interviewed all 12 Federal Reserve bank presidents and 5 of the 7 Governors of the Federal Reserve Board. These are the most extensive interviews of Federal Reserve officials ever conducted for a congressional committee.

Dr. Weintraub will be our first witness and will be followed by six presidents of the Federal Reserve banks and Dr. Arthur Burns, Chairman of the Federal Reserve Board. I think it is valuable to have their presence before the committee because we need more than just the mimeographed statements of Dr. Burns. I cannot believe in this far-flung Nation that all people are of the same voice in the Federal Reserve System, and that there are not differences of opinion.

It is essential that the Congress have this knowledge. Therefore, I hope that each of these Federal Reserve bank presidents are straightforward, and that they do not pull any punches, even if their testimony might upset the careful facade constructed by Dr. Burns through previous congressional testimony and the endless backgrounders.

Dr. Robert Weintraub received his Ph. D. in economics at the University of Chicago, and has written extensively in the area of monetary policy. He has assisted this committee over a period of several years. I think he is one of the most highly qualified people we could have, and the committee is fortunate to have him on board to conduct these interviews.

Dr. Weintraub, you are recognized, sir. Are you ready to start?

Dr. WEINTRAUB. Yes, I am, Mr. Chairman.

Mr. BROWN. Mr. Chairman?

The CHAIRMAN. Yes?

Mr. BROWN. I would like to be heard just briefly.

The CHAIRMAN. All right, go ahead.

Mr. BROWN. It is certainly convenient for any Member of Congress, especially the chairman of this committee, to pass the buck and to pass the blame, as the chairman has suggested Dr. Burns has done, to pass the blame to an agency. But there is not any question that the authority lies within the Congress not only to do what it wants to with respect to the Federal Reserve Board, but to eliminate it and to eliminate the Federal Reserve System.

The law can be repealed, and yet in the course of the 8 years I have been here, I have listened to this "Patmania" and I have yet to see the chairman of this committee come forward with a restructuring of our financial system, come forward with a proposal that would accomplish that, to correct that which he now criticizes. I think until that time it ought to be the function of this committee and the function of the Congress to attempt to work with the members of the Federal Reserve Board and the Federal Reserve System to try to get us out of the problem, rather than further contribute to it by criticism of it.

The CHAIRMAN. I thank the gentleman for those critical words, and I do not object to them at all. I am proud of them. I think that members should criticize anyone, even the chairman. But may I invite your

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attention to the fact that I have had a bill, H.R. 11, in several Congresses, not just one. It takes time to pass laws that are not administration proposals. One of the most important laws ever passed in this Congress, a bill to pay 3.5 million veterans of World War I $3.7 billion, H.R. 1, was before a number of Congresses before it finally became a law and the veterans got their money.

Now, H.R. 11 is to restructure the Federal Reserve. We not only have had it pending in several Congresses, but we have had hearings on it, and a lot has been done in that direction. I will state to the gentleman, and we may yet get it passed in time. It is possible the time will come when liquidation would be desirable, and the Federal Reserve Act provides for liquidation, and all of the assets go to the U.S. Treasury if the Federal Reserve is liquidated. But I am not advocating it at this time.

But we will wait to see if we can get any improvements in the Federal Reserve where it will not be justified. The liquidation value would be $100 billion, and the Federal Reserve has $80 billion in U.S. Government securities in its portfolio. The bonds were bought, but with Government money. The Federal Reserve did not pay a penny of that money. The U.S. Government paid for them, and those bonds are now in the portfolio of the Federal Reserve in the Federal Reserve Bank of New York, and they are still collecting interest on those bonds. They are collecting between $4 and $5 billion a year, although those have been paid for once when they took Government money and paid for Government bonds.

As every academic professor in economics will tell you, they are always proudly saying that when the obligor and the obligee become the same person the debt is paid, and this is that case.

Mr. KOCH. Mr. Chairman, may I be recognized for a moment?

The CHAIRMAN. Wait just a moment. I will yield to Mr. Widnall. He is senior minority member. We have got to get started.

Mr. KOCH. Mr. Chairman, I do not mind your yielding to Mr. Widnall. But I want to be recognized before we hear the first witness. I just think that common courtesy and the rules of the committee would provide that where a member asks to be recognized that he be recognized. Since you have already recognized two members, I would ask for at least equal time.

The CHAIRMAN. I will recognize Mr. Widnall first.

All right, Mr. Widnall.

Mr. WIDNALL. Mr. Chairman, I just have to make this comment. After many years of serving on this committee, and it has been a great committee to serve on—we have had a chairman who has a history of activity and performance in many ways that have been a credit to him and to the country. But I am a little bit sick and tired of the opening statements that have been made from time to time in which unsupported accusations are made in that statement and characterizations are made of people and their activities in a way that is, I think, unwholesome and completely unfair and something that never gets proven later on in connection with a case.

I have been here when we have had a Chairman of the Federal Reserve coming before us, and you, Mr. Chairman, have said in welcoming him that you knew he was a fine and honorable man and a man of good character, and he has been a good Chairman. But at the

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same time, if anybody else had done the things that he was doing, he would be in jail today. There has never been any followup on that, and I think things like that are extremely unfair characterizations, and I for one—and I know Congressman Brown feels very much the same way that I do—am a little bit tired of those accusatory statements that are at the beginning of a meeting, which sets up sort of an unfair background for the consideration of legislation, important legislation that we must consider on this committee. I just urge that you preside with as much fairness as you can, and we will do a much better job.

The CHAIRMAN. Well, the fairest thing I have always done, I have always yielded to you immediately after I made those statements.

[Laughter.]

Mr. KOCH. Mr. Chairman?

The CHAIRMAN. Shall we yield? If we yield to one we should yield to all.

Mr. KOCH. You have yielded to two members, Mr. Chairman.

The CHAIRMAN. How much time do you want?

Mr. KOCH. Four minutes or less.

The CHAIRMAN. Without objection, the gentleman is recognized.

Mr. KOCH. The reason that I asked for recognition was that I did not want to sit here and permit my silence to be deemed an assent to your comments with respect to Dr. Burns, and I am glad that two other members have spoken out so forcefully, because you may disagree——

The CHAIRMAN. Dr. Burns will be here next Tuesday to speak for himself.

Mr. KOCH. Mr. Chairman, please permit me to continue.

We may disagree, you may disagree with me and I with you, and the two of us on occasion with Dr. Burns. But the fact is, he is a very honorable man whose reputation cannot be blemished by the comments that the Chair makes and has made on many occasions. I agree with the ranking member on the Republican side here that it has come to a point where it has got to stop. You just simply cannot tarnish the reputations of people who come before us and then blithely go on and let the testimony be taken, and then the comments that the Chair makes go unsupported. That is number one; so I want to make that clear. I have a high regard for Chairman Burns.

The CHAIRMAN. I have not attacked him personally ever.

Mr. KOCH. The second point I want to make is this. I think it is extremely important that this committee evaluate the agenda items. I mean, it seems to me that a committee, made up of as distinguished members as this committee has, should have some input into the agenda, have some input into the witnesses that are called. I noticed, just looking at the ranks of those who have not come or those who have left, that that may be some indication of their upset at the way this agenda is put together. I just offer the chairman, for whom I have a very high regard, this comment that he ought to consider the opinions and judgments of members of this committee in making up the agenda and in the items that this committee will consider.

The CHAIRMAN. The gentleman should keep in mind that I have never made any personal attack on Dr. Burns. I have criticized his policies and will continue to do so, regardless of what the gentleman says, and that is where they are justified.

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Mr. BROWN. Mr. Chairman, when you talk about pipe-puffing generalities, there is not much question in anyone's mind in this room who you are talking about.

Mr. ANNUNZIO. I congratulate the chairman on the pipe-puffing, and I hope he drops his pipe one of these days. I am tired of watching the guy smoke while the depositors of this country and the small people of this country and the housing industry is suffering. It is too damned bad when the chairman cannot express himself.

The CHAIRMAN. All right.

Dr. Weintraub, you are recognized. Do you have a prepared statement?

Dr. WEINTRAUB. Yes, I do.

The CHAIRMAN. All right, you go ahead with your prepared statement.

STATEMENT OF DR. ROBERT WEINTRAUB, STAFF ECONOMIST OF THE HOUSE BANKING AND CURRENCY COMMITTEE

Dr. WEINTRAUB. The members have before them two statements, a long one and a condensed version, and what I am going to do is summarize from the condensed version, if that would be all right.

Let me begin by taking up what the Governors and presidents said about the part that the Federal Reserve has played in the episode of inflation, and high and still rising interest rates which have afflicted our economy since 1964.

Nearly all recognize some and many an important degree of responsibility. There is wide agreement that accelerated money supply growth stemming from stepped-up open market purchases, acts sooner or later to accelerate inflation. This is the fundamental proposition of monetary theory. President Eastburn of Philadelphia used it to synthesize monetary and other explanations of price developments in the 1965–73 period. He said:

> In longer run periods, I think that it cannot be denied that the rate of growth of money affects prices. Over this longer run period, that relationship has existed.

He continued:

> You have had rises in money growth and rises in prices, and I think the two are related. Now, when you get to subparts of that and you narrow down the time frame, then you get other elements affecting inflation. For example, fiscal policy, special factors such as crop failures, worldwide demands for goods, shortages of materials and energy and so on.

To recapitulate this important statement, while fiscal policy and special factors may account for changes in the rate of inflation for short periods, in the context of a period as long as 1965 to 1973, inflation is a monetary phenomenon, and its rate depends on the rate of growth of new money. In the 1965–73 period, the average annual increase in the Consumer Price Index or CPI was 3.2 percent faster than in the 1959–64 period. It is no coincidence that between 1959–64 and 1965–73 the average annual growth rate of the conventionally defined money stock, M–1, which consists of publicly held currency and demand deposits, jumped by 3.3 percent.

Moreover, responses by the Governors and presidents to questions on specific policy actions and trends in monetary policy during the

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1965–73 period also reveal that even in fairly shortrun contexts, there was a close lagged relationship between money supply changes and changes in economic activity, including the rate of inflation.

Inflation did not happen all at once, nor did it occur in a uniform continuous wave. It began in 1965, slowed in the fall and winter of 1966–67, then reaccelerated and reached 6.3 percent per year in the first 7 months of 1969. Referring to this subperiod, President Hayes of New York said:

We did apply the pressure in 1966 and when we did see business slowing down we reacted in early 1967. Perhaps we reacted a little too much in our fear of a recessionary development which turned out to be very temporary and not very serious. Then, in 1968, when we finally did get the fiscal support, monetary policy was fearful that the fiscal move maybe was too strong. That turned out to be a failure in judgment.

President Morris of Boston said: "The last half of 1968 was clearly a misjudgment."

M–1 growth was slowed beginning in the winter of 1969 and the deceleration continued until February 1970. In the year ending February 1969, M–1 growth was 8.1 percent. The next year it was 2.9 percent.

From August 1969 to January 1972, inflation tapered off. The annual rate of rise of the CPI dropped from 6.3 percent in the first 7 months of 1969 to 3.9 percent in the first 7 months of 1971 just before President Nixon's new economics program was put into effect, and to 2.9 percent from August 1971 to January 1972.

On this period, President Francis of St. Louis said:

In 1969 the Fed slowed down the rate of money creation and held it down to a degree through 1970. We saw during that period, I would say, some wrenching in the economy. We had some small influence, I think, also on the inflation rate—it began to taper off.

From January 1972 to the summer of 1973, M–1 growth was very rapid. Year-to-year growth was 9 percent between January 1972 and January 1973, and 8 percent in the year ending July 1973. The interviews reveal considerable dissatisfaction among Federal Reserve policymakers with what happened during this period.

Governor Holland:

With hindsight, I am sure we would have followed a less expansive monetary policy.

President MacLaury of Minneapolis:

Beginning mid-1972, I left the bandwagon, saying that we should be pursuing a more restrictive policy in terms of monetary growth than we were in fact pursuing.

Governor Brimmer:

In my view, many policy actions taken during much of 1972 were improper, and rather than fighting inflation they were adding to it.

THE NEXT QUESTION

Questioning President Black of Richmond, I said:

I would come to the conclusion that money supply is very important for understanding prices. Would you agree with that?

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He answered:

I would agree completely. But so far as saying that that is the sole cause, that is another question. You have got to go behind why the money supply did what it did.

One reason that was given to explain inflationary M–1 growth was an information problem. The Federal Reserve does not itself track demand deposits in nonmember banks. The FDIC does this through its periodic call reports. Until last month, the FDIC called and received only four reports each year, and the Fed's between-reports estimates of nonmember bank deposits and hence of M–1 were low.

This information gap has largely been corrected. The FDIC is now assembling large nonmember banks' deposits weekly and passing on the aggregates to the Fed. The information problems aside, the Federal Reserve policymakers agree that they have ample powers to control money supply.

Most important, money supply cannot grow unless the Fed wants it to. Questioning President MacLaury of Minneapolis I said:

Well, let me ask you: How could money supply, the nominal money supply, have grown? How could it grow just because the economy wants it to grow unless the Federal Reserve supplies the base for it?

President MacLaury of Minneapolis:

The way you put that, it could not. It could not. We have the ultimate control, and the question is of the growth of the monetary base. I agree with you on that.

WHY MONEY SUPPLY GREW AS IT DID

Why did it happen?

At times during the 1965–73 period, M–1 growth was stepped up deliberately to reverse developing recessions and/or to reduce unemployment, each one over the near term. Most recently this was done to reduce unemployment in 1972. Referring to the fact that unemployment was above 5½ percent until late that year, President Balles of San Francisco said:

You would have had to conclude that we needed to stimulate the economy more to get the unemployment rate down. Now, admittedly that was going to have some unfortunate effect on prices, and I think it probably did.

Another reason why M–1 grew as rapidly as it did since 1964 is that the Federal Reserve, since 1964, has tended to accommodate inflation by validating price increases which originate in special events. And many would now extend this policy to accommodate increased prices of oil and also past pervasive inflation as well.

Governor Mitchell:

If you said that the original price rise was due, say to the Vietnam war, and then you get a higher price level built into your system, then I think that monetary policy would tend to accommodate the price level rather than to roll it back.

President Black of Richmond:

With these extraneously imposed pressures on prices, you either had to create unemployment or validate those price increases.

Governor Holland:

Our monetary aggregates need to be averaging a little higher than would be true in the absence of the energy crisis or the food crisis that took place last summer.

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Governor Brimmer:

If the rate of growth in the money stock falls substantially short of a built-in rate of inflation, you end up with very depressing effects on the real economy.

Others disputed the preceding lines of argument, some very vigorously.

President Francis of St. Louis said:

I don't know why, if the level of production of goods and services in this country is forced down by an outside influence like energy, why we'd want to put more dollars in the economy to chase those goods and services. I can see only one outcome, and that would be further inflation.

President Balles of San Francisco: "It would be economic madness to keep stepping up the rate of money supply to keep up with inflation."

Excessively rapid M–1 growth also was explained as the predictable byproduct of the Federal Reserve trying to do other things. One such reason cited was choosing to monetize large parts of fiscal deficits.

President Mayo of Chicago:

Fiscal policy was the basic culprit in forcing up, if you please, the increases in the money supply.

Weintraub:

But what I'm puzzled about is the connection—the nexus. What is it that compels the Federal Reserve to act to increase money supply and to increase the rate of increase in money supply when the budget is in substantial deficit?

President Mayo:

Well, this is a direct result of the fact that the Treasury obviously has to borrow when there's a deficit.

Weintraub:

That's right.

President Mayo:

The Treasury has to borrow in a real market. The Federal Reserve, I think has a responsibility to see that a Treasury offering when properly priced in the given market environment is not thwarted by tightening up on monetary policy. That is why we have what is called even keel. The fact that the Treasury was, say doubling its demands on the market would be a constraint that we couldn't ignore, we couldn't say that the demand had to come out of somebody else's hide.

A different view on this question was expressed by President Francis of St. Louis. He said:

It is not necessary for the Federal Reserve to come to the support, say, of the Treasury, to the degree it has. I would much prefer to see the Federal Reserve try to determine the level of money that is consistent with full employment and stability, and I don't think these are inconsistent objectives. I think it can be accomplished by letting the Treasury cut its excessive needs out of the market.

Many indicated also that M–1 growth strayed from the optimal longrun path because the Fed let it do so while concentrating on fighting fires and keeping order in money markets.

President Coldwell of Dallas:

Is the Federal Reserve to have its eye only on a target 18 months out, or is it to respond to shortrun fire fights.

President Winn of Cleveland:

You know, I would agree that if you set controlling money supply as a single objective, and you were not concerned about the behavior of any of the other

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variables, you probably could control it much closer than you are able to do at the moment. But I think what happens is, is to your willingness to let some of the other elements fluctuate.

Weintraub: "There seems to be a set of targets that sometimes——"

Winn: "Are self-defeating in terms of——"

Weintraub: "Can be self-defeating certainly of a moderate money supply."

Winn: "This is correct."

Governor Sheehan:

Money is growing faster than you want it to grow, so you turn to the staff and say, "Staff, if we move against this high growth, what do you think the Federal funds rate is going to do?" The staff says. "If you want to get it down within your proposed limits, during that 3-month period, you have to be willing to accept a Federal funds rate in the range of 20 to 25 percent for 8 to 10 weeks."

Others saw dangers from neglecting money supply while trying to smooth shortrun fluctuations in the Federal funds rate and other money market rates.

President Eastburn of Philadelphia:

You can forget what happens to money. I think that's the problem.

President Eastburn also said:

If you agree that it's desirable to get growth in money down sometime, one of the problems that one incurs is finding the appropriate time, and there never seems to be a good time.

THE FEDERAL RESERVE AND INTEREST RATES

Let me turn now to the relationship between Federal Reserve actions and interest rates. It is commonly believed that the Federal Reserve can decrease interest rates by increasing M–1 growth. But it cannot. Initially it is true that open market purchases increase reserves which impels banks to increase their lending, and money supply expands and interest rates tend to fall in the process. But the fall in interest rates does not last. Together, money supply growth and lower interest rates impel increased spending. As a result, production and prices advance, and there is feedback to credit markets from the increases in production and prices and such anticipated inflation as is generated.

Questioning President MacLaury of Minneapolis, I asked:

Now, is there any feedback from the price increases and the output increases on any of these variables that you have talked about? Interest rates in particular.

MacLaury. "Definitely so. Yes."

Weintraub. "OK, what happens to interest rates as a result? The feedback?"

MacLaury. "And now you are leading me to say, and I don't resist saying, that interest rates are going to rise."

Weintraub. "There is some tendency for interest rates to rise now?"

MacLaury. "Surely."

Weintraub. "And the greater, presumably, the rate of inflation, would you go along with that theory, the greater the tendency for interest rates to rise?"

MacLaury. "Yes, I would go along with that."

President Clay of Kansas City. "Inflation causes high interest rates. I believe that high interest rates result from inflation."

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Questioning Governor Holland, I asked:

So a curious thing emerges here which is that insofar as monetary policy was responsible for the expansion and the buoyancy and the inflationary tendencies, it is responsible for the high interest rates.

Governor Holland:

Yes, I put a lot of weight on the "insofar as responsible," because I think there are a lot of factors at work here. But the more monetary stimulus that's pressed into the economy, the more response you get in terms first of real output, and then as you get close to capacity, the more that expansion spills out in prices; and the more the latter happens, the more there tends to develop subsequently a lift in interest rates.

Referring to recent years, in questioning President Morris of Boston I asked:

Given the choice that was made which was for higher money supply growth and higher, therefore, inflation in order to achieve lower unemployment, what about nominal interest rates? Did this produce higher or lower interest rates?

President Morris of Boston: "Higher."

SUBSTANTIVE ISSUES

Four major substantive questions about Federal Reserve policies and operating procedures emerge from the interviews. Resolving these issues is crucial for the formulation and implementation of monetary policy now and in the future.

One, major differences exist on the practice of stepping up M–1 growth to accommodate special inflationary developments. The burden of proof is on those who would have M–1 growth move with and not into the winds of inflation. These hearings would appear an appropriate place to ask how inflation will decelerate under this policy and why this policy would not generate continually accelerating inflation. In addition, it would be useful to clarify why we should be concerned because prices have lately increased more than M–1, inasmuch as M–1 increased more than prices in years past. Perhaps prices are just catching up. Finally, it is important to question the underlying assumption of this policy that prices with rare exception do not fall. It is very important to question that assumption.

Two, Government must pay for the goods it buys and the services it hires. In real terms, and in a full or nearly full employment economy, this requires transferring resources from the private to the Government sector. To the extent that taxes fail to provide the needed buying power, the Federal Reserve decides whether it shall be obtained by the Treasury selling securities and bidding away saving from private investors, or by the Federal Reserve issuing currency and book entries in Reserve banks, that is, essentially by printing the money. The Fed's decision has important implications for the economy. Requiring Government to raise the buying power it needs by bidding away saving from the private sector could "crush out of the private economy an equal amount of spending," as President Black of Richmond said, and raise interest rates "to astronomical levels," as President Balles of San Francisco said.

On the other hand, President Francis of St. Louis warned: "Treasury borrowing alone would be more of a transfer of money from the private sector to the public, but when you interpose new money on top

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of that, or too rapid increase in the rate of monetary expansion, I think this is the kicker on inflation." And I would add, on high interest rates, too.

Moreover, to the extent that inflation results from the Federal Reserve's decisions, appropriated expenditures will fall short of achieving the transfer of resources required to accomplish the spending goals. Thus, monetizing deficits either results in underfunded programs or requires supplemental or deficiency appropriations to cover cost overruns. It also later generates larger tax receipts which tends also to increase future spending.

This is a critical issue, a very critical issue. Are the arguments of Presidents Black and Balles valid, or is President Francis right?

Incidentally, right now I have the impression that President Balles' use of the word "astronomical" was only a way of adorning a point. He wanted, I think, to make sure that I understood that he would not dodge the fact that for a while, at least, interest rates would tend to rise if the Fed required the Treasury to finance deficits by selling securities to the public rather than to the Fed after first selling it to the public. You can question him on this, of course.

In any case, these hearings present a timely opportunity to fully air opinions on how high and for how long interest rates would rise if the Fed makes no special effort to monetize deficits, and to air also other aspects of this question.

Three, many Federal Reserve policymakers favor resisting sudden extraneously caused money market pressures even at the cost of temporarily allowing M–1 to grow faster than desired as a longrun matter. But others believe that money markets are inherently orderly. They suggest that, left alone, these markets would absorb exogenous shocks with minimal trouble, and hence need little protection. They also warn that fighting fires and keeping order in money markets can require the Fed to supply new money much faster than the desired longrun rate for an extended period of time, and with disastrous longrun consequences.

The argument of those who would protect the money market assumes that a small increase in money supply induces a large fall in money market rates and that these rates stay down for a period which is long enough to permit the extraneous pressures to decay, and it is presumed that they will decay, yet somehow the time involved is also supposed to be short enough to allow the Fed to achieve desired longrun M–1 growth. The assumption is not only complicated, it is heroic and it is without strong statistical foundation. On the contrary, there is considerable evidence that it takes large increases in money supply to induce a significant fall in interest rates and that the fall does not last very long, especially in periods of buoyant credit demands and inflation, and soon becomes a rise.

During the interviews, considerable attention was given to the findings of Phillip Cagan on the central tendency in our economy, over the years, of interest rate changes that have occurred in the wake of step-ups in money supply growth. Cagan found that following a a step-up in M–1 growth of 1 percentage point per year, the commercial paper rate at first falls and later rises. The initial decline lasts less than one-quarter and reaches only seven basis points. In the third

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quarter the commercial paper rate is higher than initially and after 2½ years, it is 40 basis points higher.

Federal Reserve policymakers for the most part were chary of Cagan's findings. They did not accept that the average size and duration of the initial effect could be as small and short as Cagan found it to be. In addition, nearly all pointed out that the size and duration of the response of interest rates following a change in money supply depends upon initial conditions, as surely is correct and Cagan surely would agree. Thus the historical central tendency can be misleading. But many also felt that in periods of buoyant credit demands and inflation, the size and duration of the initial effect was likely to be smaller and shorter than in other economic conditions.

President MacLaury of Minneapolis:

I would expect that you could have a year, a year and a half, 2 years of declining interest rates.

The question was discussed further at Minneapolis.

John Karaken, an economic adviser to President MacLaury:

To the extent that initial conditions matter, you can give an average which may not, however, have a tremendous amount of meaning.

Weintraub:

Right, there may be great variation around the central tendency. But, in a period of relatively full employment, you would expect it, the turnaround, that is, to be faster than a period of, you know, unemployment, relatively high unemployment. Do you agree with that?

President MacLaury: "I certainly do."

President Morris of Boston: "The higher the level of resource utilization, the shorter the time in which the rates react."

Questioning President Balles of San Francisco I asked:

Would you expect in an expansionary, buoyant, inflationary period the effect to be greater and shorter or smaller and longer than in a period of recession?

President Balles: "Smaller and shorter."

Governor Bucher:

And I'll tell you, the more and more the financial community and even the public become aggregate watchers, if you will, I think the more this will be exacerbated. I think this tendency will be to shorten it and shorten it, as people in their own minds, compare growth in money supply with future inflation.

Cagen's results are not conclusive. But, particularly during periods of buoyant credit demands and inflation, it appears that resisting extraneous pressures requires large increases in M–1 growth, and because feedback is rapid, the initial decline in interest rates is small and very short-lived, and unless the policy is quickly reversed, all too soon the result is faster inflation, higher interest rates, and graver money market crises. It would be appalling if this happened for no good reason because as President Eastburn of Philadelphia said: "The market could be more self-reliant with respect to changes in interest rates than it has been permitted in the past."

The relationship between money supply and money market developments has, of course, also positive implications for how to use mone-

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tary policy to fight both inflation and high interest rates. On this theme, President Francis of St. Louis said:

I don't like to say or I don't like to hear people say, that the way the central bank goes about slowing up inflation is to raise interest rates. I think the thing we can do, the tools with which we work, dictate that we get the rate of monetary expansion under control.

The fourth substantive issue that emerges from the interviews concerns the tradeoff between inflation and unemployment. Many of those interviewed believe that we can check the current inflation only if we are willing to significantly underachieve with respect to employment. They question, as President Morris of Boston did:

I don't know what the maximum level of unemployment the Congress would accept in the interest of dampening inflation.

Congressional guidance could be useful. In specific, it would be useful to set forth a desired time path for decelerating inflation. Experience, mid-1969 to mid-1971 indicates that by braking M–1 growth, substantial progress can be made in checking inflation in what appears to be a relatively short time. But unemployment increased unacceptably in that episode. Slowing down the process by reducing the deceleration of M–1 growth could hold unemployment increases to acceptable levels.

Attempts to formulate a soft landing time path must, of course, take into account that the trade off between unemployment and inflation is a slippery one. Federal Reserve policymakers are not unaware of the problem. But despite this problem, we can achieve price level stability and full employment simultaneously if appropriate policy is developed.

President Francis of St. Louis said:

Dr. Weintraub, I honestly believe that if we would get busy searching out the longrun level of monetary growth that would facilitate what many economists refer to as the growth potential in this country, that we could indeed have an economy growing at its, what should we say, normal potential, with full employment.

Is the approach recommended by President Francis the right approach? Perhaps not. But at the least, it would appear to be worth ventilating. Many believe this approach is essential if the tide in our long battle with inflation and high interest rates is finally to be changed.

Concentrating on M–1 growth will require focusing the Open Market Committee's instructions on M–1 growth. At present the instructions are focused on money market targets as well as M–1 growth, and these can be incompatible. Often this results in confusion about what to do, as the following remarks by Governor Sheehan show.

We use both aggregates and interest rate tolerances for targets. So we take an eclectic approach.

Weintraub:

When you take this eclectic approach and look at two or more variables, up to five at the same time, it's only a happy accident when they're all behaving in the appropriate way or in the expected way.

Governor Sheehan, at a different point in the interview.

There have been periods since I've been here where we didn't feel that the desk manager was doing what we told him to do. Therefore we met and recon-

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sidered, and had vigorous discussions as to "Is that really what we told him to do, and is he interpreting our instructions correctly."

Focusing the OMC's instructions on M–1 growth would put an end to such confusion. It would permit the desk manager to achieve desired M–1 growth.

RECOMMENDATIONS

It is not easy to be sanguine about the Federal Reserve's focus being changed through internal debate alone. I say this notwithstanding that among the Federal Reserve policymakers interviewed, more than a handful are men of special candor and knowledge and courage. I say this because the entrenched intellectual traditions of established institutions are seldom if ever changed from within. For 60 years Federal Reserve policy has been dominated by the themes of the banking school. To wit:

(*a*) Vary the money supply so as to smooth shortrun fluctuations in money rates; prevent, as Paul M. Warburg put it long ago, "too low money rates in times of abundance as well as too high rates in times of scarcity."

(*b*) Furnish money to accommodate the "real needs" of Government and business. Thus President Kimbrel of Atlanta posed the question: "Well, I wonder from you, how do we anticipate, how do we wonder that we're going to accommodate an honest contract? At a period of time when interest rates are already high, we're trying to change the reserves, trying to slow the things down, already in a period—but these banks are actually committed to make further loans of substantial numbers."

Weintraub:

Isn't there the possibility, at least, that if, in a period like today, if the Federal Reserve supplies banks with reserves to make these additional loans that they have committed themselves to do, that this will lead to still more inflation?

Kimbrel:

Yes, I think the answer would be that obviously, you'd be contributing more and more to inflation.

The monetarist warning that policies based on banking school themes exacerbate longrun economic instability and cause too high, not too low interest rates in times of monetary abundance has not yet been heeded. What is needed is to bring the substantive issues involved out into the open to be debated fully and regularly.

Accordingly, it is recommended that Congress treat monetary policy in the same way as it is now about to treat fiscal policy. First, let the Federal Reserve annually request from the Congress permission to operate within specified M–1 growth guidelines, which, to retain limited flexibility to deal with shortrun problems, could be expressed in terms of the behavior of year-to-year growth for the next 12 months. Targets would be set for each of the next 12 months in terms of percentage changes from the same month a year ago. For example, 5 percent for the year ending next October, plus or minus 1 percent.

Let Congress hold hearings on the Federal Reserve's recommendations. The Federal Reserve should spell out the implications of alternative target M–1 growth paths on unemployment, inflation, interest

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rates, and such priority concerns as housing. Congress can then approve or modify the recommendations as desired.

Second, let Federal Reserve policymakers be responsible as individuals for reviewing last year's money supply behavior, explaining its consequences and specifying what changes they now would make in that behavior if they could go back and change their past decisions. A single review could be submitted to the Congress if there was no disagreement. But all presidents and Governors should be required to explicitly state their concurrence.

Third, let the full minutes of the Open Market Committee meetings be made public immediately or at most 6 months after they are held, deleting until another 6 months has elapsed all so-called sensitive discussions.

These recommendations can be viewed singly or as a package. The first recommendation to establish a target money supply growth path for the coming year in open forum would provide everyone with the same knowledge about long term monetary policy. Wage and other contracts could be negotiated more rationally as a result, that is, with full understanding of the extent to which monetary policy would or would not validate inflationary contracts. Households and business could plan their budgets with knowledge of the extent to which their plans would or would not be propped up by monetary policy. Those who buy and sell securities could also use this information. But there is no reason to think that buyers or sellers could obtain a net advantage from knowledge of the Federal Reserve's money supply target growth path. Moreover, as President Mayo of Chicago pointed out, as things now are, money market transactors know all they need to know about the Fed's intentions. He said

> The market indeed does have a fairly full understanding as to what the factors are in monetary policy that are going to lead to specific steps by the Federal Reserve. This happens to be a product in part of the fact that many of these people who are in the market, and in the position of making markets, have at one time either worked in the Treasury or in the Federal Reserve. *Indeed, there is also crossfertilization the other way.* So it is no great secret as to how you interpret what the Fed is doing and indeed, is trying to do. A number of the leading writers in New York, the Lehman Letter, Lanston's Letter, and so forth, are written by former Treasury, former Federal Reserve people, and they're very good in interpreting these things.

Incidentally, the italic there is not my own. The emphasis is from the transcript of the Chicago Bank.

The latter two recommendations would permit Congress and the public to better utilize the candor, knowledge, and courage of individual Federal Reserve policymakers. These recommendations moreover are in the tradition of the Federal Reserve Act, as initially enacted. Congress rejected the Aldrich bill which would have established a single central bank with dispersed operating branches. The Federal Reserve Act rather set up a system of 12 regional central banks supervised by a Board of Governors. Of course, the System has to act as a single unit in implementing monetary policy. But it is neither necessary nor desirable to submerge the views of individual policymakers in formulating policy or to relegate them to voices in the wilderness in overseeing it.

Finally, the thrust of all three recommendations is that those who are responsible for monetary policy will do a better job if, one, their

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parts as individuals in decisionmaking are made public while the decisions are still of vital interest to the public; two, they are compelled to regularly publicly review the consequences of past decisions in a format which permits airing dissenting views rather than only setting forth the consensus view; and three, they must annually arrive at and seek approval for their consensus money supply growth path.

In closing, it should be recognized that proper monetary policy is not a panacea. It can save us only from the consequences of inadequate monetary policy. In particular, no financial system, no matter how well structured and regulated, can function smoothly in a disruptive monetary environment. Our financial system has been in a state of irregular but recurring turmoil since 1966, the year after the inflation began, accommodated and fueled by rapid money supply growth. A year ago, the turmoil centered on so-called wild card deposits. Now it is focused on Citicorp's proposed variable interest redeemable note issue. It is, in the final analysis, futile to stop these innovations in mobilizing saving on the ground that stopping them will remove the threat to the growth and development of housing oriented thrift institutions. These innovations are not the cause of the malaise which now threatens thrift institutions. They are its manifestations. Stop one, and another soon emerges. If we want a financial system in which housing oriented thrift institutions can grow and function smoothly, we must first get a proper monetary policy. Only after money supply growth is controlled so that it is neither accommodative nor generative of either inflation or recession, can we hope to succeed in assuring the viability of thrift institutions; the allocation of credit for low- and moderate-income housing, and other priorities as Congress may establish; and the equitable treatment of small savers in the mobilization of saving. Being able to explore ways of improving our financial system in a noncrisis atmosphere would be one beneficial byproduct of achieving a monetary policy which is not destabilizing. The direct benefits, once again, I believe, would be greater economic stability, minimal unemployment and minimal inflation, and reasonable interest rates.

Mr. Chairman, may I have the long document inserted in the record?

The CHAIRMAN. Without objection, so ordered.

[The "Report on Federal Reserve Policy and Inflation and High Interest Rates," submitted to the House Banking and Currency Committee by Dr. Weintraub appears at the end of today's hearing and may be found on page 31.]

The CHAIRMAN. May I suggest, Dr. Weintraub—are these two statements reconciled to where they do not unnecessarily duplicate?

Dr. WEINTRAUB. Well, the shorter paper is a condensed version of the long one, so it might be all right just to put the long one in the record.

The CHAIRMAN. And leave the other one out of the record?

Dr. WEINTRAUB. Yes.

The CHAIRMAN. I want to ask you—you interrogated five members of the Board, is that right?

Dr. WEINTRAUB. All except Chairman Burns; and I did not interrogate Governor Daane either because he was at the time leaving the Board; and I did not interrogate Governor Wallich, who took Governor Daane's place.

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The CHAIRMAN. Yes, he just came in. Why did you not interrogate the Chairman?

Dr. WEINTRAUB. He did not want to be interrogated by me. We requested it, but he declined the request. You, I believe, did request it.

The CHAIRMAN. Concerning President Hayes, of New York, who is president of the New York Federal Reserve Bank, he occupies a different position from the other presidents. Congress passed a law in 1942 or 1943, I remember it, making him eligible to attend the secret sessions of the Board at all times and to participate just like a member—ask questions, present motions or anything else. In other words, he had all the power that a member of the Board had; is that not correct?

Dr. WEINTRAUB. I would have to accept what you are saying as correct. I did not ask him about that. I do know that the presidents are not all equal and he has more powers, privileges, and duties.

The CHAIRMAN. Did you interrogate Mr. Hayes?

Dr. WEINTRAUB. Yes, I did, but I did not ask him about that, sir. I do know that he is the vice chairman of the Open Market Committee, and as such he is a perpetual voting member of the Open Market Committee.

The CHAIRMAN. Does he attend—of course, he attends all of the Federal Open Market Committee meetings.

Dr. WEINTRAUB. Yes, but whether he attends some Board meetings or not, I am not certain. But all of the Open Market Committee meetings, clearly he does.

The CHAIRMAN. Mr. Hayes is the most highly paid member of the Federal Reserve System, is he not?

Dr. WEINTRAUB. Yes, I believe he is.

The CHAIRMAN. How much is his pay?

Dr. WEINTRAUB. I believe it is $90,000 a year at the present time.

The CHAIRMAN. And international expenses.

Dr. WEINTRAUB. He is going to be here tomorrow, and I think he could answer those questions himself, better than I can.

The CHAIRMAN. Anyway, he is the highest paid one. All of them cooperated with you, except the Chairman did not want to participate?

Dr. WEINTRAUB. That is correct.

The CHAIRMAN. What about the others who did participate? Were they of a one mind and school of thought?

Dr. WEINTRAUB. There were differences among them in my opinion, and some are superior to others.

The CHAIRMAN. Did you get all of the presidents of the Federal Reserve Board—I mean of the regional banks?

Dr. WEINTRAUB. Yes, I did. I got all 12 presidents.

The CHAIRMAN. Did you get any of the directors of the regional banks?

Dr. WEINTRAUB. No, I did not get any of the directors.

The CHAIRMAN. I think it would be well to consider asking you to get the directors, because the directors run the regional banks and the Federal Reserve Board gets money to operate from the regional banks. Of course, the Federal Reserve Board does not use much money. But, in fact, the members of the Board would not even get their expenses and their salaries if the regional banks did not appropriate the money for that purpose; it that not correct?

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Dr. WEINTRAUB. That is correct, yes. The Board gets its expenses by assessing the regional banks.

The CHAIRMAN. By assessing the regional banks? Then it is up to the regional banks as to whether or not they pay it? These regional banks, they have nine directors. Six of those directors are selected by the banks themselves, are they not?

Dr. WEINTRAUB. That is correct.

The CHAIRMAN. In the region? Like the New York or the San Francisco region?

Dr. WEINTRAUB. Right.

The CHAIRMAN. The six members that are selected, of the nine, are selected by the banks themselves. Did you ever see those ballots that they use?

Dr. WEINTRAUB. No, sir.

The CHAIRMAN. I have. We got them one time, and they are just like the Democrats or Republicans will use to select their nominees or select their officers. They select the first six directors, and then the Federal Reserve Board, of course—that is, a majority; that is, two-thirds of them, they can run the show—and then, you see, the Federal Reserve Board selects the other three. But the Chairman must be of tested banking experience.

Dr. WEINTRAUB. The Chairman must be.

The CHAIRMAN. The Chairman——

Dr. WEINTRAUB. I did ask about that, Mr. Chairman. I asked some of the presidents about the fact that the Chairman of the Board of Directors had to be a man of tested banking experience, and what drew me to that was, the first bank that I interviewed, whose president I interviewed, was the Boston bank. The Chairman of the Board of Directors there is one James Duesenberry, who is an economist of some note. I asked President Morris, you know, what sort of tested banking experience Professor Duesenberry had. He kind of indicated that this was a very loosely interpreted law, and we probably would be better off without it. I asked President Hayes the same question, and he said he thinks that if this were removed from the law, this requirement, there would be nothing lost and probably a lot gained.

The CHAIRMAN. They do not need it because they have six bankers on there, six selected by the bankers: three of them must be bankers, and the other three do not necessarily have to be bankers. But we polled all of them one time and about 90 percent of them were bankers.

Dr. WEINTRAUB. Right.

The CHAIRMAN. They have no problem about the other three, because the six directors selected by member banks determine the direction of the bank.

Dr. WEINTRAUB. I think there is no question but that the banking industry is overly represented on the Boards of Directors.

The CHAIRMAN. Do they not run the show? Is it not run by the bankers?

Mr. BROWN. Mr. Chairman, I think this is all very interesting, but the gentleman has gone to a great amount of work in interviewing people about monetary policy, and that is what his report relates to. I think we ought to have an opportunity to go over it. I know I have questions I would like to ask Dr. Weintraub.

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The CHAIRMAN. We are going to let each member——

Mr. BROWN. I think the discussion up to this point has not had anything to do with his report, but rather the niceties of the individuals and personalities of the people involved.

The CHAIRMAN. May I suggest to the gentleman that I do not try to substitute my judgment for his judgment in asking questions that are relevant and material, and these are relevant and material.

Mr. BROWN. Mr. Chairman, I do not have time to sit here while—if you want to have this discussion with Dr. Weintraub, I think that is fine. If we have time later on—but we have got so many things to do and we are taking time right now when we should be in Housing and Community Development Conference, things that are very pertinent to this Nation. I think we are wasting the committee's time by going into this kind of discussion when we have before us for consideration a very important and significant report by the gentleman who is the witness.

The CHAIRMAN. Certainly; I would agree with you 100 percent, but I think each member will, without dictation from the gentleman from Michigan or the gentleman from Texas, ask questions that he wants to that are relevant and material. In fact, I was just about finished.

Mr. BROWN. Is this the chairman's time for questioning?

The CHAIRMAN. Yes.

Mr. BROWN. When does your time terminate?

The CHAIRMAN. I consider it up now, because I want all of the members to have an opportunity to interrogate. In fact, I am proud of the fact that we started this in our committee, and when I was chairman. Now nearly all of the committees of the Congress have adopted it. They give each member an opportunity to interrogate the witness.

I will yield to Mr. Widnall for the purposes of interrogating the witness.

Mr. WIDNALL. Thank you, Mr. Chairman.

In section 4 of your statement, you contend that our attempts at resisting short term extraneous money market pressures are self-defeating and produce even worse pressures in a fairly short time. I was intrigued by this, and I would appreciate it if you would explain the ways we have been attempting to deal with the short term pressures, and elaborate the reasons why these attempts have been self-defeating.

Dr. WEINTRAUB. I will try to do that, Mr. Widnall.

What I have in mind here is, let us suppose that there is a sudden pressure from any source you might want to assume, which would, if left to itself, drive interest rates up somewhat, and that the Federal Reserve decides to resist this pressure. They try to keep interest rates from rising, at least very much, in the next week or 2 weeks. The way they do this is to increase their purchases of securities on the open market and supply banks with additional reserves. Their hope is that a small increase in reserves and a small increase in the money supply emanating from that increase in reserves is all that will be required to keep interest rates from rising.

However, that is an heroic assumption, and it is an heroic assumption for the following reasons:

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Suppose that you wanted to step up the money supply growth from 4 percent a year to 8 percent a year. You have to think in terms of a year. In today's terms, we have about a $280 billion money supply—let me round that up to $300 billion, just for the sake of argument. That would mean stepping up the money supply from 4 to 8 percent would require an increase of $12 billion above what it otherwise would have been in a year. But in a month, it is only $1 billion, and $1 billion is just not enough to swing interest rates very much one way or another. If you try to go beyond that, you are going to increase the money supply much too rapidly. What you will be doing is setting in motion these feedback forces—that is, the money will be used to buy goods and services which will make credit demands still more buoyant, and before you know it, interest rates will be even higher than they were initially. You will have fed the process, rather than resisted it. This is the point I was trying to make.

Mr. WIDNALL. The country went along for a rather lengthy period with a 2 to 3 percent annual inflation rate, which did not seem to be too disruptive; do you agree?

Dr. WEINTRAUB. I would agree that somewhere around 1 to 2 percent is probably tolerable in the sense that it may reflect close to zero inflation, because there is some improvement in the quality of goods each year and in the range of goods.

Mr. WIDNALL. So, I take it you would condone further inflation at this rate.

Dr. WEINTRAUB. I am sorry, sir?

Mr. WIDNALL. Then I take it you would condone further inflation at this rate.

Dr. WEINTRAUB. At 1 to 2 percent?

Mr. WIDNALL. Two to 3 percent.

Dr. WEINTRAUB. I modified your 2 to 3 down to 1 to 2, and I do not think I would like to see it above 1 or 2 percent.

Mr. WIDNALL. In addition, we have a growing population and a growing base of commerce. It has resulted in the growth of real GNP in the neighborhood of 4 percent per year over the years.

What level of increase would you condone in the money supply to accommodate this inflation and this growth?

Dr. WEINTRAUB. I would not accommodate the inflation, I would just simply have the money supply growing to accommodate the expected long-term growth of the economy at full employment, which would be about 4 percent a year; and I would aim for 4 percent. That would be my own preference, 4 percent a year.

Mr. WIDNALL. In August of 1973, the staff of the Subcommittee on Domestic Finance of this committee presented several proposals for consideration by the committee. Among these was a suggestion that the number of members of the Open Market Committee be reduced from 12 to 5. This is felt to be a possible solution to the problem that so many persons are involved in deciding what to do that minimizing internal disputes and frictions becomes an end in itself. I did not notice any reference to this problem in your condensed report. Nor did I notice any recommendation that would reduce the membership of the committee. What are your feelings on this matter?

Dr. WEINTRAUB. Let me say that in August of 1973, had you asked that question, I would have said, absolutely, let us reduce the member-

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ship to five—the number of Governors from seven down to five, and eliminate the role of the presidents. I truthfully no longer think this way. I think that the proper way of handling the problem is the way I have suggested now: to bring everything out into the open and to utilize the candor and the knowledge of some of the presidents. I think you should give them even greater opportunity to express their views, and this is the way that things could get changed.

Mr. WIDNALL. Thank you. I regret my time is up.

The CHAIRMAN. All right, Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Your statement is very enlightening, Dr. Weintraub. A lot of it is completely over my head, but I do have three questions that I would like to ask you, referring to your discussions on pages 20 to 24 of your long statement, and 39 and 50.

Your argument is that resisting money market pressures is both futile and self-defeating. Would you go over it again; why is it futile, why is it self-defeating?

Dr. WEINTRAUB. Yes.

It is futile because we really do not get much of a bang from changing the money supply insofar as the interest rates are concerned. Economists measure something called the elasticity of the money demand with respect to interest rates. All this means is the percentage change in money demand with respect to a percentage change in interest rates, holding everything else constant. If we turn that upside down, we get the percentage change in interest rates with respect to a percentage change in money demand or money supply.

Let us suppose that this is a very low number, like 10—that is, minus one-tenth, and then invert it: 10. This would mean that in order to get a change in interest rates of 10 percent, you would require a change in the money supply of 1 percent.

A change in money supply of 1 percent in a 1-month period of time is a step-up in the annual rate of growth of 12 percent you see. What is a change of 10 percent in interest rates? It is really not very much, especially if it is going to be short lived. That 12 percent per annum change in money supply is going to quickly cause interest rates to rise again because, as it feeds into the economy, as people now begin to buy goods with it, inventories will go higher, inventory prices will go higher, people who carry inventories will demand more credit and bid up the price of credit, which is the rate of interest. It becomes very quickly self-defeating, and this is why I say that.

Mrs. SULLIVAN. Can we stop inflation by raising the interest rates?

Dr. WEINTRAUB. No. I believe if we try to do it that way we are going to be misled. This, I think, has been the problem in the last couple of years, that we have tried to stop inflation by raising interest rates—and in fact, interest rates have been driven up by inflation. We have confused cause and effect.

I would agree, myself, with President Francis that the Federal Reserve ought to do what it can do, which is to control the money supply. This would not only control inflation, it would bring interest rates down, as well. Letting money supply grow too rapidly, on the other hand, raises the Federal funds and other rates, and in fairly short time.

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Mrs. SULLIVAN. Of course, the raising of the Federal funds rate is going to affect the interest rates on every other credit transaction, is it not?

Dr. WEINTRAUB. It certainly has a rippling effect.

Mrs. SULLIVAN. It costs the banks more money, so that they have to ask for more.

Why is the Federal Reserve fearful of concentrating on money supply control? What would happen if we slowly dropped M–1 growth to 4 percent per year? Would this not raise the interest rates?

Dr. WEINTRAUB. No, it really would not, in my opinion, for any time or in any amount that would be worth talking about. I think the Federal Reserve is fearful because, they would argue, it would raise the interest rates. But I think the evidence points in another direction. The evidence points to the fact that, by reducing the rate of growth of the money supply gradually, from, the rate we have had the past few years of around 7 percent per year to 4 percent per year—which could be done over a 6-year period, frankly; a half a percent a year—would not have any effect on interest rates as far as their going up is concerned. Rather, it would bring them down. I do not think you would observe interest rates to go up significantly or for long from this effect. Any roller coaster ride, as some have put it, would be a kiddie-car ride.

Mrs. SULLIVAN. I just have one more question.

President Eastburn's lament is that "there never seems to be a good time" to get money supply growth down. When do you think would be a good time, or have you any opinion on that?

Dr. WEINTRAUB. I do; and I think starting today would be the best time, I would think. I would simply start to bring it down. I think it is important to bring it down slowly, and not to move rapidly. That is the mistake that the Federal Reserve has made in the past so often, to cut the rate of growth sharply, like last summer, from an annual rate of roughly 8 percent to zero. That is a wrenching that the financial system cannot take. But to cut it from 7 percent to 6.5 percent in 1 year, and down to 6, and then 5.5 and 5, over a period of time, is exactly what it will take to purge the economy of inflation and to reduce interest rates at the same time, without disrupting labor markets, also.

Mrs. SULLIVAN. Thank you; my time is up. I would just like to throw this out: Do you think we see and can see a lowering of interest rates soon?

Dr. WEINTRAUB. Only if the Federal Reserve lowers the rate of growth of the money supply.

The CHAIRMAN. Mr. Brown is recognized.

Mr. BROWN. Thank you, Mr. Chairman.

Dr. Weintraub, I have enjoyed very much hearing your testimony, and having an opportunity to review your report. I think I tend to concur with you, if I understand you correctly, that you feel the system has reacted to acute situations rather than chronic problems and the policy has been to soften the ripples, rather than prevent big waves; and that it should deal with big waves, not with ripples.

I am not sure, though, that I follow how—your recommendation that the Congress become involved in hearings, because if you get the Congress involved, I think all you do is focus attention on the ripples rather than the basic problems. That has been my experience, at least in the Congress.

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Dr. WEINTRAUB. Could I comment on that?

Mr. BROWN. Certainly.

Dr. WEINTRAUB. I would say I do not really believe it. I think that probably I have more trust in you, maybe, than you have in yourself, and more trust in the Congress. I think that Congress will react to long-run problems, will focus on long-run problems, if it is done in this open sort of annual, regularized hearing program that I have suggested. I believe that if you do not, the public will force you to. I really believe——

Mr. BROWN. Let me say in that regard, that if you want a broader input, would it not be better to have this broader input, as you have suggested in your report, from those in all of the banks? The economists of the several banks and all this, who really have greater expertise? If we are looking at monetary policy in somewhat of a rarified, a puristic way, and not let it get engaged in these other things that are extraneous to our basic policy, would it not be better to have those who have greater expertise to be the ones that have greater input than people who are relatively unfamiliar with the problems, the purpose, and, really, the functions of monetary policy? Just let me throw that out.

You have said that you feel that, in developing this system, that it really should match the long-term increase in the gross national product 4 percent, I think you said—something of that nature—population, gross national product and so on. But what about severe distortions in the GNP? For instance, a Vietnam war at the same time as a bread and butter domestic program that was massive compared to what we had. When you have that kind of situation, you have substantial distortion by decisions made on the fiscal side—political side—political and fiscal. You have severe distortions which cause a severe distortion in the GNP for a relatively short period; what do you do in that situation?

Dr. WEINTRAUB. I would still increase the money supply at an annual rate of 4 percent a year. Let me try and go over this interaction between fiscal and monetary policy, if I can, once again.

If we have a very large fiscal deficit which is the result of a new program or a Vietnam war or something of this nature, it is clear that it has got to be paid for, and the payment in the real sense requires the transfer of resources from other uses to that use. Now, if taxes are uct 4 percent, I think you said—something of that nature—population, then the Federal Reserve makes the decision as to whether the Government will raise its funds by selling bonds on the open market, and bills, or by essentially printing the money—which the Federal Reserve would do by first having the Government sell the bonds to you and me, and the Federal Reserve would buy them from us.

Let us just take step one. Supposing the Treasury sells the bonds to you and me. All that would happen is that the Government would step up its spending on its new programs and the war, and you and I would lower our spending elsewhere and there would be roughly a balance. In the case of the Vietnam war, I think that maybe, of the, oh, say, 20 percent rise in the Consumer Price Index that occurred from 1965 to 1970, possibly 2, maybe 3, percent could be accounted for by simply the fact that we were using resources in nonconsumption uses—that is, to produce guns, rather than butter, as the old saying

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goes. But the remainder was monetary. What happened was that we were not allowed not to spend on beer and ice cream and so forth. The Federal Reserve decided, after you and I bought those bonds, that they would buy them back from us. They induced us to do so by bidding up the prices a little bit, and that expanded the money supply and gave us the money to go ahead and start bidding up prices of the usual goods that we buy in the consumption sector. So, we had inflation, and that resulted, incidentally, in requiring the Congress to pass supplemental and deficiency appropriations, because we thought we were getting so many planes for the money, and we found out we were not.

Mr. BROWN. I would like to pursue this further, but my time has expired. But before concluding, I have one question.

I notice in your report that you indicate some opposition to the legislation that is presently pending before this committee, dealing with the variable notes issued by Citicorp.

Dr. WEINTRAUB. No, I did not relate my discussion to that legislation. What I said was that if you stop this particular note issue from going ahead right now, it is not going to solve the problem. I think you have to face up to that. You still might want to stop it for certain shortrun reasons—that is, there is no question that what inflation does is it distorts the allocation of saving and credit; that is one of its most perverse effects. You have to expect those who are hurt by it to fight back, and I think that is what you find.

Mr. BROWN. You are saying you are not opposed to it, but you think would be ineffectual?

Dr. WEINTRAUB. Yes.

The CHAIRMAN. The time of the gentleman has expired.

Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

I want to express my gratitude, Dr. Weintraub, for your encyclopedic report and all the effort that went into it.

You say 4 percent is your preferred rate of growth for the money supply, narrowly defined. Most of the monetarists put it in terms of an upper limit of 6 percent. Do you reject that?

Dr. WEINTRAUB. No. Four percent would be my target. I would have a range around the target of 3 to 6 percent.

Mr. REUSS. Looking at your table 2, Dr. Burns and his Federal Reserve Board seem to have attained an M–1 growth in the year ending April of 7.2 percent, in May of 6.4 percent, and in June of 5.6 percent.

Putting those 3 months together, that comes out at about the upper limit which you just described. Would you say that, pipe or no pipe, Dr. Burns has done a reasonably good job in the last 3 months—drawing a veil of charity over earlier aberrations?

Dr. WEINTRAUB. Certainly the facts are on that side but I think I would put in a caveat here; I think we have to be very cautions. I would like to see this in October, and then in December. I think you will see the year-to-year figures higher then than they now are, and one reason is that the currency component of the money stock has been growing very rapidly, and it just is unusual that the public should be deciding to take more currency and less demand deposits right now, and yet that is what the figures seem to show. My guess is that the tracking problem, which I mentioned in the report, was

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still with us up until June—that is, the FDIC decided only in the end of June to solve this problem, by assembling data from all large member banks.

Mr. REUSS. Why all this itch for cash, as opposed to checking accounts?

Dr. WEINTRAUB. Well, I am suspicious, and I do not believe it, really, is what I am saying. Normally, people go for cash rather than demand deposits when they are fearful the banks are not going to survive. Maybe that is true today; I hope not.

Mr. REUSS. In your paper occur some comments and controversy between various Federal Reserve bank presidents on the matter of banks making commitments to give a certain amount of credit to a certain prospective borrower. The apologists for that tend to say these are contracts, and therefore the Fed has to accommodate these sacred contracts.

Actually, the idea of letting banks make whatever so-called credit commitments, good, bad, or outrageous they want to and then validating them is a sure-fire prescription for inflation, is it not?

Dr. WEINTRAUB. Yes, it is.

Mr. REUSS. What ought the Fed or anybody else to do about it?

Dr. WEINTRAUB. Well, I think——

Mr. REUSS. This practice is highly respectable but highly dangerous, it seems to me.

Dr. WEINTRAUB. I think this is one of the dangers of focusing on a money market rate like the Federal funds rate, and it is combined with another practice that the Federal Reserve has had in the past 6 years, I think it is, which is that banks are required to put up reserves behind their deposit liabilities of 2 weeks ago.

Look and see what this results in. Banks have these commitments, these advance loan commitments that they make. Now suddenly those who are on the other side of that contract come in and say, we want the loan. The bank says, fine, and they make the loan. The result is that deposits go up and the money supply goes up. Now 2 weeks later, the banks have to find the reserves to cover the deposits that arise from increasing these loans.

How do they do that? The answer is, they bid for Federal funds, and that drives up the Federal funds rate. The Federal Reserve sees the Federal funds rate up and says, oh, my goodness, this is terrible. We had better give the banks the reserves that they need to keep the Federal funds rate in line, and they just feed the process.

I would say that two things should be done. One is that you ought to make reserves and deposit liabilities concurrent. That is that banks ought to be required to put up reserves on today's deposits, even though the information problem is a little bit severe.

The second thing is they ought to stop concentrating on the Federal funds rate and look at the money supply. This is really the major thing.

Mr. REUSS. I have just one more question.

Faced with the aggregate money supply theory, which means that money gets tight and interest rates get very high across the board, a number of conservatives—Governor Brimmer of the Federal Reserve, Chairman Bunting of the First Pennsylvania Bank, the editors of Business Week, as well as myself—have suggested that a system of

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differential reserve requirements according to the type of loans by the bank might be one way of channeling credit where it is needed, away from inflation-producing causes and toward useful causes. What is your view on the validity of such a proposal?

Dr. WEINTRAUB. I think it is probably a good proposal. I think we ought to understand that most of the distortions in credit allocation, or a good part of them, that we are now disturbed about come from inflation. But even if we had no inflation, there would remain certain problems.

These are particularly acute in housing, especially for low-income people. There are other priorities that could be mentioned, of course. I think that if we used the sort of sniper's approach to handle credit allocation in these areas, that would probably be very useful.

Mr. REUSS. Thank you. My time has expired.

The CHAIRMAN. All right.

Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Dr. Weintraub, you have put together an excellent report. Do I understand your thinking to be that if we could control the increase of money supply with a 4-percent increase annually, that we could then control inflation?

Dr. WEINTRAUB. Yes, absolutely. There is no question in my mind about it. Let me comment on that a little bit further.

Since the time of Queen Elizabeth I, the world has never had an inflation without having money supply growing more rapidly than 4 percent a year. It is just a fact. Furthermore, whenever the money supply has grown faster than this rate, we have had an inflation.

Mr. WILLIAMS. The Fed has the power to control the money supply, and, apparently, they have been permitting the money supply to grow at a faster rate than 4 percent?

Dr. WEINTRAUB. Yes, absolutely correct. They have done this for a variety of reasons that I have spelled out, none of which I think is particularly valid.

Mr. WILLIAMS. Last year they cut the money growth back to zero from 8 percent, virtually overnight.

Dr. WEINTRAUB. They certainly did during the summer. I would never recommend that sort of a sharp turnaround. I think that creates all sorts of problems for thrift institutions and housing, in particular.

Mr. WILLIAMS. What happens if the Fed would hold the increase of money supply to 4 percent, and the Federal Government continues borrowing on the open money market billions of dollars? Then there is not truly an increase of 4 percent available for the American public, is there?

Dr. WEINTRAUB. I think—there's also another problem—supposing the Congress passes the law enacting a new program. Presumably, what Congress wants is this program to be properly funded and the goods that it's supposed to buy to, in fact, be bought.

This requires that real resources, labor and capital, be transferred from other uses to these uses that Congress has now specified it wants.

If the Federal Reserve increases the money supply more than 4 percent per year in such a case, the real resources simply will not get transferred there, because what will happen is inflation will develop,

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and Congress will think, well, we had a program that was going to buy us 100 widgets for $1,000, but now we find out with the $1,000 that we appropriated, we can only buy 60 widgets, and they have to come through with a supplemental appropriation.

Mr. WILLIAMS. What if the Federal Government, in order to meet its spending requirements, raises taxes rather than borrowing from the private sector?

Dr. WEINTRAUB. I think that in some cases that would be absolutely preferable if that were done that way. I am certainly not against balancing the budget.

Mr. WILLIAMS. Actually, on page 16 of your report, you say, "Requiring Government to raise the buying power it needs by bidding away savings from the private sector could crush out of the economy an amount equal to spending." In other words, what you are really saying is that the more that the Federal Government borrows, the more buying power or spending power they are crushing out of the private sector.

Dr. WEINTRAUB. There is no question that you can only enlarge the Government sector by—I would not use the word "crushing out," that was President Black's word—by taking the resources away from some other use.

Mr. WILLIAMS. But then you say that President Balles states that this would raise interest rates to astronomical levels. I believe you took some issue with the word "astronomical."

Dr. WEINTRAUB. Yes, and I think he too would not now use it. I think you might ask him that when he is here tomorrow. But I would say I have looked at this question carefully since going over the transcript of my interview with President Balles.

There is one experience that we have had in recent years that throws some light on it. It is 1968. In 1968 there was a swing in the Government's budget deficit of about $20 billion primarily as a result of a surtax that was enacted in June of that year. It went from a $25 billion deficit down to a $5 billion deficit.

You would have expected, if you held the view that interest rates would change astronomically, that this would result in a very large fall in interest rates at that time. But what in fact did happen—and I went and I looked it up and the Treasury bill rate in June of that year was 5.54 percent. In August it had reached 5.10 percent; it fell 44 basis points and by December, it was back to 5.92 percent. It was higher than initially.

The result is that I would conclude that there is no evidence that a swing in the Government's deficit of even $20 billion is going to have very much effect on interest rates, certainly not in any longrun sense, not longer than 2 months.

Mr. WILLIAMS. Not unless the elimination of deficits became part of our long-range plan and we then had no deficits.

Dr. WEINTRAUB. I think that over a 1,000-year period or a 100-year period, I would prefer to see the Government's budget balanced. There are particular years when it would go out of balance because of a variety of events over which no one has any control.

Mr. WILLIAMS. Dr. Weintraub, thanks very much. Again, let me commend you for an excellent job.

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Mr. BARRETT [presiding]. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Thank you, Dr. Weintraub. If and to the extent that there are price increases in commodities, particularly imported commodities—and naturally, you think of oil being the prime example—how can we control that kind of inflation by our money supply?

Dr. WEINTRAUB. I am glad you asked that question. I really am, because I think it is a terribly important one.

I think we have to distinguish between a risen price and rising prices. There is no doubt in my mind that if the anchovies flee from the coast of Peru as they did a couple of years ago this is going to drive up the price of anchovy meal, and then competing substitute products like soybean meal and all derivative products from that, like cattle and so forth. This will cause by itself, at most, a once-for-all increase in the price level. In fact, it is not likely to be a permanent increase. That is, prices might go up one year from 100 to 104, let us say, on an index, but it would not go up to 108 the following year. The anchovies can flee from the Peruvian coast only once. Indeed, if they return, or if we begin to plant more soybeans throughout the world, you are going to drive that price and the index as well back down.

The only way you will get inflation built into the system as a result of this event is if the monetary authority and the Federal Reserve reacts in the first instance and says, oh, my goodness, the price of anchovies went up, and now we see this reflected in the consumer prices being higher; and pour in money to validate that. That assures that you are going to get not only a risen price but a rising price, when in fact what you could have gotten was a risen price for a short period of time, and then it decayed back to where it was initially.

Mr. MOORHEAD. I see. Why do you use the narrow definition of money supply, the M–1?

Dr. WEINTRAUB. I suppose that is just an old bias of mine, but I could have used M–2 and the results really would not be particularly different than they were with M–1. You know that Milton Friedman, under whom I studied, does use M–2.

I use M–1, I think, really because I look upon money as being something which is a medium of exchange, and the only things that qualify for that are checking accounts and currency.

Mr. MOORHEAD. On page 5 of your oral testimony, you talk about the FDIC giving information to the Fed on large nonmember banks.

Would it not be better, and workable, to have it on all banks, not just the large ones in their system?

Dr. WEINTRAUB. It certainly would. I think the reason they did not is because there is a cost of a bank filling out these forms, and the costs can be burdensome to a small bank. So if the results prove good just assembling the data from the large banks, well and good, and they will continue with this. If they do not, I think they would go to the small banks as well.

Mr. MOORHEAD. Suppose the figures on your table 1 indicate—and I grant you that it is only an indication—that the Fed has brought the increase in money supply down in recent months. Suppose they did hold to this 4 to 5 percent increase.

What would you expect interest rates to do in the short term, in the 1 month, 2-month period, 6 months, 1 year, 2 years, if they held it there?

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Dr. WEINTRAUB. If they held it right now, I would expect interest rates, starting from now, really, to go down.

Mr. MOORHEAD. It would not be a short term up?

Dr. WEINTRAUB. I think any upturn that we would have in them has already taken place. I think it is all over with, and we might just as well hold to where we are right now, and we can now expect things to start going down. I would think that if you dropped down, say to 3 percent, from this level, you might have a rise of 20 basis points in the Treasury bill rate over a 2-month period, and then things would again begin to come down, and by 6 or 7 months, it would be falling.

Mr. MOORHEAD. I see. Because I thought there would be an up-kick. But I guess you are saying that it is your testimony that you would have to go below 4 percent before you would have a short term upswing?

Dr. WEINTRAUB. I am not disagreeing with you on what you are saying. What I am saying is that the money supply deceleration that occurred in May and June may already have given us whatever up-kick we were going to have. In other words, from a slowdown in the rate of growth of money supply, we can expect a very small temporary rise in interest rates.

We have had the slowdown in money supply, if we can believe these figures, in May and June. We have had a small rise in interest rates. You may say it is not a small rise, but it is from May. In fact, Treasury bill rates are down from May. You know, in the middle of May they were 9 percent, and they are now below 8 percent. Commercial paper rates and the prime rate, of course, are up.

In other words, I think whatever roller coaster ride was going to happen from following this policy, the upside of it has already happened.

Mr. MOORHEAD. Because my time has expired, I will ask you a question, and could you submit your answer for the record?

On the bottom of page 17, you say, "Federal Reserve policymakers for the most part were wary of Cagan's findings."

My question to you for the record will be, "Why?"

Thank you very much, Mr. Chairman.

[In response to the request of Mr. Moorhead, the following information was submitted for the record by Dr. Weintraub:]

REPLY RECEIVED FROM DR. WEINTRAUB

Federal Reserve policymakers do not accept that the average size of the fall in interest rates from increasing money supply is as small as Cagan found or that it reverses as quickly as Cagan found. Moreover, they stress that the size and duration of the fall will depend on the conditions that prevail when money supply is increased and that therefore looking at the central tendency can be misleading. But, they offer no evidence which contradicts Cagan's results on the central tendency, and furthermore themselves stress that in inflationary periods (e.g., now) the size and duration of the fall are likely to be "smaller and shorter" than on the average. I would add that, even disallowing any and all feedback, which is unrealistic, to decrease the commercial paper rate, which is now about 12%, say to 10% in a three months period, would require a step up in M–1 growth of 17 percentage points per year if the interest elasticity of money demand is as low as —.25. It should be obvious that it is difficult to get back to a 4 percent per year growth track if you move up to 21 percent for three months. It is a little like the dieter who goes off the diet for "just" a few months never being able to lose weight. Finally, because feedback starts immediately, in this case going off the diet is unlikely to be as tasty a "binge" as contemplated, that is, stepping up M–1

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growth from 4 to 21 percent per year won't actually reduce the commercial paper rate from 12 to 10% (with elasticity = —.25) because feedback from the step-up in money supply starts immediately to pull up with interest rates.

Mr. BARRETT. Dr. Weintraub, you are a very fine witness. You have heard it from both sides. They are very much pleased with your report.

One short question I want to ask you, in your interviews with these various presidents. Did any of them indicate that any of them knew anything about Citicorp before it was announced?

Dr. WEINTRAUB. None of them knew, and certainly, I was not aware of this and did not ask about it.

Mr. BARRETT. In other words, the whole country knew on the same day?

Dr. WEINTRAUB. Yes. Of course, these interviews took place quite some time ago. I think you might want to ask that question of the presidents, whether they had information, say, 6 weeks ago.

Mr. BARRETT. We asked that question yesterday to all of those who were here. They said no, they learned of it only about the first few days of July, indicating nobody had heard anything or learned anything about the plan being in the works until it was announced publicly. Everybody knew, the public and the bankers alike, at the same time.

Dr. WEINTRAUB. It was a well-kept secret.

Mr. BARRETT. Thank you very much for being here as a witness this morning.

The committee now will stand in recess until 11 a.m. tomorrow morning, at which time we will have Federal Reserve bank presidents, Balles of San Francisco, Eastburn of Philadelphia, and Hayes of New York.

[Whereupon, at 12:10 p.m., the committee was recessed, to reconvene at 11 a.m., Wednesday, July 17, 1974.]

[The "Report on Federal Reserve Policy and Inflation and High Interest Rates," submitted by Dr. Robert Weintraub, follows:]

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REPORT ON FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES, SUBMITTED TO THE HOUSE COMMITTEE ON BANKING AND CURRENCY BY DR. ROBERT WEINTRAUB, STAFF ECONOMIST, JULY 12, 1974

This "Report on Federal Reserve Policy and Inflation, and High Interest Rates" is a preliminary and boiled-down version of a larger Report now being prepared on this and related questions. Like the larger Report, it is based on interviews with the twelve Reserve Bank Presidents and five members of the Board of Governors. The interviews were conducted last December, January, and February. The larger Report will utilize also testimony from these hearings.

Part I of today's Report excerpts explanations of the proximate causes of the waves of inflation which have hit our economy since 1964. Special attention is given to the part played by the Federal Reserve, in either contributing to it or holding it back. Part II probes behind the policies which were pursued that contributed to inflation. It gives Federal Reserve policymakers' views on the reasons why these policies, especially the monetary policies, were followed. Part III presents views on interest rates. Current substantive issues, as revealed by the interviews, are taken up in Part IV. Some recommendations are made in Part V.

I. Inflation, the Proximate Causes

From 1965 to 1973, the Consumers' Price Index or CPI and the M–1 money supply (publicly held currency and demand deposits) grew 3.2 and 3.3 percentage points, respectively, faster per year than in the 1959–1965 period. In the earlier period, M–1 growth measured 2.5 percent per year and inflation, 1.3 percent. In the 1965–1973 period, M–1 growth jumped to 5.8 percent per year and inflation to 4.5 percent.[1]

But, with some exception, Federal Reserve officials did not assign monetary policy the dominant role in the inflation which has afflicted our economy since 1964. With respect to the 1965–1973 period as a whole, the following quotes are representative of the majority view.

MacLaury (Minneapolis):

> I would ascribe this much more to the difference in the economy and public policy in its broader sense of war, non-war periods.

[1] M–2 growth jumped 3.1 points between 1959–64 and 1965–73, from 5.3 to 8.4 percent per year. (All calculations are December to December.)

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Morris (Boston):

> I think the primary causal force has been an excessively expansionary fiscal policy, beginning in late '65 and continuing to the present date.

Hayes (New York):

> We came quite decisively into a *demand-pull inflation* in about 1965. We have the feeling that demand was ample, if not perhaps getting close to excessive, in '65, before the Vietnam speedup, and when that speedup took place, it just was the decisive thing that broke the back of the previous relatively stable record, and from then on, the tendency was to have too much demand in the economy.

From January 1972 to July 1973, M–1 growth (seasonally adjusted) was 8.6 percent per year compound, more than twice as fast as the 4 percent per year norm corresponding to our long term output growth potential, and moreover, nearly 50 percent faster than the upper guideline of the Joint Economic Committees' 2–6 percent per year range for M–1 growth which allows for *reasonable* deviations around the norm.* Nonetheless, the sharp jump in inflation in 1973 often was explained as due primarily to special factors. These quotes are representative.

Hayes (New York):

> And, of course, the extent of the inflation in 1973, I think, went far beyond what you'd expect from those demand-pull influences because you had suddenly thrown in along with that influence all these special factors, like the world food shortage and the fuel shortage. And the effects on our own economy of devaluation; and the simultaneous boom conditions in most of the major industrial countries, having an impact all at once on commodity prices. I think all these special factors were primarily responsible for the very drastic speedup we've had in 1973.

Governor Sheehan:

> Let me talk about what I think the causes of inflation have been for the last 12 to 18 months. We've had a devaluation during that period which has been inflationary . . . Farm products were in short supply around the world. Another factor is that we had all the major economies of the world moving up at the same time and closely in phase. The European and Japanese economies are much larger and more industrialized now relative to the U.S. than in the past and competed more strongly with us for some raw materials at a time of shortages.
>
> So you've got a food shortage, raw material shortage; and then you had the Arabs throttle the oil supply. Now, what did the Central Bank have to do with that? Nothing. And it has had very little to do with the devaluation except to advise the Treasury from the sidelines on its actions. So you have surging prices.

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*I am indebted to Milton Friedman and Clark Warburton for sharpening my understanding of this episode.

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But some assigned substantial part of the 1973 inflation to monetary and fiscal policy.

Morris (Boston):

> I asked my research staff to run the St. Louis model, which is the only way I could think of to quantify these things, and to tell me in the past year—that is, the fourth quarter of '72 through the third quarter of '73—how much inflation the St. Louis model would have projected on the basis of the monetary growth rate and the Federal government fiscal policy. The model indicated, on the basis of these monetary and fiscal factors, that we should have had an increase in the GNP deflator of 3.8 percent. The actual figure was 6.8 percent. The other 3 percent came from the shortage of food, the impact of the devaluation which was a major factor, and now the energy crisis.

The contrast in views was most marked in assessing the relative contributions to inflation of fiscal and monetary policy. For example:

Governor Mitchell:

> Now as far as the last half of the 60's are concerned, and early 70's, I think that the major problem was the war in Vietnam, and I think that, more than any other single factor, conditioned the results that we got on the price front. I would say that monetary policy in this period had spurts of restraint and spurts of ease.

Mayo (Chicago):

> I feel that fiscal policy is still the biggest contributor to inflation and, at the same time, the number one instrument for inflation control.

But President Francis (St. Louis) did not agree. In his view:

> When a change in government spending that creates deficit in the government accounts occurs, there may be some small impact on the real economy but not too much. I think the key factor is when the central bank moves in to support the borrowing, and injects what I call "new money" into the economic system. Treasury borrowing alone would be more of a transfer of money from the private sector to the public, you get that I think with any period of Treasury borrowing, but when you interpose new money on top of that, or too rapid increase in the rate of monetary expansion, I think this is the kicker on inflation.

The chain of events that links inflation to Federal Reserve policy usually starts with open market purchases. Open market transactions are the principal instrument of Federal Reserve policy. The following excerpts from the interviews describe what happens:

Black (Richmond):

> Well, to generalize, very simply, which I gather is all you want at this point, if you start supplying reserves at a more

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rapid rate, this means that the banks are going to be in a position to begin their lending and investing activities at still a higher rate. And this is going to be reflected in a growth in their liabilities, either in the form of time or demand deposits and probably there will also be an increase in the supply of currency held by the public. And all of these factors are going to work towards increasing spending . . .

Weintraub:

All right. Now, just to flush this out just a little bit more, the increase in spending would, of course, impact on both output and prices, and the partitioning between them would depend critically I suppose on how close we were to full employment or how much slack there was in the economy.

Black:

Right. Hopefully you have physical output growing at the same rate as your spending. But sadly that seldom happens.

Governor Holland:

Other things being equal, the more monetary stimulus that's pressed into the economy, the more response you get in terms first of real output, and then as you get close to capacity, the more that expansion spills out in prices . . .

As indicated by President Black and Governor Holland, accelerated money supply growth stemming from stepped-up open market purchases, acts to accelerate inflation. This is the fundamental proposition of monetary theory. There is wide agreement on its validity at least as a long-run matter. President Eastburn (Philadelphia) used it to synthesize monetary and other explanations of price developments in the 1965–1973 period.

Eastburn (Philadelphia):

First of all, I think that it should be said that over the whole period, not dividing into these subperiods and consistent with the position that I stated earlier, that in longer run periods, I think that it can't be denied that the rate of growth of money affects prices. Over this longer run period, that relationship has existed. You might be interested in this chart [Chart A]. It plots percentage changes in the GNP price deflator and a three-year moving average of the percentage changes in the narrowly defined money stock.

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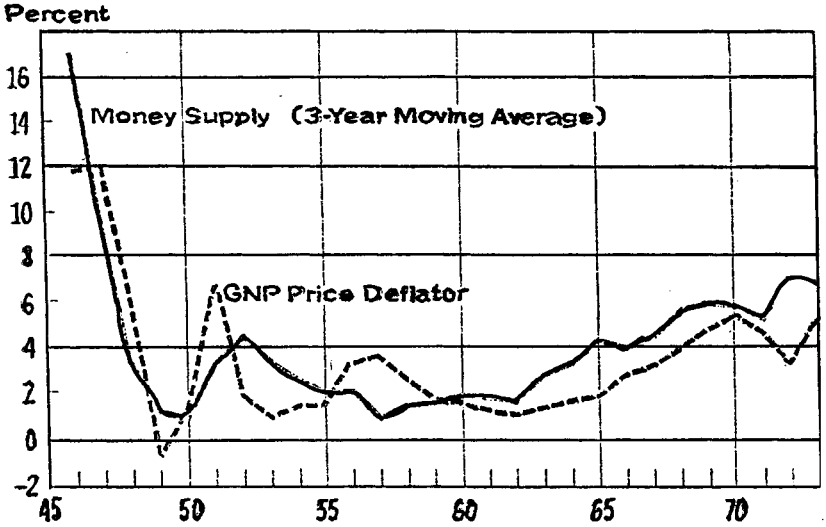
CHART A

Money Supply Growth and Inflation



Weintraub:

Yes, beginning in 1962, the money supply growth begins to rise and it proceeds rapidly in 1965, and the deflator begins its move up at that time.

Eastburn:

Well, looking at the whole period, that's been the case. You have had rises in money growth and rises in prices, and I think the two are related. Now, when you get to subparts of that and you narrow down the time frame, then you get other elements affecting inflation. For example, in the middle and late 60's, that part of the failure to contain prices can be attributed to lack of an appropriate fiscal policy which the President and Congress failed to put through. During more recent periods, I think it can be attributed to special factors such as crop failures, world-wide demands for goods, shortages of materials and energy and so on, which we're seeing now. So, that in the shorter periods, you get these special

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factors which either are superimposed on the money phenomenon or override it, and these can be used to explain specific developments in those shorter periods.

To recapitulate President Eastburn's synthesis, while fiscal policy and special factors may account for changes in the rate of inflation for short periods, in the context of a period as long as 1965–1973, inflation is a monetary phenomenon, and its rate depends on the rate of growth of new money. But, moreover, response by the Governors and Presidents to questions on specific policy actions and trends in monetary policy during the 1965–1973 period reveal that even in fairly short run contexts, there was a close-lagged relationship between money supply changes and changes in economic activity including the rate of inflation.

1965–mid-1969:

Inflation did not happen all at once nor did it occur in a uniform continuous wave. In the year ending December 1965, the CPI rose 3.4 percent. Then, after rising 3.9 percent per year in the first nine months of 1966, the rate of rise of the CPI slowed to 1.4 percent per year in the fall and winter of 1966–67. It then re-accelerated and reached 6.3 percent per year in the first seven months of 1969. As shown in Tables 1 and 2, during these years, M–1 growth was accelerated until April 1966, slowed from then until January 1967, sharply re-accelerated for two years, reaching 6.1 percent in the year ending October 1967, 7.1 percent in the year ending January 1968, and 8.1 percent in the year ending February 1969, and then slowed to an average of 4.2 percent per year until July 1969.

Referring to this period, President MacLaury (Minneapolis) said:

> Certainly in retrospect, looking back on that period . . . monetary policy during the period should have been tighter than it was. I certainly go that far.

Hayes (New York):

> We always have to walk this fine line between combating inflation and taking undue risks of setting in motion recessionary forces. And we did apply the pressure in 1966, and you recall the famous credit crunch which to some extent reflected that effort. Obviously, in the absence of fiscal support, monetary policy has a harder burden and can't be expected to do the job by itself effectively; and when we did see business slowing down, we reacted in early '67. Perhaps we reacted a little too much in our fear of a recessionary development which turned out to be very temporary and not very serious. Then, in 1968, when we finally did get the fiscal support, monetary policy was fearful that the fiscal move maybe was too strong. That turned out to be a failure in judgment. I can come back to that later because there were differences of opinion within the System at that time, but the majority view was that we should slacken up, and we did slacken up somewhat.

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TABLE 1.—MONTHLY PER ANNUM M-1 GROWTH RATES, 1959-1964 AND 1965-1974

	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
January	9.4	(0.8)	1.7	1.6	4.8	3.1	3.7	9.1	0.7	5.1	7.1	10.4	3.3	1.5	4.7	(2.7)
February	2.5	(3.4)	4.2	1.6	2.4	3.1	.7	4.2	12.3	6.4	7.7	(5.7)	13.0	13.8	5.6	12.9
March	5.1	(.8)	2.5	3.2	3.2	3.8	3.6	4.9	8.8	5.1	4.1	9.7	10.2	8.5	.9	11.0
April	1.7	1.7	3.3	2.4	3.9	1.5	2.9	14.6	(4.1)	5.7	4.7	9.1	9.0	7.5	6.0	8.7
May	5.0	(3.4)	4.1	0	4.7	7.6	2.2	.7	12.1	12.0	4.1	5.6	13.2	4.0	13.9	5.2
June	2.5	.8	2.5	.8	5.5	3.8	6.5	1.4	10.0	10.6	4.1	3.9	9.9	6.9	14.2	4.7
July	5.8	5.9	.8	(1.6)	4.7	8.3	4.3	(4.1)	9.3	7.4	4.1	5.6	7.2	11.8	4.1	------
August	[1](3.3)	5.0	2.5	(1.6)	.8	6.0	2.2	(1.4)	6.6	5.5	(2.9)	6.7	1.0	6.3	(.5)	------
September	(2.5)	2.5	4.1	(.8)	3.1	6.7	8.6	6.9	7.2	7.3	2.3	10.5	1.5	7.7	(3.6)	------
October	(3.3)	0	4.1	4.0	5.4	4.4	8.5	(4.1)	6.5	7.3	3.5	5.5	4.1	8.7	5.0	------
November	(.8)	(.8)	4.9	4.8	8.5	5.2	4.2	.7	3.9	10.9	3.5	4.4	(.5)	6.2	11.7	------
December	(2.5)	0	2.4	3.2	(3.1)	.7	6.3	2.1	4.5	7.2	(.6)	3.3	2.0	14.7	9.8	------

[1] Denotes negative growth.

TABLE 2.—YEAR-TO-YEAR M-1 PERCENTAGE GROWTH, 1965-74

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
January	4.7	5.1	1.6	7.1	8.0	3.8	5.4	6.2	9.0	5.5
February	4.5	5.4	2.3	6.6	8.1	2.9	6.8	6.2	8.3	6.1
March	4.5	5.5	2.6	6.2	8.0	3.4	6.8	6.4	7.3	7.0
April	4.6	6.1	1.4	7.1	7.9	3.8	6.8	6.2	7.2	7.2
May	4.2	5.8	2.5	7.1	7.2	3.9	7.5	5.4	8.1	6.4
June	4.4	5.3	3.7	7.1	6.6	3.9	8.0	5.2	8.7	5.6
July	4.1	4.6	4.4	7.0	6.3	4.0	8.1	5.6	8.0	------
August	3.7	4.3	5.1	6.9	5.6	4.9	7.6	6.0	7.4	------
September	3.9	4.2	5.1	6.9	5.2	5.6	6.8	6.6	6.4	------
October	4.2	3.1	6.1	7.0	4.8	5.6	6.9	7.0	6.1	------
November	4.2	2.8	6.3	7.6	4.2	5.7	6.4	7.6	6.6	------
December	4.6	2.4	6.6	7.8	3.5	6.0	6.3	8.7	6.1	------
Yearly[1]	4.3	4.5	3.7	7.0	6.3	4.5	7.0	6.4	7.4	------

[1] Average of monthly M-1 stocks this year divided by preceding year's average.

Morris (Boston):

The last half of '68 was clearly a misjudgement.

Coldwell (Dallas):

As I recall that period you're citing in there, up through '69, there was a considerable uncertainty as you may remember on the surtax question of Congress that was delayed for about 18 months. When it finally was passed in July of 1968, there was a lot of talk about overkill and putting the economy into a severe restraint. There were those of us who were on the Committee at that time who did not see it that way, but the overall total was a move toward ease. Then, of course, we reversed within a six-month period.

August 1969–January 1972:

From August 1969, to January 1972, inflation tapered off. The annual rate of rise of the CPI dropped from 6.3 percent in the first seven months of 1969, to 5.9 percent in the remainder of 1969, to 5.5 percent in 1970, to 3.9 percent in the first seven months of 1971 just before President Nixon's New Economics Program was put into effect, and to 2.9 percent from August 1971 to January 1972. M-1 growth was slowed beginning in the winter of 1969 and the deceleration continued until February 1970. In the year ending February

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1969, M–1 growth was 8.1 percent. The next year, it was 2.9 percent. After February 1970, M–1 growth was again stepped up; rapidly until early 1971 and very sharply until July. From July 1971 to January 1972, there was little growth in M–1. This subperiod provides clues on the policy pressures, time dimension and tolerances required in unwinding from inflation.

Weintraub:

> Let me show you a chart that I think is very interesting, that I also have drawn up. This one uses year-to-year price changes in the Consumer Price Index, and it runs from September 1968 to July 1971, a period of thirty-four months. You'll notice it's almost a bell-shaped curve, peaking in February 1970. That is the month that marks the highest year-to-year change in consumer prices in this period. All right? [2]

MacLaury (Minneapolis): "Yes."

Weintraub:

> It takes seventeen months for the Consumer Price Index to go from a rate of increase of 4 percent per year up to 6.4 percent, and seventeen months to get it back down, which is an interesting thing. Now I use 7–71 because of an obvious reason, which is that it is the last month before the freeze. So it strikes me perhaps we had inflation licked, at that time,

[2] Chart I replicates the chart referred to.

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due to the fiscal and monetary policies that were being followed, although there was something of a recession. Would you agree that there at least was this very strong tapering off?

MacLaury:

The numbers speak for themselves in that respect.

A caveat is in order before proceeding. Wholesale prices behaved differently during this period. The annual rate of rise of the WPI decelerated from 5.5 percent in the first seven months of 1969, to 4.0 percent in the remainder of 1969, and to 2.3 percent in 1970. But in the first seven months of 1971, it accelerated back to 5.6 percent.

On this period, President Hayes (New York) said:

And we did see some progress, as you've indicated, in the following years in the slackening rate of inflation. But it wasn't enough progress—it was rather discouraging, in fact, and it seems to us that we had a cost-push inflation which had been generated by the previous inflationary experience . . . As the real economy began to slow down, we were much more loath to apply the pressure.

Francis (St. Louis):

. . . In '69 the Fed slowed down the rate of money creation and held it down to a degree through 1970. We saw during that period, I would say, some wrenching in the economy . . . we had some small influence, I think, also on the inflation rate—it began to taper off.

From January 1972 on:

From January 1972 to the summer of 1973, M–1 growth was very rapid. Year-to-year growth was 9.0 percent between January 1972 and January 1973 and 8.0 percent in the year ending July 1973. Some felt, nonetheless, that monetary policy was not a strong inflationary factor during this period—though not endorsing it as sufficiently restraining especially in retrospect.

President Hayes, recognizing that the strength of demand-pull forces turned out to be stronger than expected, stated that:

This happened in the face of strong efforts by monetary policy to fight inflation, commencing back in '72 and getting stronger through the first half of '73 . . .

Weintraub (in a question put to Governor Bucher):

We seem to have embarked on a path in the last few years which has taken us away from this long-run growth of the money supply which is consistent with minimal inflation and full employment with absorption of labor force growth and productivity. At least I think that that is what has happened in the last few years.

Governor Bucher:

I wouldn't agree with that. There have been some circumstances that have caused some problems. There have been other factors in the economy that have made us adjust our

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thinking a bit at certain times. At least as long as I have been here, I have felt the objectives have not been inconsistent with the type of program you have in mind.

Weintraub:

I think the objectives may be there, but the results I'm not so sure about, as far as the money supply is concerned anyway I know that . . .

Governor Bucher:

I think generally we've done a pretty good job, money supply wise. That is, of course, my opinion.

Governor Sheehan:

If you measure real growth in narrowly defined money, it was about the same as the real growth in the economy. So by this measure, at least policy was not stimulative. In one recent period we measured, we had something like 7.4 percent real economic growth and 7.6 percent growth in money—M–1. So we weren't flooding the economy with liquidity, just as Art Okun has said.

Mayo (Chicago):

The expansion of the money supply, I believe, can be fairly stated as being consistent with the expansion of real growth that took place in the calendar year 1972, on the rough order of 7½ percent in each case, if I remember my figures correctly.

Others interviewed had different opinions:

MacLaury (Minneapolis):

I think that the—certainly my reading of Fed policy intentions, starting with mid-'71, which is when I came into this slot, we did look upon the price freeze and subsequent incomes policies, price and incomes policies, as permitting us some leeway to have an expansive policy in that period of high unemployment than we could have without those policies. I think that's a fact, as I understand it.

Clay (Kansas City):

I think you can explain that pretty easily—may not like it, but I think you can explain it on the basis that overly optimistic expectations as to the effectiveness of Incomes Policies that resulted in less cautious fiscal and monetary actions after you get into your Incomes Policy.

Governor Holland:

With hindsight, had we been sure in the summer of '72, that so strong an upsurge in private demand was due to happen through the fall months and the winter of 1972 and 1973, I am sure we would have followed a less expansive monetary policy.

MacLaury (Minneapolis):

Beginning mid-'72, some of us, myself included, became increasingly concerned by the rate of growth in the money sup-

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ply and other things that we saw going on in the economy, and I can't remember what month it was that I succeeded in casting at least one negative vote in that committee, saying that I felt our policies were overly expansive. So that, I left the bandwagon about mid-'72, saying that we should be pursuing a more restrictive policy, in terms of monetary growth, than we were in fact pursuing. I have felt that was true; well, I think in retrospect, that has been vindicated.

Governor Brimmer:

I am on the published record for all of this. Beginning on September 1, 1972, I indicated my view of what I thought the Federal Reserve was doing and started voting "no." The issue came up in connection with the Board's consideration of the proposed discount rate. The Board disapproved increases in the rate some eight times between September 1 and December 18, 1972. That was a real debate. There was some debating in meetings of the Federal Open Market Committee but the real issue, the cutting edge in 1972, was over the discount rate. . . . In my view many policy actions taken during much of 1972 were improper, and rather than fighting inflation they were adding to it.

1967 Until Now, the Monetarist View:

Francis (St. Louis):

Then we did go through the two-year period of 1967 and 1968 at rates of money expansion somewhere around seven percent, as I remember. And we saw the economy grow I guess at pretty rapid rates, and we saw the rate of inflation pick up constantly through that period. In mid-'68 the Congress finally acted to increase taxes as one means of trying to fight the inflation that was developing, and there were many I think who believed that a balancing of the budget alone at that time through a shift to higher taxes might set off an instant recession in the economy. Some of us who look more closely at money argued that unless the rate of monetary expansion slowed with the fiscal action probably nothing really was going to happen. And I think history proved that point. The rate of inflation continued to grow throughout 1968, and then we went into the next period you mentioned when in '69 the Fed slowed down the rate of money creation and held it down to a degree through 1970. We saw during that period, I would say, some wrenching in the economy, not as bad as we have in some other times during history, but dropped the rate of real production down into the zero area for a quarter, or two, or three. But we had some small influence, I think, also on the inflation rate—it began to taper off. But there again, following 1970 and beginning in 1971 and running right up to the present time, we have seen a monetary expansion somewhere in the area of seven percent annual rate on M–1, and we have seen inflation, while slowed, temporarily, come right back into the picture and reach the highest level we have seen in a great period of time.

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The Next Question

Referring to data showing a strong association between money supply growth and rates of inflation both among different countries in the same time period and over time in the United States, I said to President Black that, "I would come to the conclusion that money supply is very important for understanding prices. Would you agree with that?"

Black (Richmond):

> I would agree completely. But so far as saying that that is the sole cause, that's another question. You've got to go behind why the money supply did what it did.

II. Why Money Supply Grew As It Did

Why did M–1 grow as rapidly as it did from early 1967 to early 1969, from early 1970 to mid-1971 and from January 1972 to mid-1973? Many stressed, as the preceding excerpts show, that mistakes were made in predicting that fiscal overkill would develop rapidly from the surtax of mid-1968, and in failing to recognize the strength of the economic expansion that was developing in 1972. Some also pointed out that a mistake was made in believing that Incomes Policy would effectively check price hikes in 1972 and 1973. These errors appear to be the proximate causes of inflationary M–1 growth in the second half of 1968 and again in 1972. But we have to dig deeper. As shown in Tables 1 and 2, money supply also grew rapidly enough to cause inflationary problems (faster than 6 percent per year) both before the bad forecast of mid-1968 and before and after the misreading of the economic winds in 1972–73.

Why did it happen? Broadly speaking, there are three possible reasons:

(1) M–1 growth was deliberately stepped up to reverse developing recessions and achieve "full" employment, and to accommodate inflationary developments—startling though this may seem to some.

(2) Inflationary money supply growth emerged as the predictable byproduct of monetizing Government deficits and fighting fires and keeping order in money markets.

(3) It happened because of inability to control money supply growth.

Excerpted now are quotes from the interviews articulating the positions of Reserve Board Governors and Reserve Bank Presidents on these explanations of what happened.

A Deliberate Choice:

To Reverse Developing Recessions and To Achieve "Full" Employment

Frequently it was said that inflationary policies, including excessively rapid M–1 growth, had been and continued to be followed, basically, because the Nation prefers inflation to unemployment and

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depression. In specific, M–1 growth was stepped up to reverse developing recessions and to achieve "full" employment.[3]

Governor Bucher:

I'm also, I think, quite pragmatic in my awareness of how Congress reflects public opinion, and I feel this is a real restraint. Here I'm referring to such things as the extent to which unemployment is allowed to increase. Thus things which we might be able to do in a vacuum and which would probably make the most economic sense cannot be fully implemented because of possible Congressional reaction.

Clay (Kansas City):

Well, fundamentally, I think the reason that we have inflation—and probably the reason we'll continue to have inflation to some degree—is that the people of the United States have experienced a Great Depression within their time, or at least within the memories of their fathers and mothers. As a result of that, every political person, every person that has gone through that sort of thing, says, "Let's never let that happen again." So the natural tendency of our political system at the present time is to make any mistakes on the side of greater ease, rather than greater tightness.

As we go along and begin to recognize that the Government is spending too much money—or that the Federal Reserve is producing too much money—we are slower to make the correction to slow down these rates of Government spending or the rates of the increase of the money supply or credit, than we are to turn the other way on the other side of the picture. Politically it is unacceptable to take any penalties from recession—and certainly from depression.

Morris (Boston):

I think when we talk about inflation control, we ought to consider it in the context within which we have to operate. The Federal Reserve System is not empowered by the Congress to pursue in a single-minded fashion the goal of controlling inflation. The Congress expects us to do the best job we can in coming up with a mix of unemployment and inflation which is going to be acceptable to the American people. I don't know what the maximum level of unemployment the Congress would accept in the interest of dampening inflation.

Balles (San Francisco):

I can look back even to 1972 and recall that it wasn't until late in the year that the unemployment rate got below 5½

[3] In the 1965–73 period, unemployment averaged 4.5 percent compared to 5.7 percent in 1959–64, but the difference is at least partly attributable to differences prevailing when the two periods began. In 1958 unemployment averaged 6.8 percent compared to 5.2 percent in 1964. (In December 1958 it was 6.1 percent as compared to 5.0 percent in December 1964.) Moreover, during the earlier period, unemployment fell steadily after the 1960–61 recession. The 5.0 percent rate in December 1965 was just two-tenths of a percent below the December 1973 rate.

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percent. Well, given what has emerged as something of a consensus goal on an acceptable long-term unemployment rate of 4 percent, that clearly meant that if you looked at the unemployment rate as an indicator of whether policy ought to be less expansive or more expansive, you would have had to conclude that we needed to stimulate the economy more to get the unemployment rate down. Now admittedly, that was going to have some unfortunate effect on prices, and I think it probably did, so how are we going to resolve those conflicts in national goals?

Accommodating Special and General Inflation

In addition, because of the desire to avoid unemployment, the Federal Reserve since 1964 has tended to validate price increases which originate in events other than accelerations of money supply growth and also to accommodate past pervasive inflation. Such accommodations of inflation are based on the following (simplified) perceptions of the economy and economic processes. To wit: that price increases increase the demand for money as the public seeks to finance the higher cost of transactions. If additional money is not supplied, the public reduces spending and because prices are rigid-downside, the spending cuts cause production and employment cuts. Not all Federal Reserve policymakers agree that such accommodations should be made, however.

Governor Holland:

We are experiencing a sharp rise in energy costs, just as we experienced a sharp rise in food costs last summer . . . Now, I believe the evidence in the modern American economy suggests that it is very hard to drive prices down very far in any sectors. Indeed, if you try to do so by any general policy, you produce a lot of disruption—a lot of unemployment, a lot of unutilized resources. Therefore, I wouldn't regard it as an appropriate target for monetary policy to drive down other prices enough to average out the rise in prices of food and energy. I think that means that our monetary aggregates need to be averaging a little higher than would be true in the absence of the energy crisis or the food crisis that took place last summer.

Governor Mitchell:

If you said that the original price rise was due, say to the Vietnam war, and then you get a higher price level built into your system, then I think that monetary policy would tend to accommodate the price level rather than to roll it back . . .

Weintraub:

So what you're saying is that somehow or other, let me see if I understand this, that we get a series of events in the last 8 or 9 years, starting with the Vietnam war, which essentially boosted prices and that because we are unwilling to wring the price boost out, we validate this with a monetary expansion.

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Governor Mitchell:

I think this is easiest to observe in the Vietnam war.

Black (Richmond):

And you have these extraneous factors that work from the outside. You had the devaluation, worldwide inflation, shortages of raw materials and other products that were driving up prices and so on to some extent, and I think probably to a large degree because of our wage and price controls. And with these extraneously imposed pressures on prices you either had to create unemployment or validate those price increases.

MacLaury (Minneapolis):

As a legitimate reason—explanation if you want to—for exceeding 6 percent at the current moment, let us say, I would see it as a legitimate explanation mainly that we are in an environment of 8 percent price increases, part of which is exogeneously determined, and whereas I would certainly not want to validate the whole of the price increase, it seems to me quite reasonable that we should be validating, if you want to put it that way, I don't like that phrase in this context, but taking account of some part of that annual rate of increase in prices, so that for example, take 8 percent. If that was your price increase, maybe we should take a 4 percent rate of growth in prices and only validate half of what is happening at the moment, and I don't see that myself as building in problems for us for the future.

Governor Brimmer:

... If the rate of growth in the money stock falls substantially short of a built-in rate of inflation, you end up with very depressing effects on the real economy.

Coldwell (Dallas):

We're looking at a pretty sizable change in the inflation rate. And if that's the case, and if our prices are going up so much higher then there is a major upsurge in transaction demand because of this higher price level, maybe there has to be some bow in this direction. I would be reluctant, however, in a theoretical position, to say that we must validate all the rates of inflation coming down the pike because we then get into this racheting problem.

Governor Bucher:

I think that your central banks feel a responsibility to provide funds, at the minimum, adequate enough to fund the real growth of the economy; and probably more than that—probably enough to fund a major portion of the nominal growth of GNP.

Others disputed the preceding lines of argument. Their disagreement is represented next.

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Referring to a recommendation that M–1 growth be kept at 7–9 percent per year to override the oil shortage and compensate for past price increases, President Mayo (Chicago) said:

> I feel that's entirely too accommodative . . . our major concern should still be fighting the battle against inflation.

Francis (St. Louis):

> I don't view the energy crisis as a great complication in this process. Now, I know that there are different views, and there are many who have spoken out, that if indeed the energy crisis should develop to the point where it influences our rate of production downward, you need to raise the money supply, and that I completely cannot understand. I don't know why, if the level of production of goods and services in this country is forced down by an outside influence like energy, why we'd want to put more dollars in the economy to chase those goods and services. I can see only one outcome, and that would be further inflation.

Hayes (New York):

> But I don't think we should be too quick to try to do anything on the monetary side to meet the immediate failure of supply....

Balles (San Francisco):

> It would be economic madness to keep stepping up the rate of money supply to keep up with inflation.

Predictable Byproduct

MONETIZING DEFICITS

Excessively rapid M–1 growth also was attributed to accidental reasons. One such reason cited was that rapid growth was a byproduct of the Federal Reserve choosing to monetize large parts of fiscal deficits.

Coldwell (Dallas):

> The Federal Reserve has normally taken a position that it should support the credit of the United States in its issuance of any securities . . . And we monetized the Government's efforts to spend for the Vietnam war.

Mayo (Chicago):

> Let me go back again to my basic philosophy as it applies to this particular period. I feel very strongly that taking the whole period together, fiscal policy in the '66 through '68 period was the basic culprit in forcing up, if you please, the increases in the money supply.

Weintraub:

> But what I'm puzzled about is the connection—the nexus. What is it that compels the Federal Reserve to act to increase

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money supply and to increase the rate of increase in money supply when the budget is in substantial deficit?

Mayo:

Well, this is a direct result of the fact that the Treasury obviously has to borrow when there's a deficit.

Weintraub:

That's right.

Mayo:

The Treasury has to borrow in a real market. The Federal Reserve, I think has a responsibility—I wouldn't call it a compulsion—to see that a Treasury offering when properly priced in the given market environment is not thwarted by tightening up on monetary policy . . . That is why we have what is called even keel, which is I think much more reasonably handled nowadays than when I was in Treasury . . . the fact that the Treasury was, say doubling its demands on the market, would be a constraint that we couldn't ignore . . . we couldn't say that the demand had to come out of somebody else's hide . . .

Black (Richmond):

You can find that there were reasons, institutional reasons, why we erred on the easy side when we did, for example, back in the period we were talking about earlier when we had the heavy deficits. You know you pretty well have to underwrite those deficits unless you are going to crush out of the private economy an equal amount of spending. And that's not feasible sometimes, so you're kind of stuck with that.

Weintraub:

Is there any reason why money supply has to grow because of a large federal deficit?

Balles:

Well, it's awfully hard to prove this one way or another. But my impression from years of study of monetary policy has been that when you're right down at the firing line, the Federal Government does have to get financed. It would simply be unthinkable for the central bank to refuse to provide the financing the Federal government needs, based on the existing facts of expenditures, revenues and the deficit. To refuse to do so would probably be to create chaotic conditions in money markets and probably very severe deflationary effects on the economy. You can postulate a constant rate of growth of the money supply in the face of large private demands augmented by the Federal government demands in a period of budget deficit. If we simply refuse to expand the money supply, then what happens is fairly clear. Namely, private demands for credit would somehow get squeezed out, and interest rates would rise to astronomical levels.

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A different view of this question was expressed by President Francis (St. Louis). He said:

> Of course, I believe and I've said this literally hundreds of times in speeches, that I think it is not necessary for the Federal Reserve to come to the support say, of the Treasury, to the degree it has. I think it is more a matter of a tradition of central banking that has done that, and we continue to follow that tradition. I would much prefer to see the Federal Reserve try to determine the level of money that is consistent with full employment and stability, and I don't think these are inconsistent objectives. I think it can be accomplished by letting the Treasury cut its excessive needs out of the market. This would have been my preference, but it's not the way it worked during the early period.

Fighting Fires and Keeping Order in Money Markets

The Federal Reserve's frequent absorption with money-market problems also was given as a reason for excessively rapid M–1 growth. Many indicated that M–1 growth strayed from the optimal long run path because the Fed let it do so while concentrating on fighting fires and keeping order in money markets.

Coldwell (Dallas):

> Well, I think we need to look at what are to be the actions of the Federal Reserve. Is the Federal Reserve to have its eye only on a target 18 months out, or is it to respond to short-run fire fights and other things which develop in the economy and internationally?

Governor Bucher:

> I also think there are times when we have to vary from paths. There are circumstances, such as the Penn-Central situation, and others, which are beyond our control. In these cases, we have to leave what would normally be a desirable path as far as money growth and other conditions are concerned.

Winn (Cleveland):

> You know, I would agree that if you set controlling money supply as a single objective, and you were not concerned about the behavior of any of the other variables, you probably could control it much closer than you are able to do at the moment. But I think what happens is, is to your willingness to let some of the other elements fluctuate.

Weintraub:

> This I get is—one of the findings that I'm getting as I interviewed the Presidents and some of the Governors in the Federal Reserve System, is precisely that there seems to be a set of targets that sometimes . . .

Winn:

> Are self-defeating in terms of . . .

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Weintraub:

Can be self-defeating certainly of a moderate money supply . . .

Winn:

This is correct.

Later, returning to this theme, President Winn indicated that holding a steady monetary growth course could bring substantial money market rate changes. In specific, Winn said:

I'm contrasting this now in terms of the policy you're proposing. And you know, I know what we got in this period with what we did—what would have been the results if this had been different. And you know, what would 15 or 20 percent Federal funds rate mean?

Weintraub:

Well, we're not a bit sure that we would have had 15 or 20 percent.

Winn:

No. No. No. I mean this is—you can't rule it out.

Weintraub:

No, I understand. I've been told that there was a period recently—it may have been one hour when it hit 50 percent.

Winn:

We had that one day. That's right. We had a couple of transactions reported on that kind of a rate.

Weintraub:

I really find it hard to believe that with steady money supply growth, that you'd get anything like this sort of aberration and gyration in interest rates.

Winn:

Well, you're assuming with constant growth that you don't have these fluctuations I mentioned as a result of other forces, which are really quite a surprise.... We're shooting to achieve a multiplicity of targets and you want to shoot at a single one—but the result of that is that you get even greater extremes on some of these other trends.

Governor Sheehan:

During the first quarter of 1973 the money supply as defined by M–1 grew very modestly, it shrank in January, and grew just a little in February and March. Then, in the second quarter it grew at a rate of between 10 percent and 11 percent. We got it back down again in the third quarter. Well, you sit in the Open Market Committee Meeting debating this, and you are in the middle of the second quarter and money is growing faster than you want it to grow, so you turn to the staff and say, "Staff, if we move against this high growth,

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what do you think the Federal funds rate is going to do?" The staff says, "If you want to get it down to within our proposed limits, during that three-month period, you have to be willing to accept a Federal funds rate in the range of 20 to 25 percent for 8 to 10 weeks." And then you say, "Well, is that all right with Friedman, just control the money stock, to hell with the interest rate. Can we ignore the stress this puts on S&L's all over the country and the financial system as a whole? It's just impracticable to completely neglect interest rates."

Weintraub:

. . . I would have reduced the growth to around 5½.

Governor Mitchell:

But Bob, you are saying that without saying what goes with it. That's why I come back to this question right at the beginning: "Would you go for a 10 percent mortgage rate?"

Hayes (New York):

There were times in '72 when I would have wanted to slow the rate of growth of money somewhat more than the System did. But . . . I suspect that a 4 percent growth in the money supply would have brought some awfully sharp market reactions because of wild interest rate moves.

Governor Brimmer:

Would I just aim for some growth rate in the money stock? The answer is no. There would be a great risk in setting our policy target in terms of the narrowly defined money supply and then sticking to that target. You mentioned the need to avoid disruptions in labor markets and so on. In fact, that is not where you would first see the disruptions. You would see them first in the financial markets long before you got to the real economy. You have already seen what will happen to the savings and loan associations. Many people do not realize it, but there has also been an impact on the brokerage business. There is no doubt that a good bit of financial turmoil that we see is simply indicative of what would happen more generally to the real economy. Financial institutions carry their assets rather substantially in the form of fixed values. Wide fluctuations in interest rates have a sharp impact on the prices of such assets. Certainly, if we were to adopt a policy track designed to get the rate of inflation down to—let us say to 3 percent from 8 or 9 percent over too short a period of time—that would mean restraining the rate of growth in money and credit to rates so small that we would end up with substantial capital losses for financial institutions and others. The counterpart of those effects, of course, is bankruptcy. I stress that because many people, especially many of the monetarists, do not pause to survey the debris that would be built up along the way.

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Others saw dangers from neglecting money supply while trying to smooth short-run fluctuations in the Federal Funds rate and other money market rates.

Balles (San Francisco):

> To keep the money supply growing at a constant rate, and to do this by controlling our operating target, I don't think we can or should ignore big shifts that can and do occur in the demand for money. If we were to try to keep the M–1 growing at a rigidly controlled rate, I think we would probably see some pretty wide and counter-productive fluctuations in the level of interest rates in the short run. I think that we can allow variations in the rate of monetary growth to occur over short spans of time with a view to preventing undue instability in the behavior of interest rates. Longer run, however, I am very much of the view that interest rates as a target are going to get us into trouble.

Eastburn (Philadelphia):

> Well, let me say one thing. As you confront this task, if you agree that it's desirable to get growth in money down sometime, one of the problems that one incurs is finding the appropriate time, and there never seems to be a good time.

Eastburn (at another point in the interview):

> I do feel that the Open Market Committee has to watch interest rates, and I don't want to leave the impression that money is the sole indicator.

Weintraub:

> Let me ask you why that's true then?

Eastburn:

> There are a number of factors. One factor has to do, of course, with the effect of instability in the markets. If you take the view that the Fed has a key responsibility for some degree of stability in financial markets, I think that as a lender of last resort, the Fed has the responsibility to prevent panics, and this to some extent, is an interest-rate phenomenon. Also, there is some question as to less extreme fluctuation of interest rates. The Open Market Committee, as you know, has not been prepared to take the money supply as the be-all and end-all policy target. It also looks at interest rates, especially short-term rates. My view is that the market probably could be more self-reliant with respect to changes in interest rates than it has been permitted in the past. And therefore, perhaps, we would have to focus less than before on short-run fluctuations in interest rates. Nevertheless, I think there may be times when disorderly markets result and disrupt the rest of the economy, and that must be watched . . . The difficulty is not so much which one is the better indicator, but what happens when you use money market

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conditions and rates as a short-term guide. I think using money market rates can get you into difficulties in the longer run. And this was what we were talking about earlier. You may look at them from meeting to meeting or week to week or day to day and they can be a good guide. But when you rely on interest rates, you can forget what happens to money. I think that's the problem.

Control Problems

Federal Reserve policymakers do not deny that they have ample powers to control money supply growth from year to year. However, nearly all Governors and Presidents mentioned an information problem as a reason why M–1 growth had been faster than it appears, at least in retrospect, was desired in 1972 and 1973. M–1 consists of currency and coin and demand deposits held by the public. The Federal Reserve does not itself track demand deposits in non-member banks. The FDIC does this through its periodic call reports. During this period the FDIC called and received only four reports each year—one each quarter—from non-member banks on these deposits. During the 1972–73 period, the Fed's between-reports estimates were low. Moreover, because there was only one report each calendar quarter, the reliabilty of the information received from the FDIC on non-member bank deposits was less than perfect.

As a result, sometimes the estimate of non-member bank deposits for a given month had to be revised upwards more than once. The first revision was made on the basis of the FDIC reports for the immediate quarter and later revisions on the basis of later reports.

Ample Powers

Weintraub:

There would be, as I understand it, no difficulty in the Federal Reserve's controlling the growth of the money supply from year to year, or controlling the 12-month moving average of it, if it so desired.

Governor Holland:

If we were giving that top priority. If we decided that the goal of hitting that target overrides everything else we could do, I think we could probably come fairly close from one year to the next in achieving the M–1 growth that we decided we wanted to create in the economy.

Weintraub:

First off, a year is long enough to control the money stock if that were what the Federal Reserve was trying to do.

Francis (St. Louis):

Well, certainly a year, and of course, I believe we can do it effectively on a quarterly basis.

Weintraub:

Well, let me ask you. How could money supply, the nominal money supply, have grown—how could it grow just be-

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cause the economy wants it to grow, unless the Federal Reserve supplies the base for it?

MacLaury (Minneapolis):

The way you put that, it could not. It could not. We have the ultimate control and the question is, of the growth of the monetary base. I agree with you on that.

Inadequate Information

Governor Mitchell:

The only information we have on 25 percent of the money supply is four observations through the year. On the remainder we have an observation every single day. Fluctuations in those deposits can be very substantial.

Weintraub:

Now, could the Federal Reserve, if it were instructed, or if it desired of its own volition, keep this 12 months' average . . .

Morris (Boston):

Yes, with the single provision that I mentioned at lunch, that the money stock is subject to annual revisions based on the non-member bank data. It could be that an annual revision will be sufficiently large to throw us out of the range.

Governor Sheehan:

We were surprised 2 years in a row about the growth rate of that part of the money supply which is in non-member banks and that we do not collect data on ourselves.

III. The Federal Reserve and Interest Rates

The relationship between Federal Reserve actions and interest rates is one of the least understood and perhaps the most misunderstood questions in monetary economics. There is wide recognition that open market purchases increase reserves and tend also to decrease the federal funds rate and Treasury bill rates, and that, in turn, the increase in reserves impels banks to lower loan rates and increase their lending, with money supply expanding in the process. This is the feed-in from open market purchases to money supply and interest rates. There also is feedback. Often this is overlooked.

Together, money supply growth and lower interest rates impel increased spending. As a result, production and prices advance. Feedback derives from the increases in production and prices and such anticipated inflation as is generated. It causes credit demand to increase and hence interest rates to be bid up. Also to the extent that inflationary expectations are stimulated, saving is discouraged and interest rates are thereby propelled upwards even more.

The Outline

Governor Brimmer:

The Federal Reserve does not control interest rates. The Federal Reserve controls bank reserves in this country . . .

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> If you really want to judge the efficiency of monetary policy, then you should look at the behavior of bank reserves and the timing—the quantitative change in bank reserves and the timing.

There is, however, a link between bank reserves (the control variable) and interest rates. As developed in a discussion with Governor Brimmer,

> . . . the observed interest rates today—leaving aside their behavior and talking about their structure and content—contain some payment for the use of money in the traditional sense. But they also contain a substantial discount for future inflation and expectations of future inflation.

Weintraub:

> I would like to ask you to focus if you would on this one element which is common to both you and Fisher, called the allowance for expected inflation. If I were to say that the Federal Reserve influences, or can influence, interest rates through this element, would you agree with that?

Brimmer:

> The Federal Reserve can certainly influence market perception and behavior through its actions such as those affecting bank reserves and the money supply. It may induce the public to expect more or less inflation . . . If an economy is operating close to capacity . . . so an increase in the supply of money or credit might induce the public to believe that the demand for real goods and services will increase and thus the rate of inflation. In this situation, the public would want to hedge. If they are lending money, they might want to demand a higher premium.

Weintraub:

> Now, is there any feedback from the price increases and the output increases on any of these variables that you've talked about? Interest rates in particular.

MacLaury (Minneapolis):

> Definitely so. Yes.

Weintraub:

> Okay, what happens to interest rates as a result? The feedback?

MacLaury (Minneapolis):

> And now you are leading me to say (and I don't resist saying) that interest rates are going to rise, and that one can make the argument in time sequence that one ends up exactly no better off than he was before by this kind of a variant of money supply policy.

Weintraub:

> There is some tendency for interest rates to rise now?

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MacLaury:

Surely.

Weintraub:

And the greater, presumably, the rate of inflation, would you go along with that theory, the greater the tendency for interest rates to rise?

MacLaury:

Yes, I would go along with that.

Clay (Kansas City):

When the supply of money is in excess of the demand for money, we would expect interest rates to fall: money would be worth less. So, we would expect it to fall—in that kind of situation. And I think that on a short-run basis, this would generally be true.

Weintraub:

Now, then, because this also induces increased spending by consumers and investors and acts to expand both output and, as we approach full employment, the rate of inflation also goes up. Then there is a feedback as I understand it or, as I understand the theory, there is a feedback that causes interest rates to rise, so we can explain . . .

Clay:

I think that what you're saying—and I believe it is so—is that inflation causes high interest rates. I believe that high interest rates result from inflation.

Weintraub:

Now, so that we really have to—in a sense—if we wanted to explain high interest rates, then we have to ask ourselves what is causing the current inflation . . . let's say open market purchases, a shift upward in the rate of purchases, would immediately do what to interest rates? It would reduce them is that . . .

Governor Holland:

It would make interest rates immediately lower than they otherwise would be.

Weintraub:

And simultaneously add to bank reserves and to currency held by the public to . . .

Governor Holland:

And to some monetary aggregates.

Weintraub:

Right. Okay. And the decreases in interest rates and the increases in the monetary aggregates together will expand consumption and investment spending.

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Governor Holland:

Yes, that's right. It stimulates some kind of response in spending. . . . I think the effect you get on real output expansion, on the one hand, and on price on the other, will vary. I'll put it in a more simplistic kind of way: the closer we are to full employment, the more the effect of that monetary stimulus tends to be diverted into price advances and the less is utilized in financing an expansion of real output. But there's always some effect on both fronts. . . .

Weintraub:

Now, we come to this last element and factor you mentioned, mainly some sort of feedback. And in particular, I'm interested in the feedback on interest rates from the increase in output and the increase in the rate of increase in prices. There is a feedback on interest rates?

Governor Holland:

I believe there's a strong tendency in this direction.

Recent Experience

Weintraub:

You believe. Okay, now. So that in a sense one might say, looking at the past few years, that we have high interest rates today in part, because the economy has been so buoyant and we've had rapid expansion both of output and of prices in recent years. The high interest rates today would reflect this buoyancy and expansion?

Governor Holland:

Yes, I think it's one of the ingredients that has contributed.

Hayes (New York):

I think that obviously if you get too much of a boom effect from the increase in money supply and that turns into accelerated inflation, the very fact of the inflation is going to tend to make people want to get higher interest rates as a trade-off against that inflation. Is that what you're talking about?

Weintraub:

Essentially. Let's see if I understand that—you're saying that the inflation feeds back and causes the interest rates to rise then.

Hayes:

Yes.

Weintraub:

So, a curious thing emerges here which is that insofar as monetary policy was responsible for the expansion and the buoyancy and the inflationary tendencies, it is responsible for the high interest rates.

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Governor Holland:

Yes, I put a lot of weight on the "insofar as responsible," because I think there are a lot of factors at work here. But there's no question in my mind but that we're dealing with an interacting mechanism. Other things being equal, the more monetary stimulus that's pressed into the economy, the more response you get in terms first of real output, and then as you get close to capacity, the more that expansion spills out in prices; and the more the latter happens, the more there tends to develop subsequently a lift in interest rates, due partly to the increase in credit demands you've created and due partly to the tendency for an inflationary discount to be built into interest rates.

Weintraub, referring to recent years,

. . . given the choice that was made which was for higher money supply growth and higher, therefore, inflation in order to achieve lower unemployment—what about nominal interest rates? Did this produce higher or lower interest rates?

Morris (Boston):

Higher.

Kimbrel (Atlanta):

Interest rates certainly were influenced by a buoyant economy. But had you wanted to hold the interest rates down, then what would you have chosen as a measure to try to restrain them?

Weintraub:

My own would have been to have kept the rate of growth of the money supply below the six percent guideline. I think that this would have produced, as I think I said before, a less steep rise in interest rates during both of these periods, and we would have had lower rates now than we have.

Kimbrel:

But I assume, though, that you would have had this lower growth much earlier than the period that you point out.

Weintraub:

Well, I said the year ending June 1973. Less than six percent rather than 7½ percent. (Revised data now show that M–1 grew 8.7 percent in the year ending June 1973.)

Kimbrel:

Well, I think that if all other things had been the same as they were, and you had started earlier and had provided less reserves, yes. I think that is exactly right.

President Mayo (Chicago) had a partly different view:

I think we would have higher interest rates . . . We would have had higher especially in the short area . . .

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This becomes a rather delicate value judgment if you are talking about long-term rates because of the inflation factor, an expectational inflation factor.

Weintraub:

Would it have made inflation higher, 5½ (percent M–1 growth) as compared to the 7?

Mayo:

Inflation may have been inhibited by going to 5½ percent instead of 7 percent. On the other hand, we might very well be in a recession today.

Weintraub:

Well, quite apart from that because I don't know whether the 5½ percent would have created a recession or not. This is an "iffy" question, but if inflation would have been inhibited then clearly the inflationary additive in interest rates would have been less than it now is.

Mayo:

Oh yes; that's why I made the point.

President Black (Richmond) stressed inflation's impact on long-term rates, but because of arbitrage possibilities, indicated his belief that short rates also would rise in periods of expansion and inflation:

I think in retrospect when we look back on that period, although it was a period of very rapid physical growth in the economy, real GNP was increasing at maybe a 7 percent rate during 1972 or something like that. That in retrospect and, again, let me say in retrospect, I think we let the money supply grow too fast during that period of time. And my feeling would definitely be that if we'd kept it at a slower rate of growth that we probably would have ended up with lower interest rates than we did because we would not have unleashed some of the inflation and inflationary expectations that did in fact occur . . . you would have had less of an inflation premium in interest rates than you in fact did.

Parthemos (Senior Vice President and Director of Research, Richmond):

Talking about long-term interests only, Bob?

Black:

Yes.

Weintraub:

Well, the effect——

Black:

I was thinking primarily of long ones really.

Weintraub:

To the extent that there is arbitrage here which——

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Black:

What I'm saying really is if we had curbed demand better in 1972 we wouldn't have had as much pressure on interest rates across the board later on as we did, I believe.

Weintraub:

Let me begin by asking a question about why interest rates are high today—nominal interest rates.

Francis (St. Louis):

Well, my view of the high interest rates is one that involves the rate of monetary expansion, and while as I remember the elementary course I had in money and banking said something like easy money or fast monetary expansion means low interest rates and tight monetary policy means high interest rates, I think the books had to be rewritten and something added that while those statements may be true over a very short-run, that given high rates of monetary expansion, over long periods of time, two things usually happen: you get inflation in prices and you get high interest rates. I think there's a relationship there.

Weintraub:

So essentially, we might say the relationship between money supply growth and interest rates is one that, initially interest rates fall when money supply growth is increased, but this effect is transient, a temporary effect, and there is a feedback that comes from the increases in output and prices that accompany monetary expansion.

Francis:

I think this is a direct result of the influence of a change, a more rapid growth rate in money supply having what I believe to be an impact on the demand for goods and services; and as that demand for goods and services goes up, the demand for credit increases. I think it's purely a matter of a market relationship, as the demand goes up against the given supply, and even though that supply must be increasing, the demand may go up faster and interest rates go up also.

Balles (San Francisco):

My overall impression of what happened in the latter half of the 1960s and to some extent in the early half of the 1970s was that efforts to keep interest rates down led to a rate of monetary expansion which eventually was inflationary and caused interest rates to go up. I think you've got that kind of a dilemma. In a short run the central bank can keep interest rates down, even in the face of rising demands. But in the long run it cannot do it because inflation itself will cause interest rates to go up. Investors will demand a premium for investing in long bonds, and I think we now see a large inflation premium in long term interest rates.

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Referring to 1972–1973, President Balles continued:

> If you want to try to pinpoint the thing a little more, I would think that within a say a three to six month span, we could have seen (1972–1973) interest rates higher had the money supply growth been lower. Now I don't think that would have persisted over a much longer period than that.

IV. Substantive Issues

(1) *Relationship of Money Supply to Inflation and Interest Rates*

(a) Federal Reserve policymakers have diverse opinions about the role that monetary policy has played in the several waves of inflation which have hit the U.S. economy since 1964. Nearly all recognize some and many an important degree of responsibility. To synthesize, for short periods, the pace of inflation since 1964 was dominated by sporadic non-monetary events such as fiscal excesses, extraordinary demand increases for medical care, wage push, protein feed shortfalls and the oil embargo. But taking the long view, the rate of inflation was linked to the rate of growth of M–1 money supply.[4]

The 3.2 percentage point jump in the annual rate of rise in the CPI in the 1965–1973 period, from the 1959–1964 rate, as was earlier observed, corresponds very closely to the 3.3 percentage point jump in M–1 growth between these periods. This striking statistical association is supportive of the synthesis proposition linking the long run rate of inflation to M–1 growth during the 1965–1973 period. Many Federal Reserve Policymakers stress additionally, that the timing of the several waves of inflation which we experienced after 1964 conforms closely to the patterns of M–1 growth that occurred.

(b) Interest rates also depend strategically on M–1 growth. Trends to higher interest rates develop from accelerating M–1 growth. Federal Reserve officials nearly all recognize the feedback forces which generate higher interest rates from stepped up M–1 growth. Initially stepping up M–1 growth decreases interest rates and increases spending, and with this, output and prices rise. As a result, credit demands increase and saving tends to fall. As a further result, interest rates rise. We have high interest rates today because past M–1 growth was too fast.

(2) *Controllability of Money Supply*

The Federal Reserve has ample powers to control M–1 growth from year to year and even from quarter to quarter if it desires to do so.[5]

(3) *Policy and Procedure Roots of Rapid M–1 Growth in the 1965–1973 Period*

M–1 growth was accelerated because of bad forecasts in the second half of 1968 and in 1972. The interviews also reveal:

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[4] Discussions during the interviews centered on M–1. The relationships of the economy's performance to the growth of other monetary aggregates correspond closely to the relationship to M–1 growth.

[5] From a purely technical standpoint, the major constraint on close control in the recent past was informational. The Federal Reserve did not receive an adequate flow of reliable information on demand deposits in non-member banks. This situation was recently substantially corrected when the FDIC agreed to sample weekly deposits of non-member banks and pass the aggregated statistics on to the Federal Reserve.

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(a) M–1 growth was deliberately stepped up to reverse developing recessions early in 1967 and early in 1970, and to achieve fuller employment throughout 1972.

(b) M–1 growth was deliberately stepped up at times to accommodate special inflationary developments. This was done in order to avoid putting downward pressure on sales in immediately unaffected sectors.[6]

(c) M–1 growth increased at times as a byproduct of monetizing Government budget deficits.

(d) M–1 growth often accelerated as a byproduct of the Federal Reserve focusing on fighting fires and keeping order in money markets.

(4) *Substantive Questions To Be Resolved*

Four major substantive unsettled questions about Federal Reserve policies and operating procedures thus emerge from the interviews. Resolving these issues is crucial for the formulation and implementation of monetary policy to decelerate inflation and reduce interest rates.

(i) Major differences exists on the practice of stepping up M–1 growth to accommodate special inflationary developments. The interviews reveal this being done in the past. Moreover, the interviews indicate substantial support for now accommodating pervasive inflation on the ground that spending fell off last winter because the rate of rise of the CPI now exceeds M–1 growth. Possible benefits and risks involved in accommodating M–1 to inflation, whatever the source, are revealed by the following exchanges with President MacLaury (Minneapolis) and Governor Sheehan:

Weintraub:

> In view of the lags in the economy from the money supply, does the policy prescription—how would you interpret it? How sensible is it? We're already in the first half of the year in which we . . .

MacLaury:

> Yes, I see your point entirely.

My point, as President MacLaury saw, was that increasing current M–1 growth would spur a recovery which is in the cards anyway, and hence only add to future inflation. Governor Sheehan at first disagreed, saying:

> Is it the function of the Fed to squeeze that resulting inflation out? If it does, which prices will fall so that all prices can be stable, and how much unemployment are we going to suffer as a result? We all must recognize that the cost in terms of unemployment might not be acceptable.

Later, however, Governor Sheehan recognized that there is a danger of accelerating inflation from stepping-up money supply growth.

[6] That the Federal Reserve accommodates inflationary developments blurs causality in monetary economics. Ordinarily we think of a causal event as one that precedes the result. But given this accommodating behavior, accelerated M–1 growth will not precede accelerated inflation. Yet, in a deeper sense it is nonetheless the cause; for without it, the step-up in inflation would not endure.

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Weintraub:

> I think it's fairly clear, to me at least, that the higher the rate of growth of the money supply, the more inflation we're going to have. And that rates of 20 percent as Japan has had are going to produce 20 percent inflation, sooner or later.

Governor Sheehan:

> The Japanese are a very good example. The Japanese have had a severe problem with inflation in the last 12 to 18 months.

The burden of proof is on those who would have M–1 growth move with and not into the winds of inflation. These hearings would appear an appropriate place to ask how inflation will decelerate under this policy. Also, inasmuch as today's increases in M–1 have effects on future spending, why this policy would not generate continually accelerating inflation. In addition, it would be useful to clarify why we should be concerned because prices have lately increased more than M–1, inasmuch as M–1 increased more than prices in years past. Perhaps prices are just catching up. Finally, it is important to question the assumption that prices (with rare exception) do not fall. There is a considerable body of evidence which shows that many goods prices fall as well as rise. They fall even in periods of pervasive inflation. Witness what has happened recently to prices of harvested commodities, livestock, and derivative products, and many industrial commodities. Many other prices surely would fall if the underpinning of a monetary policy which accommodates and validates and often leads inflation were removed. Witness what happened to new and used car prices, fuel oil, and coal and many other prices in the mid 1960s. Also, interest rates would fall, and they are an important cost element especially in housing.

(ii) Government must pay for the goods it buys and the services it hires. In real terms, in a full or nearly full employment economy, this requires transferring resources from the private to the Government sector. The transfer can be accomplished by taxing the private sector. If this is not done, Government runs a deficit. It can finance the deficit either by selling interest-bearing securities or issuing noninterest bearing currency and Federal Reserve book entries. If the former method is used, Government obtains the buying power it needs by bidding away financial resources (ultimately savings) from private investors. If currency and member bank Federal Reserve book entries are issued, Government, in effect, prints the buying power it needs.

In our economy, Congress and the Executive decide whether to use Government's taxing powers to achieve a desired transfer of resources from the private to the Government sector. To the extent that this decision fails to provide the needed buying power, the Federal Reserve decides whether it shall be obtained by bidding away saving from private investors or printing the money. The Fed's decision has important implications for the economy. During the interviews it was argued that requiring Government to raise the buying power it needs by bidding

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away saving from the private sector would "*crush* out of the private economy an equal amount of spending," as President Black (Richmond) said, and raise interest rates "to astronomical levels", as President Balles (San Francisco) said.

On the other hand President Francis (St. Louis) warned:

> I think the key factor is when the central bank moves in to support the borrowing, and injects what I call "new money" into the economic system. Treasury borrowing alone would be more of a transfer of money from the private sector to the public, you get that I think with any period of Treasury borrowing, but when you interpose new money on top of that, or too rapid increase in the rate of monetary expansion, I think this is the kicker on inflation.

Moreover, to the extent that inflation results from the Federal Reserve's decisions, appropriated expenditures will fall short of achieving the transfer of resources required to accomplish the spending goals. In this way, monetizing deficits, will either result in underfunded programs or require supplemental or deficiency appropriations.

This is a critical issue. Are the arguments of Presidents Black and Balles valid, or is President Francis right? These hearings present a timely opportunity to fully air both sides of the question.

Whatever decisions the Federal Reserve makes in deciding each year, as it now does whether consciously or not, how much of Government's deficit is to be monetized, are ones that Congress should closely follow. The Federal Reserve should be asked to set forth annually how and why it made the choice it made and whether in retrospect the decision was wise or in what way it should have been modified.

(iii) Many Federal Reserve policymakers fear that, unless the Federal Reserve keeps order in money markets, there will be financial chaos, including money market rates so high that today's rates will seem low, disintermediation on a still unimagined scale and widespread bankruptcies, plus a full fledged depression, at least in housing. They favor resisting sudden extraneously caused money market pressures even at the cost of temporarily allowing M–1 to grow faster than desired as a long run matter. But others believe that money markets are inherently orderly. They suggest that, left alone, these markets would absorb exogenous shocks with minimal trouble, and hence need little protection. They also warn that fighting fires and keeping order in money markets can require the Fed to supply new money much faster than the desired long run rate for an extended period of time, and with disasterous long run consequences.

The argument of those who would protect money markets rests on two unproven assumptions. First, it assumes that all or a large part of an unresisted exogenous increase in interest rates would last long enough to cause disintermediation and other financial disruptions and depress housing and inventory and other investments. If the exogenous change did not endure long enough, it could be ignored.

On this point a comment made by Governor Mitchell on a related question indicates that "long enough" may not be very long at all; it would happen very quickly.

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He said:

> Well, I think some actions wouldn't involve any lag at all and other actions do. We were talking earlier about a 10 percent mortgage rate. If the market should today perceive that the Federal Reserve is going to tighten up, and we got bill rates up to say about 8½ or 9 percent; we got disintermediation in thrift institutions; and we got 10 percent mortgages—that could all happen in 30 days.

Governor Mitchell nonetheless had doubts about focusing on money market developments. He continued:

> But I think the easiest effects to perceive, and maybe the effects that we are over-influenced by, are the ones that you see immediately. And I think these are the effects that Congress perceives, too. Sometimes it's difficult to get Congress' attention away from these short-run effects to the longer-run effects which may, in fact, be more important.

Further testimony on this matter would appear useful. Experience this year could throw light on the lag before disintermediation begins, or at least becomes substantial, in the wake of rising money market rates. Also, Governor Mitchell's comment suggests exploring how the Federal Reserve's focus can be shifted from the short to the long run. Are the Federal Reserve's perceptions of Congress' concern correct?

Second, the argument additionally assumes that a small increase in money supply induces a large fall in money market rates for a period which is long enough to permit the extraneous pressures to decay, and yet short enough to allow the Fed to achieve desired long run M–1 growth. Figure I may help in understanding what is involved. The figure plots the target interest rate vertically and M–1 horizontally. The inner demand line prevails at the start, and initially we are where we want to be, which is at point A. Extraneous forces then pull demand up. If M–1 doesn't change we go to point B which gives us a much higher interest rate. We needn't stay there, however, as we can be anywhere along the new (outer) demand line. We choose to go to point C, involving a small increase in M–1 and preventing a large rise in the interest rate. The extraneous pressures decay quickly and we return to the desired neighborhood at point A.

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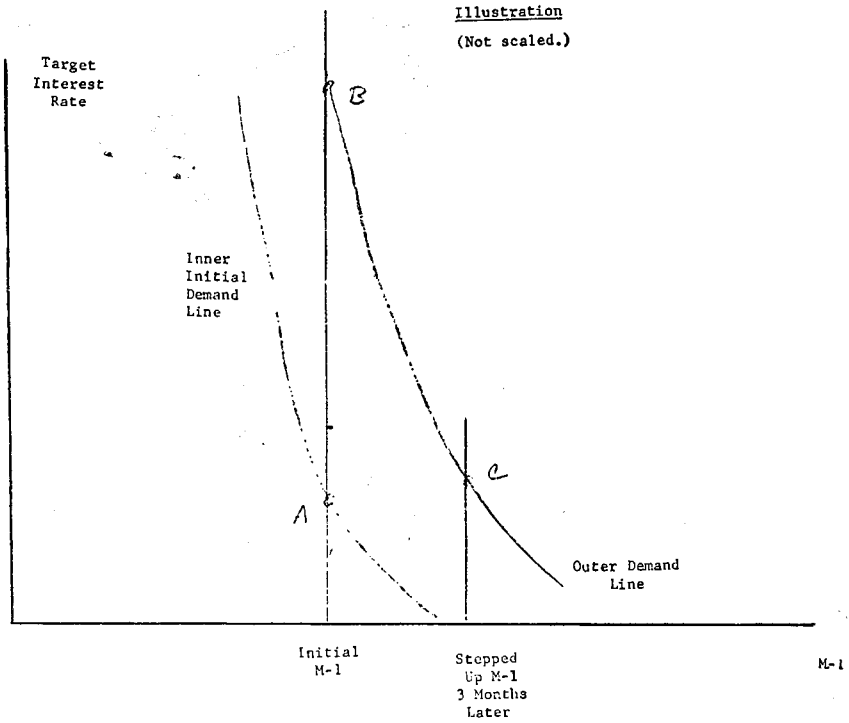
Figure I

Illustration

(Not scaled.)



In evaluating this scenario several points should be kept in mind. First, Federal Reserve actions to change the rate of M–1 growth a small amount, say 2 percent per year will, after a month produce only two-twelfths of one percent change in M–1 from what it would have grown to under the previous policy. After three months, the change will be one-half of one percent. After six months it will be only one percent. This means per annum M–1 growth must be increased substantially to bring about modest increases in M–1 in a few months. Second, because the interest rate elasticity of money demand increases as time passes (reflecting that market responses to interest rate changes

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are not instantaneous) the resulting opposite change in interest rates which develops from a given money supply change with other factors held equal, is larger the shorter the period. In terms of Figure I, the outer demand line flattens, using point B as the pivot, as time passes. Third, feedback to interest rates from the production and price effects of increasing M–1 starts almost immediately. In terms of Figure I, this pulls out the demand line and thus provides long run upward impetus to interest rates.

The following questions are pertinent. What are the time elasticities of money demand with respect to changes in interest rates? Put otherwise, how much would various interest rates (short and long term) change in response to given M–1 changes after one month, three months, etc.? Keep in mind that, for a one-half of one percent change in M–1 which results after three months of accelerating M–1 growth by 2 percent per year, for example, a given interest rate will change only 2 percent even if the three months money demand elasticity is as low as $-1/4$. For an interest rate initially at 8 percent, the three months response is thus only 16 basis points, a snow flurry some would say. Unless it can be shown that money demand interest rate elasticities are extraordinarily low in the appropriate period, resisting money market pressures could succeed only by generating excessive and probably irreversible M–1 growth, and also, there would be little to fear from gradually moderating M–1 growth regardless of money market pressures. Moreover, even if such elasticities prevail, we can't be sure that getting off the desired long-run M–1 growth track would be a net benefit because feedback from any money supply increase reduces the Fed's power to resist interest rate changes in the short run, thus requiring more and more money creation to do the job, and operating thereby to defeat the original purpose in the long run.

Second, how long does it take before the direction of the initial change in interest rates which develops from changing M–1 growth reverses? If the lag is short, there again would appear to be no reason to fear keeping M–1 on the desired long run growth track, and considerable risk in leaving this path inasmuch as this would cause money market pressures to build up cumulatively over time because of the feedback.

During the interviews considerable attention was given to the findings of Phillip Cagan on the central tendency in our economy, over the years, of interest rate changes that have occurred in the wake of step-ups in money supply growth. Cagan's results cover both the feed-in and feedback from money supply changes and ignore extraneous influences. They thus shed light on the size and duration of the initial interest rate "bang" which we can expect from changing money growth, and on the long run effects as well. Cagan's findings on the M–1, commercial paper rate nexus in the 1953–1965 period are plotted in Chart II. Following a step up in M–1 growth of one percentage point per year, the commercial paper rate at first falls and later rises, just as the discussions in Part III of this report indicate will happen. The initial decline lasts less than one quarter and reaches only 7 basis points. In the third quarter the commercial paper rate is higher than initially and after 2½ years it is 40 basis points higher.

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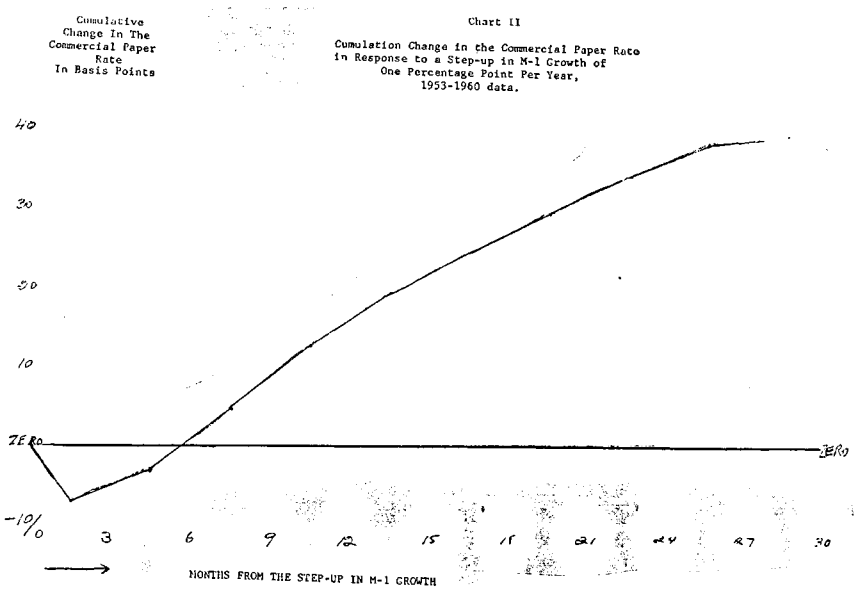

Federal Reserve policymakers for the most part were chary of Cagan's findings. They did not accept that the average size and duration of the initial effect could be as small and short as Cagan found it to be. In addition, nearly all pointed out that the size and duration of the response of interest rates following a change in money supply depends upon initial conditions, as surely is correct and Cagan surely would agree. Thus the historical central tendency can be misleading. But many also felt that, in periods of buoyant credit demands and inflation, the size and duration of the initial effect was likely to be smaller and shorter than under other economic conditions.

Eastburn (Philadelphia):

> My understanding of the literature is that the findings on this are diverse. What I know of the MPS model, for example, suggests to me that its estimates would be considerably longer. The model of the Federal Reserve Bank of St. Louis has relatively short lags, and you say the Cagan model has relatively short lags. My feeling is that the judgments aren't all in. When you have so many experts disagreeing on this, we're still stuck with the position that lags are variable uncertain.

Hayes (New York):

> It may be that you probably ought to ask one of these associates.

Weintraub:

> Well, perhaps, let me ask Richard Davis what he thinks.

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Davis (Vice President):

Well, the estimate of lags is awfully tricky, and Cagan's lags sound very short to me.

MacLaury (Minneapolis):

I suppose I would say that, as a rule of thumb—and you can check me because I don't have this in front of me—but I would expect that you could have a year, a year and a half, two years, of declining interest rates by this kind of phenomenon or logic that we've talked about, and then, probably a couple of years of rising interest rates. That could be, in some sense, a typical cycle.

The question was discussed further at Minneapolis.

Kareken (Economic Adviser):

It's a little bit tricky. I think that it's a very hard question to answer because if you believe, as Anderson of the St. Louis Bank and others have found, that the response of the economy depends upon initial conditions, for example, you might expect what happens to interest rates when you start this experiment could depend upon how close you are to full employment, or something like that. So, I think that to the extent that initial conditions matter, you can't give—you can get an average which may not, however, have a tremendous amount of meaning.

Weintraub:

Right, there may be great variation around the central tendency. But, in a period of relatively full employment, you would expect that some—someone said they expected it to be faster than a period of, you know, unemployment, relatively high unemployment. Do you agree with that?

President MacLaury:

I certainly do.

Weintraub:

How about you, John?

Kareken:

Well, that is certainly the conventional wisdom, and I'm not prepared at this point to toss it out, but it's a tricky question.

Francis (St. Louis):

I've never felt too sure about specific timing of lags. I'm quite sure there are time lags. To be specific, and say in every instance it's going to be three months one way and nine another, I'd be a little fearful of that. The lags are there and it may be three months, it may be less or more. I think that differing economic situations might vary time lags. . . .

Morris (Boston):

I don't think you can generalize. It depends on the state of the economy at the time the money supply increase was in-

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jected. I think the higher the level of resource utilization, the slower the lag, or the shorter the time in which the rates react. . . .

Weintraub:

Would you expect in an expansionary buoyant inflationary period the effect to be greater and shorter or smaller and longer than in a period of recession?

Balles (San Francisco):

Smaller and shorter.

Weintraub:

All right. I think I'm back on now. The question I had raised when the tape ran out was whether or not the initial effect, this so-called reverse effect of the change in the money supply, would be shorter or longer in an inflationary period than in a period of recession or depression.

Coldwell (Dallas):

My instinctive reaction to this is that you're likely to get a shorter period of time in an inflation than you do in a deep recessionary period, just partly because you get this inflationary impact on interest rates and interest rates reflecting the inflationary period.

Governor Bucher:

Now, I think when you have an increase, particularly a significant increase, in the money supply, although it does temporarily reduce short-term rates, . . . an excess supply of money is going to have a long-range effect on prices and, therefore, on interest rates through anticipation of inflation.

Weintraub:

Suppose we now were in a period, though, in which we have had price increases, and the public has become accustomed to experiencing inflation, and now we again stepped up the rate of growth of the money supply. In this sort of a period would you expect the time before interest rates began to rise again, following their initial fall, to be shorter?

Governor Bucher:

Yes, I would.

Weintraub:

Okay, fine. I agree with that entirely. I would expect the longer we lived in inflation the shorter this period could become.

Governor Bucher:

And I'll tell you, the more and more the financial community and even the public become aggregate watchers, if you will, I think the more this will be exacerbated. I think this tendency will be to shorten it and shorten it, as people, in

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> their own minds, compare growth in money supply with future inflation.

Cagan's results are not conclusive. But they present a formidable empirical challenge to those who would use monetary policy to resist money market pressures and who fear the money market effects of gradually moderating M–1 growth. The challenge, as the interviews reveal, is especially persuasive during periods of buoyant credit demands and inflation. We are now in such a period. Those who would ignore Cagan's findings in formulating and implementing monetary policy should be asked to provide strong contradictory evidence. If fighting money market fires and resisting extraneous pressures requires M–1 growth to shoot-up well above the desired long run growth path (as may well have happened in 1974 and certainly has happened before), then, unless it is quickly brought back down, all too soon the result will be still faster inflation, even higher interest rates, and graver money market prices. It would be appalling if this happened for no good reason because the expected initial response of interest rates was either trivial or ephemeral; and in today's conditions it may be both.

As President Eastburn (Philadelphia) said, in an earlier quoted discussion:

> . . . the market could be more self-reliant with respect to changes in interest rates than it has been permitted in the past.

The relationship between money supply and money market developments has of course also positive implications for how to use monetary policy to fight both inflation and high interest rates. On this theme President Francis (St. Louis) said:

> Well, Dr. Weintraub, I have always taken a little different approach. I don't like to say, or I don't like to hear people say, that the way the central bank goes about slowing up inflation is to raise interest rates. I think the thing we can do, the tools with which we work, dictate that we get the rate of monetary expansion under control. Now if this should cause interest rates to kick up momentarily, I wouldn't be upset about that, but I think that if we were doing the right thing on the aggregates, say M–1 for example, or the base, any kick-up in interest rates would be very short lived and over the longer pull you would see interest rates come down. So, I prefer for the Federal Reserve System to focus in on the monetary aggregates, or maybe better put, the rate of monetary expansion.

(iv) Many of those interviewed believe that we can check the current inflation only if we are willing to significally under-achieve with respect to employment. They question, as President Morris (Boston) did, as quoted earlier:

> I don't know what the maximum level of unemployment the Congress would accept in the interest of dampening inflation.

Congressional guidance could be useful. In specific, it would be useful to set forth a desired time path for decelerating inflation. Expe-

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rience (mid 1969-mid 1971) indicates that by braking M–1 growth substantial progress can be made in checking inflation in what now appears to be a relatively short time. But unemployment increased unacceptably in that episode. Slowing down the process by reducing the deceleration of M–1 growth would hold unemployment increases to acceptable levels.

Attempts to formulate a soft landing timepath, whether made by the Congress in carrying out its oversight responsibilities or the Federal Reserve alone or together with the Executive Branch, must take into account that the trade off between unemployment and inflation is a slippery one. Federal Reserve policymakers are not unaware of the problem.

MacLaury (Minneapolis):

> I think the first point I would make is that on the unemployment level, there is a debate and I think a serious one, on what is a—whether there is a new trade-off on the Phillip's curve between unemployment and inflation, and I think I subscribe to the George Perry kind of argument that in fact what used to be thought of as the trade-off at 4 percent is now 5 percent or something like that . . .

Weintraub:

> I think so, but I want to press you a little bit more on it. Perry has said, and you apparently agree with this, that the trade-off terms have changed.

MacLaury:

> Adversely.

Weintraub:

> . . . So that the—and against us, and the Phillip's curve is a slippery device at best, isn't it?

MacLaury:

> Correct.

This does not make it impossible to achieve price level stability and full employment simultaneously.

Weintraub (questioning President Francis of St. Louis):

> You have indicated, in answering one of the questions, that we could achieve both, reasonably full employment and reasonable price stability, simultaneously.
>
> Now there was, a few years ago at least, a hypothesis abroad that we couldn't; there was a trade-off between the two. And I guess (looking at the 1960's), one could say there may have been a trade-off, but the terms (at least) have changed (but still exist). But your notion would be that over a longer period of time the so-called trade-off simply is too slippery to be a useful policy tool.

Francis:

> I have never seen monetary policy, and I guess substantially because of this lag thing that we talked about, as being

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> a very useful instrument to offset short-run happenings in the economy. And I think that over history we can see too many periods of time when it would appear that in attempting to use monetary policy for that purpose we have gotten perhaps opposite results than were intended . . .
>
> Dr. Weintraub, I honestly believe that if we would get busy searching out the long-run level of monetary growth that would facilitate what many economists refer to as the "growth potential" in this country, that we could indeed have an economy growing at its, what should we say, normal potential, with full employment.

Is the approach recommended by President Francis the right approach? Perhaps not. But at the least, it would appear to be worth ventilating.

The interviews show that the Francis approach would involve major changes in the Federal Reserve's current (and traditional) policies and operating procedures. In essence, the Federal Reserve would have to focus less (much less) on solving perceived short run problems and concentrate its efforts on achieving long run goals. In specific, the following changes would be required.

(i) The Federal Reserve would have to refrain from accommodating special events and developments. Such restraint could be a large plus. Accommodating behavior, which is reminiscent of "real bills" behavior, lends itself to magnifying economic cycles. Monetary policy is no more stabilizing in years that are marked by rapid M–1 growth and inflation even though there is rapid economic growth, than in years when low M–1 growth is matched by low economic growth even though prices are stable. Accelerated inflation comes with and after the former; recession with and after the latter. Recommendations to match M–1 growth to predicted or past inflation appear especially counterproductive. Those who urge this, as was earlier discussed, should be asked how inflation is to be decelerated and related questions. Refraining from such short run accommodating or matching behavior could eliminate a major cause of past cycles.

(ii) The Federal Reserve must determine on a continuing basis exactly how much debt (old and new) it has to monetize for M–1 to grow along the desired long run track. It must refrain from monetizing more than is required in years when the deficit is large and less than is required when the deficit is small or the budget in surplus.

(iii) Perhaps most importantly, the Federal Reserve must be chary of resisting money market pressures, lest, as has often happened in the past, money supply is forgotten and grows at a destabilizing rate as the byproduct of the actions taken to fight fires and keep order in money markets. As discussed earlier, there is no evidence that resisting money market pressures achieves its purposes. Rather, the evidence indicates that desired interest rate effects are small and short-lived and that the permanent effect is to pull interest rates up significantly. Thus little if anything will be lost by concentrating on M–1 growth, and there is much that can be gained.

Last, concentrating on M–1 growth will require focusing the Open Market Committee's instructions on M–1 growth. At present the instructions are focused on money market targets as well as M–1 growth,

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and these can be incompatible. Often this results in confusion about what to do, as the following remarks by Governor Sheehan show.

> We use both aggregate and interest rate tolerances for targets. We do look at the aggregate and set targets for them. We do look at a variety of interest rates and set targets for them in ranges. We try to balance our activity between 4 or 5 selected targets. Over time we may find that exogenous factors may affect one and we'll disregard it for a short period of time. Currently M–1 is depressed, or there's a percentage of change on the upside because certain things are happening, we'll tend to disregard that for the next 4 to 6 weeks and see what happens while we focus on 3 or 4 others: M–2, the Federal funds rate, and other rates.

Weintraub:

> All right.

Governor Sheehan:

> So we take an electric approach.

Weintraub:

> This can be dangerous, of course. I think it was Lee Bach who said many years ago at the 1964 anniversary hearings on the Federal Reserve that when you take this eclectic approach and look at two or more variables, up to five, at the same time, it's only a happy accident when they're all behaving in the appropriate way or in the expected way. So that sometimes they're inconsistent and then you have to make a choice.

Governor Sheehan (At another point):

> It's very difficult to find out really what the Fed is doing if you're not on the inside.

Weintraub:

> Well, all right.

Governor Sheehan:

> There have been periods since I've been here where we didn't feel that the Desk Manager was doing what we told him to do. Therefore, we met and reconsidered, and had vigorous discussions as to, is that really what we told him to do, and is he interpreting our instructions correctly?

Focusing the OMC's instructions on M–1 growth would put an end to such confusion. It would thereby permit the Desk Manager to achieve desired M–1 growth. This, many believe is absolutely essential if the tide in our long battle with inflation and high interest rates is finally to be changed.

V. Recommendations

It is not easy to be sanguine about the Federal Reserve's focus being changed through internal debate alone. I say this notwithstanding

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that among the Federal Reserve policymakers interviewed more than a handful are men of special candor and knowledge and courage. I say this because the entrenched intellectual traditions of established institutions are seldom if ever changed from within. For 60 years Federal Reserve policy has been dominated by the themes of the Banking School. To wit:

(a) Vary the money supply so as to smooth short run fluctuations in money rates; prevent, as Paul M. Warburg put it long ago, "too low money rates in times of abundance, as well as too high rates in times of scarcity."

(b) Furnish money to accommodate the "real needs of Government and business. Thus President Kimbrel (Atlanta) posed the question:

> . . . We were trying to police bank credit and yet in the real world, the banks had extraordinary commitments that they had made in earlier periods. They had sought accounts with the attraction that we'll have commitments for lending available, not thinking that these at some future time would be utilized. Well, I wonder from you, how do we anticipate, how do we wonder that we're going to accommodate an honest contract? At a period of time when interest rates are already high, we're trying to change the reserves, trying to slow the things down, already in a period—but these banks are actually committed to make further loans of substantial numbers.

Weintraub:

> Isn't there the possibility, at least, that if, in a period like today, if the Federal Reserve supplies banks with reserves to make these additional loans that they have committed themselves to do, that this will lead to still more inflation?

Kimbrel:

> That was certainly our thought at the time, and with the same set of circumstances existing today, yes—I think the answer would be that obviously, you'd be contributing more and more to inflation.

And with inflation, to higher and higher interest rates.

The monetarist warning that policies based on Banking School themes exacerbate long-run economic instability, and cause too high, not too low interest rates in times of monetary abundance has not yet been heeded. What is needed is to bring the substantive issues involved out and into the open to be debated fully and regularly.

Accordingly, it is recommended that Congress treat monetary policy in the same way as it is now about to treat fiscal policy. First, let the Federal Reserve annually request from the Congress permission to operate within specified M–1 growth guidelines, which, to retain limited flexibility to deal with short-run problems, could be expressed in terms of the behavior of year-to-year growth for the next 12 months. (Targets would be set for each of the next 12 months in terms of percentage changes from the same month a year ago, for example,

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for the year ending October 1974, 5 percent plus 1½ or minus 1 percent.)

Let Congress hold hearings on the Federal Reserve's recommendations. The Federal Reserve should spell out the implications of alternative target M–1 growth paths on unemployment, inflation, interest rates, and such priority concerns as housing. Congress can then approve or modify the recommendations as desired. If within the next 12 months the Federal Reserve wants to operate outside the established guidelines, it can request that special hearings be held for the purpose of relaxing the guidelines. Congress has demonstrated capacity to act promptly in other connections and presumably could do so in this connection if such action was really needed. Moreover, in monetary policy as in all affairs, haste often leads to unwanted results.

Second, let Federal Reserve policymakers, be responsible as individuals for reviewing last year's money supply behavior, explaining its consequences and specifying what changes they now would make in that behavior if they could go back and change their past decisions. (A single review could be submitted if there was no disagreement. But all Presidents and Governors should be required to explicitly state their concurrence.)

Third, let the full minutes of the Open Market Committee meetings be made public immediately or at most six months after they are held, deleting until another six months has elapsed all so-called sensitive discussions.

These recommendations can be viewed singly or as a package. The first recommendation to establish a target money supply growth path for the coming year in open forum would provide everyone with the same knowledge about long term monetary policy. Wage and other contracts could be negotiated more rationally as a result, that is, with full understanding of the extent to which monetary policy would or would not validate inflationary contracts. Households and business could plan their budgets with knowledge of the extent to which their plans would or would not be propped-up by monetary policy. Those who buy and sell securities could also use this information. But there is no reason to think that buyers (or sellers) could obtain a net advantage from knowledge of the Federal Reserve's money supply target growth path. Moreover, as President Mayo of Chicago pointed out, as things now are:

> . . . the market indeed does have a fairly full understanding as to what the factors are in monetary policy that are going to lead to specific steps by the Federal Reserve. This happens to be a product, in part, of the fact that many of these people who are in the market, and in the position of making markets, have at one time either worked in the Treasury or in the Federal Reserve. Indeed there is also cross-fertilization the other way. So it is no great secret as to how you interpret what the Fed is doing and indeed is trying to do. A number of the leading writers in New York—the Lehman Letter, Lanston's Letter and so forth—are written by former Treasury, former Federal Reserve people, and they're very good in interpreting these things.

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There would appear to be much to be gained and nothing substantially to be lost in setting the money supply target openly in public forum.

The latter two recommendations would permit Congress and the public to better utilize the candor, knowledge, and courage of individual Federal Reserve policymakers. These recommendations moreover are in the tradition of the Federal Reserve Act. Congress rejected the Aldrich Bill which would have established a single central bank with dispersed operating branches. The Federal Reserve Act rather set up a system of 12 regional central banks supervised by a Board of Governors. Of course the System has to act as a single unit in implementing monetary policy. But it is neither necessary or desirable to submerge the views of individual policymakers in formulating policy or to relegate them to voices in the wilderness in overseeing it.

Finally, the thrust of all three recommendations is that those who are responsible for monetary policy will do a better job if (1) their parts as individuals in decisionmaking are made public while the decisions are still of vital interest to the public, (2) they are compelled to regularly publicly review the consequences of past decisions in a format which permits airing dissenting views rather than only setting forth the consensus view, and (3) they must annually arrive at and seek approval for their consensus money supply growth path.

In closing, it should be recognized that proper monetary policy is not a panacea. It can save us only from the consequences of inadequate monetary policy. No financial system, no matter how well structured and regulated, can function smoothly in a disruptive monetary environment. Our financial system has been in a state of irregular but recurring turmoil since 1966, the year after the inflation began, accommodated and fueled by rapid money supply growth. A year ago, the turmoil centered on so-called "wild card" deposits. Now it is focused on Citicorp's proposed variable interest redeemable note issue. It is, in the final analysis, futile to stop these innovations in mobilizing saving on the ground that stopping them will remove the threat to the growth and development of housing oriented thrift institutions. These innovations are not the cause of the malaise which now threatens thrift institutions. They are its manifestations. Stop one, and another soon emerges. If we want a financial system in which housing oriented thrift institutions can grow and function smoothly, we must first get a proper monetary policy. Only after money supply growth is controlled so that it is neither accommodative or generative of either inflation or recession, can we hope to succeed in assuring the viability of thrift institutions; the allocation of credit for low and moderate income housing, and other priorities as Congress may establish; and the equitable treatment of small savers in the mobilization of saving. Being able to explore ways of improving our financial system in a non-crisis atmosphere would be one beneficial byproduct of achieving a monetary policy which is not destabilizing. The direct benefits, once again, are greater economic stability—minimal unemployment and minimal inflation—and reasonable interest rates.

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FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES

WEDNESDAY, JULY 17, 1974

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 4:05 p.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman [chairman], presiding.

Present: Representatives Patman, Barrett, Sullivan, Reuss, Moorhead, Stephens, Hanna, Gettys, Rees, Koch, Widnall, Johnson, Brown, Wylie, Burgener, and Rinaldo.

Also present: Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee.

The CHAIRMAN. If you gentlemen will get seated and put the microphone in front of you, we'll get started pretty soon.

We want to apologize for being late, but we were tied up all day, in caucus or on the floor of the House, or before the joint meeting of the conferees.

Today we are going to hear testimony from three Federal Reserve bank presidents: John J. Balles of the San Francisco bank, David P. Eastburn of the Philadelphia bank, and Alfred Hayes of the New York bank. President Hayes also is vice chairman and a permanent voting member of the Open Market Committee. Presidents Balles and Eastburn serve as voting members of the committee only once every 3 years.

Some members of this committee took exception yesterday to my charging in my opening statement that "the Federal Reserve has been the engine of our current inflation." Let me assure the gentlemen that I would welcome a debate on the substance of this issue. Let the gentlemen be mindful that no light is cast on the issue by their attacking me. I stipulate that Dr. Burns is an honorable man, and a fine fellow, for that he is as I have said on numerous occasions including when he was appointed. Defense of the Federal Reserve and its various chairmen is nothing new in this committee.

But in this critical period I would hope that the members will direct their attention to the substantive issue of the Federal Reserve's performance. Let us abandon knee-jerk defenses of agencies which we are charged with overseeing and start talking about the consequences of their policies.

Yesterday we heard very persuasive testimony from Dr. Robert Weintraub, a member of our staff, that Federal Reserve Open Market Committee money supply policies have caused and accommodated the raging inflation and high interest rates which afflict our economy.

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The witness yesterday called attention to four critical issues in monetary policy, which in recent years appears to have been persistently resolved by deciding to take action which accommodates and generates inflation and high interest rates. In his interviews he found a substantive difference of opinion about the wisdom of accelerating money supply growth, as the Federal Reserve has been doing, to accommodate and validate transient and even self-reversing inflationary developments such as bad harvests. He found also differences of opinion about the Federal Reserve's normal practices of monetizing Government deficits and fighting fires and keeping order in money markets, even though the predictable byproduct of these practices are inflationary money supply growth and in short order, higher interest rates. Finally, he found concern about the possible employment effects of moderating money supply growth to check inflation.

The witnesses we will hear from today should be able to enlighten us about these critical issues. It also is my hope that Presidents Balles, Eastburn, and Hayes will comment on the staff's recommendations to improve all aspects of monetary policy: Formulation, implementation, and oversight evaluation.

The staff recommended that the Federal Reserve annually provide Congress with analyses of the implications of alternative money supply policies and that the Congress select the policy to be implemented. It was recommended also that all Federal Reserve policymakers annually review and evaluate last year's money supply behavior and that the minutes of the Open Market Committee be made public immediately.

Gentlemen, your comments on these issues and recommendations could be of great value to the committee. Let me welcome you and express the hope that you will be straightforward and not pull any punches in your testimony.

You may proceed by summarizing your testimonies, starting with President Hayes, as he is the vice chairman of the Open Market Committee. After President Hayes, we will then hear from President Balles and then President Eastburn.

Gentlemen, you are recognized in that order, and I say again, we are delighted to have you, you are welcome; and we will certainly give careful consideration to everything you tell us because we know that you have expertise in this line that we do not have, and we welcome your testimony. Mr. Hayes, you may commence your testimony.

STATEMENT OF ALFRED HAYES, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. HAYES. Thank you. Mr. Chairman and members of the committee, I am happy to have this opportunity to express my views on some of our current economic problems, especially as they relate to monetary policy and the Federal Reserve System.

I will shorten my statement, which I will submit in full for the record.

I would like at the outset to add my voice to those who believe that our most serious current economic problem is inflation. Indeed, the solution to many of our other difficulties, including high interest rates, the slump in housing, the liquidity problems of business and financial institutions, as well as many of our problems in the international

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financial sphere, depends importantly on our ability to get inflation under control. I believe that control of inflation clearly should be the main objective of monetary policy for the present and probably for quite some time to come.

I won't go into the whole history of the reasons for our inflation, it has had a long evolution, leading back to the late 1960's. The demand inflation, which it was at first, led in due course to cost pressures and steadily mounting inflationary expectations.

Over a long period of nearly 10 years, we have paid an increasingly heavy price, in terms of irregularly accelerating inflation, for giving insufficient attention to the limits on our capacity to meet evergrowing demands at stable prices. Over most of this period, the Federal budget has been in significant deficit and fiscal policies have certainly been too expansionary during the period as a whole. Nor would I argue that monetary policy has been immune over this long period to the national tendency to try to expand demand at a rate in excess of what can be produced at stable prices. Indeed, I think there have clearly been times, particularly in 1968 and in 1972, when monetary policy has been rather too expansionary.

In any case, I think we have learned that the virus of inflation becomes progressively more difficult to cure as its treatment is postponed or neglected. The prospect of an ever-accelerating inflation is truly frightening in its implications for the stability of our economic and social system. The point has now been reached where we must direct our attention to solving this problem even though the cure may have painful side effects in the short run. As I will later indicate in more detail, I do not believe that our present inflationary problems stem solely from demand conditions. Nor do I believe that monetary and fiscal policies, which are the main tools of demand management, are the only ones we should use in bringing inflation under control. But I think that prudent moderation in aggregate demand is an absolute precondition to the restoration of price stability.

Against this general background, I would like to address myself now to some issues in which the chairman indicated a particular interest in his letter inviting me to testify.

One of those is the so-called tradeoff between inflation and unemployment and its implications for formulating monetary policy. In my view the notion that unemployment can be permanently reduced below some specified minimum simply by pumping up aggregate demand—and without any improvement in the structural characteristics of our labor markets—is quite misleading. Indeed, the notion that low levels of unemployment can be achieved by monetary policy alone has probably caused a good deal of mischief.

To be sure, if unemployment is abnormally high, the judicious application of monetary stimulus can help reduce unemployment to more moderate levels with little adverse effects on inflation. Beyond a certain point, however, one that seems to be dictated largely by the structural characteristics of labor markets, attempts to reduce unemployment in this way require progressively larger doses of stimulus. Thus, a progressively more rapid inflation is required to achieve given effects on unemployment. Certainly, our present situation of unemployment in excess of 5 percent, coupled with the escalation of inflation rates that we have witnessed, strongly suggests that this process has been at work over the past decade.

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At the same time, I do not want to suggest that an unemployment rate such as 5 percent needs to be accepted for all time as the best we can do. What I think has to be recognized is that the only way permanently to reduce the levels of unemployment compatible with price stability lies in measures that will increase the qualifications of the labor force that are in demand and that will produce a more efficient and speedy matching of willing workers and available jobs. Any attempt to solve the problem by pumping up aggregate demand can, in the end, have only devastating inflationary consequences with the accompanying risk of leading ultimately to really serious slumps in the economy and heavy unemployment.

I would like to turn to the relationship between monetary and fiscal policies, and the problems posed to monetary policy by fiscal stimulus in the inflationary environment. Monetary and fiscal policies work best in tandem, not when they are working at cross-purposes. While monetary policy can offset some of the effects of an excessively expansive Federal budget, it cannot compensate for all of the shortcomings of fiscal policy.

When productive facilities are strained by excessive demands for goods and services, Federal deficits tend to exert upward pressure on prices. At the same time, deficit financing also puts upward pressure on interest rates as the Government bids for credit to cover its deficits. This situation creates a dilemma for monetary policy. To underwrite the deficit by monetizing the Federal debt would of course tend to be inflationary. Inflation tends in the longer run to become embedded in the credit markets in the form of higher interest rates, as I shall indicate more fully in a moment.

On the other hand, preventing credit from expanding to accommodate a Federal deficit would tend to put immediate upward market pressures on interest rates. Such developments are, of course, unpopular, and it's all too easy without realizing it, almost, to accommodate the pressures generated by fiscal deficits.

Reliance on monetary policy alone to restrain inflation in the face of overly expansive fiscal policy therefore does entail risks. Rising market rates of interest induce savers to withdraw funds from thrift institutions, thereby drying up the major source of private financing of residential construction. Extremely tight money, moreover, can imperil the liquidity and even the solvency of credit-dependent firms. The Federal Reserve cannot be oblivious to the risk of pushing monetary restraint too far. We must bear in mind our essential role as lender of last resort to the economy. If liquidity pressures mounted to the point that a breakdown of the credit system appeared to be a serious threat, the Federal Reserve would have to take steps to forestall it. This might entail some temporary deviation from the monetary growth rates that would be consistent with long-run price stability.

I would like to comment also on the relationship among the monetary aggregates, inflation and interest rates. Certainly, historically, there has been a broad long-run relationship between trends in monetary expansion and the behavior of prices. Over a long period of time, price stability depends upon a rate of money and credit growth commensurate with the economy's capacity to produce. Ultimately, therefore, the return to an era of price stability will require the restoration of the monetary aggregates to moderate rates of growth. I should perhaps add that some of our current notions of what constitutes moder-

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ate growth would have seemed rather rapid in an earlier period of relative price stability.

I think it would be an oversimplification, though, to attribute all fluctuations in the pattern of inflation to the behavior of the monetary aggregates. There may be many nonmonetary developments which can have a powerful influence on the behavior of prices for a period of 1 year, or 2, or even longer; I need only mention the recent case of fuel and food supply shortages as an example.

There are other factors that may have an important influence over prices, quite independent of the behavior of the monetary aggregates. One of the most conspicuous of these in recent years has been the behavior of foreign exchange rates. I think there is little question that the overall depreciation of the dollar since early 1971 has been a significant inflationary force in this country.

With regard to the relationship between inflation and interest rates, the trend to higher levels of interest rates that has developed over the past several years has clearly reflected in major part the behavior of prices. In a situation where rising prices have steadily eroded the real value over time of debt instruments, lenders have come to demand an inflationary rate premium, and borrowers have felt justified in paying such a premium. It is hard to persuade savers to lend their savings at interest rates lower than the rate of inflation, especially when real estate and other commodity investment exist as alternatives to fixed dollar instruments. In this setting an attempt to bring down interest rates by rapid expansion in money and credit would be self-defeating, except perhaps in the very short run. I am convinced that the only way to restore more normal levels of interest rates is to restore stability—and this will require restraint in monetary expansion, not extravagance.

The problem for monetary policy in bringing inflation under control and interest rates down to more normal levels is indeed essentially a single problem. The solution requires a degree of monetary restraint over a period sufficiently long to wring inflation out of the economy.

On a number of occasions in recent years during periods of monetary restraint, tight money conditions have resulted in sharp liquidity pressures on particular institutions, or particular segments of the markets. In some instances these have been so acute, or threatened to become so acute as to create risks for the financial system as a whole. In such instances the Federal Reserve has recognized and accepted its responsibilities, particularly in its role as lender of last resort, and has taken action designed to cushion the impact of such pressures.

There are a number of things that could be done to make the task of monetary policy easier. I mentioned fiscal restraint, programs to aid housing, such as those recently announced by the administration; a third would be efforts to improve the functioning of our labor markets, perhaps including, if needed, Federal job programs for the unemployed.

One important factor that gives me hope that our job may be a little easier this time is the widespread conviction on the part of the American people, at least as I observe it personally, that inflation is public enemy No. 1. I am hopeful that this will be reflected in a healthy measure of self-restraint in our common fight against inflation, including

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restraints by labor in wage settlements, and by industry in the setting of prices.

In any case, I think a patch of prudent monetary restraint for however long is needed to restore price stability is the only responsible course of action. A premature easing would lead to a resurgence of demand pressures, and a renewed and even more virulent acceleration of inflation. This would, I am convinced, pose serious dangers for our economic and social fabric. Price stability, as I said, is the key to many things, to low interest rates, to a smoothly functioning financial system, to a healthy housing industry, to a strengthened international economy, and to the opportunity for sustainable economic growth.

All of these things can be achieved through responsible policies, including monetary policy, not without temporary costs, to be sure, but at costs that will be far outweighed by the accrued benefits.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Hayes. We have a policy here for the panel, that each one make his statement, comments; and then we will interrogate all three of you at the same time, each member will be allowed a limited time to do the interrogating.

In order to shorten it, sometimes we ask the witnesses if they are willing to answer in writing questions that members may submit to them, and if that's agreeable—we have that policy, and if that's agreeable, we'll do that in many instances rather than asking the questions. Would that be satisfactory to you gentlemen?

Mr. HAYES. Fine.

[Testimony resumes on p. 97.]

[The prepared statement of Mr. Hayes follows:]

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Statement by
Alfred Hayes
President, Federal Reserve Bank of New York
before the
Committee on Banking and Currency
of the
House of Representatives
July 17, 1974

Mr. Chairman and members of the Committee, I am happy to have this opportunity to express my views on some of our current economic problems, especially as they relate to monetary policy and the Federal Reserve System.

I would like at the outset to add my voice to those who believe that our most serious current economic problem is inflation. Indeed, the solution to many of our other difficulties, including high interest rates, the slump in housing, the liquidity problems of business and financial institutions, as well as many of our problems in the international financial sphere, depends importantly on our ability to get inflation under control. I believe that control of inflation clearly should be the main objective of monetary policy for the present and probably for quite some time to come.

Our current inflationary situation has had a long evolution, dating back to the mid-1960s. It began with our unwillingness, for a long period, to provide increased taxes to finance the Vietnam war and expanded social programs. The result was an excessively stimulative fiscal policy and pressures on aggregate demand. The ensuing demand inflation led, in due course, to cost pressures and to steadily mounting

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inflationary expectations. These secondary, but apparently inevitable, consequences of prolonged demand pressures made inflation progressively more deep-rooted and difficult to cure. The recession of 1970 removed demand pressures for a time. While it went too far in generating idle resources, the rate of inflation did begin to come down. Unfortunately, the gains in this respect were disappointingly slow and modest to an understandably frustrated public. I believe the program of price and wage controls begun in mid-1971 made a significant contribution to reducing inflation as long as demand pressures remained under control. By late 1972, however, the economy was again expanding too rapidly. Demand pressures reasserted themselves, making controls of little use and even counterproductive over the last portion of their life.

Over a long period of nearly 10 years, we have paid an increasingly heavy price, in terms of irregularly accelerating inflation, for giving insufficient attention to the limits on our capacity to meet ever growing demands at stable prices. Over most of this period, the Federal budget has been in significant deficit and fiscal policies have certainly been too expansionary during the period as a whole. Nor would I argue that monetary policy has been immune over this long period to the national tendency to try to expand demand at a rate in excess of what can be produced at stable prices. Indeed, I think there have clearly been times, particularly in 1968 and in 1972, when monetary policy has been rather too expansionary.

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In any case, I think we have learned that the virus of inflation becomes progressively more difficult to cure as its treatment is postponed or neglected. The prospect of an ever accelerating inflation is truly frightening in its implications for the stability of our economic and social system. The point has now been reached where we must direct our attention to solving this problem even though the cure may have painful side effects in the short run. As I will later indicate in more detail, I do not believe that our present inflationary problems stem solely from demand conditions. Nor do I necessarily believe that monetary and fiscal policies, our main tools of demand management, are the only ones we should use in bringing inflation under control. Nevertheless, I think it is clear that prudent moderation in aggregate demand is an absolute precondition to the restoration of price stability. And monetary policy certainly has a very large role to play in this development.

Against this general background, I would like to address myself now to come issues in which the Chairman indicated a particular interest in his letter inviting me to testify. One of these issues is the so-called "trade-off" between inflation and unemployment and its implications for formulating monetary policy. In my view, the notion that unemployment can be permanently reduced below some specified minimum simply by pumping up aggregate demand--and without any improvement in the structural characteristics of our labor markets--is quite misleading. Indeed, the notion that low levels of unemployment can be

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achieved by monetary policy alone--provided only that a little more inflation be tolerated--has probably caused a good deal of mischief.

To be sure, if unemployment is abnormally high, the judicious application of monetary stimulus can help reduce unemployment to more moderate levels with little adverse effects on inflation. Beyond a certain point, however, one that seems to be dictated largely by the structural characteristics of labor markets, attempts to reduce unemployment in this way require progressively larger doses of stimulus. The resulting inflation, which may be moderate at first, tends to accelerate progressively. In time, inflation comes to be built into the structure of costs and expectations and its stimulative effects wear out. Thus, a progressively more rapid inflation is required to achieve given effects on unemployment. Certainly, our present situation of unemployment in excess of 5 per cent, coupled with the escalation of inflation rates that we have witnessed, strongly suggests that this process has been at work over the past decade.

I do not pretend to know just what rate of unemployment might be a sustainable minimum for price stability under the conditions of the 1970s. I do feel sure, however, that it is something materially above the 4 per cent figure that was often cited in the past as an appropriate full employment goal.

At the same time, I do not want to suggest that an unemployment rate such as 5 per cent need be accepted for all time as the best

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we can do under conditions of sustained price stability. What I think has to be recognized is that the only way permanently to reduce the levels of unemployment compatible with price stability lies in measures that will increase the qualifications of the labor force that are in demand and that will produce a more efficient and speedy matching of willing workers and available jobs. Attempts to solve the problem by pumping up aggregate demand can, in the end, have only devastating inflationary consequences with the accompanying risk of leading ultimately to really serious slumps in the economy and in employment.

Even if we could be sure we could trade a higher level of employment for an additional measure of inflation, this would seem to be a very bad bargain for the American people under the present circumstances. The longer inflation is allowed to run unchecked, the larger will be the distortions built into the economy and the more difficult and painful will it be to bring inflation under control. Thus, even though unemployment is not as low at present as most of us would like to see it, I think we have no real alternative to a policy of moderate but continuing monetary restraint. The short-term costs of restraint at this juncture will be less than would ultimately have to be paid if we were to allow inflation to gain even further headway before acting decisively to bring it under control.

A somewhat special problem for monetary policy in combating inflation can arise, as the Chairman suggested in his letter, when

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non-recurring price increases stemming from supply shortfalls arise. The increase in petroleum prices associated with the Middle Eastern oil boycott last winter is the most conspicuous recent example. I think it is difficult to generalize about the possible implications for monetary policy of such developments. Much depends upon circumstances.

In some cases, I would think such developments need not require any change in the thrust of monetary policy. In principle, the rise in prices in one sector of the economy may set in motion compensating price changes in other sectors as available funds are diverted to the sectors where prices have risen. Thus there may be, especially, in the longer run, little net change in inflationary pressures and no reason to change the thrust of policy. In particular instances, however, much depends upon the flexible and timely reaction of prices in the sectors not directly affected by the special development. In the shorter run, such developments clearly can add to the overall rate of inflation.

Of course, shortages of oil or other essential commodities can have a magnified depressing effect on total real output since they are needed to produce other goods and services. This was a matter of considerable concern during the recent oil embargo. While we in the Federal Reserve were under no illusions that we could increase the supply of oil by increasing the supply of money, we were also alert to the danger that the shortage-induced downturn in the economy could

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cumulate into a general recession. We were prepared to ease monetary policy if such a process seemed to be getting under way. This did not develop, however, and policy was not changed in any major way in response to the effects of the embargo.

I would now like to turn to the relationship between monetary and fiscal policies and the problems posed for monetary policy by fiscal stimulus in an inflationary environment. Monetary and fiscal policies are most effective when they are used in tandem, rather than working at cross purposes. While monetary policy can offset some of the effects of an excessively expansive Federal budget, it cannot compensate for all of the shortcomings of fiscal policy. Our experience over the past several years bears testimony to this truth. While a combination of factors has exacerbated our inflationary problem, Federal budgetary deficits have played a significant underlying role.

When productive facilities are strained by excessive demands for goods and services, Federal deficits tend to exert upward pressure on prices, as the Government competes with the private sector for scarce resources. At the same time, deficit financing also puts upward pressure on interest rates as the Government bids for credit to cover its deficits. This situation creates a dilemma for monetary policy. To underwrite the deficit by monetizing the Federal debt would of course tend to be inflationary. And inflation tends in the longer run to become imbedded in the credit markets in the form of higher

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interest rates, as I shall indicate more fully in a moment. On the other hand, preventing credit from expanding to accommodate a Federal deficit would tend to put immediate upward market pressures on interest rates. Such developments are, of course, unpopular and it is all too easy, almost without realizing it, to accommodate the pressures generated by fiscal deficits.

Reliance on monetary policy alone to restrain inflation in the face of overly expansive fiscal policy therefore does entail risks. Rising market rates of interest induce savers to withdraw funds from thrift institutions, thereby drying up the major source of private financing of residential construction. Extremely tight money, moreover, can imperil the liquidity and even the solvency of credit-dependent firms. The Federal Reserve cannot be oblivious to the risks of pushing monetary restraint too far. We must bear in mind our essential role as lender of last resort to the economy. If liquidity pressures mounted to the point that a breakdown of the credit system appeared to be a serious threat, the Federal Reserve would have to take steps to forestall it. This might entail some temporary deviation from the monetary growth rates that would be consistent with long-run price stability.

In practice, monetary policy must weigh the dangers of accommodation against those of resistance to excessive fiscal stimulus. The results are unlikely to be entirely satisfactory as long as excessively expansive fiscal policy is tolerated. I am encouraged

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by Congressional steps to gain better control over fiscal policy. I hope a more active and concerted role by the Congress in framing fiscal policy will significantly diminish the risk that monetary policy will have to select among bad choices in the face of inappropriate fiscal policy.

In commenting on the role of fiscal policy, I do not want to imply that monetary policy has not played a role in the evolution of our present situation. Indeed, as I indicated earlier, I think monetary policy has clearly been somewhat too expansionist at times over the past decade.

I would now like to turn to the relationships among the monetary aggregates, inflation and interest rates. Certainly, there has been, historically, a broad long-run relationship between trends in monetary expansion and the behavior of prices. Over long periods of time, price stability depends upon a rate of money and credit growth commensurate with the economy's capacity to produce. Ultimately, therefore, the return to an era of price stability will require the restoration of the monetary aggregates to moderate rates of growth. And I should perhaps add that some of our current notions of what constitutes "moderate" growth would have seemed rather rapid in an earlier period of relative price stability.

It would, however, be a gross oversimplification to attribute all fluctuations in the pattern of inflation to the behavior of the monetary aggregates. There may be many non-monetary

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developments that can have powerful influences on the behavior of prices for periods as long as one, two, or more years. The special case of supply shortages, as in the recent fuel and food cases, has already been touched on. As I noted earlier, such supply developments need influence only relative prices in the longer run, with spending being diverted from other sectors whose prices should in principle fall, or at least rise less rapidly, leaving the overall rate of inflation unaffected. But in the shorter run, the prices of goods in sectors not directly affected by such special developments may be rather unresponsive to demand conditions. Under these circumstances, there may be, and I believe have been, significant, if temporary, effects on the overall price level.

There are, moreover, many other factors that may have an important influence over prices quite independent of the behavior of the monetary aggregates. One of the most conspicuous of these in recent years has been behavior of foreign exchange rates. I think there is little question that the overall depreciation of the dollar since early 1971 has been a significant inflationary force in this country. The depreciation of the dollar has raised the dollar prices of goods we import. It has also tended to raise the prices of goods produced in the United States and sold in both domestic and foreign markets.

Among other influences on inflation apart from the behavior of the monetary aggregates, I have already noted the role of excessively

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stimulative fiscal policy. More broadly, I think the rough long-run statistical parallelism between price and monetary behavior conceals important social and political factors that partly account for this statistical relationship. The well-known association between wars and inflation, for example, has often reflected the unwillingness of governments to finance military spending through adequate taxation. This has often led to pressures on central banks to accommodate government borrowing through excessive monetary and credit expansion. And wars have not provided the only instances of governmental failure to face up to the costs of spending programs with consequent pressures, direct or indirect, on central banks to make up the difference by monetary expansion.

With regard to the relationship between inflation and interest rates, the trend to high levels of interest rates that has developed over the past several years has clearly reflected in major part the behavior of prices. In a situation where rising prices have steadily eroded the real value over time of debt instruments, lenders have come to demand an inflationary rate premium and borrowers have felt justified in providing it. It is hard to persuade savers to lend their savings at interest rates lower than the rate of inflation, especially when real estate and other commodity investments exist as alternatives to fixed dollar instruments. In this setting, an attempt to bring down interest rates by rapid expansion in money and credit would be self-defeating, except perhaps in the short run.

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I am convinced that the only way to restore more normal levels of interest rates is to restore price stability--and this will require restraint in monetary expansion, not extravagance.

The problem for monetary policy in bringing inflation under control and interest rates down to more normal levels is indeed essentially a single problem. The solution requires a degree of monetary restraint over a period sufficiently long to wring inflation out of the economy. This will mean gradually reducing the growth of the monetary aggregates to a trend compatible with long-run price stability.

The task of restoring price stability is likely to be protracted. The experience of recent years indicates that our price system reacts only gradually to changes in demand conditions owing to the long-lasting secondary effects of demand pressures on costs and expectations. In view of these factors, I do not expect price behavior to react quickly to monetary restraint. The length of time that will be required to bring the long-run trend of monetary expansion, aggregate demand, and price behavior to a satisfactory point will depend upon a number of factors. The ability of our financial markets to withstand restraint, the impact of restraint on unemployment and on particularly sensitive areas of the economy such as the savings institutions and the housing industry, will affect the feasible path of monetary policy.

On a number of occasions in recent years during periods of monetary restraint, tight money conditions have resulted in sharp

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liquidity pressures on particular institutions or particular segments of the markets. In some instances these have been so acute, or threatened to become so acute as to create risks for the financial system as a whole. In such instances, the Federal Reserve has recognized and accepted its responsibilities, particularly in its role as lender of last resort, and has taken action designed to cushion the impact of such pressures.

There are a number of things that might be done to make the task of monetary policy easier. Fiscal restraint is certainly one of these. A budget surplus would be very helpful in relieving strains on financial markets. Programs to aid housing, such as these recently announced by the Administration are another example. A third would be efforts to improve the functioning of our labor markets, perhaps including, if needed, Federal job programs for the unemployed.

An important factor that I hope will make our job easier this time is the widespread conviction on the part of the American public that inflation is public enemy number one. I am hopeful that this will be reflected in a healthy measure of self-restraint by all of us in our common fight against inflation--including restraint by labor in wage settlements, and by industry in the setting of prices.

In any case, I think a path of prudent monetary restraint for however long is needed to restore price stability is the only responsible course of action. A premature easing would lead to a

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resurgence of demand pressures, and a renewed and even more virulent acceleration of inflation. This would, I am convinced, pose serious dangers for our economic and social fabric. Price stability is the key to many things, to low interest rates, to a smoothly functioning financial system, to a healthy housing industry, a strengthened international economy, and to the opportunity for sustainable economic growth. All of these things can be achieved through responsible policies, including monetary policy--not without temporary costs, to be sure, but at costs that will be far outweighed by the benefits accrued.

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The CHAIRMAN. The next witness is John J. Balles, president of the Federal Reserve Bank of San Francisco. I believe you are next, Mr. Balles.

STATEMENT OF JOHN J. BALLES, PRESIDENT, FEDERAL RESERVE BANK OF SAN FRANCISCO

Mr. BALLES. Thank you, Mr. Chairman, I appreciate this opportunity to share my thoughts with this committee on the problems raised in your letter. I have submitted a longer statement for the record.

The CHAIRMAN. It may be inserted in the record.

Mr. BALLES. In the interest of brevity, sir, I will try to capsulize in about 10 minutes the essence of my views.

The CHAIRMAN. All right; yes, sir.

Mr. BALLES. As you pointed out in calling this hearing, certainly two of the most serious problems in this country today are rampant inflation and sky-high interest rates. The present inflation is especially pernicious because it has hit hard at the poor, that is where the greatest price increases have been, in food, fuel, and the necessities of life. There is no doubt that the high level of interest rates has had a very serious dislocation effect in numerous areas in our economy that I spell out in my detailed statement for the record.

As you all know, this problem is not confined to the United States. It's a worldwide phenomenon, high interest rates, high inflation—in most countries worse than in our own. How did this happen? I don't believe that governments and central banks operate out of blind ignorance, or perverse motives; thus I have tried to identify some deep-seated causes around the world that have brought this result about.

Two things have been very important. One is the increasing pressure we seem to have on the world's available resources that has been created by a growing, more affluent population around the world by people and in country after country that have rising aspirations for a higher standard of living.

Another key factor seems to have been that, as a result of the greatest depression that we all suffered from around the world in the 1930's, government after government after World War II adopted a conscious full-employment policy, giving very high priority to rapid growth, to reaching capacity output, and keeping unemployment down to what we consider acceptable levels. Given that priority, governments have committed themselves to ongoing expansionary domestic policies to prevent these unacceptable levels of unemployment. At the same time there has been created in this country, and most others, an underlying policy bias toward inflation.

You might well ask, why hasn't monetary policy been more effective in first heading off, or later combating inflation when it does develop?

I would like to identify what I think are the three key things that have prevented that from happening. The first key factor, I think, that inhibited the effective use of monetary policy is the long succession of Federal budget deficits that we have had 14 of the last 15 fiscal years, $193 billion increase in debt, or about 67 percent since 1959. In theory, it can be argued that a tighter monetary policy ought to be able to offset this. In practice, Mr. Chairman, I find the opposite tends to take place. I think the reason is along the following lines:

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Large-scale deficit financing, first of all, does add greatly to credit demand in the market; and the initial effect is to have a rise in interest rates. Since many sectors of the economy are adversely affected by interest rates, some more than others, especially housing and municipal finance, you soon get pressures, to keep interest rates from rising to what are considered to be unreasonable levels, or even dangerous levels.

For example, in the spring of 1973, you recall there was a serious effort made by some Members of the Congress to freeze interest rates, or even roll them back to the level of January 1. The central bank in this country, or any other, cannot and should not be independent of government. The central bank, in this country and others, must respond to what it perceives to be the order of priorities as determined by the national administration and the national legislature. Unfortunately the only way that mounting credit demands can be satisfied—in the short run at least—without an increase in interest rates, is for the Fed to accelerate the growth of money and credit, and in the process we generate inflationary pressures that show up a year, or 2 later.

It has been my observation, in short, that excessive deficit financing has been the main thing pulling monetary policy off course toward excessive monetary expansion which creates inflation in the long run.

The second major fact, in my view, that has been adversely affected the use of monetary policy as an anti-inflation tool is the conflict that sometimes arises between policy goals of full employment and stable prices. Since the early 1960's it has been my understanding that the full employment goal of this country has generally been expressed as an unemployment rate of not more than 4 percent.

There are some good studies, including one made by Brookings Institution and one by Professors Eckstein and Brimmer for the Joint Economic Committee, that suggest that a 4-percent unemployment rate today represents a much tighter labor market than it did, say 10 years ago, or 20 years ago, principally because of an increased participation in the labor market by teenagers, by part-time women workers, and by others who may lack marketable skills. As a result monetary and fiscal policy design today to reduce the jobless rate to 4 percent tends to create inflationary pressures.

I would suggest that rather than imposing inflation on everyone by attempting to reach our laudable employment goals by expansionary fiscal monetary measures, our aim should be a much more vigorous use of selective measures to deal with the structural unemployment problems, steps to facilitate worker mobility, or low-interest education loans to youth, minority workers, or retraining programs for workers directed toward jobs where vacancies are abundant. I'm not for unemployment; I'm for a different mix of programs, sir, to deal with it.

The third factor that I think has tended to inhibit the effective use of monetary policy is a rather complicated technical one, and that is the lag impact we get on the economy from a change in monetary policy. We don't know as much about this as I would like to, our knowledge of lag is imperfect; but it's pretty clear that the lag in the effect of a policy change is much shorter for production, employment, and profit than it is for prices.

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In an easy money situation the good news appears first, that is the stimulating effect on jobs, output and profit, you may see that, let's say, in 6 to 12 months; but, the bad news comes later. The inflation doesn't appear until 1 or 2 years later as a lagged impact of the easy money.

Conversely, in a tight money situation the process is reversed, so that the bad news comes first, that is the dampening of economic activity; and the good news is delayed, of diminished rate of inflation. Given this, it's not difficult to predict what type of policy is the more popular, that is easy money in the short run, which is, I'm afraid the type of horizon most of our people would look at.

I think we've got to recognize that the very sharp escalation of interest rates we have seen in the first half of 1974 has occurred despite a rise in the money supply, that some of our critics fear it is still too large to be noninflationary. In short, the money supply has gone up at something over a 7-percent annual rate in the first half of this year, and yet interest rates have escalated.

Thus, the extremely high level of interest rates in my view has stemmed mainly from the forces set in motion by inflation itself, which is the inflation premium which you find in interest rates that is, lenders demanding a premium because the purchasing power of their assets is going to be reduced and by the fact that inflation magnifies credit needs because the prices of goods and services go up.

High and rising interest rates have certainly taken their toll on the economy and on financial markets. Again, as I spelled out in more detail in my prepared statement.

One may certainly ask whether we must put up with such severe dislocations, with all that it implies for disruption in our economy. Unfortunately, I don't see any way out of it, short run, because a policy specifically aimed now at reducing interest rates would require us in the Fed to provide a massive injection of loanable funds into the banking system, and an acceleration in the growth of money and credit.

The result might be, in the short run, some stabilization or possibly a decline in interest rates; but in the longer run that policy would surely cause an even sharper rise in prices as we got the delayed impact of too many dollars chasing too few goods, and with that higher rate of inflation down the road, interest rates would soar even higher.

I conclude with the question, what can we do to extricate the economy from the present situation of surging inflation and sky-high interest rates?

I have four specific recommendations, Mr. Chairman, realizing with some spirit of humility that we don't know all the answers, I certainly don't know them all; but at least this represents my best judgment.

First of all, I think it would be very beneficial for the Congress, the administration, and the Fed itself to take a longer view of things in its policy planning measures, to adopt the longer term policy horizon because we do have lag impact of things that we do in the fiscal policy area, lagged effects of what we do today in the monetary policy area. I'm afraid all too often we tended to do shortrun good, but have produced longrun harm.

Second, budget reform. I applaud the Congress for the moves taken this year in moving toward budget reform. For the first time, Congress will be able to vote on fiscal policy, and that is a major leap forward.

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But, beyond that, I think it is vital to push for actual budgets which are restrictive in periods of severe inflation, such as we have today. Specifically, I think the best fiscal policy for the current fiscal year would be at least a balanced budget, or preferably a surplus, instead of the $11.5 billion deficit that is presently projected. In my judgment that is the most important single step that the Congress itself could take to relieve pressures on the credit market, to relieve inflationary pressures, to get the level of interest rates down. Up to this time we have tried to lean too heavily on monetary restraints to do the job with the result that we have a rather narrow focus to our anti-inflation efforts, that is, credit controls, and resulting high interest rates.

The third recommendation I would make would be an amendment to the Employment Act of 1946, assuming that the Congress agrees with this philosophy, stating explicitly that price stability is a coequal goal of economic policy along with those famous triple goals of the Employment Act of 1946, maximum employment, production, and purchasing power. I think in the past our laudable emphasis on maximum employment, production, and purchasing power has caused us to down play the importance of price stability with the results we see today.

My final recommendation has to do with monetary policy itself. If we are to overcome inflation, we need to have congressional and administration support in pursuing a noninflationary growth target for money and credit, even if high-interest rates, and possibly some increase in unemployment are necessary in the short run, as we wring inflationary forces out of the economy.

In conclusion, I think it's particularly vital that we in the Fed are not pulled off course toward excesses, that is inflationary credit ease, by two major forces that have done so in the past; first, the necessity to finance large-scale budget deficits, and the tendency to call for easy money to solve structural unemployment problems that could be better handled through selective measures of the type that I have described.

In conclusion, Mr. Chairman, your letter of June 19 set forth six specific areas in which there are disputes in monetary economics. My prepared statement does contain a summary of my views point by point on each of those, but in the interest of brevity I will not read it at this time.

The CHAIRMAN. Thank you kindly, sir.

[Testimony resumes on p. 121.]

[The prepared statement of Mr. Balles follows:]

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Statement of John J. Balles, President
Federal Reserve Bank of San Francisco

to

House Committee on Banking and Currency
Washington, D. C.

July 17, 1974

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PROBLEMS OF INFLATION AND HIGH INTEREST RATES

Mr. Chairman, I appreciate this opportunity to share my thoughts on basic monetary problems with this Committee. I will attempt to set forth and analyze what I believe are the major issues and the appropriate policies to deal with them. In that context, I will deal with the questions you raised in your letter of June 19.

As you pointed out in calling these hearings, two of the most serious problems currently facing the U.S. economy are an unprecedented rate of peace-time inflation and a record high level of interest rates. The present inflation is especially pernicious because many of the largest price increases have been for necessities such as food, housing and fuels, so that the poor and those living on reduced retirement income have been hardest hit. Such perverse effects of inflation tend to negate the attempts of the government in recent years to assist such groups with direct government programs. Similarly, it is clear that the current high level of interest rates has created serious dislocations and strains in our economy. These include the adverse impact on the housing market, the large capital losses to those persons in all walks of life who have put their savings into stocks and bonds, directly or through mutual funds and pension trusts, and the threat to the liquidity of financial institutions.

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World-Wide Problem

As you are aware, the problems of rampant inflation and extremely high interest rates are not restricted to the United States. All of the major industrial countries are experiencing similar, or even higher rates of inflation, and the high interest rates which go with these rates of inflation. A significant share of our current inflation results from the fact that the prices of many basic goods -- such as oil, wheat, cotton, and lumber -- are determined in the international market place, rather than in the U.S. market alone. Thus, worldwide inflation acts to exacerbate and complicate our domestic inflation problem. For similar reasons, the resolution of our current inflation and high interest rate problems does not lie completely within our hands, but rather requires the cooperation of the major industrial countries of the world.

What has led to this unprecedented worldwide inflation? Some observers would cite excessive monetary and fiscal expansion as the major immediate cause. But since I do not believe that governments and central banks act out of blind ignorance or perverse motives, we must consider the social and political climate which tends to produce a bias toward inflationary policies. One major factor appears to be the increasing pressure on the world's available resources which has been created by a growing and more affluent population with ever-rising expectations for a higher standard of living. Another key factor appears to be the increased priority that governments have assigned to achieving a fully employed economy, both here and abroad,

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since World War II. Given this priority, governments have committed themselves to ongoing, expansionary domestic policies to prevent "unacceptable" levels of unemployment from developing. These secular developments have tended to create an underlying inflationary bias in government policies throughout the world.

The cultural and economic forces generated over the past three decades have provided the basis for our present inflationary experience, but they do not explain why serious worldwide inflation occurred in the first half of the 1970's, rather than the second half of the 1960's, or at some other period. The reasons for the timing of our problems are complex. However, one element which has not received as much attention as it deserves is the breakdown of the Bretton Woods System, and the decline in recent years in foreign confidence in the U.S. dollar. In the years from the end of World War II until the mid-1960's, the world looked on the U.S. as the strongest and most stable country, and the dollar as the strongest and most stable currency. As a result, both foreign governments and private persons tended to accumulate dollar assets. But as the U.S. suffered an almost unbroken string of deficits in our balance of payments, and as the U.S. inflation rate gradually accelerated in the late 1960's towards 6 percent, confidence in the dollar weakened, and there was an incentive to switch out of dollars into other currencies.

This movement out of dollars accelerated in the period after the U.S. suspended convertibility of the dollar into gold in August, 1971. The movement only came to a halt in March 1973, when most industrial countries floated their exchange rates, and thereby rang down the curtain on the

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Bretton Woods system of fixed-exchange rates.[1/] In the period up to March 1973, foreign governments resisted an appreciation in value of their own currencies *vis-a-vis* the dollar because they believed that it would hurt their export industries, slow their growth, and create domestic unemployment. The consequent intervention in foreign-exchange markets by other governments substantially increased the domestic money supply in these countries as they bought dollars by issuing their own money through central bank operations. Thus the well-publicized dollar overhang was matched by foreign monetary expansion. Simultaneous monetary expansion in all major industrial countries helped to foster a simultaneous business-cycle boom around the world, which aggravated the inflation from which we all now are suffering.

Having noted the worldwide inflationary climate, I would now like to turn to a more specific analysis of the underlying factors that have produced rampant inflation in the United States, even in the face of a softening in economic activity. It may be helpful to put this problem in historical perspective, before attempting to assess possible cures.

Effect of Budget Deficits

Our domestic inflation problem owes much to the fact that the Federal Government in the United States has run deficits in 14 of

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1/ "How Well Are Fluctuating Exchange Rates Working," Report of the Subcommittee on International Economics of the Joint Economic Committee, 93rd Congress, 1st Session (Washington, D.C.: U.S. Government Printing Office), August 14, 1972.

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the last 15 fiscal years. These deficits, which have occurred in all phases of the business cycle, have expanded the Federal debt by $193 billion, or 67 percent since 1959. Federal deficits became an especially critical problem with the major escalation of the Vietnam war in mid-1965. The size of these deficits increased at an alarming rate during the Vietnam build-up period between 1966 and 1968 when the economy was at, or near, full employment. The fiscal situation was temporarily relieved by the belated income-tax surcharge in mid-1968, and by a leveling off in military expenditures at about the same time. However, the situation deteriorated further in 1969-70 when outlays for civilian programs outstripped recession-reduced revenues, and became still worse in the 1971-73 period when a full-blown expansion got underway.

It can be argued that a tighter monetary policy ought to have been able to offset the inflationary effects of this large, sustained deficit financing. In theory this may be true, but in practice the opposite has tended to occur. When huge Federal credit demands are added to those of a fully-employed private sector, interest rates tend to rise sharply. There are some sectors of the economy, such as housing construction, and programs financed with municipal bonds, that are especially sensitive to such a development because they depend heavily upon long-term credit. Because high interest rates have an uneven impact on the economy, demands for relief are quickly heard. For example, in the spring of 1973, there was a serious effort made by some members of Congress to freeze interest rates, or even roll them back to the level of January 1, 1973.

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In short, large-scale deficit financing by the Government tends to bring great pressures on the central bank to keep interest rates from rising to "unreasonable," "unacceptable," or "dangerous" levels. Unfortunately, the only way that mounting credit demands can be satisfied without an increase in interest rates in the short run is for the Federal Reserve to accelerate the growth of money and credit. But if done for too long, or to an excessive degree, such action can generate inflationary pressures which may persist for a long period of time and result in even higher interest rates in the long run.

It has been my observation that large and persistent Federal deficits are a major factor in pulling monetary policy off course, in the direction of excessive monetary expansion, as the central bank attempts to cope with the conflicting pressures that develop. Too often in practice, therefore, an expansionary fiscal policy tends to generate excessive expansion in money and credit.

Priority of Employment Goal

The second major factor tending to inhibit the use of monetary policy in combatting inflation is the conflict in national goals that often occurs as between "full employment" and stable prices. Since the early 1960's, the "full employment" goal in the U.S. generally has contemplated an unemployment rate of 4 percent or less. Such a rate was regarded by many as a practical minimum, in view of the normal shifting of workers between jobs and the lack of marketable skills of some job-seekers. Whenever the conventional or aggregate unemployment rate has exceeded 4 percent, pressures have developed for expansionary

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monetary and fiscal policies. For example, recently there have been demands for a tax cut to take up slack in the economy and to reduce our conventional or aggregate unemployment rate from the 5.2 percent level that prevailed last month. Were such policies to be undertaken, I greatly fear that they would simply accelerate the already extremely high inflation rate in the U.S.

In my view, there has not been enough policy use of a refined analysis of the employment and unemployment data, concentrating on the "hard core" of our labor force -- i.e., heads of households or "breadwinners" -- for whom the social and economic costs of unemployment are the highest. Among this group, the unemployment rate last month was only 3.1 percent, in contrast to the conventional or aggregate unemployment rate of 5.2 percent.

The significance of a 4 percent aggregate unemployment rate has gradually changed over time because of shifts in the composition of the labor force. An earlier study by George Perry of the Brookings Institution[2/], and a more recent study by Eckstein and Brimmer for the Joint Economic Committee[3/] suggest that a 4 percent unemployment rate today represents a much tighter labor market than it did

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2/ George L. Perry, "Changing Labor Markets and Inflation", Brookings Papers on Economic Activities, No. 3, 1970

3/ "The Inflation Process in the United States." Study prepared for the use of the Joint Economic Committee by Otto Eckstein and Roger Brimmer, (Washington, D.C.: U.S. Government Printing Office), February 22, 1972.

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twenty years ago, in view of the increased participation in the labor market by teenagers and other new entrants who also lack marketable skills. Generally, it now seems to take a higher rate of inflation to achieve a 4 percent unemployment rate than it did some years ago because of those factors. Thus if we should now attempt to follow a monetary policy aimed at reducing unemployment to 4 percent, the likely consequence would be to exacerbate present inflationary pressures, which have already reached dangerous levels.

This, of course, is not to imply that monetary and fiscal policy should never be used to help deal with unemployment. What it does mean is that, because of shifts in structure of the labor force, there may be a change over time in the practical minimum unemployment target that can be achieved through expansionary monetary and fiscal policies without creating an unacceptable rate of inflation. Thus, some knowledgeable observers would hold that, because of the shift in the composition of the labor force already noted, the practical miniumum target today might be about 4½ - 5 percent as far as measures to stimulate aggregate demand through monetary and fiscal policy are concerned.

In these circumstances, a very useful way to fight unemployment is to attack the structural source of the problem by helping to increase the marketable skills of those groups who lack experience. Such measures as low-interest education loans to youth and minority groups, retraining programs directed toward skills where job vacancies are high, and steps to facilitate worker mobility are all important in this context. Rather than imposing inflation on everyone by attempting to reach our employment goals through expansionary monetary and fiscal

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policies, our aim should be a much more vigorous use of selective means to deal with these specific problems. We need a high-powered rifle shot approach, rather than the shotgun approach of monetary and fiscal policy.

For whatever reason, there has been a tendency for the goal of "full employment" to take priority over stable prices, in view of actions in recent years by the Administration and Congress -- whose job it is to determine national priorities. Not enough attention seems to have been paid to the trade-off -- i.e., the additional inflation that must be accepted to get a lower unemployment rate. In essence, my argument is that we have had both a faulty diagnosis, and in part the wrong medicine, for the unemployment goal. First we need a more meaningful "target rate" for unemployment, as I have explained. Secondly, we need new perceptions and new remedies for structural unemployment, particularly among teenagers, minority groups and part-time women workers.

Lags in Monetary Policy Impact

A third major factor which tends to inhibit the use of monetary policy in combatting inflation, and which results in calls for its use to provide short-term stimulus to the economy, is a complicated technical one. Namely, the lags in the effects of a change in monetary policy seem to be shorter for production, employment and profits than for prices. Admittedly, our knowledge about the length of those lags is imperfect. But it is reasonably clear that the "good news" from easy money appears first, with production, employment, and profits expanding within, perhaps, 6 to 12 months. However, the "bad news" comes later, in the form of increased inflation with a lag of perhaps 1 to 3 years. Conversely, if a tight money policy is adopted, the bad news of a dampening of

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economic activity comes first, whereas the good news of a diminished rate of inflation is delayed. In these circumstances, it is not surprising that elected officials who must face the voters at regular intervals tend to prefer an easy money policy.

Has Monetary Policy Been Too Expansive?

Thus, it may be asked, has monetary policy been a principal cause of our inflation problem, with the accompanying high level of interest rates, and could this have been avoided if monetary policy had been tighter in recent years? In testimony earlier this year before the Congress, Chairman Burns acknowledged that, with the benefit of hindsight, monetary policy may have been overly expansive in 1972. Some of our critics, such as Professor Milton Friedman, would go much further -- alleging that the money supply has grown too fast since about 1970, and that this played a major role in producing the current inflation.

Such criticism, whether or not fully justified, is easy enough to make, based both on monetary theory and statistical studies, but it seems to me to ignore real problems in the real world. No central bank can be or should be wholly independent of government. The elected representatives of the people of the United States, both the Congress and the Administration, must have the ultimate responsibility for economic policy. The Federal Reserve System must take account of the high priority which the Congress and the Administration have assigned to full employment and economic growth, which has often conflicted with stable prices. Central banks cannot completely ignore such imperatives -- even against their better judgment. It is vital that this matter be thoroughly appreciated,

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yielding market instruments, and the consequence has been a major curtailment of funds to the housing industry. To the man on Wall Street, the dangers have been just as ominous. For example, public utilities have experienced serious difficulties in raising money in the capital market, and the commercial banks have had increasing problems in raising funds to meet heavy loan demands.

The market disruptions caused by high interest rates, in turn, have seriously affected the real economy. Those who have invested in stocks and bonds, directly or through mutual funds and pension trusts, have suffered substantial capital losses, and have become poor sales prospects for new homes, new cars and other big-ticket items. And higher borrowing costs generally have contributed to higher prices of most goods and services.

One may certainly ask whether we must put up with such severe dislocations in the financial markets and the overall economy. Unfortunately, the answer to this question appears to be yes. A policy specifically aimed at reducing interest rates now would require massive injections of reserves into the banking system by the Federal Reserve and an acceleration in the growth of money and credit. The result might be a temporary levelling off or decline in interest rates, and a short-run rise in output. But in the longer run, this policy would cause an even sharper rise in prices, which in turn would cause interest rates to rise even higher.

Since high interest rates have had such painful consequences, it is pertinent to ask whether they have done any good in moving toward a solution to the inflation problem. I see mounting indications that the high cost of credit is having the desired rationing effect, both

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from the standpoint of borrowers and lenders, in "cooling off" the economy. This is a necessary first step in purging the economy of inflationary excesses and starting on the long road back toward stable and non-inflationary growth.

Policy Recommendations

What can policymakers do to extricate the economy from the present situation of surging inflation and high interest rates? I believe that several major lessons are implicit in what I have already said about the dangers of inflation and of unbalanced policy responses. However, these lessons can be summarized in the following four specific policy recommendations.

1. Longer-term policy horizons. Both with regard to monetary and fiscal policy, I suggest that we explicitly recognize the lagged effects of policy measures, and work within somewhat longer time horizons than has been the custom in the past. In our present uphill battle against inflation, we should expand our policy-planning horizon to at least three years to measure the effect of policy actions being taken currently. A planning horizon which does not capture the full consequences of current policy actions, especially with regard to prices, necessarily has an inflationary basis.

2. Budget reform. I applaud Congress' efforts this year in moving toward budget reform. By setting up new machinery that will deal with the budget as a singl entity, you are in effect creating a vested interest devoted to the cause of economic stabilization. For the first time, Congress will be able to vote on fiscal policy. But

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beyond that, it seems essential to push for actual budgets which are restrictive in periods of severe inflation. The best fiscal policy for fiscal 1975 would be at least a balanced budget, or preferably a surplus, instead of the $11.4 billion deficit currently projected. In my judgment, this is the most important single step that the Congress could take to relieve inflationary pressures and to reduce the level of interest rates. Up to the present, far too great a burden has been placed on monetary policy, with the anti-inflation effort centered around credit controls and the resulting high price of credit.

3. Economic priorities. I would recommend an amendment to the Employment Act of 1946, stating explicitly that price stability is a co-equal goal of economic policy, along with "maximum employment, production, and purchasing power." Further, I would suggest making explicit in policy decisions the implicit trade-off between full employment and stable prices whenever a conflict arises between these two goals. In the past, our laudable emphasis on the full-employment goal has caused us to downplay other necessary objectives, with the results we see today.

4. Monetary policy. If we are to overcome inflation, the Federal Reserve System must have Congressional and Administration support in pursuing a non-inflationary growth target for money and credit -- even if high interest rates and some increase in unemployment are necessary in the short run, as inflationary forces are wrung out of the economy. It is particularly vital that we not be pulled off course toward excessive credit ease by the two major forces that have done so in the past -- i.e., the necessity to finance large-scale budget deficits, and the tendency to call for easy money to solve structural

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unemployment problems that could be handled better through selective measures of the type I've described.

Concluding Comments

My testimony, Mr. Chairman, has attempted to deal with the broad problems raised in your letter of June 19. Now I would like to conclude with a brief recapitulation directed specifically towards the six issues noted in that letter that involve some dispute in monetary economics. While recognizing that there are differences of opinion on these matters, both within and without the Federal Reserve System, my own views are summarized below.

1. The reliability of the trafe-off between inflation and unemployment as a guide for monetary policy.

The trade-off between inflation and unemployment seems to be unstable and subject to change. In recent years, it appears that the trade-off has worsened -- i.e., it now takes more inflation to produce a given decline in unemployment. Even with the recent 11.5 percent inflation rate, the unemployment rate last month was 5.2 percent. Moreover, the trade-off appears to be a short-run phenomenon. In the long run, say, three years or more, a higher inflation rate will not "buy" a lower unemployment rate. Only in the short run of one to two years will we possibly observe a higher rate of inflation leading to a temporary decline in unemployment. This observation follows from the widely-accepted doctrine that in the long run the growth in the money supply affects only the general price

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level, while in the short run the principal effects are on production and employment.

2. Benefits and risks involved in the Federal Reserve accommodating non-recurring price increases originating in supply shortfalls and other special events.

It is my view that the Federal Reserve should seldom, if ever, accommodate price increases originating from supply shortfalls and other transitory events. This will do nothing to ease the supply problem, and by facilitating higher prices, it will contribute to a higher permanent rate of inflation. As Chairman Burns said last winter, we recently have had a shortage of oil, not a shortage of money, and we cannot increase the supply of the former by increasing the supply of the latter.

3. The benefits and risks involved in monetizing deficit spending.

As I indicated earlier, it is undesirable for the Federal Reserve to monetize the deficits of the Federal Government in periods of full or nearly-full utilization of resources. At such times, the monetization of Federal deficits tends to pull monetary policy off course toward excessive monetary expansion, and thus contributes to inflation. In periods of recession, on the other hand, it is appropriate and beneficial to monetize Federal deficits as part of a program aimed at recovery. Unfortunately, Federal budget deficits (as measured by the unified budget) have occurred in 14 of the last 15 years, irrespective of the

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state of the business cycle. There have been a number of important technical reforms in recent years, such as the auctioning of Treasury securities, which have reduced the Federal Reserve's role in support of the debt management area. However, the fundamental solution to the problem lies in keeping spending in line with receipts, thereby eliminating the deficits when they are not needed to bolster a sagging economy.

4. The benefits and risks involved in the Federal Reserve fighting money market fires.

A primary function of any central bank is to act as the lender of last resort to protect the institutional integrity of the financial system. In this sense the Federal Reserve must "fight money market fires." Many scholars believe that a serious aggravating factor in the Great Depression was the Federal Reserve's failure to perform this function in an aggressive way. In my opinion, the Fed has done a creditable job in protecting the institutional integrity of financial markets in recent decades during periods of liquidity crises, without letting the money supply get out of control on the upside.

5. Relationships between money supply, inflation and interest rates.

The rate of growth in the money supply is a major influence determining the level of interest rates in both the short run of a few months, and in the long run of a few years. However, the nature of this influence is quite different in these two time periods, because of the role of inflation in these relationships.

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In the short run, accelerated money growth can force interest rates down, and restricted money growth can force interest rates up, by altering the short-run supply of funds relative to demand for these funds. However, short-run changes in money growth have little if any direct effects on the overall rate of inflation. In the long run, sustained changes in the rate of growth in the money supply are a major determinant of the rate of inflation, and expectations of future inflation rates. Since current rates of inflation and inflation expectations are major determinants of the current level of interest rates, sustained changes in the rate of money growth will have a major effect on the level of interest rates. The lesson here is that efforts to reduce interest rates by accelerating money growth in the short run will be self-defeating in the long run. Thus, excessive easy money over a period of several years leads to inflation, which is a major factor producing high interest rates.

6. <u>How to use monetary policy to check inflation and to bring interest rates back down to reasonable levels</u>.

Monetary policy can check inflation and bring interest rates back down to reasonable levels through a gradual but steady policy of reducing the rate of monetary expansion to a non-inflationary growth track. But to make this a viable approach, we will need a powerful assist from a policy of fiscal restraint, along with support for making stable prices a goal of equal importance with economic growth and full employment.

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The CHAIRMAN. Our next witness is David P. Eastburn, president of the Federal Reserve Bank of Philadelphia. Mr. Eastburn, you may proceed in your own way.

STATEMENT OF DAVID P. EASTBURN, PRESIDENT, FEDERAL RESERVE BANK OF PHILADELPHIA

Mr. EASTBURN. Thank you, Mr. Chairman, it is a pleasure to be here.

I would like to talk about four points; first, is the causes of inflation; two, is what to do about inflation; three, is the role of interest rates; and four, is the question of evening out the burdens of inflation.

First, on the causes of inflation, I think without minimizing any of the difficulties we face, that inflation is our major economic problem. It has many causes, but I think it's helpful to divide the causes into two aspects. One aspect involves extraordinary events, such as crop failures, oil embargoes, dollar devaluations. These come and go and often not much can be done about them. We have beef prices skyrocketing, and then tapering off; wheat prices diminish, then expand; anchovies disappear from the coast of Peru, and then reappear. If we are lucky these phenomena occur at different times. Unfortunately, in the last couple of years we have been unlucky; many of these have occurred together. This is one aspect, these extraordinary causes of inflation.

The second aspect is monetary. Whatever immediate events may cause prices to rise, including shortages and higher wage costs, a higher price level cannot be maintained without sufficient money. In retrospect it would have been better if money had not grown so rapidly over the past decade. The reasons for this growth go to a large extent to considerations other than inflation, which the Federal Reserve has believed to be important.

Throughout much of the period there was primary concern about the disadvantaged, those unemployed living in dilapidated housing and attending crowded schools. Ample growth in money was necessary to meet these economic and social problems.

In more recent periods the Federal Reserve, partly reflecting views of Congress, has been concerned about the effects of high and rising interest rates. Still more recently concerns for the stability of financial institutions have come to the fore. Whatever the reasons, the consequence of this history is that we found ourselves with rapid increases of both prices and money, and the question is how to deal with them.

This brings me to my second point, what to do about inflation. Inflation has taken nearly a decade to build up, and it will take considerable time and discipline to unwind. There are, I believe, four essential requirements to dampen the inflation.

First, we have to become more realistic about our capacity to fulfill our wants. There has been a tendency in recent years to pass over a hard fact of life, and that is the scarcity of resources. We simply cannot fulfill all desires for all people all at once, although we may earnestly wish to do so. Scarcity is still with us, even in an affluent society.

The second requirement for fighting inflation is a firm handle on fiscal policy. In this regard I would like to join in the comments made

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by the other participants that Congress is to be congratulated for passing the recent budget reform bill; this legislation can give Congress the kind of control that is long overdue.

Third, I believe there is a limited role for an income policy. We have just been through 32 months and four phases of controls, and the economy has just plain had it with controls for awhile. But, there could still be a useful role for monitoring and publicizing key wage and price decisions.

Finally, we need to keep a firm grip on money and credit. History teaches us two lessons about the impact of monetary policy. One is that inflation cannot continue without the money to finance it; therefore, if inflation is to be moderated, growth in money must also be moderated.

The second lesson is that growth in money must be moderated slowly to avoid sending the economy into a serious recession. Translated into current policy, these lessons mean that the recent 7-percent growth in money must be moderated over a period of time, and this time could be quite long. I believe it's important, therefore, for the Federal Open Market Committee to set longrun targets for moderating growth, and then diligently pursue hitting these targets. The FOMC has in fact been attempting such a procedure for over 2 years now, and I am hopeful that with experience and resolve we will be able to improve the accuracy of our aim.

This brings me to the third point, what is the role of interest rates? What would this policy of a gradual restriction on money mean for interest rates?

I'm uncomfortable with high interest rates, especially with the record levels we are currently experiencing. We should be clear about two things: One is what is necessary to bring interest rates down; the other is the role which interest rates play in combating inflation.

The Federal Reserve could try to lower interest rates by supplying money and credit more generously than it has. A faster growth rate for money would likely lower short-term interest rates temporarily, but only temporarily. Opening the money spigot further would add still more fuel to the fires of inflation. This in turn would add to inflationary expectations and interest rates would rise as lenders protect themselves by building in larger inflation premiums. A looser monetary policy aimed at lowering interest rates now would eventually lead to higher rates.

The surer way to lower interest rates is by reducing inflation. In order to do this, the Federal Reserve has to be less generous in supplying money and credit. Cutting back on the flow of money and credit into the economy itself will push up interest rates temporarily. In time, however, lower monetary growth will lead to less inflation and lower interest rates. A restrictive monetary policy will lead in time to lower interest rates, not higher ones.

In the meantime, we should recognize that interest rates are playing an important role in combating inflation; and I say this despite the fact that I know that there is a good deal of debate about the effects of interest rates on the economy. I believe, however, that rising interest rates do choke off some demand for credit, and therefore do help to bring total demand for goods and services into better balance with the ability of the economy to meet these demands.

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A final question remains, however, and that is, what is the impact of credit restraint and high interest rates on various sectors of our economy and society?

That brings me to my fourth point, and that has to do with evening out the burdens of fighting inflation.

One of the burdens of combating inflation will be a higher unemployment rate than we would like. I believe the benefits of moderating inflation will be widely distributed and therefore the burden of fighting inflation should be as widely distributed as possible. Liberalized unemployment benefits, public service jobs, welfare reform, training and education programs are all ways of dealing with problems of those hit hardest by slack in the job market.

The financial burdens of a restrictive monetary policy are also not distributed evenly across the economy. High interest rates, for example, impact heavily on housing and some public projects. A logical question, therefore, is whether we could allocate credit in such a way as to smooth out the burden or even favor some high priority sectors at the expense of lower priority ones. In other words, should the Federal Reserve allocate credit as well as create credit?

I happen to approach this question with considerable sympathy because I think the forces at work in our society, especially over the past decade, confront us with aspects of the distribution of burdens and benefits in a way that we have never had before, with an urgency we have never felt before. They will not go away, and there is good reason, therefore, for the Fed to consider the matter of the allocation of credit with great care and concern.

As a matter of fact, a few years ago I explored this question as thoroughly as I knew how in a paper which I should be happy, Mr. Chairman, to submit for the record.

The CHAIRMAN. Without objection it will be inserted in the record. [See page 425.]

Mr. EASTBURN. Thank you very much. In addition to that I asked our research staff to undertake further studies of selective credit controls, involving their history and their efficacy. We will be putting out the first volume in this series of studies shortly after the turn of the year.

Let me just make five points in summary on this question of allocating credit.

First, selective credit controls are less necessary when markets are working well. One reason credit does not flow into markets such as housing is that artificial limitations are placed on interest rates and lenders. The point is that action to eliminate usury ceilings and other such restraints would make selective credit controls less necessary.

Second, the Fed's experience in attempting to direct credit into "productive" and away from "nonproductive" uses has not been good. The reason is that it becomes virtually impossible in practice to determine which uses are really productive and which are nonproductive. I agree with those who believe a basic solution to inflation is to enlarge the economy's ability to produce. My point is that selective credit controls offer little practical promise of directing funds in ways that will accomplish that. In fact, if it should be part of policy to direct funds into capital investment, this is being done quite effectively by today's tight capital market.

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Third, the idea that positive incentives might be helpful in directing funds in certain ways has a great deal of appeal. We have, in Philadelphia, researched this in some depth, particularly the proposal that variable reserve requirements be placed on various kinds of bank assets. For example, you could place a lower reserve requirement on a high-priority loan, and higher requirements on lower priority loans.

Our research reveals there may be a problem, and that is that credit is extremely mobile, and people are ingenious in substituting one kind of credit for another. If, for example, reserve requirements were to favor home mortgages over business loans, it seems inevitable that businessmen would simply bypass banks to go to other lenders or the open market. An effective program of credit allocation would have to apply across the board; and the workability of such a program seems questionable, to say the least. The costs would be enormous.

Fourth, if, in spite of these difficulties, Congress were to decide that credit should be controlled in accordance with social priorities, I believe that the determination of these priorities is properly a matter for Congress, not the Federal Reserve.

Fifth, the goal of stimulating certain sectors of the economy and restraining others might in some cases better be approached through fiscal rather than credit action. The variable investment tax credit is one possibility. Direct provision of funds for the mortgage market is already being employed; and other possibilities should be explored.

I conclude from this, Mr. Chairman, that over time the question of allocating credit should be studied further. Our analysis today, however, suggests serious problems. Perhaps the most important point is that if we can avoid inflation through general monetary and fiscal policy, we have less reason to be concerned with the allocation of credit. A program of credit allocation is no substitute for responsible policy in dealing with the overall supply of money and credit.

Thank you, sir.

[Testimony resumes on p. 133.]

[The prepared statement of Mr. Eastburn follows:]

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STATEMENT

BY

DAVID P. EASTBURN, PRESIDENT

FEDERAL RESERVE BANK OF PHILADELPHIA

BEFORE

COMMITTEE ON BANKING AND CURRENCY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

July 17, 1974

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I welcome the opportunity to be with you today. When Congress created the Federal Reserve System over 60 years ago, it was fearful of too much power concentrated in too few hands. Thus, it wisely established a decentralized central bank with powers shared by a seven-man Board of Governors in Washington and 12 regional Banks throughout the country, all outside the executive branch. But this organizational arrangement in no way was intended to reduce the accountability of the Federal Reserve to Congress. We are a creature of Congress and accountable to it. I think it is most appropriate, therefore, that Federal Reserve officials testify frequently before the various Committees of the Congress and also that from time to time you hear from the Presidents of the various Reserve Banks.

I should like to talk briefly about four closely related problems: 1) causes of inflation; 2) what to do about inflation; 3) the role of interest rates; and 4) evening out the burdens of fighting inflation.

1) Causes of Inflation

If we could somehow create an economic discomfort index the way weathermen combine temperature and humidity, I suspect we would find ourselves about as uncomfortable as at any time in recent years. Prices are soaring, the unemployment rate is creeping up and interest rates are at record levels.

Without minimizing any of the difficulties we face, I believe the major problem is inflation. We are in perhaps the worst peace time inflation in our history. Unless we begin to unwind inflation, I am fearful of the consequences not only for the economy but for our entire social fabric.

Our current inflation has many causes, but it is helpful to divide them into two main aspects. One aspect involves extraordinary events such as crop failures, oil embargoes, and dollar devaluations. They come and go and

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often not much can be done about them. Beef prices skyrocket then taper off; wheat supplies diminish then expand; anchovies disappear from the coast of Peru and then reappear. If we are lucky, these phenomena occur at different times. In the last couple of years we have been unlucky; many extraordinary events have occurred together.

A second aspect is monetary. Whatever immediate events may cause prices to rise--including shortages and higher wage costs--a higher price level cannot be sustained without sufficient money. In retrospect it would have been better if money had not grown so rapidly over much of the past decade. The reasons for this growth go to a large extent to considerations other than inflation which the Federal Reserve has believed to be important. Throughout much of the period there was primary concern about the disadvantaged--those unemployed, living in dilapidated housing and attending crowded schools. Ample growth in money was necessary to meet these economic and social problems. In more recent periods, the Federal Reserve, partly reflecting views of Congress, has been concerned about the effects of high and rising interest rates. Still more recently, concerns for the stability of financial institutions have come to the fore.

Whatever the reasons, the consequence of this history is that we find ourselves with rapid increases in both prices and money. The question is how to deal with them.

2) What to do about Inflation

There are no quick or painless answers. Inflation has taken nearly a decade to build up and will take considerable time and discipline to unwind. There are, I believe, four essential requirements for dampening inflation:

First, we have to become more realistic about our capacity to fulfill

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our wants. There has been a tendency in recent years to pass over a hard fact of life--scarcity of resources. We simply cannot fulfill all desires, for all people, all at once, although we may earnestly wish to do so. Scarcity is still with us even in an affluent society.

A second requirement for fighting inflation is a firm handle on fiscal policy. In this regard, Congress is to be congratulated in passing the recent budget reform bill. This legislation can give Congress the kind of control that is long overdue.

Third, I believe there is a limited role for an incomes policy. We've just been through 32 months and four phases of controls and the economy has just plain had it with controls for awhile. But there could still be a useful role for monitoring and publicizing key wage and price decisions.

Finally, we need to keep a firm grip on money and credit. History teaches two lessons about the impact of monetary policy. One is that inflation cannot continue without the money to finance it. Therefore, if inflation is to be moderated, growth in money must also be moderated. A second lesson is that growth in money must be moderated slowly to avoid sending the economy into a serious recession.

Translated into current policy, these lessons mean that the recent seven percent growth in money (the narrow money supply or M_1) must be moderated over a period of time, and the time could be quite long. I believe it is important, therefore, for the Federal Open Market Committee to set long-run targets for moderating growth and then diligently pursue hitting these targets. In fact, the FOMC has been attempting such a procedure for over two years now. I'm hopeful that with experience and resolve we'll be able to improve the accuracy of our aim.

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3) Role of Interest Rates

What would such a policy mean for interest rates? I am uncomfortable with high interest rates, especially with the record levels we are currently experiencing. But we should be clear about two things: one is what is necessary to bring interest rates down; the other is the role which interest rates play in combatting inflation.

The Federal Reserve could try to lower interest rates by supplying money and credit more generously than it has. A faster growth rate for money would likely lower short-term interest rates temporarily, but only temporarily. Opening the money spigot further would add still more fuel to the fires of inflation. This in turn would add to inflationary expectations and interest rates would rise as lenders protect themselves by building in larger inflation premiums. So, a looser monetary policy aimed at lowering interest rates now would eventually lead to higher rates.

The surer way to lower interest rates is by reducing inflation. In order to do this, the Federal Reserve has to be less generous in supplying money and credit. Cutting back on the flow of money and credit into the economy itself will push up interest rates temporarily. In time, however, slower monetary growth will lead to less inflation and lower interest rates. So, a restrictive monetary policy now aimed at slowing the rate of inflation will lead in time to lower interest rates, not higher ones.

In the meantime, we should recognize that interest rates are playing an important role in combatting inflation. I say this despite the fact that the effect of interest rates has long been debated. I believe, however, that rising interest rates do choke off some demand for credit and therefore do help to bring total demand for goods and services into better balance with the

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ability of the economy to meet these demands.

A final question remains, however: what is the impact of credit restraint and high interest rates on various sectors of our economy and society?

4) Evening Out the Burdens of Fighting Inflation

One of the burdens of combatting inflation will be a higher unemployment rate than we would like. I believe the benefits of moderating inflation will be widely distributed and therefore the burden of fighting inflation should be as widely distributed as possible. Liberalized unemployment benefits, public service jobs, welfare reform, training and education programs are all ways of dealing with problems of those hit hardest by slack in the job market.

The financial burdens of a restrictive monetary policy are also not distributed evenly across the economy. High interest rates, for example, impact heavily on housing and some public projects. A logical question, therefore, is whether we could allocate credit in such a way as to smooth out the burdens or even favor some high-priority sectors at the expense of lower-priority ones. In other words, should the Federal Reserve allocate credit as well as create credit?

I approach this question with considerable sympathy. Forces at work in our society, especially over the past decade, confront us with aspects of the distribution of burdens and benefits with an urgency that we have never felt before. They will not go away. There is good reason for the Fed to consider the matter of the allocation of credit with great care and concern.

A few years ago I explored the question as thoroughly as I knew how in a paper which I should be happy to submit for the record.* I asked our research staff to undertake further studies of selective credit controls, their

* "Federal Reserve Policy and Social Priorities," BUSINESS REVIEW, November 1970

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history and their efficacy. The first volume of these studies will appear shortly after the turn of the year. I should like now simply to make five points in summary.

First, selective credit controls are less necessary when markets are working well. One reason credit does not flow into markets such as housing is that artificial limitations are placed on interest rates and lenders. The point is that action to eliminate usury ceilings and other such restraints would make selective credit controls less necessary.

Second, the Fed's experience in attempting to direct credit into "productive" and away from "nonproductive" uses has not been good. The reason is that it becomes virtually impossible in practice to determine which uses are really productive and which are nonproductive. I agree with those who believe that a basic solution to inflation is to enlarge the economy's ability to produce. My point is that selective credit controls offer little practical promise of directing funds in ways that will accomplish this. If, in fact, it should be part of policy to direct funds into capital investment, this is being done quite effectively by today's tight capital market.

Third, the idea that positive incentives might be helpful in directing funds in certain ways has a great deal of appeal. We in Philadelphia have done considerable analysis, for example, of the proposal that variable reserve requirements be placed on various kinds of bank assets. A lower requirement could be placed on high-priority loans and a higher requirement on lower-priority loans. Our research indicates a major problem: credit is extremely mobile and people are ingenious in substituting one kind of credit for another. If, for example, reserve requirements were to favor home mortgages over business loans, it seems inevitable that businessmen would simply bypass banks to go to other lenders or the open market. An effective program

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of credit allocation would have to apply across the board. The workability of such a program seems questionable, to say the least. The costs could be enormous.

Fourth, if, in spite of theae difficulties, Congress were to decide that credit should be controlled in accordance with certain social priorities, I believe that determination of these priorities is properly a matter for Congress, not the Federal Reserve.

Fifth, the goal of stimulating certain sectors of the economy and restraining others might in some cases better be approached through fiscal rather than credit action. The variable investment tax credit is one possibility. Direct provision of funds for the mortgage market is already being employed. Other possibilities should be explored.

I conclude from all this that, over time, the question of allocating credit should be studied further. Our analysis to date, however, suggests serious problems. Perhaps the most important point is that if we can avoid inflation through general monetary and fiscal policy, we have less reason to be concerned with the allocation of credit. A program of credit allocation is no substitute for responsible policy in dealing with the overall supply of money and credit.

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The CHAIRMAN. I don't intend to be blunt, but it will sound almost blunt, the questions I ask, as I try to reduce the length of the questions, to cover the maximum number of subjects that I would like to. But, I will take advantage of the opportunity to ask some of them in writing and send them to you gentlemen, send them to the clerk, and he will convey them to you. I would appreciate a frank answer. Of course I would expect to, I have no reason to believe that I wouldn't get a frank answer.

First is, the biggest thing about the Federal Reserve right now is the $80 billion portfolio in the Federal Reserve Bank of New York. The portfolio bonds were purchased by the Government's credit, you took the Government's money and bought the bonds, and you didn't cancel the bonds.

But, you know, academic professors, almost invariably say in dealing with credit instruments and things of that nature, they use, usually, this phrase: "That when the obligor and the obligee become the same person or entity, the debt is canceled."

Have you heard that phrase, Mr. Hayes?

Mr. HAYES. Not in so many words.

The CHAIRMAN. Not in so many words?

Mr. HAYES. But I understand what you mean.

The CHAIRMAN. But, this $80 billion was not paid for by any other money but the Government's money.

Now, then, the debt is not being canceled; the taxpayers are still being compelled to pay between $4 and $5 billion on that money every year. That looks to me like it's clearly wrong, and a bad policy for any agency of the Government, to abuse credit in the way it is being abused in this case. That means, when these bonds become due—they have already been paid for once—William McChesney Martin in answer to my question, right here where you are sitting, said they have been paid for once.

So, now, then, if they are not canceled, they will have to be paid for again when they become due and payable, nobody questions that. You don't question that, do you, Mr. Hayes?

Mr. HAYES. Yes, sir; I do.

The CHAIRMAN. You do?

Mr. HAYES. Yes.

The CHAIRMAN. I will ask you to explain it. Go right ahead, Mr. Hayes.

Mr. HAYES. I would say very briefly——

The CHAIRMAN. Be as brief as I was.

Mr. HAYES. I would say the bonds you are speaking of were initially sold by the Government to various investors all around the country, institutions primarily, and persons; and those institutions and persons paid the Government money for those bonds. We, then, bought those bonds on the open market, and we paid for those bonds. Naturally, the person who had bought them from the Government had to be paid.

The CHAIRMAN. With Government credit.

Mr. HAYES. He would have been out of an asset, which he had bought with his legitimate funds.

The CHAIRMAN. But you paid with Government credit.

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Mr. HAYES. No, we paid them—let's say we buy from a bank, we pay by crediting the bank's reserve account on our books.

The CHAIRMAN. That's right.

Mr. HAYES. There is no skulduggery here, it's a very straight transaction. Then we hold these bonds as security for the obligations, our obligations, security for our note obligations which are the currency we all carry with us; or as an offsetting asset to our reserve account for these various banks. It's a perfectly clean-cut bookkeeping operation, and I don't understand the double-payment theory.

The CHAIRMAN. Well, the double payment is when you reach over into the Government's money, and pay for these bonds that were sold in the open market. If you had canceled the bonds right there, it wouldn't have been near as bad. But, having kept the bonds you have both this $80 billion reserves or book entry outstanding, and the Government bonds outstanding, that's $160 billion.

And, since you are carrying them, they will have to be paid for or "rolled over" when they become due. The Federal Reserve claims to be fighting inflation, and accumulating this portfolio causes it in the very worst way. That's just like trying to put out a fire by using gasoline instead of water; you just can't do it that way.

The last few years the interest rates have gone up, up, up, commencing with June 9, 1969, that was the highest prime rate in the whole history at that time, 8½ percent. Today interest rates are even higher and are still going up, up, up, the Federal Reserve telling us that, now, we ought to put them up further in order to put them down. But, they don't go down except just a little bit for a short time; but they keep on going up, and now the prime is 12 percent. I think that is an immoral rate. I think you gentlemen ought to consider that an immoral rate and do something about it, stop it.

The Federal Reserve can make interest rates go up, interest rates go down, make interest rates remain low; they have done that 14 years one time in our history. For 14 years they kept them there, the Federal Reserve can do it.

Now, then, I think if that $80 billion were canceled like the churches do sometimes, when the obligation is paid they have a big bond burning right out in front of the church, they can see it at the end of the year, or 20 years. So, if we had an $80 billion bond burning out here in front of the Capitol. They have been paid for once, why not burn them? Why make the people pay $4 or $5 billion a year interest on bonds that have already been paid for? Why, that's almost—not a crime——

No; I can't yield. Let's not ask members to yield their 5 minutes, now. No; it hasn't been 5 minutes yet.

Mr. STEPHENS. Did you yield a minute in the last 25 minutes?

The CHAIRMAN. Just half a minute, and I'll be finished. But, why should we leave those bonds outstanding. I think that is a terrible thing, and I ask you, Mr. Hayes, and you gentlemen there, to give serious consideration to that; you are doing this country a great disservice.

The small businessman spends 16½ percent interest, now. That never happened before in the history of this country, and you gentlemen can do something to stop it; and I will ask you now to do something to stop it.

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Now I'll yield to Mr. Widnall.

Mr. WIDNALL. Thank you Mr. Chairman.

Mr. Hayes, did you want to say something in answer to that?

Mr. HAYES. I just wanted to make a couple of comments. In the first place, the chairman urges us to get interest rates down. I thought we had made it pretty clear in our testimony that in our judgment perhaps inflation is the main reason why interest rates are where they are; and getting inflation down in order to get interest rates down is something we very much agree with, but it will take a lot of time.

With respect to those bonds I would point out, although there is interest of $4 or $5 billion on the bonds, virtually all of that is repaid into the Treasury by us anyway because all of our profit over and above a relatively small part which goes to meet expenses, automatically goes back to the Treasury.

Finally, I would point out, if these bonds were canceled, the Federal Reserve System would be left without any assets against a very large liability to the member banks' reserve accounts, and also the liability on our notes which we all carry in our pockets.

Mr. WIDNALL. Thank you, Mr. Hayes.

First, I want to thank all three of you appearing here as witnesses today for extraordinarily fine, and thoughtful statements, and constructive approach to the most serious problem we have.

Mr. Hayes, in your statement you call for a long-run period of monetary restraint in order to slow the rate of inflation and bring down interest rates.

Yesterday, while testifying before this committee, Dr. Weintraub, our staff economist has told us that a 4 percent per annum increase in the money supply would clamp sufficient restraints on the economy to reduce and keep down inflation and interest rates. Do you believe the 4-percent figure is an appropriate one?

Mr. HAYES. Mr. Widnall, I don't believe that there is any exact formula for finding out just what is the right number over an extended period, whether it's 4 percent, or any other percent.

I think that's a gross oversimplification of the task of monetary policy. Under certain circumstances 4 percent might be fine for a while; under other circumstances it might be much too low. I suspect that right at the present moment it might be much too low.

I believe the amount of money that we allow to increase—that we create in the economy—is only one of the factors that we ought to look at in determining our total policy. That is, I am not one of those that believe that the rate of increase in the money supply is the sole determinant of prices and costs in the economy. I think that interest rates themselves have very great effects, can have very great effects on various industries, on the liquidity of institutions, on their willingness to lend, and so forth. I think that we have to follow a rather flexible policy as to the growth rate we would like to see in the money stock; that's always a very important part of our deliberations, that is, we do look ahead and say, well, we would like to see it growing at a certain rate.

I'm precluded from saying what we think the rate ought to be within the next few months, and you will understand that. But, in any case, I don't believe you can name one specific figure and say, for a long period of time, that this is the right number.

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Mr. WIDNALL. Mr. Balles, I was surprised by your—what I took to be a pessimistic statement concerning the future of prices and interest rates. You said, "It will probably require several years to reduce the rate of inflation, and hence interest rates to more reasonable levels."

You suggest the only way to solve our difficulties is through sustained monetary and fiscal restraint. To me that is a rather ominous suggestion. Could this sustained restraint cause a sustained recession; or is a recession the only way to insure price levels and interest rates?

Mr. BALLES. That is a very good question, sir, and I wish I had an answer that I was completely confident of. The reason I took the view that you think is pessimistic, and perhaps it is, that it will require several years, that if we were to attempt to suddenly get down to a 3- or 4-percent rate of expansion of the money supply, versus the 7 percent that we had in the first half of this year, annual rate; I think the shock effect on the economy would tip us into a serious recession.

Broadly speaking, I think all the students of money and credit that I'm aware of, and in whose judgment I would place confidence, who have looked at this question, caution that even though we must get the rate of monetary expansion down from what it has been in recent years to be a noninflationary growth path, that they caution not to do it too rapidly, to do it in small stages because we are not concerned in this country, as you well know, only about the price level, as bad as that is right now, and as serious as that question is right now.

We simply, in my view, sir, should not take steps that have a shock effect on the economy, and that would upset the applecart badly in terms of current production, orders, jobs, and that sort of thing.

In short, it took us a number of years to get into this inflationary situation, and I don't know of any magic to get us out of it quickly. I hope that we can avoid a recession, we are certainly going to try as far as monetary policy is concerned. But, I'm not promising that it's going to happen. There is a risk there.

Mr. WIDNALL. Thank you.

Mr. Eastburn, in your statement you mention that there are two major aspects to the causes of our current round of inflation: extraordinary events and monetary mismanagement.

I think it's important to define these aspects, as you have done. But we must not stop there because if we do the answer to the cause of inflation is incomplete. It is vital that we determine the weight of each aspect in the creation of inflation; only then can we begin to solve our problems.

What is your feeling about the proportional contribution of these two aspects to the current inflationary trends?

Mr. EASTBURN. That is a very difficult question to answer. I have given some thought to this; we investigated that in our research department, our staff; and there are various estimates that are given about the relative proportion of what you might call these extraordinary causes, and what you might call monetary causes.

As nearly as we can tell in recent periods, it comes out about half and half. About half of the price increases have been caused by these peculiar, special conditions; and about half have been caused by the basic underlying monetary aspect which you referred to. This is a very rough rule of thumb.

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Mr. WIDNALL. Would you consider a recent unfortunate experience, wage and price controls, an extraordinary phenomenon, as opposed to the monetary aspect of inflation; or do other conscious policy decisions and programs constitute a third facet of inflation?

Mr. EASTBURN. Well, that's a very good question. I divided that into two parts, two aspects because I think the monetary one underlies all the others. I would consider that despite whatever controls we might have that apply to prices and wages, that if you have an ill-considered monetary policy, that those controls will not be effective.

That is, if you try to put ceilings on prices and wages and you continue to expand the money supply rapidly, too rapidly, these controls will give way.

Putting this in another frame, therefore, when you have prices going up with removal of the controls, these I would consider part of the extraordinary forces, rather than the basic underlying factor; they reflect an effect, a catchup effect of the basic underlying forces, but they are in the same category as these extraordinary forces that I mentioned.

Mr. WIDNALL. Thank you, I believe my time is up.

The CHAIRMAN. All right. Mr. Barrett?

Mr. BARRETT. Mr. Chairman, I just want to welcome Mr. Eastburn here, a Philadelphian, coming from the "City of Brotherly Love," and also Mr. Balles and Mr. Hayes; three very, very fine witnesses.

I'm maybe a little bit prejudiced, but I think Mr. Eastburn has indicated in some way how we can bring inflation under control. I would like to ask the three of you the same question I asked several who were before us the other day.

When did you learn about Citicorp's plan being in the works?

Mr. HAYES. My answer to that is very easy as I just returned——

Mr. BARRETT. Pardon, me; I can't hear you.

Mr. HAYES. My answer is very easy as I just returned from a European trip last weekend, and I read about it in the paper over in Europe.

Mr. EASTBURN. My answer is, I read it in the paper when it appeared in the press.

Mr. BALLES. Same answer.

Mr. BARRETT. In other words, all the Federal Reserve banks and all the banks in this country learned about it the same way. As long as I have been on this committee, I have always believed that a Chase Manhattan, or the First National Bank of New York would invariably go in and see the Federal Reserve people, and say, "This is what we are contemplating, what do you think about it?"

On this occasion I think Citicorp just did solely what they wanted to do in spite of what harm it would do to the mortgage market and the monetary policies of this country.

I can't see any answer for that, and I want to ask the three of you the same question as I did the other day; is the inflation out of control?

Mr. HAYES. No; I would hope that the inflation is not out of control. I think the inflation is in a very dangerous—at a very dangerous level; but I'm rather optimistic that on balance, with the kinds of policies we have been talking about, with a reasonably cooperative fiscal policy and a moderate monetary policy persisting over considerable time, I think there is a very good chance that we will see the inflation rate abating within the next year; but I think there is some big question mark there.

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Obviously the rate of increase in prices should slow noticeably in food and fuel, and some other areas but we may not have seen the worst in some of the industrial price increases and we are facing the question of the wage-price spiral.

Mr. BARRETT. Do you think it's uncontrollable at this point?

Mr. EASTBURN. I would agree with Mr. Hayes, that it is not out of control; but I do think it's vital to understand that if it is to become controlled, it requires a great deal of sacrifice.

Mr. BALLES. I would agree also, Mr. Barrett. I would refer, I think, to the findings of the famous Douglas subcommittee and the Patman subcommittee on this subject in the early 1950's. My recollection of both of those committees is that they proposed that vigorous coordinated and timely use of monetary credit and fiscal policy be the main means that we use to achieve the aims of the employment act of 1946.

I think the testimony of the three of us today has called for that sort of vigorous and coordinated use of monetary and fiscal restraints to lick inflation. If we do that, I think we can get things under control, although not quickly.

Mr. BARRETT. I think you made three very fine statements here, but I do say the gentleman from the "City of Brotherly Love" hit more toward the target than you two. We heard testimony here yesterday about ways to check inflation and bring the interest rates down—and Mr. Hayes talked about this. I was wondering if the interest rate can be brought down by controlling the growth of money supply to less than 4 percent, or a rate of, say, 6 percent a year.

Would either of you agree on that, and if all of you agree on that, how do you think this control can be used to bring down the inflation to a normal level?

I would like to hurry up here, before my 5 minutes terminates. Would you agree that this is the job that the Federal Reserve should have. If you do agree on that, why aren't they making more strenuous efforts to control the money supplies?

Mr. HAYES. Could I just——

Mr. BARRETT. Yes, Mr. Hayes, I think I would like to hear from you.

Mr. HAYES. I would say that our efforts are rather strenuous. First I would like to say that the 6 percent figure that you mentioned does happen to be the rate at which money grew in 1970, and 1971, and 1972.

Mr. BARRETT. May I just interpose here. This is the reason I asked you this question because you said in your statement there two or three times, that this goes back a decade, and you are going back to that, practically. Why wasn't it controlled when it started skyrocketing.

Mr. HAYES. Well, originally, I think, the failing was largely fiscal, the unwillingness to tax in the middle 1960's, when our expenditures were going up very rapidly, was the origin, in my judgment, of the acute form of inflation.

I admit that our own policies may not have been perfect, either, sometimes I believe they were too liberal, in retrospect.

But I think now, when you say why aren't we making strenuous efforts, we are trying to limit the growth of credit and money at a time when public demands are enormous; and the resulting signal of that, the common thermometer of what's happening, is the fact that for instance the Federal funds rate is around 12 percent, it has

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even been around 13 percent. Some people consider that a measure of quite strenuous effort on the part of the Federal Reserve.

The CHAIRMAN. The gentleman's time is up. Mr. Johnson?

Mr. JOHNSON. Thank you, Mr. Chairman.

I, too, want to welcome you three gentlemen here. I think we are highly honored to have the presidents of three of the great Federal Reserve banks of the United States here. I guess it may be a "first" for this committee; and we are certainly glad that you are here.

Mr. Eastburn may be from Philadelphia, but I want you to also know that Mr. Balles is late of the city of Pittsburgh, from the Mellon bank in Pittsburgh. So, we have two Pennsylvanians here. I don't know whether you are from Pennsylvania or not, Mr. Hayes, but we wish you were.

Mr. HAYES. My father was.

Mr. JOHNSON. That's fine. Recently I read an article in one of the financial magazines, and the headline was, "High Interest Rates Are Here To Stay"; and in reading the article carefully, the thrust of the article seemed to be about what you have said on page 11, Mr. Balles, that interest rates and the price of money are determined by the supply and demand for funds which in turn are critically influenced by inflation expectation.

This article went on to say the reason for high interest rates is that anybody loaning out money will want to hedge, so that when he gets that money back 2 years from now, instead of being able to buy 10 Cadillacs, he will only be able to buy 8 Cadillacs; and therefore his way of compensating is to get a high interest rate which is, as I say, a hedge.

Mr. Balles, we understand as long as inflation continues the way it does, that theory is correct; and you seem to expound it here, interest rates are really going to be high, and for an indefinite period?

Mr. BALLES. I certainly agree with the thrust of your remarks, Mr. Johnson; and unless we can convince the people in this country that their Government, the Congress, the administration and the Fed are working together, are going to take effective steps to get the rate of inflation down, unless we can do that, then I think you are quite right, interest rates will stay high, and for the very reason that you mentioned, that lenders will expect and demand a premium above a real rate of return to protect the value of their assets.

That's why I think it's so terribly important as to our credibility in an anti-inflation program. If we can get this credibility established, and the people realize that the Congress is going to take effective steps, say through fiscal policy; and that the administration is going to take effective steps; and that the Fed is going to diminish the rate of monetary growth, and that we get this expectation established that prices are going to come down, then I believe that interests will come down; and again for the reasons you cited, quoting that article.

Mr. JOHNSON. Mr. Eastburn, I want to pin some more laurels on you because you say on page 3, which probably is the most significant thing that you have said in your statement, and that is: "Inflation cannot continue without the money to finance it."

I think that is a pretty fair summation of inflation today. Is that one of the reasons for, say, the high interest rate policy of the Fed, to make money harder to get, so that we don't have so much money around to finance these inflationary pressures?

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Mr. EASTBURN. Yes, sir. This explains why the Federal Reserve is trying to exercise monetary restraint, to combat inflation. The initial impact of that monetary restraint is our interest rates, in the interest of getting interest rates down in the longer run.

In response to the question you asked John Balles, an interesting statistic is that if you look at—long term—interest rates over a period of time, and you see that they are now running 9, 10, 12 percent, and you adjust them for what has happened to prices; and if you do that over a period of time, you will see then what might be called the real interest rate is remarkably constant at something like 3 percent, which indicates that underlying the economy is a real interest rate of 3 percent, and the rest is all inflation.

Mr. JOHNSON. Would you like to comment on that, Mr. Hayes?

Mr. HAYES. I just want to add one note, which in a way I would regard as a hopeful note, that the interest rate really reflects not the present or the past rate of inflation, but expectations as to the future rate of inflation.

So, it's quite conceivable that if we can establish credibility and real belief that we are going to lick the problem, you could get a downward trend in interest rates before you have achieved very much in actual dampening of the inflation.

Mr. JOHNSON. If we could say that high interest rates are really the result of inflation, then this abuse, let's say, that is being heaped on Dr. Arthur Burns for being a high interest rate man, and being the cause of it, that particular abuse is not warranted; isn't that so?

Mr. HAYES. Yes, sir. I would say that none of us central bankers love high interest rates. We accept high interest rates as an unfortunate sign and thermometer that the fever is high.

Mr. JOHNSON. Thank you. My time is up.

The CHAIRMAN. Mrs. Sullivan?

Mrs. SULLIVAN. Thank you, Mr. Chairman.

All three statements that you gentlemen made are very helpful and very enlightening. The statement that you made on page 5, Mr. Eastburn, where you say that liberalized unemployment benefits, public service jobs, welfare reform, training, education programs are all ways of dealing with problems of those hit hardest by a slack in the job market, we have passed legislation on every one of these issues, I believe, except welfare reform. Many times we had to attempt to pass legislation over a Presidential veto, or come back another year to pass it again because we too, feel that we must keep unemployment down as much as we can.

I would like to ask several things. No. 1, I think that you gentlemen are all familiar with the staff recommendations that were made to us yesterday; and I would like to have your comments on these recommendations, but not right now because there are too many. If you could give us a brief comment when the transcript is sent to you for correction.

[The replies requested by Mrs. Sullivan from the witnesses on the recommendations presented by Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee, may be found on page 361.]

Mrs. SULLIVAN. President Eastburn, you stated, as I understand it, that the market could be more self-reliant with respect to changes in

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interest rates than it has been permitted to be. I wonder if you could amplify on that; what are you getting at?

Mr. EASTBURN. There has been a term used in the past called money market myopia, which has to do with concern with the minute changes in the financial markets in New York, and a desire to try to "fine tune" the market, if you will, to keep interest rates stable over a very short period of time.

What I am saying, essentially, is that as you look at the tradeoff between trying to get money under control, and trying to stabilize interest rates, there is some benefit in letting interest rates fluctuate more in order to accomplish that greater stability, or greater control over the money supply.

Mrs. SULLIVAN. I see. Do you really believe that we can stop inflation by raising the interest rates?

Mr. EASTBURN. I believe we will probably continue to have some degree of price increase, even with the best of policies; and that doesn't greatly concern me if it's fairly moderate and fairly constant, and predictable.

What does concern me is the very rapid and unpredictable kinds of changes in prices. I believe that unless we have a responsible monetary policy, and monetary restraint over a sustained period of time, which in turn will mean high interest rates, we will not get inflation under control; and we will not, in turn, have lower interest rates in the longer run.

Mrs. SULLIVAN. Well, I have been saying—I don't know if I'm right or wrong—that the higher the prime rate goes, the more the product of the business—usually the large business concern can get money and can pay the high interest rates because whatever he has to pay he is going to charge back in the service he produces, or the product. So, he is getting this money, and raising the prime rate hasn't stopped big business from getting these loans.

The reason I say this is because some of the bankers who have come before us—not just at this time, but prior to this—have said, well, they have made commitments to their customers long before, and they just must have that money or they lose their customers; and they get it, regardless of what rate they have to pay.

It's the small businessman that suffers, does he not? Because he can't afford to pay these rates. Am I wrong when I say that most businesses have to do their daily work based on credit, they don't work out of cash on hand; they work through credit; am I right or wrong?

Mr. HAYES. I think you are right that by and large, that large business firms have better, more access to credit and more optional ways of raising money than the small company. That's one way that it is quite true that a period of tight money, high interest rates, does tend to have differential effects, there isn't any doubt about it, I think.

Mrs. SULLIVAN. Big business is getting the loans, isn't it?

Mr. HAYES. I would say I believe, as one of my associates has brought out in his paper, there is a marginal effect when rates become as high as this, that does begin to freeze out certain transactions that otherwise would have taken place, even among big companies. When they find they have to pay 10 or 12 percent, they may think a little longer about doing a given piece of business.

Mrs. SULLIVAN. Thank you, I'd like to pursue it——

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Mr. HAYES. I also would like to say the prime rate is not set by the Federal Reserve; it's set by the commercial banks.

The CHAIRMAN. Your time is up.

Mrs. SULLIVAN. Thank you.

The CHAIRMAN. Mr. Brown?

Mr. BROWN. Thank you, Mr. Chairman; and thank you gentlemen for being with us today.

The chairman of this committee on many occasions has said that high interest rates are a cause of inflation, rather than a result of inflation; but I think it's the position of you gentlemen that it's the other way around. Is that not correct?

Mr. EASTBURN. Yes. I think to be completely objective about this, that there are both effects. I think that there is a cost effect interest rates that is built into cost of business and operation, and so on.

I think it would be our feelings that costs, more than offsetting that effect, is the effect in reducing demand for credit and the demand for goods and services. So, they are both working, but one is more effective than the other.

Mr. BROWN. Oh, of course, the increased interest rates then add to inflation.

Mr. EASTBURN. Yes. It's a relatively minor aspect, I think.

Mr. BROWN. Secretary Simon has said recently that the Federal Government, either in its direct borrowings, or in its contingent borrowings of its different programs, FHA, or anything else, has preempted 60 percent of the capital and credit markets of this country. Do you agree with that?

Mr. HAYES. I couldn't give you the figure, Mr. Brown. It sounds a little high.

Mr. BROWN. That's what Paul Volcker said.

Mr. HAYES. Is this including State and local governments?

Mr. BROWN. No, he said, as I recall—and it seems high to me and that's why I questioned it—his statement was, I believe, and it was in U.S. News and World Report, one of the interviews, he was saying that the Federal liability, direct and contingent, amounts to 60 percent of the domestic markets.

The only reason I ask this is that it seems to me whenever we run into these problems of not getting credit into housing when we want it, we always think of some way to—we talk about either allocation of credit; we talk about in some way coming up with special gimmicks to get money into it through extra borrowings by the Federal Reserve Board, the Treasury and all; and we always talk in some way about advantaging the disadvantaged sector.

Why don't we ever look at it the other way, you accomplish the same result if you disadvantage the advantaged sector, don't you?

Mr. HAYES. Yes. I think, as a matter of fact, Chairman Burns' suggestion of the tax, the variable tax, would do just that.

Mr. BROWN. I thought that would probably be your rebuttal. However, if you then look at the fiscal side of things, the investment tax basically ends up with a budgetary negative because to the extent that you provide investment tax credit, variable investment tax credit, you are taking away from revenues, rather than adding to them.

Why not a borrowing surcharge? There is no question that corporate borrowings today since, corporations are roughly in the 50

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percent bracket have an effective rate different from the apparent rate. If they are paying 14 percent, they have an effective rate of 7. The home buyer, the homeowner, the mortgagor, in turn being in a different bracket, when he has to pay 14 percent, his effective rate is probably 12.

So, now, why not restrict the deductibility of interest? Historically, I think, that 7 percent has been a rate that has been about as high as interest rates have gotten except in tight money times, and so why not restrict the deductibility interest above that figure.

Then, what you would be doing, you would be disadvantaging the advantaged sector, and it will result in a budgetary plus, yet be consistent with an economic policy of restraint.

Mr. EASTBURN. I think that is a very intriguing idea.

Mr. HAYES. I think, as you recognize, there are times when you want to encourage investments.

Mr. BROWN. I would say you can tie on your variable investment tax credits, if you want to, you are getting it then on both sides. But at least you are saying that we have established a norm, and we are not going to advantage the advantaged sector any time we want that sector disadvantaged.

Mr. EASTBURN. Could I respond to the first part of your question, sir?

Mr. BROWN. Yes.

Mr. EASTBURN. I think as a general principle the country is better served by using incentives, rather than disincentives, if I can make that distinction.

Mr. BROWN. Well, that's a little bit—aren't you laboring under the same basic problem that we have, and that is that we have always wanted an expanding economy. It's a little bit like having a farm policy that was always trying to handle surpluses; we don't know how to react in an economy when we have to work on the other side of the ledger, instead of stressing expansion, we should concern ourselves with contraction?

Mr. EASTBURN. We do have an economy based on a profit motive, and it seems to me the extent to which you can use the profit motive and push something the way you want it, rather that prohibiting it from going the way you don't want it, then you are better served.

Mr. BROWN. My time has expired. Oh, excuse me, Mr. Balles.

Mr. BALLES. I just wanted to make a brief comment, Mr. Brown. I think in our remarks so far we have possibly failed to touch on one very important way of helping to solve inflation in the longer run, and that is the increased supplies. We have been talking about restraining demand, which is the big problem now.

But certainly, anything that can be done through public policy to generate strong rates of increase in productive capacity will help solve inflation over a period of 2 to 5 years ahead. We have a capacity crunch in this country, I'm sure you know, in many industries.

Mr. BROWN. The only trouble is, it seems to me, and I think you will agree, it has been much easier to increase the supply of credit than it has the supply of eggs.

Mr. BALLES. Unfortunately.

Mr. BROWN. Thank you very much, gentlemen.

The CHAIRMAN. Mr. Reuss.

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Mr. REUSS. Thank you very much, Mr. Chairman.

Mr. Hayes, not long ago the Federal Reserve Bank of New York came to the rescue of the Franklin National Bank to the tune of more than $1 billion. Can you tell us—and if you prefer to make this answer in the record, rather than offhand, that's entirely up to you—where Congress set forth by statute the power of the Federal Reserve bank to engage in that kind of operation?

Mr. HAYES. I'd rather look that up because I can't quote the authorization.

Mr. REUSS. That will be entirely satisfactory, when you correct your testimony.

Mr. HAYES. I would like to say this, that it's my belief that a basic function of any central bank is to provide, try to provide, a certain stability in financial markets. The reason for stepping in here, essentially, was not any love of Franklin, or any love of its management, or any great regard for the way the bank had been run, quite to the contrary.

Our reason was fear that a failure of a bank of that size could lead to very serious financial——

Mr. REUSS. I appreciate the reasons that motivated you all, I wanted to see the grant of authority by the legislature.

Mr. HAYES. I'll be glad to write that for you.

[In response to the request of Mr. Reuss, the following information was submitted for the record by Mr. Hayes:]

STATEMENT REGARDING STATUTORY AUTHORITY FOR LENDING BY FEDERAL RESERVE BANK OF NEW YORK TO FRANKLIN NATIONAL BANK

The statutory authority for lending by the Federal Reserve Bank of New York to Franklin National Bank, a member of the Federal Reserve System, is found in the eighth paragraph of Section 13 and in Section 10(b) of the Federal Reserve Act, 12 U.S.C. § 347 (1970) provides in relevant part that:

"Any Federal reserve bank may make advances for periods not exceeding fifteen days to its member banks on their promissory notes secured by the deposit or pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or by the deposit or pledge of debentures or other such obligations of Federal intermediate credit banks which are eligible for purchase by Federal reserve banks under section 13(a) of this Act, or by the deposit or pledge of bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended; and any Federal reserve bank may make advances for periods not exceeding ninety days to its member banks on their promissory notes secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this Act, or secured by such obligations as are eligible for purchase under section 14(b) of this Act."

Section 10(b) of the Federal Reserve Act, 12 U.S.C. § 347b (1970), provides in relevant part that:

"Any Federal Reserve bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank."

Pursuant to Section 13 and other provisions of the Federal Reserve Act, the Board of Governors of the Federal Reserve System has issued its Regulation A, entitled "Extensions of credit by Federal Reserve banks" (12 C.F.R. 201). Reserve Bank extensions of credit, including loans by this Bank to Franklin, are made in accordance with the provisions of that regulation.

Mr. REUSS. Mr. Eastburn, first let me congratulate you on that November 1970, article in Business Review which has been put into the record; I think it's a splendid job and ought to be widely read, as I hope it will be.

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As I look over the financial situation in this country with particular regard to inflation, I'm not terribly encouraged. I see utility after utility failing in its attempt to get loans to expand vitally needed energy resources; I see State and local governments, including the largest local government in our country failing to secure funds which are desperately needed; I see that greatest source of capital investment and ingenuity in this country, the small- and medium-sized corporation, failing to secure either from the banking system, or outside the banking system, the money for new plants and equipment so desperately needed to combat inflation.

On the other side I see the great money market banks, the big Wall Street banks, for instance, increasing their loans by some 20 percent over a year ago, reaching out for new sources of funds at home and abroad in the most ingenious manner. I see a large part of those loans going for bidding up the price of inventories, bidding up the price of scarce supplies, bidding up the price of real estate.

Just as you have been generous enough to congratulate Congress on reforming fiscal policy—and we accept that with pleasure—isn't it time to reform monetary policy and see if there isn't a way whereby the Federal Reserve could allocate credit, as well as create credit?

In short, isn't that the goal that you have been pursuing, in your thinking at least, for the last 4 or 5 years?

Mr. EASTBURN. Yes, Mr. Reuss. I must say, I have a great deal of sympathy with what you are saying, and I have for a long time; that's why I am struggling with the problem. What disappoints me is the realities of working it out, of making it work.

Mr. REUSS. One of the things that disappointed you a little bit, I think—and you stated it in your testimony today—is that if there are to be priorities, then establishing these priorities is clearly a matter for Congress, not the Federal Reserve.

Have you had a chance to look at the material on this which I had in the record several weeks ago?

Mr. EASTBURN. Yes; I have. I have read your bill, and I think you have done this in your bill, except for item E. Item E, as I remember, leaves it to the Federal Reserve to determine other areas.

Mr. REUSS. With the right of Congress to veto it.

Mr. EASTBURN. That's right.

Mr. REUSS. This is neither the time nor the place, and certainly my time doesn't permit to ask you for a full answer, but do you think the approach I suggested is worth exploring?

Mr. EASTBURN. I have felt that—I thought that this approach is worth exploring for some time, and that is the reason we have done the research that we have done on it. But, I must say, the further we look at it, the more difficulties I see in making it work. The main reason is that applying it solely to banks can't be the solution because it spills out of banks into the marketplace; and that means that you have to make it applicable across the board. That, I think, is quite a different proposition than the kind of bill that you propose, which applies just to banks. The costs and the burdens are much greater.

Mr. REUSS. Thank you.

The CHAIRMAN. Mr. Wylie?

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Mr. WYLIE. Mr. Chairman, thank you.

There is no question that the subject most on Mr. and Mrs. John Q. Public's mind is inflation and interest rates. I happen to think inflation comes first, and if we can place inflation under control, interest rates will come down.

Mr. Reuss, the gentleman from Wisconsin asked about his bill. I'll ask about mine. I have introduced a bill, H.R. 15375, which would reduce Federal spending below income, and call for a reduction of the Federal debt on a graduated basis.

I would like to have your comment on H.R. 15375 from each of you. Do you think passage of H.R. 15375 would effectively control inflation?

Mr. HAYES. I'm sorry to say, I'm not familiar with the details of the bill, so, I'm just——

Mr. WYLIE. Let's assume that the bill would require Federal spending below income, and that it would reduce the Federal debt by 2 percent for fiscal 1975 if followed.

Mr. HAYES. I would think that in the present setting something along those lines could be very useful, yes. If it's a matter of doing this year in and year out, all the time, I'm not so sure because I think there may be times when a Federal deficit could be actually not harmful, but positively useful. But certainly not in an overheated atmosphere like now.

Mr. WYLIE. But on a short-term basis you think it might be helpful, and might in fact be desirable.

Mr. BALLES. I would strongly endorse it, Mr. Wylie. In my prepared statement I indicated, and I would like to reiterate, the most useful single step that Congress could take in this current fiscal year is to have at least a balanced budget, and preferably a surplus, rather than the $11.5 billion deficit.

If that is the thrust of your bill, I would certainly have to endorse it very strongly.

Mr. WYLIE. That is indeed the thrust of my bill. Mr. Eastburn?

Mr. EASTBURN. I agree with that.

Mr. WYLIE. Thank you.

The gentleman from Wisconsin, Mr. Reuss, touched on the allocation of credit rather—I think he used the words "pursuing credit," I'm not real certain what he meant—but I know that Governor Brimmer has advanced the theory for some time, that the Federal Reserve Board ought to allocate credit.

Now, is that workable? I say that because allocation of credit is difficult at best because it extends well beyond the banking system. For example, corporations can go to insurance companies and get credit; or they can issue their own commercial paper.

Would you care to comment on that, Mr. Hayes?

Mr. HAYES. Could I comment—I don't want to seem like a backsliding reactionary, and I certainly welcome the kind of study that my colleague, Mr. Eastburn, has been doing on this subject. I must admit I start with a more negative view on the likelihood of finding a workable way of allocating credit, than perhaps he does.

In fact, I think that in the Federal Reserve System as a whole, there is still a great reluctance to get into this area of credit control, or allocation; and I think with good reason because I think it's such an

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overwhelming problem. As you say, the banks are only a part of the problem. But, once you got started on that, I don't know where it would end. I think it would be too much of a task for the Federal Reserve.

Mr. WYLIE. Mr. Eastburn?

Mr. EASTBURN. Yes, sir. Governor Brimmer's proposition is essentially the same as Mr. Reuss' bill, which would provide differential reserve requirements on different kinds of assets, to encourage, or discourage, the direction of flow of funds.

I think the same thing would apply to Governor Brimmer's proposal as I have applied to the Reuss bill, and that is the difficulty of applying the allocation of credit simply to banks; and the point that you have made about the corporations and the marketplace underscores the difficulty of allocating credit.

Mr. WYLIE. Thank you. My time has already expired, and I have only just begun. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman; and I also want to thank you, Mr. Hanna, for not asking to go on.

I want to welcome, of course, my old friends and my new friend from Pennsylvania to this panel. The first question was touched on by all of you, but I would like to direct it, at least at first, to Mr. Balles; and this is the question whether, if we have perfect fiscal and monetary policies, and if inflation is really worldwide—can we solve the problem?

Mr. BALLES. Mr. Moorhead, I think that we can solve a large part of the problem, but not necessarily all of it. To the extent this is a worldwide inflation, the solution to it doesn't lie entirely within our own grasp, and that bothers me.

It will take some cooperative efforts by other governments, and by that I mean cooperating with us in the sense of trying to calm down inflation because if they don't, we are likely to import some of their inflation through prices of imports. So, that the problem is not entirely of our own choosing in terms of how we go about solving it.

But as the biggest, most powerful country in the world, we should exert some leadership in the area; and I think if we did that we could get some cooperation of other countries, I hope. I'm fairly optimistic on that.

Mr. MOORHEAD. I wish I shared your optimism. I see not just the disappearance of the anchovies off Peru, but I see the developing nations insisting on higher and higher prices for their raw materials. I have introduced legislation to anticipate where we are going to have troubles, and whether we can't plan offsets, alternative sources, offer ways of reducing demand.

Mr. Eastburn, you said we could not have inflation without money to finance it, and yet all of you seem to shy away from moving as rapidly, as safely as possible toward getting the ideal growth rate of money.

It would seem to me—and maybe I should direct this to Mr. Hayes as the permanent member of the Open Market Committee—that you could move toward a decreased growth and test the wind, and if it's all right take another step. Couldn't we get to whatever is the optimum

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growth rate more rapidly than I get the feeling from the testimony of all three of you?

Mr. HAYES. I think, Mr. Moorhead, in a sense we are doing that all the time. We are trying to find out what the interrelationships are between growth of money and growth of other credit measures, and levels of interest rates; and we are measuring what effects these interest rates are having on markets, or having on financial institutions.

At the same time, as has been pointed out, we recognize that there are risks on the economic side that we don't want to exceed. We certainly intend to have in mind the danger of having such an unfavorable influence on the economy that we begin to tip it over into recession, which is the last thing we want to do.

I think we really are doing what you say, we are treading a very narrow tightrope, really, and trying to slow down the expansion as rapidly as we can without creating various difficulties for ourselves, either financially, or economically.

Mr. EASTBURN. Might I say something?

Mr. MOORHEAD. Yes, certainly.

Mr. EASTBURN. I might just say, we are not talking about theory here, we are talking about something based on experience. If you go back and look at what happened in the 1950's and 1960's with respect to the growth of the money supply, you will see a very clear relationship between when you have a drastic reduction in the rate of growth of money supply, you have following that, after a certain lag period, you have a recession. I think this is experience which stands us in good stead now.

Mr. MOORHEAD. I want to be sure that the record doesn't leave the inference that I'm in favor of a drastic cutback in the growth; I meant, can we do it a little more quickly and test the wind? This is the question and the proposition I was urging.

Mr. BALLES. It sounds like a promising idea, and perhaps we should try it.

Mr. MOORHEAD. Thank you.

Mr. Eastburn, in your study of selective credit controls, do you include consumer credit controls?

Mr. EASTBURN. Yes, sir.

Mr. MOORHEAD. Do you advocate them at this time?

Mr. EASTBURN. No, sir; I do not advocate them at this time for two main reasons. One is that excess consumption is not our problem, and I don't think we need control of the consumer credit.

The second reason is that I think it remains to be determined how effective consumer credit controls are; and I think this also needs a good deal of study.

The CHAIRMAN. Mr. Burgener?

Mr. BURGENER. Thank you, Mr. Chairman.

Gentlemen, it's a privilege to have you here. Would you outline for me a few of the various instruments of Federal debt, like savings bonds, Treasury notes; would you recite the various instruments, examples, I mean.

Mr. HAYES. Well, you mean Treasury bills and Treasury certificates?

Mr. BURGENER. Yes. What's the typical maturity of those?

Mr. HAYES. The Treasury has maturities running all the way from 90 days to 25 years, or 30 years.

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Mr. BURGENER. The savings bond would be one that's a long term, what is the typical interest rate on those?

Mr. HAYES. Savings bonds are now 6——

Mr. BURGENER. Just roughly.

Mr. HAYES. Roughly 6 percent, but I'm not sure.

Mr. BURGENER. What's the highest yield instrument put out by the Federal Government?

Mr. HAYES. By the Federal Government, I suppose the highest yield is on some of the recent, some of the newest issues which have been in the neighborhood of something like 9 percent.

Mr. BURGENER. All of these documents collectively assembled are the national debt, are they not?

Mr. HAYES. Right.

Mr. BURGENER. I have here a Federal Reserve note——

Mr. HAYES. Yes, sir.

Mr. BURGENER. That one has instant maturity, I take it.

Mr. HAYES. That is money.

Mr. BURGENER. Right. If these wear out, they make new ones. They burn them up and make new ones, right?

Mr. HAYES. Right.

Mr. BURGENER. But you also add new ones when they are not worn out, right?

Mr. HAYES. There is a certain increment, yes.

Mr. BURGENER. What I'm getting at, just quickly the mechanics of creating new money in the economy. Could you just give me about 1 minute on that, quickly?

Mr. HAYES. I am not an economist, but I will give you just a kind of layman's view. Money really is created, all basic money is created by the Federal Reserve when through open market operations, or the discount window, but primarily through open market operations, we create reserves in the hands of member banks.

Those member banks can use those reserves to get money like that from us, so that they will have it for their customers; or if they don't need it for that purpose, they will use those reserves as the base for deposits on the books of the member banks, whether demand deposits, or time deposits.

Mr. BURGENER. Each year more and more of these cash things get into circulation, right?

Mr. HAYES. Right.

Mr. BURGENER. What act, or what authority causes them to be printed? They are backed by the general credit of our Government, right; they are not backed by gold or silver.

Mr. HAYES. They are collateralized. When we issue those, we have to have acceptable forms of collateral, primarily U.S. Government securities, behind them.

Mr. BURGENER. All right. So, you have a bond, or a note, or a bill, which has replaced the old gold standard back in the 1930's, right?

Mr. HAYES. Yes.

Mr. BURGENER. I was just trying to get the mechanics. If you issue a bond for $1 million, and somebody pays you cash for it, you got a credit and a debit; you've got the cash in your hand, and you owe somebody $1 million, plus interest. So, you don't think you are creating something for nothing. I couldn't follow the chairman's earlier——

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Mr. HAYES. That bill constitutes an obligation. It's an obligation of the Federal Reserve bank that issued it; it's also an obligation of the U.S. Government.

Mr. BURGENER. The other day on the House floor about 200 Members voted to add $300 million to an HEW bill, probably a very worthwhile cause; 92 of those people also voted against increasing the debt ceiling. What's your reaction to that, do you have a reaction?

Mr. HAYES. They voted—excuse me.

Mr. BURGENER. They voted to add $300 million to an HEW spending bill, probably for a very worthwhile cause; 92 of those same people voted against increasing the debt ceiling.

Mr. HAYES. My own personal feeling is that limitation on the debt ceiling is a sort of indirect and inefficient way of trying to limit public spending. The approach, in my judgment, toward public spending should be direct, you decide whether you want to spend it, or don't spend it. The debt ceiling is just a way of financing it. If you decide to spend it, you have to——

Mr. BURGENER. It's already spent, I realize that. But, what I am really trying to get at is that we are doing a little doubletalking around this place.

Every witness that has been here in the last 18 months, almost without exception, has asked for a reduction in Federal expenditures as a means of combating inflation; and almost every member on both rows has agreed with all these witnesses; and then voted for billions of dollars that we can't pay for, that's my point.

The CHAIRMAN. The gentleman's time has expired. Mr. Stephens?

Mr. STEPHENS. Thank you, Mr. Chairman.

I appreciate the fact that our chairman has scheduled these hearings; and I think it's about time for us to have you gentlemen here, as well as others that have been scheduled, and will be scheduled.

Here is something that worries me, and I don't know whether there is an answer to it, or not; but, we have been talking about, and everybody is talking about high interest rates. In 1954 I bought a home in Athens, Ga., and I bought it for $30,000. The loan from the Federal Savings and Loan that I had on it was at 4 percent.

In 1974, the same property that has had 20 years of depreciation, has been estimated to be worth $60,000, and the loan that I could get on it from the same savings and loan would be at least 8 percent. So, I haven't gained anything, or lost anything. When we are talking about high interest rates and real money, we haven't changed in 20 years.

I'm not as concerned, maybe, about interest rates when you are talking about real dollars. So many people seem to be, in respect to the real dollar. I remember when I got married in 1938, we were paying 11 cents for a can of Vienna sausage. Now it's about 43 cents. But, I was just making $108 a month when we got married, I was teaching at the University of Georgia.

The thing that worries me and concerns me is this: Are we still talking—when we are talking about real high interest rates—about the high cost of everything in relationship to real money? Or, are we talking about the fact that in 1938 and 1954 these prices were paid then, and that we are comparing those prices then to those prices now? We also, it seems to me, must take into consideration that everybody has got a high wage, and a high rate; and we haven't changed the real value of money.

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I guess the only time the bank interest rates will go down is when my banker calls me up and says, "I've got some money here, and I want to lend it to you." Those are some observations, but I have been wondering how practical those are, the high interest rates and the high cost of everything, unless we put it on a comparative basis.

I've got more money now than when I was making $108 a month, except I owe a few more people.

Mr. HAYES. I think a lot of us face the same situation, Mr. Stephens.

Mr. STEPHENS. I don't know whether it's necessary to comment on that, I was just curious about it.

Mr. EASTBURN. If I might react, Congressman, I think that the problem about inflation is, all people aren't affected equally by what happens over this period. Some people are debtors, for example, and some people are creditors, and people who are debtors tend to benefit by inflation, and people who are creditors tend to lose. This is the thing about inflation that some people benefit, and some people do not.

Mr. STEPHENS. Excuse me, let me get that straight, people who are creditors tend to——

Mr. EASTBURN. Tend to lose by inflation; people who are debtors tend to gain by inflation, and therefore you have unequal effects, in retrospect.

Mr. STEPHENS. What I should do, then is to sell my house now for $60,000, and just wait until the $60,000 are worth $120,000, based upon the real value of money. I never have been a creditor so I'm not sure——

Mr. BURGENER. If the gentleman would yield.

Mr. STEPHENS. I don't know if I've said anything.

Mr. BURGENER. Yes, you have. If you could borrow a million dollars today and pay it back with cheaper dollars, you would greatly benefit by inflation. There is some gamble as to what might happen in the next couple of years, so, there is some risk involved.

Mr. STEPHENS. Thank you very much. My time is up, maybe I shouldn't have used it at all.

The CHAIRMAN. Mr. Rinaldo.

Mr. RINALDO. Thank you very much, Mr. Chairman. I certainly want to thank the distinguished panel of witnesses for their testimony.

I would like to direct my first question to Mr. Eastburn. I gather from reading and listening to your testimony that you favor long-term monetary and fiscal restraints as a means of combating inflation and high interest rates. Certainly, in proposing this, you have agreed with many other economists who have appeared before us, and with others with whom I have discussed this problem.

But, it's vital, as I see it, that we thoroughly investigate the effects of this policy of restraint on unemployment. I didn't notice, for example, in your testimony much mention of the present or future levels of unemployment. What do you consider to be the effects on unemployment of a restrictive monetary and fiscal policy such as you outlined?

Mr. EASTBURN. That's a very difficult question to answer. Let me make a stab at it. First of all, I think that it is a very astute observation that one of the prices that we pay for getting inflation under control is higher unemployment. It's likely that unemployment will be rising this year to 6 percent, and possibly even higher in 1975, as the

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economy continues to be sluggish, and as monetary restraints continue. So, that this is the price we do pay for trying to combat inflation.

I'm not sure what level of unemployment is tolerable from the point of view of the American people in order to accomplish price stability. I think that the degree of acceptance of higher unemployment is now greater than it would have been a few years ago. I think that people are more concerned about inflation than they were before, and are more willing to pay the price in terms of higher unemployment.

How high they would be willing to see it go, I really don't know; but I think it will probably have to be higher than it is now.

The point of my remarks in my statement was that I think we need a two-pronged policy to deal with this problem. One is that you need monetary restraint to deal with inflation. You need social policies to deal with the unemployment impacts. And I think the two have to go hand in hand.

Mr. RINALDO. This is all well and good, and I understand exactly what you are driving at. However, take a look, for example, at the district I represent, Union County, N.J., and particularly at the unemployment level. The monetary policy that Mr. Balles discussed is aimed at reducing unemployment to 4 percent. He says the likely consequence would be to exacerbate present inflationary pressures. I agree with him there.

All right, let's say we raise that level to 5 percent. It still would not satisfy the present problem because the unemployment rate in my district, and in many other districts is well above the 5.2 percent national rate. It is pretty difficult to go back and tell the unemployed individual that this is the policy that the Government proposes, the policy that we in Congress are going to go along with; this is the policy that at some future date will curb inflation; but in the meantime this policy is going to make it more difficult for you to get a job and it is going to cause other people to become unemployed. Certainly people do not—and I can easily understand why they don't—accept such an answer.

Perhaps what we should be discussing, in addition to restraint, which I agree is vitally needed; in addition to perhaps a debt ceiling; in addition to curbing Federal expenditures, are some concrete methods of curbing unemployment.

Mr. HAYES. I think we all agree 100 percent with what you are saying, and I think that I certainly stressed in my statement, and I think the others did, too, that we believe it's vital and very urgent that measures be taken to deal with unemployment, specific measures. The unemployed people should not regard general credit policy of the Federal Reserve as the means to solve their problem, that's really our——

Mr. RINALDO. They shouldn't, you know, and I sympathize with everything that has been said not only by each of you, but by other witnesses, and by other economists, and in the literature that I have read, and the arguments pro and con. It all boils down to one thing: cut Federal spending.

Mr. Hayes, you said that we must utilize "measures that will increase the qualifications of the labor force that are in demand, and that will produce a more efficient and speedy matching of willing workers and available jobs."

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My time has expired, Mr. Chairman, but perhaps for the record, could you elaborate upon this by specifying the types of measures to which you referred in your statement?

Mr. HAYES. I would be glad to try, I'm not an expert on that.

The CHAIRMAN. He can submit that in writing.

Mr. RINALDO. That's what I asked for, Mr. Chairman.

[In response to the request of Mr. Rinaldo, the following information was submitted for the record by Mr. Hayes:]

REPLY RECEIVED FROM MR. HAYES

DISCUSSION OF MEASURES WHICH MIGHT BE UNDERTAKEN TO RAISE LEVELS OF EMPLOYMENT COMPATIBLE WITH PRICE STABILITY

Over the past two decades, the United States has consistently experienced higher rates of unemployment than have other industrialized nations. The comparatively high rate of unemployment in the United States is essentially a structural problem, one that is rooted in the relatively frequent spells and high incidence of joblessness among particular age-sex-race groups in the work force. A permanent reduction in the level of unemployment compatible with price stability will require structural improvements in the labor market. At the Federal Reserve Bank of New York, our concentration is of course on monetary and financial matters rather than labor market economics. After considerable thought and experience over the years, we have concluded that the solution to the problem of structural unemployment does not lie in stimulative monetary and fiscal policies. After a certain point, at least, such policies can at best achieve only temporary reductions in unemployment in the absence of ever larger and more inflationary doses of stimulus. Nevertheless, there are a number of measures that have been suggested from time to time to improve the structural characteristics of the labor market that appear to us worthy of serious consideration by the Congress. Before discussing some of these measures, however, it might be useful to discuss in greater detail some salient features of the unemployment problem.

The burden of unemployment in this country has not been distributed equally among the various groups of workers. Women, teenagers, and members of minority groups bear a disproportionately large share of total unemployment, in periods of excessive aggregate demand as well as in periods of slack overall economic activity. The high rates of joblessness in these groups appear not to represent a large core of permanently unemployed but, rather, a constantly shifting incidence of unemployment among individuals. In fact, the average duration of unemployment is usually quite short. Typically, about two-thirds of the people who become unemployed are out of work for five weeks or less. Among adults aged 25 and above, while the unemployment rate for women has been consistently higher than for men, the average duration per spell of unemployment has been lower for women. Workers who have either (1) quit their previous jobs, (2) are new entrants looking for their first job, or (3) are reentrants into the labor force typically account for between one-half and two-thirds of total unemployment.

These characteristics of the labor force suggest that the major unemployment problem in the United States has to do with the instability of individual employment. Workers in those age-sex-race groups of the labor force with high rates of unemployment tend to change jobs frequently, often being unemployed for fairly brief periods in the interim. To a considerable extent, this experience reflects the unavailability of many of these workers of jobs offering high wages, good working conditions, job security, and opportunities for advancement (sometimes referred to as "primary" jobs). Because of the relatively unattractive nature of the jobs available to these workers ("secondary" jobs), their job attachment is often weak. For them, the time spent between jobs may be as much a relief from the drudgery of unpleasant unrewarding work as it is an opportunity to search for a new job. The bleak prospects facing many of these workers reflect both artificial barriers to entry into primary jobs and lack of skills needed for more rewarding work.

Permanent decreases in the unemployment rate can be brought about by measures that would reduce either the frequency of job changes or the average

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length of individual periods of unemployment. Among the remedial measures that would seem likely to be effective are a modification of the minimum wage laws as they apply to young workers, public employment programs, improved and better funded manpower training programs, more efficient fitting of available workers to available jobs, modification of the unemployment compensation program, and the elimination of the barriers against entry into certain professions. Each of these proposals will be considered in turn.

1. Revised Minimum Wage Laws for Teenaged Workers

Teenaged workers tend to quit their jobs or are laid off more often, exit from and then reenter the labor force more frequently, and spend more time in search of a job than do adult workers. This pattern of behavior underlies not only the very high rate of unemployment among teenagers but also their low and volatile labor force participation rate. It should be noted, however, that the high unemployment rates for teenaged workers tend to overstate the seriousness of the problem to some extent. First, a high proportion of unemployed teenagers is comprised of full-time students looking for either part-time or summer jobs. Second, throughout the year, a large number of unemployed teenagers are new entrants into the labor force. Since these new entrants lack work experience and well defined career goals, it takes them somewhat longer to find a job than it takes older, experienced workers. Third, with few commitments and responsibilities, some teenaged workers may respond to increases in wages by electing to work shorter hours or for shorter stretches since higher wages can enable them to maintain an acceptable high money income even as they devote more time to leisure activities.

The fundamental problem connected with—but overstated by—the high unemployment rates of teenaged workers would seem to be the unavailability of jobs offering either the opportunity of advancement within the firm or training and experience that would enhance the marketability of these young workers. It seems to us that the consequences of this dearth of good jobs may be far-reaching and long-lasting. We may be putting an excessive reliance on formal education so that young workers who have less than the average amount of education and few marketable skills—the "underprivileged"—tend to become enmeshed in the secondary labor market, with only "dead-end" jobs ever opening up to them.

As a general rule, firms will provide young workers with job opportunities affording them on-the-job training or learning through experience only if their value to the firm while they are being trained at least equals the sum of their wage costs and the cost of providing the training. The unavailability of good jobs to teenaged workers is attributable in part to the minimum wage laws, as well as to discrimination on the part of employers, seniority systems that block them out of good jobs, and the high quit rate of young workers as they explore career possibilities.

Some modification of the minimum wage laws that apply to young workers would seem to be in order. For as these laws presently stand, they make it uneconomical for firms to offer jobs with a low immediate productivity but a high degree of general on-the-job training. At least a partial solution to the unemployment problem faced by young workers is to exclude them from coverage under the minimum wage laws. Conceivably some consideration might be given to subsidies either in the form of income supplements to young full-time workers to ensure them a livable income, or to firms to encourage them to hire and train young workers. Furthermore, additional vocational training and guidance in high schools would no doubt also be beneficial.

2. Public Employment Programs

Public employment programs can serve as a useful means for tiding workers over temporary spells of slack demand in the private sector as well as for providing the work experience and on-the-job training required for successful private placement. The concept of public employment encompasses both public works and public service jobs. Public works usually involve long-term capital projects while public service generally covers such community-service jobs as school and medical aids.

In the last recession, stepped-up Federal government subsidization of state and local public employment was used to mitigate the impact of slack labor demand in the private sector. In 1971, Federal funds were provided for 128,000 positions. The countercyclical advantage of public service employment is that it can be more rapidly instituted and later terminated than public works programs which might hold skilled labor out of the private sector during an upswing. To the extent that both types of programs absorb unskilled labor, however,

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they do not seriously aggravate labor supply bottlenecks and associated labor cost pressures in the private sector.

It is important to note that any public employment program should be supported by taxation. To finance such programs through increased deficits would tend to be inflationary. Another possible drawback of public employment programs in combating residual unemployment in periods of strong demand is that the programs may not consist of jobs providing training and experience which will result in advancement. To the extent that the public jobs are "dead-end" jobs, then the type of workers filling these slots may well experience the same rapid turnover and consequent unemployment that occur in similar private sector job categories.

3. Manpower Training Programs

Manpower training programs are designed to provide training and upgrade the skills of disadvantaged workers, enabling them to move up from the secondary to the primary work force. In the past, the manpower training programs have evidently not been terribly successful in providing "good" jobs to disadvantaged workers. Perhaps what is needed are programs which make it in an employer's own interest to extend career opportunities to secondary workers. Policies along these lines might include contractual employment programs whereby the Federal government underwrites the private cost of hiring and training disadvantaged workers and tax credits covering employers' investments in human capital.

4. Employment Services

In recent years, unemployed workers have had to spend between one and one and a half months on average searching for a new job. Most of this time is spent in scanning the want-ads in newspapers, contacting friends and acquaintances, and canvassing potential employers. Expanded government employment services might greatly facilitate the matching up of available jobs and workers, even within the present institutional framework. There may be enormous potential benefits to be gained from having a centralized computer data bank listing the available jobs and employees over wide geographic areas. Indeed, a 25 percent reduction in the average duration per completed spell of unemployment, if it could be achieved, would translate roughly into a 25 percent reduction in the overall rate of unemployment.

5. Unemployment Compensation Reform

Work disincentives built into the system of unemployment compensation appear to have increased the average rate of unemployment in the United States. While the specifics evidently vary widely among states, a worker's unemployment compensation benefits have been estimated to be on average about 50 percent of his gross weekly earnings. However, because these benefits, unlike the income earned from working, are exempt from Federal, state and local income taxes, the percentage differences between the average worker's take-home pay and the benefits he can collect are much smaller than the differences between his gross pay and these benefits. Indeed, the cost to the individual worker of becoming unemployed or of remaining unemployed for additional weeks—up until the time his eligibility to receive benefits expires—may be quite low in many cases. Such workers may thus have little incentive to avoid being laid off, or to return to work very soon after becoming unemployed. The unemployment compensation system should be reexamined with a view to reducing the disincentives to work while at the same time insuring workers against a total loss of income on account of involuntary unemployment. Meanwhile, the work disincentive effect could be reduced materially if unemployment compensation benefits were taxed at the same rate as workers' normal income.

6. Breakdown of Artificial Barriers to Entry

Economists and others have long recognized the deleterious and self-perpetuating employment impacts resulting from artificial barriers to entry into certain occupations. One common denominator behind such diverse barriers to entry as occupational licensing, educational requirements, and union membership is the discrimination that it permits along age-sex-race lines. Without attempting to disentangle cause and effect, it remains true that such discrimination, for whatever reason, acts to maintain the segmentation of the workforce into primary and secondary subsectors.

The cause of productive efficiency, as well as the cause of justice, dictates the elimination of unnecessary barriers to entry into the primary subsector of the labor market. To a large extent, the ways in which this can be brought about

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are those that have already been discussed: employment service, manpower training programs, public employment programs, and elimination of the minimum wage laws for young workers. Hence, inasmuch as these proposals would also mitigate the *de facto* discrimination and segregation within the labor market, it would seem all the more urgent that some such measures be implemented.

7. Concluding Comment

As was indicated earlier, the various proposals that have been outlined here are merely suggestions that appear promising as a means of reducing the structural component of our unemployment problem. Upon closer examination, some may well appear more appropriate than others. The basic point, however, is that structural measures along these general lines are the only means through which we can expect the level of employment compatible with reasonable price stability to be increased. In the absence of such measures, attempts to reduce unemployment through aggregate demand policies alone quickly run into the problem that ever more inflationary amounts of demand stimulus are needed to maintain the higher levels of employment. Our current situation of unprecedently rapid peace time inflation, an inflation that has accelerated, with interruptions, for nearly a decade, coupled with unemployment rates in excess of 5 percent, shows the ultimately self-defeating nature of attempts to solve the unemployment problem without the needed structural reforms.

The CHAIRMAN. Mr. Hanna.

Mr. HANNA. I'm as pleased as the others to have you here, and especially you, Mr. Balles, coming from the State of California.

Mr. BALLES. Thank you.

Mr. HANNA. I am struck by the humility that I read in your presentations, and I find that highly laudable; it reminds me of a statement that Mr. Churchill was supposed to have said to somebody. He said, "It's fine to find you humble for you have so much to be humble about."

[Laughter.]

Mr. HANNA. I think that humility ought to spread. I really believe that we are looking too strongly at you, and at inflation, and at interest rates; and not strongly enough at the real problems, some of which you have indicated.

I think we are looking at a patient that has boils and a fever, and a broken leg. We are treating the fever and the boils, but are not doing anything about the broken leg; and the leg marrow is what produces the agent that reduces infection and fever. So, now we are putting in artificialities and nobody is treating the broken leg.

It seems to me Congress is as much to blame as anybody else. We don't have a congressional policy where we ought to have it; the administration doesn't have a policy where they ought to have it; and some of the suggestions you made, together with suggestions I'm going to indicate, I think is the way we ought to be going.

I think that what the Congress and the administration both need—and since the administration isn't going to get it, I think the Congress ought to pursue it—is a model, an economic model of the international economy because we are going to have to look what is happening internationally as well as domestically. As you have indicated, Mr. Balles, many of these things are coming at us not because of the aggregate demand economy; Mr. Hayes, forget it, this is not the problem of the aggregate supply and demand economy. This is the broken leg that comes when you have a severe shortage of fuel for the activities of industry, and therefore a high rising price under these conditions for products; when raw materials that industry uses in its activity are going up and up; and when there is a fast growing policy on the basis

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of everybody that puts the pressure on; high population growth, which puts additional pressure on. All of these things are occurring outside to a great degree of our own economy, but we ought to have some better understanding how that is ultimately going to impact the inside.

Here is where I think you, as the good doctors, ought to come in and say, look, don't ask me to do the bone work, I'm not the bone specialist; I can continue to do something about the boils and the fever.

What I suggest is that we have got to learn to live with some of that fever because there isn't enough artificial medicine to keep it down; but what we could do is to strike out for this kind of a policy:

A very subdued growth rate in the economy.

No. 2, an inflation that's probably going to go to at least somewhere between 6 and 8 percent, at least for a while.

Interest rates that are going to be between 8 and 9 percent, for a pretty substantial period of time. Unemployment that is going to be somewhere between 4 and 5 percent, or in that range.

Then, taxes, taxes which will allow you to make the redistribution of wealth that you are talking about, that will offset the benefits and burdens of the era that we are in, so that we can come online with some of these programs, not to lessen our spending, but to spend it intelligently and to tax for it, not borrow for it; and to tax the elements that are still benefited by what the engine of the economy is actually doing.

That kind of a program would seem to me to make good sense; and we could bring into this thing the bone specialist to help you fellows that are dealing with the boils and the fever. I would like to have you react to those kind of suggestions on the record, if you would.

Mr. HAYES. Without endorsing all the specific figures, I think the basic idea is an excellent one, that is that Congress and the Government in general, should be directing its thoughts to where they want to go on all these things. This goes certainly far beyond what the Federal Reserve can do.

Mr. HANNA. Exactly, you can only do so much. I think that allocation of credit is absolutely imperative. If we don't do some of these things within 9 months from now, gentlemen, you guys are going to be doctors for a terrible patient.

I see in about between 9 and 18 months, that's all the time we've got to start moving this thing from where it is now. When you increase the interest, you don't decrease inflation, not under the circumstances that I have been talking about. You are going to decrease jobs; you are going to decrease evolutions of the economic machine; you will reduce consumption because there will be reduced production. But, you will not decrease prices, I guarantee it, you will not decrease prices because the price of fuel is not coming down; the price of metals and minerals is not coming down; and the price of food is not coming down. It has nothing to do with what the interest rates are, in the main. It has to do with population growth, with the higher aspirations, with the attitudes of the people who have these basic raw materials.

The CHAIRMAN. Mr. Rees?

Mr. REES. Thank you, Mr. Chairman; I defer to Mr. Gettys.

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Mr. GETTYS. Thank you, Mr. Chairman, thank you Mr. Rees, I am sitting out of order. I'm not sitting as chairman of the lower row today.

The CHAIRMAN. You are sitting in the wrong place.

Mr. GETTYS. Mr. Chairman, the hour is late, and I won't take but a few minutes. I would like to say to Mr. Hayes, and Mr. Eastman, and Mr. Balles, I wish my friend from Atlanta was here because, you know, it seems like we are always forgetting about the great Southern States. But, we are delighted to have you from New York, and San Francisco, and from Philadelphia, these distinguished gentlemen.

The immediate problems, of course, of inflation are critical. The Congress and the President have the problems of fiscal policy; you gentlemen in the Federal Reserve have the monetary policy.

Is there some area where we can get more cooperation and coordination between these objectives, the purely economic views that you have, and the political situation; and at the same time answer the question of whether the independence of the Federal Reserve Board should be eliminated and the Board be responsive to the political situation.

Would you comment, each of you, very briefly on that?

Mr. BALLES. I might try to start, Mr. Gettys. With respect to getting better cooperation, I couldn't agree more that that is absolutely vital, and I am hopeful that we will make a strong start on this with the new congressional approach to the budget.

As I said in my opening statement, I think for the first time Congress is going to have a chance to vote on fiscal policy. That has not been done heretofore, as you know, the appropriations bill being considered more or less independently of each other, and not in relation to the total revenue, and hence——

Mr. GETTYS. I agree with you wholeheartedly. I participated in it and supported that thing. But I'm afraid we are relying too much on these budget matters. Aren't we looking for too much from that law?

Mr. BALLES. Well, I hope not. It's yet untested, perhaps your guess as to how it will come out will be better than mine; but I'm going to be very disappointed for the sake of the country if it doesn't work well.

Mr. GETTYS. No question, it is moving in the right direction, but I think we are expecting too much. I don't think it is going to be something that solves all problems in the field.

Mr. BALLES. As far as the second half of your question is concerned, should the independence of the Federal Reserve be eliminated, or retained; that, of course, will have to rely on the ultimate judgment of the Congress, as to how the country will best be served. The Federal Reserve System is the agent of the Congress, we are independent only within the Government to the extent that you delegate authority and responsibility to us.

I would hope you would continue to believe that trust is well placed. But, that will have to be your decision, not ours.

Mr. GETTYS. That I understand. But, what is your opinion on the continuation of the present structure; and I think you would like the independence, as it is interpreted in today's words, to continue; is that correct?

Mr. BALLES. Yes, sir, I would.

Mr. GETTYS. Would you gentlemen——

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Mr. EASTBURN. Yes, may I say a word. I would endorse what Mr. Balles says about fiscal policy. Could I say a word about your second question on independence?

I think this is a term which is very loosely used and not very often understood, or explored. As indicated, the Federal Reserve considers that this word "independence" applies to its independence from the executive branch; and there is long historical reason for this independence that goes back through our history, and has been demonstrated time and again that the sovereign, or the executive, has abused the privilege of money control for his own benefit.

Therefore the founders of the Federal Reserve System carefully insulated the Federal Reserve from control by the executive branch, and made it responsible to Congress.

There is a more subtle question, having to do with its independence with relationship to Congress. As Mr. Balles indicated, we are a creature of Congress, and we are subject to Congress. On the other hand, I think that it is necessary for Congress to consider the proper relationship with respect to the Federal Reserve with respect to conducting its day-to-day business; and a certain degree of——

Mr. GETTYS. I thank you, Mr. Eastburn, my time has expired, but with the indulgence of the chairman and the members, could Mr. Hayes comment, maybe, 1 minute?

The CHAIRMAN. With unanimous consent, so ordered.

Mr. HAYES. I would agree entirely with my colleagues on this point, and I would point out that a certain degree of independence of the central bank from the administrative executive of the country is something that has been tested around the world, and by and large has been adhered to. Not entirely, but still believed to be a worthwhile thing. I believe it's not worthwhile. The Federal Reserve, I would add that we have an advantage over certain other central banks in having a regional system, where the regions of this very large country are given some degree of semiautonomy within the system. That also adds strength to the Federal Reserve System.

Mr. GETTYS. Thank you, Mr. Hayes, and thank you, Mr. Chairman. I would like to pursue that subject another time, and I appreciate the indulgence.

The CHAIRMAN. Mr. Rees?

Mr. REES. Thank you, Mr. Chairman.

Mr. Eastburn, I was very impressed with your testimony. I would like to request that the material you offered us on page 5 of your prepared statement—especially your paper on "Federal Reserve Policy and Social Priorities" be submitted for the record. I would also like to have other papers you have been developing in the field of credit allocations inserted in the record. [See page 425.]

I want to talk about two points: The first is that the Federal budget is always the whipping boy because everyone wants to cut the Federal budget. I consistently vote against the defense budget, so I guess I have one of the best economy votes in the House, but I usually vote for all the domestic proposals, as well as the national debt increase.

Dr. Burns wants to cut the budget $10 billion. I have here a list of the new Federal Reserve buildings that are going to be constructed around the country. The one in Philadelphia is going to be completed in the very interesting year of 1976; it will cost $53 million. The Boston Bank Building will be completed the same year, for $75 million. And

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there are plans to build new buildings in Richmond and San Francisco in addition to the Dallas Bank Building and subsidiary offices of the New York Federal Reserve Bank.

The CHAIRMAN. The gentleman's time has expired.

Thank you, gentlemen, very much for your testimony. You have been very fine witnesses, and we appreciate your testimony; and what you have said will really receive consideration of all the members of the committee.

We have, some of us, questions to submit to you in writing, if you would answer them when you correct the transcript. Thank you very much.

Mr. HAYES. Thank you, Mr. Chairman.

Mr. EASTBURN. Thank, you.

Mr. BALLES. Thank you, Mr. Chairman.

The CHAIRMAN. The hearing is recessed, subject to the call of the Chair.

[Whereupon, at 6:30 p.m., the hearing was recessed, subject to the call of the Chair.]

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FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES

THURSDAY, JULY 18, 1974

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 2128 Rayburn House Office Building, Hon. Wright Patman [chairman], presiding.

Present: Representatives Patman, Barrett, Sullivan, Reuss, Moorhead, Stephens St Germain, Gonzalez, Minish, Gettys, Annunzio, Rees, Hanley, Koch, Fauntroy, Young, Moakley, Stark, Boggs, Widnall, Johnson, Stanton, Blackburn, Brown, Williams, Heckler, Rousselot, McKinney, Frenzel, Roncallo, Burgener, and Rinaldo.

The CHAIRMAN. Today we are going to hear testimony from three Federal Reserve bank presidents, Darryl R. Francis of the St. Louis bank, Robert P. Mayo of the Chicago bank, and Francis E. Morris of the Boston bank. All three serve as rotating members of the Open Market Committee, President Mayo once every 2 years and Presidents Francis and Morris once every 3 years. We have heard testimony for 2 days now substantiating that the Federal Reserve, by accelerating open market purchases and the money supply growth, has been an engine of our raging inflation and high interest rates.

In particular years other factors have played a role, but over the long run, special factors, decay and reverse, and it is the Federal Reserve's money supply policies that dominate. Yesterday President Balles of the San Francisco Federal Reserve Bank testified:

> In the long run, sustained changes in the rate of growth of the money supply are a major determinant of the rate of inflation and expectations of future inflation rates.

President Hayes of New York said:

> I think there have clearly been times, particularly in 1968 and 1972, when monetary policy has been rather too expansionary.

President Eastburn of Philadelphia told us:

> Whatever immediate events may cause prices to rise . . . a higher price level cannot be sustained without sufficient money. In retrospect, it would have been better if money had not grown so rapidly over much of the past decade. . . . Inflation cannot continue without the money to finance it. Therefore, if inflation is to be moderated, growth in money must also be moderated. A second lesson is that growth in money must be moderated slowly to avoid sending the economy into a serious recession.

Your opinions on the effects that the Federal Reserve's money supply policies have on prices and interest rates will be of great bene-

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fit to the committee. It is my hope that you will comment also on the issues in monetary policy which the staff report called attention to on Tuesday relating to the employment effects of moderating monetary growth; the Federal Reserve's policy of accommodating and validating transient and even self-reversing inflationary developments, monetizing deficits, and keeping order in money markets.

I also want to ask you to comment for the record, you gentlemen, after you receive your transcripts, on the staff recommendations.

You may proceed by summarizing your testimonies, and if it is all right with you gentlemen, the members only have 5 minutes each to interrogate you and we usually have an understanding that each member reserves the right to submit written questions to you, and that the witnesses will reply when they examine their transcript for approval or correction.

Will that be satisfactory with you gentlemen?

[A chorus of "yes, sirs."]

The CHAIRMAN. You may proceed by summarizing your testimony, starting with President Francis and proceeding in alphabetical order with President Mayo and then President Morris. All right, Mr. Francis, you are recognized.

STATEMENT OF DARRYL R. FRANCIS, PRESIDENT, FEDERAL RESERVE BANK OF ST. LOUIS

Mr. FRANCIS. Mr. Chairman and members of the committee, it is good to have this opportunity to meet with this committee and present my views regarding our country's inflation and high interest rates and the role of monetary policy in dealing with these and other economic problems.

I have submitted to the committee a full statement of my views, so what I present now is a brief summary of them.

The CHAIRMAN. With your approval, we will submit the whole statement for the record.

Mr. FRANCIS. Thank you.

My position regarding the cause of current inflation and high market interest rates is that they both stem from the same source—an excessive trend rate of expansion of the Nation's money stock since the early 1960's. Monetary policy, therefore, can contribute to solving both of these problems over a period of a few years by fostering a noninflationary rate of growth of the money supply.

My view is that growth of a concept called the monetary base is a prime determinant of growth of the money stock. The major source of growth in the base is changes in the volume of Federal Government debt purchased by the Federal Reserve System on the open market. The relationship between the narrowly defined money stock and the monetary base is very close, and where differences occur the cause can be clearly identified. Thus, control of the monetary base gives the system the ability to closely control the money stock.

In my opinion, the actions that led to the acceleration in growth of the monetary base and money supply since the early 1960's occurred as a result of three things:

First, excessive preoccupation with the prevailing level of market interest rates;

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Second, the occurrence of large deficits in the Federal Government budget; and

Third, shifting emphasis of policy actions because of an apparent shortrun tradeoff between inflation and unemployment.

Throughout most of the 1960's, and to some extent in the 1970's, the conduct of open market transactions was influenced, in considerable measure, by a desire to prevent unduly high market interest rates from choking off growth of output and employment. The System purchased Government securities in increasing quantities in an attempt to hold interest rates at the then prevailing levels.

Past experience, in my opinion, indicates quite conclusively that the Federal Reserve has little ability to control the level of market interest rates for any extended period of time. Experience also indicates, for both this and other countries, that growth of total spending has been retarded very little by high interest rates. On the other hand, attempts to resist upward movements in market interest rates have resulted in faster growth of money.

The Federal Reserve, at various times over the past 10 years, has been concerned about dislocations in flows of funds to financial intermediaries and their customers. Attempts to maintain nominal interest rates below their free-market level have resulted in accelerating money growth, an acceleration in inflation, and still higher interest rates.

Another concern regarding market interest rates relates to the Federal Reserve's role in the orderly marketing of U.S. Government debt. Since changes in interest rates traditionally have been viewed as interfering with the orderly process of marketing new issues, fluctuations of market rates during the financing period have been limited by purchases of securities on the open market which in turn, add to the monetary base. Furthermore, System purchases of securities during such periods were not fully offset by subsequent sales and, as a result, money growth accelerated.

This process, in effect, has resulted in at least partial financing of Government deficits through the creation of money rather than borrowing from the private sector. When the Federal Reserve buys outstanding securities from the public, a part of the Government debt is ultimately being financed by the creation of new money. The ultimate effect of this indirect debt monetization is manifested in an increase in the price level—inflation—and higher interest rates after a substantial lag.

Since the early 1960's emphasis of monetary policy actions has, at various times, shifted between reducing inflation and reducing the unemployment rate.

On balance, the actions taken to achieve these shifting goals resulted in periods of rapid monetary growth which were longer than those of slower growth, and the result was a rising average growth rate of the money stock.

My analysis of the unemployment-inflation tradeoff leads me to conclude that it is nonexistent, except possibly for very short intervals of time. Therefore, with relatively stable monetary growth over a long period, I believe it would be possible to have an essentially stable average level of prices, and this could be accomplished without accepting a permanently higher unemployment rate. The desire to reduce the average level of unemployment should be approached through programs

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with this method of financing, I believe, that has contributed to the process of inflation. Once the inflation has been generated, a substantial period of time is required to reverse it, and unfortunately this can be accomplished only by incurring costs of lost output and higher unemployment.

Thus, over short periods of time it has appeared that debt monetization gives society something for nothing. And although this alternative may not have been chosen consciously and the actions which monetized the debt may not have been taken for that purpose, the excessive concern over market interest rates and the occurrence of large Government deficits led to this course of action.

I can find no benefits accruing to the whole of society from debt monetization, but the risks are very serious and can be expressed in one word -- inflation. In the way that I have described above, to a considerable extent since the mid - 1960's deficit spending financed indirectly by Federal Reserve purchases of securities on the open market has meant an increase in money which has exceeded the growth in our output potential, and therefore has been inflationary.

Turning to another issue, it is my belief that shifting emphasis of monetary actions because of a presumed trade-off between inflation and unemployment has contributed to the rapid monetary expansion. The idea of a trade-off between unemployment and inflation typically assumes that high rates of unemployment are

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associated with low inflation, and low rates of unemployment are associated with high rates of inflation. This view has led some analysts to argue that policy actions can assist the economy in achieving an acceptable combination of unemployment and inflation.

However, experience indicates that the unemployment-inflation trade-off, if it exists at all, is purely a short-run phenomenon. Chart 4 demonstrates that there exists no long-run relationship between the unemployment rate and the level of inflation. The only striking features I find are that since 1952 the yearly average unemployment rate has clustered around its average (4.9 percent) for the whole period, and the rate of inflation, regardless of the level of the unemployment rate, has moved progressively higher since the mid - 1960's.

In the past, emphasis of monetary policy actions has, at various times, shifted between reducing inflation and reducing the unemployment rate. For example, according to the published policy Record, since the early-1960's (except 1966 and 1969) a primary goal was lower unemployment, and expansionary monetary policies were adopted to achieve it. In 1966 and 1969 emphasis was on achieving lower rates of inflation, and restrictive monetary policies were accordingly adopted. However, on balance

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the actions taken in the past decade resulted in periods of rapid monetary growth which were longer than those of slower growth, and the result was a rising average growth rate of the money stock. More recently the emphasis of the adopted policies again has been to reduce inflation, but the actions taken thus far have not resulted in a reduction in the average growth rate of the money supply.

It is my view that there will always be some normal rate of unemployment as new workers enter the labor market, as relative demands and supplies for labor services change, and as workers simply leave present jobs to find more rewarding ones elsewhere. Such a level is not necessarily desirable, but rather it is a level determined by the normal functioning of our product and labor markets, given existing institutional and social conditions.

Monetary actions cannot influence this normal level of unemployment; other policies are necessary to attack that problem. As a matter of fact, monetary actions taken in an effort to reduce unemployment have contributed to increased inflationary pressures. Subsequent attempts to arrest inflation have temporarily fostered increased unemployment <u>in addition to</u> the normal amount consistent with existing labor market conditions.

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My analysis of the unemployment-inflation trade-off leads me to conclude that it is non-existent, except possibly for very short intervals of time. Therefore, with relatively stable monetary growth over a long period, I believe it would be possible to have an essentially stable average level of prices, and this could be accomplished without accepting a permanently higher unemployment rate. The desire to reduce the average level of unemployment should be approached through programs which reduce or eliminate institutional rigidities and barriers to entry in labor markets, which provide job training, and which improve information regarding job availability.

In recent months a new proposal has been advanced which, if adopted, would most likely lead to further acceleration in the rate of monetary expansion, thereby adding to inflationary pressures. It has been suggested that it is appropriate for monetary and fiscal authorities to stimulate aggregate demand during periods when domestic production is curtailed by some special event, such as the oil boycott, or when foreign demand for a specific product, like wheat, increases suddenly. The argument is that the resulting price pressure from such non-recurring events is inevitable and that an expansionary aggregate demand program is required

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to protect employment in the case of a decrease in domestic production, and to protect consumer buying power in the case of an increase in foreign demand. Unfortunately, the probability of achieving either of these goals with stimulative monetary actions is very small and the costs in terms of accelerated inflation are certain.

The main point to keep in mind is that the forces that cause prices to rise in a specific market are very different from those which cause inflation - a persistent rise in the average price of all items traded in the economy. The prices of individual items rise and fall continuously, and an increase in a particular price, even if it is the price of an important budget item like food, is not necessarily an indication of general inflationary pressures. In the absence of additional monetary stimulus to aggregate demand, price increases in specific markets are a signal that either the demand or supply conditions, or both, have changed; not that total demand for all goods and services has increased. Such price increases serve a very useful function of allocating scarce resources according to consumer preferences.

An increase in foreign demand for American products is not inflationary per se. It represents a shift in the composition

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of demand for our output, but not an inflationary increase in aggregate demand. Inflation would occur if monetary actions were taken in order to accommodate the price pressure in individual commodity markets. In the case of some unforeseen event, such as a domestic crop failure or an embargo on imports of raw materials, the productive capacity of the economy is reduced. Most of the time the effect is temporary, but, as in the case of the oil embargo, the effect can be long-lasting. There is little that an increase in aggregate demand can do to stimulate more production in such a situation.

In my opinion, a monetary policy which results in an increased growth of the money stock has no role to play in accommodating the relative price effects of autonomous changes in demand or supply in specific markets. Such monetary actions would only raise the overall rate of inflation. Temporary gains in output and employment might be achieved, but the ultimate effect would be only on the rate of change of prices in general.

I now turn to my final topic - the contribution that monetary policy can make to reducing the rate of inflation and lowering market interest rates. My views on this topic should by now be very obvious; monetary actions can, and must, make

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a positive contribution. The interests of the whole economy would be best served if the trend growth rate of the money stock were to be gradually, but persistently, reduced from the high rates experienced in the recent past. I believe that, once we achieved and maintained a 2 to 3 percent rate of money growth, both the rate of inflation and the level of interest rates would ultimately decline to their levels of the early 1960's.

I believe such a policy of gradual, rather than abrupt, reduction in the rate of monetary expansion from the high average rate so far in the 1970's, would not have severely adverse effects on the growth of output and employment. Such a gradual policy would probably mean, however, that the period of combatting inflation and high interest rates would extend through the balance of the 1970's.

Some analysts believe that if the Federal Reserve sought to control the rate of growth of the money supply within a fairly narrow range, unacceptable short-run fluctuations in short-term interest rates would be generated. I do not believe that it is necessary for the Federal Reserve to intervene systematically in financial markets in order to maintain orderly conditions.

It seems to me that there are three basic parts to this argument regarding the desirability of actions to smooth short-run

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interest rate fluctuations. First, the argument assumes that Federal Reserve actions in the past have in fact reduced short-run fluctuations in short-term interest rates compared to what they otherwise would have been. As far as I am aware, there is no substantial body of empirical evidence supporting this claim. There is, however, a large and growing body of evidence suggesting that highly organized financial markets by themselves do not generate excessive and unwarranted short-run interest rate fluctuations.

Second, this argument assumes that by stabilizing short-term rates the System can, in the short-run, stabilize intermediate and long-term interest rates. Again, I am not aware of any empirical evidence in support of this proposition.

Third, this position assumes that short-run fluctuations in interest rates have a significant impact on the ultimate goals of stabilization policy - namely, price stability, a high level of employment, and economic growth. I know of no reason to believe that moderating short-run fluctuations in short-term interest rates has any significant stabilizing influence on prices, output, or employment. Even within the context of the well-known econometric forecasting models, stabilization of short-term

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interest rates has almost no stabilizing influence on prices, output, or employment.

Some would oppose my recommended course of monetary policy on the grounds that it would not allow the Federal Reserve to perform its responsibility of a lender of last resort; so I want to make my views clear on this point. I believe it is possible that the failure of a major bank or other corporation can, at times, disrupt the smooth functioning of our financial markets. In my opinion, the Federal Reserve has an obligation to prevent the temporary problems of a major institution from affecting financial markets and perhaps even affecting the economy.

At the same time, however, I do not think that the System should subsidize inefficient management by making funds available at interest rates well below market rates, or be concerned about the losses that stockholders of a basically unsound institution might suffer. In the long-run, such actions can only weaken, rather than strengthen, the financial system, as well as the business community at large.

Any temporary assistance to a basically sound institution should be unwound in a relatively short period of time. At the same time, the provision of funds through the Federal Reserve discount window should be matched by a sale of securities from

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the System's portfolio in order to prevent an expansion in the monetary base and the money stock.

Carrying out the monetary policy actions that I recommend could be greatly facilitated by complimentary actions on the part of others. A balanced Government budget would eliminate much of the pressure on interest rates, thereby removing one cause of accelerating money growth in the past. Legislation removing impediments to the free functioning of our product, labor, and financial markets would allow these markets to adjust to monetary restraint more rapidly, and without the severe dislocations of the past.

It would also be helpful if all segments of our society would realize that rapid monetary growth, inflation, and high market interest rates go hand-in-hand; that, once initiated, inflation cannot be eliminated without some temporary costs in terms of slower growth of output and employment; and that considerable time will be required to reduce substantially both the rate of inflation and the level of interest rates. Such realizations would tend to mitigate the short-run pressures that in the past have resulted in postponements of efforts to curb inflation.

Darryl R. Francis

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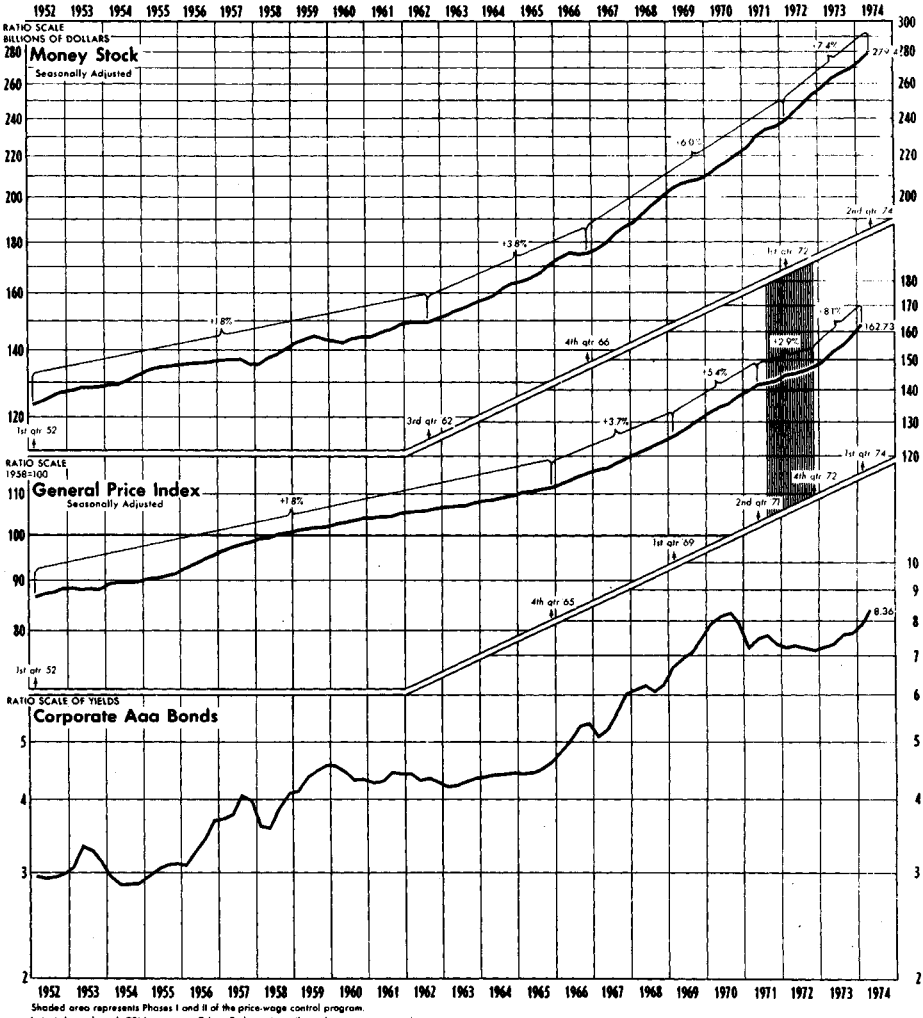
Chart I



Shaded area represents Phases I and II of the price-wage control program.
Latest data plotted: GPI-1st quarter; Others-2nd quarter estimated

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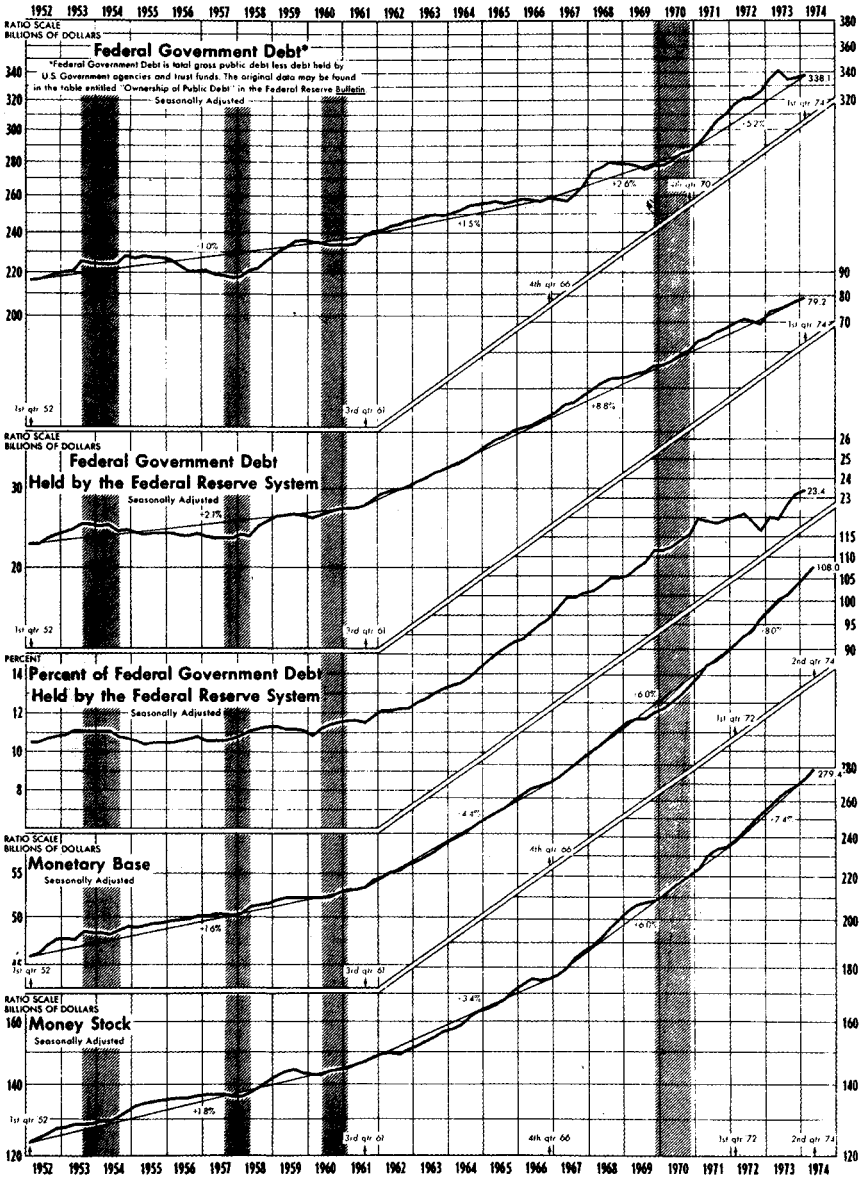
Chart 2

Influence of Federal Government Debt on Monetary Expansion



Shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research.
Latest data plotted: Monetary Base and Money Stock-2nd quarter estimated; Others-1st quarter

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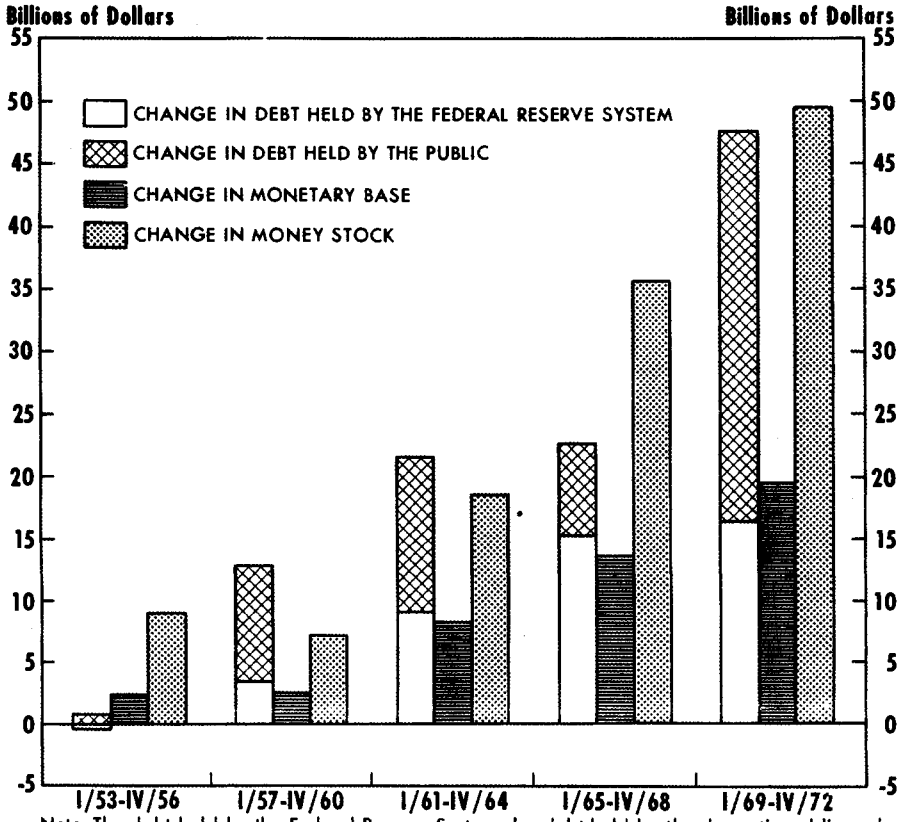
Chart 3

Growth of Government Debt and Money



Note: The debt held by the Federal Reserve System plus debt held by the domestic public and foreigners is net government debt, which is equal to total gross public debt minus debt held by Government agencies and trusts. The monetary base is net monetary liabilities of the Government. The money stock (M_1) is defined as demand deposits plus currency held by the public. Each of the five groups of bars depict level changes from the beginning to the end of the period indicated. All data are seasonally adjusted.

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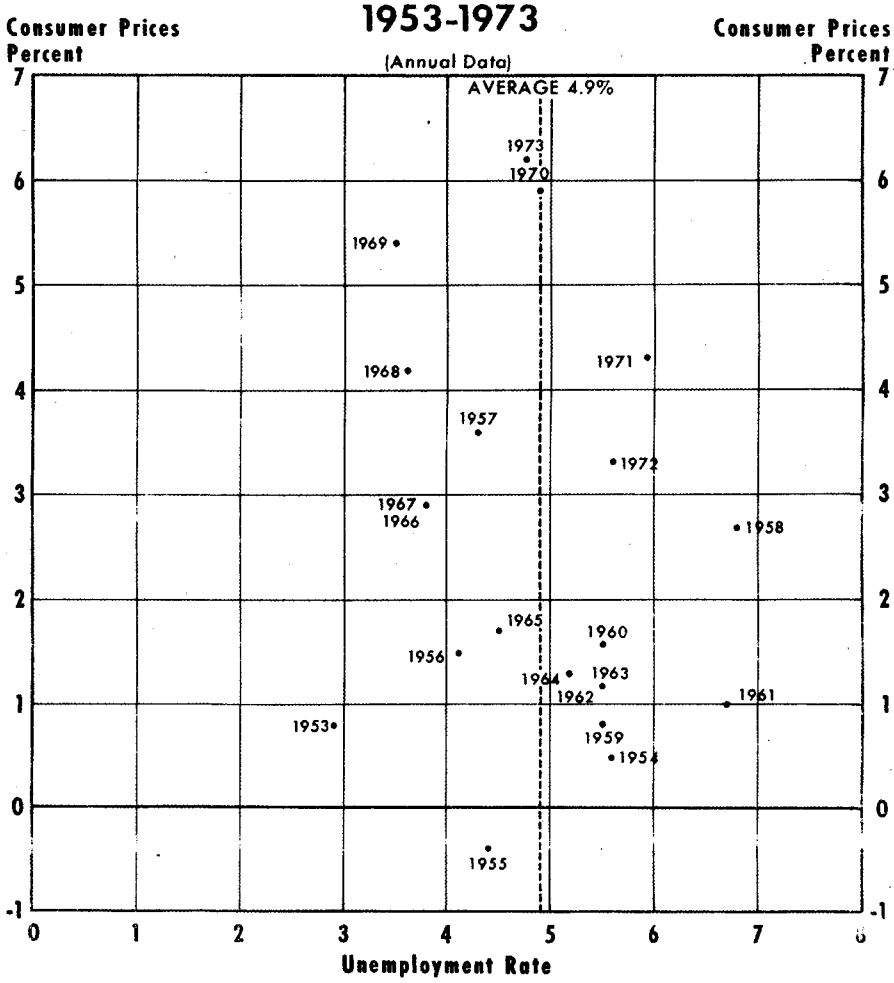
Chart 4

Prices and Unemployment 1953-1973

(Annual Data)



Source: U.S. Department of Labor

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The CHAIRMAN. Thank you, President Francis.

We will next have Robert P. Mayo of the Chicago bank. Mr. Mayo, you are recognized, sir.

STATEMENT OF ROBERT P. MAYO, PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO

Mr. MAYO. Thank you, Mr. Chairman, members of the committee.

I am pleased to be with you today to do whatever I can to help in this important inquiry into the problem of inflation and its effects on our economy and alternative cures. I think you will find as you listen to my testimony today, ladies and gentlemen, that I take a slightly different approach to the problems of monetary policy than my associate, who has just spoken. I respect his judgment very much and I consider it carefully, even though I must say in my own deliberations I come to somewhat different policy prescriptions. Yet I must add in the same sentence that his and my prescriptions are both within identical broad economic goals, and we share those fully. Each of us making his monetary policy recommendations within the Open Market Committee must, of course, in all candor, use his own experiences, his own observations of the world, his own framework for sorting things out, for organizing these observations and doing his own weighing of the information available. That is what we are supposed to do in carrying out these responsibilities.

These differences in approach are appropriate and useful to monetary policy formulations. No individual that I know of has perfect knowledge and foresight. I certainly do not. There are no perfect, unchanging relationships among either the real or the financial variables of our economy. There are no mechanistic certainties in the responses of our economy to meet our monetary policy actions. There are only indicators, and I think we all have to keep that in mind.

These differences, ladies and gentlemen, are fully examined in the uninhibited forum of the Open Market Committee. They interact and they add to each other and they modify each other, and they form, in my opinion, a more complete fabric for policy construction than any individual could possibly produce singlehandedly. That is the beauty to me, and the strength, of the open market system.

Indeed, it is the strength, in my opinion, of the whole Federal Reserve System—an institutional wisdom that Congress has created and has strengthened over the years.

We have learned much in recent years about the consequences of our actions, but we still have even more to learn as we face the challenge of an even more complex domestic and international economy. We just do not know all of the answers, particularly when the questions keep changing.

I might just say that the role of finance in my mind is to grease the wheels of production, distribution, and consumption—to make those wheels more efficient. Finance—not just monetary policy, but finance as a whole—is therefore a means to an end, not to an end in itself, and that is why I put so much weight on the analysis of the production, distribution, and consumption functions in our economy as I look at the problems of monetary policy.

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I think we all agree that inflation and its effects on interest rates, on asset values, on real incomes and on the general welfare of our citizens are serious indeed, particularly today.

Those of us in the Fed share with the Congress and the administration the desire and the responsibility for achieving our national goals of high employment, relatively stable prices, sound economic growth, and a reasonable balance in our international payments.

I think it is crystal clear that the Fed is not only fully aware of the dangers and costs of continuing inflation, but is making what I think is every reasonable effort to resist and contain the current rising trend in the general price level. The public is fed up with inflation; that is perhaps one thing that all of us in this room can agree on today. The public has finally decided that price rises have gone beyond a tolerable level. They are willing, I think, to support effective efforts to control inflation, recognizing that there are substantial costs involved in so doing.

The current inflation has developed over a long time. It is worldwide, not just a U.S. phenomenon. As leaders of the free world, we cannot take too much satisfaction in that since we are sharing a disease, if you please, that is worldwide. We have some inflation control responsibilities that extend far beyond our own borders.

But for all of us—whether we be German, Italian, British, Japanese, or Americans—it will take time, determination, and patience to resolve these problems.

As we choose the course to follow in combating inflation wisely, we must keep in mind that the U.S. economy responds only gradually over time to the majority of the actions that we take. There is no such thing as instant policy in the monetary field, and indeed, its lag is variable and is not precisely predictable.

No one will deny that inflation is directly concerned with the relationship between the quantity of goods and the quantity of money. That relationship, in turn, has many facets. The great perspective of 20–20 hindsight tells me, for instance, that the growth of the money supplied during 1972 and the first part of 1973 was somewhat higher than many of us wished in view of the way the underlying economic situation turned out, and thus added in some degree to inflationary pressures.

I say this candidly, even though a review of the decisions in the perspective of the environment at the time that those decisions were made, suggest to me no substantive disagreement with each decision that we made. We can always do our quarterbacking a little better on Monday morning. But even more importantly, I cannot ignore the fact that many other factors outside of the influence of the Federal Reserve played a very important role in the unprecedented inflation of 1973 and 1974. Those factors include the coincident strong expansion of all of the industrialized nations of the world, crop failures abroad, successive devaluations of the dollar, and the termination of wage-price program, which was necessary, at least in its early stages, to help mitigate the effects of our deficit-riddled fiscal policy of 1967 and 1968.

All of these events together produced 1973 export demand far exceeding expectations, and added price pressures to a domestic economy already operating at full capacity. Then, of course, the oil embargo and oil price increase added to the problem.

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In addition to these special factors, hopefully, each of them nonrecurring, fiscal policy did become too expansionary in 1971 and 1972 as the Federal Government worried more about large potential increases in unemployment, which did not develop, than about large increases in inflation, which did.

The Federal Reserve has an independent charge from the Congress to act as a prudent manager of monetary policy. But the Fed is also charged with the responsibility for maintaining an effective, viable financial system for the reasons I indicated in my introduction, not just fighting inflation blindly, regardless of what the consequences might be. When the administration recommends and Congress authorizes expenditures far in excess of revenues, the Treasury has no alternative but to issue more securities to pay for its spending. The Federal Reserve, of course, has the responsibility to see that each Treasury issue is reasonably priced, and that the Treasury is successful in the acquisition of the necessary funds to finance the U.S. Government.

The net result of assisting deficit financing in an economy which is already generating sufficient momentum to achieve very high employment levels, is, of course, inflationary. The Congress has not, of course, intentionally placed this burden on the Treasury or the Fed. It is a residual burden, even though it is a heavy one. Rather, my experience as a Treasury debt management official for many years, as Director of the Bureau of the Budget in 1969 and 1970, and then as a Federal Reserve bank president, indicates to me that this situation arises from a fundamental flaw in governmental coordination of economic policy and public finance up until the present time.

I testified a year ago in my own behalf, not for the Fed, before the congressional budget reform committee as a strong proponent of the proposal that, in effect, the Congress has now enacted to have a Joint Committee on the Budget fully staffed to provide the Congress with an independent view of the whole budgetary picture.

I think it will work. I certainly hope it will. Again, we are all human beings and work in an institutional environment that does not work perfectly. But, I think it will work well enough to make a positive contribution to control the fiscal policy actions by the Congress.

Let me turn then just for a moment to the question which is a very important one. Where we have the economy operating close to full capacity, monetary growth in excess of the growth of the capacity to produce goods and services, obviously, tends to sustain general price inflation and will result in higher interest rates, as ongoing rates of inflation are built into those rates.

In such a situation we must ask why the rate of inflation and interest rates cannot be decreased simply by reducing the rate of monetary growth. I think the answer lies, ladies and gentlemen, in the fact that we as a nation have more than one economic goal. In addition to our desire and need to reduce the rate of increase in the general price level, we must consider the effects of any contemplated restrictive actions on unemployment and on overall economic growth. We must be cognizant of the sectoral ramifications of various degrees of constraint—the housing sector being the most obvious example today, as it was in 1966 and 1969. Nor can we neglect the needs of small businesses and local governments. Finally, we must always remember that our actions do not have their principal effects today, but some months hence, and

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we do not even know precisely how many months hence; they are diluted; they vary.

We cannot expect immediate price restraint from restrictive actions, but we also must take great care we do not overstay our welcome and precipitate a serious economic downturn.

I do not think we are overstaying our welcome today. The trade-off relationship that exists between the rate of general price increase and the rate of unemployment is unstable, and is therefore, in my opinion, of limited usefulness as a guiding principle of economic policy. Nevertheless, we cannot ignore this relationship as we assess the alternatives open to us at any time. A restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. We know that the expectations of consumers, businessmen, Government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance, not by promises, and even then very slowly.

A reduction in the rate of inflation and in price level expectations will eventually produce a decline in interest rates. This result will occur only after an appreciable delay. When economic activity is stimulated to a point where output in dollars exceeds real capacity output, the initial response of interest rates to the adoption of a restrictive monetary policy is increased, not decreased interest rate. Given our reliance on general fiscal monetary restraint, declining interest rates will occur only after aggregate demand is reduced, thus reducing demands for money and credit.

As prices respond, the rate of inflation will then subside and expectations of inflation will be reduced. It is only then, not before, that the inflation premium built into interest rates today will be eroded.

We have seen a good example of the shorter-run relationship between restraint and monetary growth and interest rates during the past 6 months.

During this period the U.S. economy suffered from inflation stemming from one, past fiscal and monetary stimulus, two, relaxation, and then termination of a wage-price control program that, in my opinion, had overstayed its welcome and its usefulness, three, the effect of shortages in energy and agricultural products, and four, international developments.

When it became clear to everyone that the Fed was indeed moving further to restrain these inflationary forces, interest rates, as you also well know, increased rapidly. Demands for money and credit far exceeded expectations which reflected in part the sharper than anticipated rate of general price increases. We were all disappointed in this.

I must add, Mr. Chairman, that everything else being equal, I share the feeling that is common in this country, that we are better off when interest rates are low than when they are high. But we cannot always afford that luxury of low rates. We get closer to it than most countries of the world. We, again, cannot do it as perfectly as we would like because of our other economic goals.

Market interest rates have increased so far and so fast this year in response to our efforts to restrict availability of funds to banks that new questions have arisen in the minds of many people about

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the operation of our Nation's financial markets. The economy has been subjected to a highly unusual shock by the arbitrary and very sudden increase in petroleum prices. Underwriting these price increases fully by monetary expansion is, as my predecessor in the testimony this morning indicated, self-defeating if the monetary expansion simply results in further price increases.

I think there is a little more to it than that. Increases in energy prices of the magnitude we have witnessed require reallocation of real consumer and business spending throughout our economy. Spending patterns will either shift toward more dollars spent on energy at the expense of other things, or there will be a reduction in energy use, or some combination of the two will occur. In the textbook economy that adjusts instantaneously to rapid and large changes in relative prices, such a reorientation could take place without undue strain. The economy of this country does not adapt that quickly to changes of such magnitude. Thus, insistence that increases in energy prices be treated as relative price changes that should not be permitted to increase the general price level at all runs, in my opinion, the serious risk of precipitating an economic downturn. It seems preferable to me, then, ladies and gentlemen, to permit a portion, but as little as is reasonable, of these nonrecurring price increases to be reflected in increases in the general price level in order to provide additional time for adjustment to what is really a new environment. On both of these grounds, then, minimizing financial market adjustment problems and adapting carefully to the sudden change in energy prices, and, if you wish, the aftermath of the 1973 upsurge in agricultural prices as well, I believe monetary aggregate growth in recent months modestly in excess of what might be considered "normal" guidelines is entirely appropriate.

Under these circumstances, an overly protective or timid appraisal of the ability of financial markets to withstand strain, or an excessive accommodation of highly unusual price increases, would have the effect of worsening inflation. Throughout our discussion, we must bear in mind that the sharp increases we have seen in key prices are only beginning to appear in their secondary effects on prices of other products, and in wages.

Our own analysis of economic developments during the second quarter of 1974 indicates we have passed through the critical period of serious petroleum shortage reasonably well, all things considered. Unemployment did not increase significantly and our economic decline seems to have leveled off. Yet we are just now facing what in many ways is the more serious phase of our problem. Inflation continues and will accelerate in some areas in response to earlier price increases in key commodities. Financial markets remain unsettled. Uncertainty is still a major factor.

While the current situation may seem to present only limited grounds for optimism, I am inherently an incurable optimist and I believe that we now have the opportunity to reduce our inflationary problems without imposing unacceptable high social costs and human misery and foregone output. The downturn in the first quarter was not accompanied by a large increase in unemployment. Pressure to be fiscally expansive in order to reduce unemployment has not been strong. There is some promise of relief from price pressures in the agricultural area in the coming months.

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We probably will have our best crops in history, even though the weather has perhaps lessened some of those estimates a bit. Petroleum products are at least available once again, even though prices are high.

Finally, viewed against the background of recent price performance, monetary policy has already set in place strong restraining forces that will act as a brake on inflation and on interest rates in the months ahead.

[Testimony resumes on p. 209.]

[Mr. Mayo's prepared statement follows:]

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Statement by Mr. Robert P. Mayo, President,
Federal Reserve Bank of Chicago
to the Committee on Banking and Currency,
U. S. House of Representatives, Washington, D. C.,
July 18, 1974

I am pleased to have the opportunity to meet with you today to do whatever I can to assist your Committee's inquiry into the problem of inflation in our national economy. We all agree that inflation and its attendant effects on interest rates, asset values, real incomes, and the general welfare of our citizens are indeed serious. Those of us in the Federal Reserve System share with the Congress and the Administration the desire and the responsibility to achieve our national goals of high employment, relatively stable prices, sound economic growth, and a reasonable balance in international payments. I think it is crystal clear that the Federal Reserve System is not only fully aware of the dangers and costs of continuing inflation, but is making every reasonable effort to resist and contain the current rising trend in the general price level.

In our present unusual economic environment, this is not an easy task. But the task would be even more difficult if the Federal Reserve System, as the manager of the nation's monetary system, did not possess a strong regional orientation and structure. Since I assumed my position as President of the Federal Reserve Bank of Chicago almost four years ago, I have found the economic input from the members of my Board of Directors most helpful as I have attempted to evaluate policy alternatives in an environment in which our national economic intelligence--even though the best in the world--is still inadequate. The existence of this strong regional structure, in my view, permits the Federal Reserve to be more flexible and responsive to a rapidly-changing economic environment that

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is only reflected in more formalized data with a significant time lag.

I can also report to you that the degree of public support in the Seventh Federal Reserve District for current Federal Reserve monetary policies is very strong, judging by the comments I have received wherever I go. The encouragement for continued monetary restraint comes not only from the banks but also from institutions and individuals whose own financial condition often has been and will continue to be adversely affected by continued market pressures. The public is fed up with inflation. They have finally decided that price rises have gone beyond the tolerable level. They are willing, I believe, to support effective efforts to control inflation--recognizing that there will be substantial costs involved in so doing.

I am gratified by this support. Without it we might become less confident in our resolution to accomplish the difficult task that lies ahead. Yet we must always remember that excessive zeal in combatting inflation could lead to even more serious economic difficulties than those that now confront us. The current inflation has developed over a long time. It is worldwide--not just a U. S. phenomenon. But as leaders of the free world we have inflation control responsibilities that extend far beyond our own borders. It will take time, determination, and patience to resolve these problems.

As we choose the course to follow in combatting inflation wisely, we must keep two important factors in mind--the sequence of events that has led us to our current situation and, exactly where we stand at this juncture. A brief review of the past provides us with a better understanding of earlier misjudgments that should be avoided in future actions. Knowledge of the current situation is essential because the U. S. economy responds only gradually over time to the majority of forces leading to change.

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Therefore, we must take into account forces already set in motion that are not as yet evident. There is no such thing as instant monetary policy. Its lag is variable and not precisely predictable.

No one will deny that inflation is concerned with the relationship between the quantity of goods and the quantity of money. But that relationship in turn has many facets. The great perspective of 2020 hindsight tells me that the growth of the money supply during 1972 and the first part of 1973 was somewhat higher than many of us wished in view of the way the underlying economic situation turned out, thus adding to some degree to inflationary pressures.

But even more importantly, we cannot ignore the fact that many other factors outside the influence of the Federal Reserve played a very important role in the unprecedented inflation of 1973-74. Those factors include the coincident strong expansion of all of the industrialized nations of the world, crop failures abroad, successive devaluations of the dollar, and the termination of the wage-price control program which was necessary, at least in its early stages, to help mitigate the effects of our deficit-riddled fiscal policy of 1967 and 1968. All of these events together produced 1973 export demand far exceeding expectations, and added price pressures to a domestic economy already operating at full capacity or beyond. Finally, of course, the oil embargo was an obvious unanticipated shock, and the substantial price impact domestically was equally unnerving.

In addition to these special factors, hopefully non-recurring--fiscal policy, in terms of budget deficits, became too expansionary in 1971 and 1972 as the federal government worried more about large potential increases in unemployment (which did not develop) than about large increases in inflation (which did). The Federal Reserve has an independent charge from the Congress to act as a prudent manager of monetary policy. But the

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Fed is also charged with responsibility for maintaining an effective, viable financial system--not just fighting inflation blindly regardless of the consequences. When the Administration recommends--and the Congress authorizes--expenditures far in excess of revenues, the Treasury has no alternative but to issue more securities to pay for its spending. The Federal Reserve has, of course, a responsibility to see that the Treasury is successful in acquiring the necessary funds without significant distortion and disruption in financial markets.

When excess capacity exists in the economy, and the money and capital markets are quiet, the Treasury can handle deficit financing and refund maturing issues fairly easily. But, as the economy approaches capacity output and the deficits persist because of fiscal policy lags, the Treasury must compete with other market participants for increasingly scarce financial resources. Under these circumstances, continued large Treasury financings, particularly with an ever shortening debt maturity structure, can have significant impacts on market interest rates. In order to avoid serious disruptions in private capital markets, then, the Federal Reserve is under pressure to allow more rapid increases in monetary aggregates than would be the case in the absence of debt management pressures. The net result of assisting deficit financing in an economy which has already generated sufficient momentum to achieve very high employment levels is, of course, inflation.

The Congress has not, of course, intentionally placed this burden on the Treasury and the Federal Reserve. It is a residual burden--albeit a heavy one. Rather, my experience as a Treasury debt management official, as Director of the Bureau of the Budget, and as a Federal Reserve Bank president, indicates to me that this situation arises from a fundamental flaw in governmental coordination of economic policy and public finance

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up until the present time. There is great need for a system to review all of the authorizations of the Congress and their spending implications in totality, taking into account the impacts of these actions not only in specific areas but also on financial markets and the growth of economic activity in general.

I testified a year ago before the Congressional budget reform committee as a strong proponent of the proposal that the Congress establish a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture, and with an analytical staff capability of its own to lessen its factual dependence on the Executive Branch. I am most enthusiastic about your recent approval of such overall fiscal control. The cynics say it won't work because of the deep-seated jealousies of Congressional committees. I disagree. It can work and I believe Congressional leaders will see to it that it does.

I now turn my attention to a few key issues in our current environment. We know that once the economy is operating close to full capacity, monetary growth in excess of the growth of the capacity to produce goods and services will sustain general price inflation and will result in higher interest rates as ongoing rates of inflation are built into those rates. In such a situation, we must ask why the rate of inflation, and interest rates, cannot be decreased simply by reducing the rate of monetary growth.

The answer lies in the fact that, as a nation, we have more than one economic goal. In addition to our desire and need to reduce the rate of increase of the general price level, we must consider the effects of any contemplated restrictive actions on unemployment and on overall economic growth. And, we must be cognizant of the sectoral ramifications of various degrees of constraint--the housing sector being the most obvious example currently, as it was in 1966 and 1969. Nor can we neglect the needs of

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small businesses and our local governments. Finally, we must always remind ourselves that any actions we do take will have their principal effects not today, but some months hence. We should not expect immediate price restraint from restrictive actions. We also must take great care that we do not overstay whatever restriction is adopted and precipitate a serious economic downturn. The problem is made even more difficult by the limited ability to forecast future economic developments.

The tradeoff relationship that exists between the rate of general price increase and the rate of unemployment is unstable and is therefore of limited usefulness as a guiding principle of economic policy. Nevertheless, the relationship cannot be ignored as we assess the alternatives open to us at any time. A restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. And we know that the expectations of consumers, businessmen, government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance--not by promises--and even then very slowly. We must move cautiously yet firmly with our restrictive actions and be prepared to adhere to those policies long enough for the effects to be felt.

A reduction in the rate of inflation--and in price level expectations--will eventually produce a decline in interest rates. But this result will occur only after an appreciable lag. When economic activity is stimulated to a point where the rate of output in dollars exceeds real capacity output, the initial response of interest rates to the adoption of a restrictive monetary policy will be <u>increased</u> rather than <u>decreased</u> interest rates. This is true because real money balances tend to be reduced below desired levels within our existing income and price structure. Given our reliance on general monetary and fiscal restraint, declining interest rates will occur

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only after aggregate demand is reduced, thereby reducing demands for money and credit. As prices respond, the rate of inflation will then subside and expectations of inflation will be reduced. It is only then that the inflation premium in interest rates will be eroded--not before.

We have seen a good example of the shorter-run relationship between restraint in monetary growth and market interest rates during the past six months or so. During this period, the U. S. economy suffered from inflation stemming from (1) past fiscal and monetary stimulus, (2) relaxation--and then termination--of a wage-price control program that had overstayed its welcome and its usefulness, (3) the effects of shortages in energy and agricultural products, and (4) international developments. When it became clear that the Federal Reserve was moving further to restrain these inflationary forces, interest rates, as you all know so well, increased rapidly. Demands for money and credit far exceeded expectations which reflected in part the sharper than anticipated rate of general price increases.

Market interest rates have increased so far and so fast this year in response to our efforts to restrict availability of funds to banks that new questions have arisen about the operations of our nation's financial markets. The economy has been subjected to a highly unusual shock by the arbitrary and very sudden increases in petroleum prices. Underwriting these price increases fully by monetary expansion is, of course, self-defeating if the monetary expansion simply results in further price increases. But there is much more to it than that.

Increases in energy prices of the magnitude we have witnessed require reallocation of real consumer and business spending throughout our economy. Spending patterns will either shift toward more dollars spent on energy, away from other areas or there will be a reduction of energy use--or some combination of the two will occur. In a textbook economy that adjusts

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instantaneously to rapid and large changes in relative prices, such a reorientation could take place without undue strain. But the economy of this country does not adapt that quickly to changes of such magnitude. Thus, insistence that increases in energy prices be treated as relative price changes that should not be permitted to increase the general price level at all runs the serious risk of an economic downturn. It seems preferable to me to permit a portion (but as little as is reasonable) of these non-recurring price increases to be reflected in increases in the general price level in order to provide additional time for adjustment to the new environment. On both of these grounds--minimizing financial market adjustment problems and adapting carefully to the sudden changes in energy prices--and the aftermath of the 1973 upsurge in agricultural prices as well--I believe monetary aggregate growth modestly in excess of what might be considered "normal" guidelines in recent months is appropriate.

We are sailing on uncharted seas. Our 1974 economic environment is a new experience in terms of supply constraints. Reliance on past patterns and relationships as a guide to policy making and policy execution has been less than adequate. Therefore, we are still operating in a highly unpredictable environment, one in which the broad outlines of an unfolding situation are only now becoming a little clearer. Here again I am thankful for the role that our regional Federal Reserve bank board of directors play in helping us clear away some of the clouds of uncertainty.

Under these circumstances, an overly protective or timid appraisal of the ability of financial markets to withstand strain, or an excessive accommodation of highly unusual price increases, would have the effect of worsening inflation. And, throughout our discussion, we must bear in mind that the sharp increases we have seen in key prices are only beginning to appear in their secondary effects on prices of other products--and in wages.

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We do not have the ability to perform miracles. We have no magic wands to wave. Our own analysis of economic developments during the second quarter of 1974 indicates that we have passed through the critical period of serious petroleum shortage reasonably well, all things considered. Unemployment did not increase significantly and our economic decline seems to have leveled off. Yet we are just now facing what in many ways is the more serious phase of the problem. Inflation continues and will accelerate in many areas in response to earlier price increases in key commodities. Markets remain unsettled. Uncertainty is still a major factor.

While the current situation may seem to present only limited grounds for optimism, I believe we now have the opportunity to reduce our inflationary problem without imposing unacceptably high social costs in human misery and foregone output. The downturn in the first quarter was not accompanied by a large increase in unemployment, and pressure to be fiscally expansive in order to reduce unemployment has not been strong. There is some promise of relief from price pressures in the agricultural area in the coming months. Petroleum products are at least available once again even though prices are high. Finally, viewed against the background of recent price performance, monetary policy has already set in place restraining forces that will act as a brake on inflation and interest rates over the months ahead.

In conclusion, I want to remind all of us that we as a nation cannot reasonably expect to eradicate inflation during the next two or three years. If our policies are successful, they will be successful only in reducing the rate of inflation gradually. Nor should we as a nation ask monetary policy to carry the entire burden of inflation control. The social costs and adverse sectoral impacts of relying on a single general type of policy are simply excessive. It is absolutely essential that both specific and general fiscal policy measures be coordinated with monetary policy during the coming period if we are to truly dampen inflation.

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The CHAIRMAN. Thank you, sir, and we now have Mr. Morris of the Boston bank, and Mr. Morris, if you will please summarize your statement by emphasizing your principal points, it will give the members more time to ask you questions, and very likely, all the more will be brought out that way.

STATEMENT OF FRANK E. MORRIS, PRESIDENT, FEDERAL RESERVE BANK OF BOSTON

Mr. MORRIS. My prepared statement is quite brief, Mr. Chairman, but I will try to shorten it.

I welcome the opportunity to testify before this committee. In your letter, Mr. Chairman, inviting me to testify, six specific issues were raised. I think it is best to approach these issues by placing them in a broad framework emphasizing two things. First, that policy must always be judged in the light of the information available at the time the decisions were made. Second, that we in the Federal Reserve have learned a great deal from the events of the past decade and we are determined to benefit from this knowledge.

With these two things in mind, I would like to first talk about the problems of the Federal Reserve's basic longrun policy, and second, to talk about the day-to-day problems of implementing policy.

In evaluating the Federal Reserve performance, the central question must be whether the trend rate of growth of the money supply, over which the Federal Reserve has reasonably effective control, was properly given reasonable forecasts of the money-to-GNP relationship, which the Federal Reserve does not control. Evaluation of past policy must proceed in the light of the information on the economic relationships available at the time the decisions were made.

Following the experience of late 1968, when monetary policy was clearly too expansionary, the Federal Reserve moved to reconsider its policy procedures. In early 1969, Chairman Martin appointed a subcommittee of the Open Market Committee, of which I was a member. The subcommittee recommended that the FOMC place greater emphasis on the growth of monetary aggregates and less emphasis on interest rates in future policy terminations.

Beginning in January of 1970, this recommendation was implemented in a clause in the directive defining basic monetary policy in terms of monetary growth targets.

This 1970 shift in the way policy is formulated will, I think, appear in the historical accounts of economic policy as a milestone of importance comparable to the Treasury-Federal Reserve Accord of 1951. The form of the directive we are now using reflects the Federal Reserve acceptance of the proposition that, other things being equal, significant and sustained changes in money growth produce significant changes in the course of the economy.

This important proposition, however, simply alters the starting point for our analysis. Because other things are not constant, the relationship between money growth and GNP growth is not constant.

I have in my prepared text an illustration of the policy problem of 1972 and 1973, pointing out that in those years the velocity of circulation of money, which had been increasing prior to this time at about 1 percent a year, jumped to 4 percent a year, and as a consequence, we

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had a bigger growth in money GNP in the years 1972 and 1973 than our earlier relationships would have forecast on the basis of the rate of growth in the money supply.

Unfortunately, this extra growth in GNP was reflected to a large extent in a higher rate of inflation than could have been anticipated on the basis of earlier relationships. Obviously, if we had known that GNP would grow by 11 percent in these 2 years, we would have planned for a less rapid monetary expansion. A GNP growth rate in the neighborhood of 8 percent would have been better than 11 percent. However, if we look at the problem from the vantage point of 1971, suppose we had held money growth to 4 percent and suppose velocity, instead of growing at 4 percent a year, had grown at 1 percent a year—then GNP would have grown at an annual rate of 5 percent instead of the 8 percent we were shooting for. In that event, the central topic of this meeting would be how to deal with unemployment rather than how to deal with inflation.

My views on the appropriate stance of policy have been affected by this experience. Advocates of discretionary policy—and I am one of those—have always recognized that policy should become neutral once the economy has reached the neighborhood of full employment, unless it is possible to identify a clear disturbance that ought to be offset. I am now of the view that the neighborhood around full employment calling for a neutral policy is wider than I had previously thought, and I am less optimistic than I used to be in a world which is growing increasingly interdependent, that policymakers can always identify and offset disturbances.

If this view is correct, it means that all of us must be more patient. We must be willing to ride out surprises in the expectation that most such surprises are self-correcting. There is nothing that monetary policy can do to offset the inflationary effects of a worldwide food shortage or oil embargoes; in terms of general monetary and fiscal policy, we must be patient and wait for increased food and oil production to level off or to reverse these price disturbances.

There is clear evidence, I think, that in the long run, a lower trend rate of money growth will be needed if the rate of inflation and the level of interest rates are to be reduced. It would not be wise, however, to think about this problem in terms of setting now a schedule for reducing money growth over the next few years.

We certainly should seize any opportunities to move more quickly than any schedule might suggest, but we must be aware of the possibility that we will be forced to move more slowly should unemployment climb higher than expected.

The only clear guideline we have at the moment is that we should be very careful not to permit the trend rate of growth in money to rise significantly above the growth rates of recent years. We should be completely honest about the possibility that the American people may have to grit their teeth and endure a period of moderate unemployment. If every small increase in unemployment is met by demands for accelerated money growth while declines in unemployment are not met by reduced growth, then inflation is certain to accelerate in the long run.

In pursuing a longrun policy to reduce inflation, it would be extremely helpful if continuous fiscal restraint could be maintained. By

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reducing the upward pressures on interest rates caused by the Federal deficit financing, it would be possible to maintain a policy of moderate monetary expansion while at the same time making clear progress toward the goal of lower interest rates.

One of the lessons of the past decade, it seems to me, is that the American public is not going to be satisfied with the Government's stabilization program until such time as we can develop a better mix of fiscal and monetary policy.

Looking over the past 10 years I find only one period—late 1968 through 1969—during which fiscal policy could be described as substantially restrictive. During the rest of the 10-year period fiscal policy ranged from neutral to strongly stimulative, and the aggregate Federal budget deficit for the period amounted to substantially more than $100 billion.

Beginning in 1964, we proceeded to reduce individual income tax rates, corporate income tax rates, and excise tax rates substantially below the levels prevailing in 1960. With the exception of the temporary surcharge, which lasted only 18 months, the only major tax rate we have seen fit to raise during this inflationary era has been the social security tax. All the other tax rates are lower.

This is not to say, with the benefit of hindsight, that monetary policy should not have done more to offset expansionary fiscal policies than it did. However, it does emphasize the handicap under which monetary policy has had to operate during most of the past decade.

If fiscal policy is not to carry its fair share of the stabilization burden, monetary policy will have to be applied more severely than would otherwise be necessary. The social and economic problems occasioned by a severely restrictive monetary policy stem in large part from the fact that its impact is not evenly distributed throughout the economy. It hits especially hard on those units most vulnerable to a sharp rise in short-term money rates, such as the thrift institutions. It inevitably means a sharp contraction in residential construction. It impacts severely on securities markets and the holders of outstanding stocks and bonds, and it bears heavily on the small businessman whose access to money is limited to the commercial banks.

We need in this country an anti-inflationary program which distributes the burden of restraint more evenly among the various sectors of the economy. This, in my opinion, can only be achieved by a balanced application of fiscal and monetary policy. I will comment very briefly on some of the issues surrounding short-term policy implementation.

I think the major problem for the Federal Reserve in implementing policy, a policy designed to control the rate of growth in the money stock, is to distinguish between short-term fluctuations in interest rates which serve an equilibrating function and those that are a consequence of disequilibrating disturbances. There is no question in my mind that it is absolutely essential for the Federal Reserve to intervene to stabilize financial markets following events such as the Penn-Central bankruptcy and the subsequent disturbance in the commercial paper market in 1970. Events of this kind are characterized by irrational market reactions affecting institutions other than those directly involved. It is obvious from the pre-Federal Reserve experience and the experience of the early 1930's that snowballing financial failures can

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create enormous difficulties. We cannot risk the generation of such a snowball.

However, I am inclined to believe that one of the lessons of recent years is that we have been too ready to cushion interest rate movements with the result that we have experienced more variable money growth in the short run than is necessary or desirable. While very shortrun variations in the rate of growth of the money supply have little economic significance in themselves, smaller variations will help us to keep closer to the desired longrun growth path in the future.

Some of these issues are currently being explored by a new Committee on the Directive, which Chairman Burns recently appointed, and of which I am a member. We have extensive staff work now underway and I am optimistic that we will soon be able to come up with improvements in our present operating procedures which I think will give us a better way of controlling the rate of growing in the money stock.

In summary, Mr. Chairman, it seems to me that we have learned a great deal from the experience of the last decade, and what we have learned is that a change toward a more stable monetary and fiscal policy in the neighborhood of full employment is critically needed. But in viewing our recent experience we should be careful not to learn lessons that are not true. I am told that lawyers have the saying that tough cases make bad law, and it may well be that abnormal economic developments teach bad lessons.

Our inflationary, shortage-ridden economy of the past year has been abnormal and we must be very careful not to overreact. By placing recent events in a longer historical context, let us hope that we can learn the right lessons.

[Testimony resumes on p. 225.]

[Mr. Morris' prepared statement follows:]

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Statement of

Frank E. Morris

President, Federal Reserve Bank of Boston

before the

House Committee on Banking and Currency

July 18, 1974

I welcome the opportunity to testify before this Committee on the fundamental issues of monetary policy. In Mr. Patman's letter of June 19 inviting me to testify, six specific issues were raised. I believe it is best to approach these issues by placing them in a broad framework emphasizing two themes. The first theme is that policy must always be judged in the light of the information available at the time the policy decisions were made. The second theme is that we have learned much from the events of the past decade. With these two themes in mind, I would like to discuss, first, the issues connected with the Federal Reserve's basic long-run policy and, second, the issues connected with the day-to-day problems of implementing the basic policy.

Long-Run Policy Issues

In evaluating Federal Reserve performance the central question must always be whether the trend

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rate of monetary growth, over which the Federal Reserve has reasonably effective control, was proper given reasonable forecasts of the money-to-GNP relationship, which the Federal Reserve does not control. Evaluation of past policy must proceed in the light of the information on economic relationships available at the time the policy decisions were made.

I am not going to attempt an evaluation of past monetary policy decisions; judgments of this kind are perhaps best left to independent and unbiased observers rather than to policy-makers in positions such as mine. What I do want to do is to discuss some of the considerations underlying monetary policy decisions and to examine what I believe to be the major lessons of recent experience.

Following the experience of late 1968, when monetary policy was clearly too expansionary, the Federal Reserve moved promptly to reconsider its policy procedures. In early 1969 an FOMC subcommittee on the Directive was formed. The Directive Committee, of which I was a member, recommended that the FOMC place greater emphasis on the growth of monetary aggregates, and less on interest rates, as explicit policy targets. Starting in January, 1970, this recommendation was implemented in the form of a

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clause in the FOMC Directive defining basic monetary policy in terms of monetary growth targets.

The 1970 shift in the way monetary policy is formulated will, I believe, appear in historical accounts of economic policy as being a milestone of importance comparable to the Treasury-Federal Reserve Accord of 1951. The form of the Directive since 1970 reflects, in my opinion, Federal Reserve acceptance of the proposition that, other things equal, significant and sustained changes in money growth produce significant changes in the course of the economy.

This important proposition, however, simply alters the starting point for policy analysis. Because other things are not constant, the relationship between money growth and GNP growth is not constant. To illustrate the problems caused by changes in economic relationships, consider the situation faced by policy-makers in the fourth quarter of 1971, at the beginning of the experiment with wage-price controls.

In planning the appropriate monetary policy at that time it was necessary to take account of the likely effects of the wage-price controls, fiscal policy, and other factors affecting the

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economy. However, it was also necessary to take account of the changed historical relationship between GNP and money, or what is called the income velocity of money. Whereas velocity grew at a 3 percent trend rate before 1966, after 1966 it grew about 1 percent per year and so it was not unreasonable in 1971 to anticipate a continuation of this new velocity trend.

Between the fourth quarters of 1971 and 1973 the annual rate of money growth averaged about 7 percent. If the recent historical relationships had prevailed, GNP would have grown at a rate of about 8 percent per year. In fact, over this period GNP grew at an 11 percent rate, and unfortunately much of the extra growth reflected a higher rate of inflation than was anticipated.

The recent change in velocity is by no means unprecedented; changes of a similar order of magnitude were not uncommon in the early 1950s and early 1960s. But the recent behavior of velocity--a 4 percent rate of increase over the last two years--is a surprise given the marked slowing of the trend rate of change in velocity between 1966 and 1971. If we had known that the GNP would grow by 11 percent per year we obviously would have planned for less rapid monetary expansion. A growth rate for the GNP

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in the neighborhood of 8 percent would have been better and, as a matter of arithmetic, if velocity were completely independent of the rate of growth of money, then a 4 percent money growth rate would have been appropriate. However, looking at the problem from a 1971 vantage point, suppose we had held money growth at 4 percent but suppose velocity had continued to grow at the 1 percent trend characteristic of the late 1960s. Then GNP would have grown at an annual rate of only 5 percent and unemployment would almost certainly have risen above the already elevated levels of 1971. In that event, the central topic of these hearings would have been unemployment rather than inflation.

My views on the appropriate stance of monetary policy have been affected by this experience. Advocates of discretionary policy--and I certainly include myself in this group--have always recognized that policy should become neutral once the economy has reached the neighborhood of full employment unless it is possible to identify a clear disturbance that ought to be offset. I am now of the view that the neighborhood around full employment calling for neutral policy is wider than I had previously thought, and I am less optimistic than I used to be that in a world which is increasingly interdependent policymakers can identify and offset disturbances. What

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this means in practice is that in the absence of a clear and present danger to economic stability policy-makers should be more aware of the need to set a stable policy setting.

If this view is correct, however, it means that all of us must be more patient. We must be willing to ride out surprises in the expectation that most such surprises are self-correcting. There is nothing that monetary policy can do, for example, to offset the inflationary effects of a world-wide food shortage or oil embargoes; in terms of general monetary and fiscal policy we must be patient and simply wait for increased food and oil production to reverse these price disturbances.

There is ample evidence, I believe, that in the long run a lower trend rate of money growth will be needed if the rate of inflation and the level of interest rates are to be reduced. It would not be wise, however, to think about this problem in terms of setting now a schedule for reducing money growth over the next few years. We certainly should seize any opportunities to move more quickly than a schedule might suggest, and we must be aware of the possibility that we will be forced to move more slowly should unemployment climb higher than expected.

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The only clear guideline that I can offer is that we should be very careful not to permit the trend rate of money growth to rise significantly above the growth rates of recent years. We should be completely honest about the possibility that the American people may have to grit their teeth and endure a period of moderate unemployment. If every small increase in unemployment is met by demands for accelerated money growth while declines in unemployment are not met by reduced growth, then inflation is certain to accelerate in the long run.

In pursuing a long-run policy to reduce inflation it would be extremely helpful if continuous fiscal restraint could be maintained. By reducing the upward pressures on interest rates caused by Federal deficit financing, it should be possible to maintain a policy of moderate monetary expansion while at the same time making clear progress toward the goal of lower interest rates.

One of the lessons of the past decade is that the American public is not likely to be satisfied with our stabilization program until such time as we can develop a better mix of fiscal and monetary policies. In only one period during the past ten years--late 1968 through 1969--can fiscal policy by any measure be described as substantially restrictive. Fiscal policy in the other nine years ranged from neutral

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to strongly stimulative, and the aggregate Federal Government deficit for the period amounted to substantially more than $100 billion. Beginning in 1964 we proceeded to reduce individual income tax rates, corporate income tax rates and excise tax rates substantially below the levels prevailing in 1960. With the exception of the temporary surcharge, which lasted only 18 months, the only major tax rate we have seen fit to raise during this inflationary era has been the Social Security tax.

This is not to say, with the benefit of hindsight, that monetary policy should not have done more to offset expansionary fiscal policies than it did. However, it does emphasize the handicap under which monetary policy had to operate during most of the past decade.

If fiscal policy is not to carry its fair share of the stabilization burden, monetary policy will have to be applied more severely than would otherwise be necessary. The social and economic problems occasioned by a severely restrictive monetary policy stem in large part from the fact that its impact is not evenly distributed throughout the economy. It hits especially hard on those units most vulnerable to a sharp rise in short-term money rates, such as the thrift institutions.

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It inevitably means a sharp contraction in residential construction. It impacts severely on securities markets and the holders of outstanding stocks and bonds. It bears heavily on the small businessman whose access to money is limited to the commercial banks.

We need an anti-inflationary program which distributes the burden of restraint more evenly among the various sectors of the economy. This can only be achieved by the balanced application of fiscal and monetary policy.

Short-Run Policy Issues

My discussion of the issues surrounding short-run policy implementation can be fairly brief. My most important point is that the more stable long-run policies discussed above frequently will require active short-run intervention. A stable policy should not be confused with a hands-off policy. We cannot permit stones in the road to throw us off course. Just as the stable tax policy of 1966-67 produced an inappropriate fiscal policy when Vietnam expenditures rose sharply, so also could Federal Reserve inaction permit events to push monetary policy off course.

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In this regard the major problem for the Federal Reserve is to distinguish between short-run fluctuations in interest rates that serve an equilibrating function and those that are a consequence of disequilibrating disturbances. There is no question in my mind that it is absolutely essential for the Federal Reserve to intervene to stabilize financial markets following events such as the Penn-Central bankruptcy and the subsequent disturbance in the commercial paper market. Events of this kind are characterized by irrational market reactions affecting institutions other than those directly involved. It is obvious from pre-Federal Reserve experience and the experience of the early 1930s that snowballing financial failures create enormous difficulties.

The way to stop an avalanche is to stop the snowball when it is small. But some snowballs are harmless. For the Federal Reserve this issue of judgment arises frequently, for it is often necessary to decide when interest rate shocks ought to be cushioned and when not.

I am inclined to believe that one of the lessons of recent years is that we have been too ready to cushion interest rate movements with the result that we have experienced more variable

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money growth in the short-run than is necessary or desirable. While very short-run variations in the rate of growth of the money supply have little economic significance in themselves, smaller variations will help us to keep closer to the desired long-run path. It may well be that in the absence of identifiable money markets disturbances we should intervene less often to smooth interest rate fluctuations. In recent years the markets have learned to cope with larger interest rate fluctuations and while the Federal Reserve's criteria for defining "undue" fluctuations have changed, we have perhaps lagged somewhat behind the market.

Some of these issues are currently being explored by a new Committee on the Directive, of which I am a member. Extensive staff work is now under way and I am optimistic that we will soon have a clearer picture of how our operating procedures can be improved.

Concluding Comment

In summary, it seems to me that what we have learned from the experience of the last decade is that a change toward more stable monetary and

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fiscal policies in the neighborhood of full employment is needed. In viewing our recent experience, however, we must be careful not to learn lessons that aren't true. Lawyers have a saying that tough cases make bad law, and it may well be that abnormal economic developments teach bad lessons. Our inflationary, shortage-ridden economy of the past year has been abnormal and we must be very careful not to over-react. By placing recent events in a longer historical context, let us hope that we can learn the right lessons.

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The CHAIRMAN. Thank you, sir.

President Francis, is it your testimony that Federal Reserve policies have caused both inflation and high interest rates?

Mr. FRANCIS. My testimony is that a long run, what I would term excessive, rate of monetary expansion causes both inflation and high interest rates, in that order.

The CHAIRMAN. There are those that say that we can stop inflation by raising interest rates. Let me ask you if interest rates rise, as we all know they have been doing for the past few years, whether this means that the Federal Reserve is fighting inflation?

Mr. FRANCIS. Mr. Chairman, I guess to answer that question I put myself in a little different view than some of my colleagues. But nonetheless, I hold the view, given my original statement, that a high trend rate of monetary expansion is the cause of high interest rates following the development of inflation. I think the cure lies in the reversal. As I see the high interest rates in the market today, I do not interpret those high interest rates as being the result of restrictive monetary actions. Rather, I interpret them as being the result of a long period of rapid monetary expansion.

The CHAIRMAN. Do you not think it is terrible that people who have to buy a home now, say costing $20,000 or $25,000, that they have to obligate themselves to pay twice as much for their home in interest on what they borrow. In other words, they pay for three homes in order to get a title for one.

Mr. FRANCIS. Mr. Chairman, I think that situation is double-barreled.

No. 1, it would be a bit difficult, as a result of the inflation we have had in building costs, to buy that $25,000 home in my area right now, and so I think the home buyer perhaps suffers just as much or more from the inflation in the original cost as he does from the high interest rates.

One thing is true. When he buys the house at a given price, he is obligated for that inflated price. If he takes care in his mortgage, he could, assuming lower interest rates later on, adjust his interest rate cost. It is an unhappy situation for a home buyer.

The CHAIRMAN. Do you believe that interest costs should be considered in the cost of living index?

Mr. FRANCIS. I do not even know if they are.

The CHAIRMAN. They are not.

Mr. MORRIS. Mr. Chairman, I believe that mortgage interest costs are in the Consumer Price Index.

The CHAIRMAN. That is considered, but interest rates, generally, are not considered, and it occurs to me that when interest rates are so high, like when we are paying $29 billion a year in interest rates on the national debt alone, that should certainly be an item that should be considered. I do not know but I am just offering that as a suggestion, that it should be considered.

President Mayo, you said something that I, of course, agree with. I have been considered a low interest man a long time and you stated, as between the two, the country would be better off with low interest than high interest. Is that right?

Mr. MAYO. I thought that would appeal to you, Mr. Chairman.

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The CHAIRMAN. We have not had any thrift campaigns going on. I think people have been a little negligent there in not having thrift campaigns going on at all times to advise people about the burdens and responsibilities, and the inability to pay sometime enormous debts that they are accumulating, which makes it hard on themselves and their families for a long time to come.

Do you not think we could well afford to give a little bit more attention to thrift campaigns?

Mr. MAYO. I think this is an important aspect of the problem, Mr. Chairman.

The American people have turned out to be a surprisingly thrifty people over the years. They have done this at low interest rates as well as at high interest rates. This is going to be a very important key to the solution of the future problem that we have, Mr. Chairman, in satisfaction of capital demands that are going to be absolutely fantastic, even by today's standards, in their volume.

I happened to work for the Treasury for many years and maybe that is why I made my earlier statement. We always tried to borrow as cheaply as we could. I learned some lessons from that, Mr. Chairman, though, in that there were times when we were making false savings, and we had to go to higher rates to borrow in a real market in competition with the rest of the world. I have changed my philosophy quite a bit in the last 30 years in that respect even though I still have a liking for lower interest rates.

The CHAIRMAN. President Morris, you made the statement about taxes being reduced in the last decade, or even longer. I just wonder if those reductions have been in proportion or proportionately between the corporations and individuals.

What has been your observation and recollection on that? In other words, has the burden gone up for individuals on taxes and up for corporations, or have they been disproportionately going up or down?

Mr. MORRIS. Well, sir, I happen to have some estimates by the Brookings Institution of 1975 tax revenues on the basis of the present tax rate structure, and the structure in effect in 1960. I think the numbers are rather interesting. If we had the 1960 tax rate structure in effect, we would expect individuals to pay in 1975, $157 billion as against $134 billion under the present tax structure. The comparable figures for the corporate tax rate are $66 billion under the 1960 structure, as against $57 billion under the current structure.

So proportionately the corporate rate has been reduced somewhat more. The biggest reduction, however, has been in the excise tax take, which would have been $35 billion under the 1960 rates, and is now estimated at $17 billion. It is about cut in half.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

I want to welcome you three gentlemen here today. Yesterday we were honored by the presence of the presidents of the banks of New York, Philadelphia, and San Francisco, and we are equally honored today to have you men here. I think it is fine of you to leave your busy schedule to come here and give us the benefit of some very serious testimony.

I would like to put in perspective here how you increase the money supply and so forth. One of my staff said, Mr. Johnson, on television the other night it showed how inflation occurs, and the culprit was the

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Federal Reserve System. You were displayed as cranking out Federal Reserve notes indiscriminately and whenever we needed money around, all you did was print some paper money.

I have been connected with a bank all my life in one capacity or another. However, I have not in the last 10 years since I have been on this committee, but when we in that country bank wanted $5,000 worth of currency, we contacted the Federal Reserve Bank of Philadelphia. They sent us $5,000 worth of currency but they charged our account for it. There was a debit on our account for $5,000, and we received $5,000 in currency.

You people do not deliberately issue currency willy-nilly unless the banks around the country need currency for purposes of their day-to-day operations with business and customers; is that not true?

Mr. MAYO. That is correct.

Mr. JOHNSON. Is there any change in the way you are issuing currency today than, let's say, 15 years ago when I was working with it?

Mr. MAYO. No change.

Mr. JOHNSON. Also, mutilated currency—is it not true that member banks, when they send in mutilated currency to you, you destroy it and then you either give them credit on their accounts or you issue new currency and send it to them? You do not inflate the currency over and above that mutilated?

Mr. MAYO. That is correct.

Mr. JOHNSON. This television show really was a false portrayal. I did not see it, but I think the American people should realize that you do not just deliberately crank out money without getting quid pro quo. Is that not right?

Mr. MAYO. Correct.

Mr. JOHNSON. Now, the other statement here by Mr. Francis.

In your statement, when the Federal Reserve System buys outstanding securities from the public, a part of the Government debt is ultimately being financed by the creation of new money, the Fed pays for the securities purchased on open market by giving member banks credit, which increases the monetary base.

What you are trying to say is that if a country bank wants to sell $100,000 worth of Government bonds, you will buy them up and you will give them credit for the bonds on their members' reserve account, and of course, you will thereby be creating new money, but you will be satisfying a need engendered by that community back home, will you not?

Mr. Francis?

Mr. FRANCIS. I take a little different approach to that. What I am referring to is the purchase and sale of Government securities through the operating desk of the Open Market Committee in the New York bank. The process would be like this. May I take a minute?

Mr. JOHNSON. Yes.

Mr. FRANCIS. I think there is widespread misunderstanding about this business of money creation, and it comes about because of a little different type of accounting system that we in the Federal Reserve enjoy as compared to what most other institutions could do. It is given to us by the Congress through the authority to issue money.

If it were the desire of the Federal Open Market Committee to add to the money supply, it would ask the operating desk in New

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York to go into the market and buy securities. They could be, I suppose, from literally anybody, whoever sold those securities. Let's say there was $1 million involved. Whoever sold those securities would receive a check from the Federal Reserve drawn on itself in payment for the securities. The seller, I would think, would very shortly deposit that $1 million in his account with his commercial bank. The commercial bank with whom he deposited his $1 million, in turn, upon having given him credit in his deposit account for the $1 million, would send a check to us for collection. We would pay the check by a credit to that bank's reserve account. Therein lies the accounting difference. Both sides of our ledger rise simultaneously.

We would have $1 million more in assets as a result of the acquisition of the new securities. We would have $1 million more in liabilities because we gave a $1 million credit in reserves to that member bank.

Any other institution or individual that I know of making that purchase could not run up both sides of his ledger. He would have to have an asset somewhere to transfer to the purchaser.

Mr. BURGENER. Will the gentleman yield for a question on that?

Mr. JOHNSON. Yes.

Mr. BURGENER. The one link I did not quite understand—the operating desk buys securities. What kind of securities?

Mr. FRANCIS. Governmental securities.

Mr. JOHNSON. I am sorry, my time is up.

The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

I am very happy to have my fellow St. Louisan come before us. Your statement, Mr. Francis, and that of the others, have been excellent. I do not pretend to understand them all, but I have some questions to ask.

I presume that you gentlemen are familiar with the recommendations that Dr. Weintraub made the day before yesterday? When you get your transcripts, I wish you would let us have a comment on the recommendations so that we are privy to that.

[In response to the request of Mrs. Sullivan, the replies on the recommendations of Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee, may be found on page 361.]

Mrs. SULLIVAN. I wanted to ask you again, Mr. Francis, you were asked—interest rates have been rising—but I did not quite get your answer. Does this mean that you have been fighting inflation by these rising interest rates?

Mr. FRANCIS. Mrs. Sullivan, there are two schools of thought on that subject. I must respect both, but I will have to give you my belief. I think the rising interest rates are an indication of a long-term, expansion in the money supply—excessive monetary expansion, if you please. In my judgment, the high rates that exist today, and that many write about as representing tight Federal Reserve policy, just does not square. I think the high rates represent a tight credit market. But in my view, the continued rapid rate of monetary expansion, which continues right up to now, would not indicate a tight series of monetary actions. On the contrary, my feeling is that we are continuing to now, in terms of monetary actions, on an even course.

Mrs. SULLIVAN. I think that answers the question I was going to put to you: Should the Fed fight inflation by raising interest rates or decelerating money growth?

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Mr. FRANCIS. Mrs. Sullivan, I might respond very quickly to that. I think the only way that the Fed can really lower interest rates over the longer run—now, they might really for a momentary period lower interest rates—but over the longer run, the only way the Federal Reserve can reduce interest rates is to slow up the rate of monetary expansion. This in turn, with some lag, should begin to ease the rate of inflation. In that process, there might be a short while when interest rates go even higher because of the slowup in the rate of monetary expansion. But over time, they will turn and work their way down if we persist in the lower rate of monetary growth.

Mrs. SULLIVAN. In some of your statements that I think you made to the staff, when you say that the tradeoff between unemployment and inflation is a slippery one, what do you mean, more precisely?

Mr. FRANCIS. I mean, as I look at the history of the last 20 or so years, and I plot the levels of unemployment against the levels of inflation that exist at a given time—and there is a chart in my statement which I hope you will look at—you find that maybe for a short run you can almost trace out the so-called Phillip's curve; but over the long run it disappears and there seems to be no direct relation between the rate of inflation and the rate of unemployment. Indeed, if you look at two or three periods of time, you will find it interesting, with different levels of economic policy stimulus, how the unemployment level has tended toward an average in each period, of approximately 4.9 percent.

Mrs. SULLIVAN. What sort of a glide down to minimal inflation, with minimal disruptions in labor markets, do you envision? What protections must we keep for housing and other sensitive sectors during this glide?

Mr. FRANCIS. Of course, if I had my choice, the wind down from the high levels of monetary expansion that we have now would be a gradual one, because we have been through periods in recent history when we have made rather abrupt and substantial moves, which tends to shake the economy in terms of production and in terms of unemployment.

Given the fact that we have a long history of inflation buildup, and that we have had sort of an escalating trend rate in monetary expansion, I would not want to try to bring this thing under control too quickly, because I think the cost would be too high in terms of lost production and unemployment. If we could gradually wind down over the remainder of the 1970's and I think we can do so—maybe with not the optimal level of real production in this country, but at least with a positive level—we would observe an unemployment rate which is perhaps above what we would like, but not above what we can stand or take care of.

Mrs. SULLIVAN. Thank you very much; my time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. All right.

Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

I certainly want to thank you three gentlemen for appearing here this morning. Your testimony and that of all of the presidents of the various Federal Reserve banks has been outstanding, and it has been quite an education.

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As I understand it, under monetary policy we can reduce the increase in the money supply, so that it only increases at a rate of about 4 percent annually; this would stop fueling the fires of inflation by making too much money available. Then, under fiscal responsibility, if we can accomplish what seems to be the impossible task of stopping Federal borrowing to cover Federal deficit spending, and do this by either raising taxes or reducing spending, then this would be a major step toward the control of inflation, which eventually would bring down interest rates.

There is a third factor, and that is, today credit is readily available through credit cards, and so forth, and very little downpayment is demanded on anything any more. What would you think about a modified regulation W, which was used during the 1950's, at a time when we were having inflation and increased interest rates. I would like an answer from all three of you.

Mr. MAYO. Mr. Williams, if I may start, it seems to me that your suggestion has merit in terms of the general idea of trying to get into more specific credit controls as, again, a general proposition. In other words, do we have to just have the one big, general approach in terms of a broad monetary policy?

Mr. WILLIAMS. Regulation W, as it was finally prepared by the Federal Reserve Board, was pretty detailed.

Mr. MAYO. Yes, I am coming to that.

Of course, regulation W related to consumer particulars. I do not see any real danger at this point, if I may put it that way, in the way in which credit is going ahead in the consumer area, at a time when we have a basic sluggishness in terms of consumer spending. The statistics over the last year on retail sales—in particular, if you adjust them for price increases—indicate a pretty flat performance of the consumer. Interestingly enough, the consumer is saving more money than you might have guessed, knowing what we know now. So, I am saying that I do not think in this instance a selective credit control, related to consumer purchases—either on installment or through credit cards—would help us much in the battle against inflation.

Mr. WILLIAMS. You see, you have touched upon one of the things that really concerns me. You have money flowing out of all of our financial institutions, whether it is S. & L.'s, mutual savings banks, or commercial banks. Apparently there is some question about where it is going, because there is no apparent place that it is going.

During the depression, when people lost confidence in the banks, people had money in safe-deposit boxes, hidden around the houses, and that sort of thing. If you are going to say to somebody who is buying an article, you have got to place 25 percent down, is that not going to help to slow down inflation and to bring down interest rates? The funny part of it was, regulation W was feared in many circles as destined to be the complete break in our economy. It was not; it caused very little disruption in our economy, if any.

Mr. MAYO. It is, as you realize, a very difficult sort of thing to administer. It can be done as you suggest; it has been done. But I guess I go back again to the idea that it was done, both during World War II and during the Korean conflict again, to mitigate a peculiarly consumer-oriented aspect of the inflation problem—an aspect which does not exist in quite the same way today.

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One of the peculiar phenomenon, of course, growing out of this inflation is that your wife and mine have to spend more money on food and on gas for the car, just to get the same number of physical units. That, in itself, provides a restraint on our purchases—meals out, or movie tickets, whatever it may be—and there is sort of a built-in restraint here. So I feel that, at least as far as it applies to the consumer, I would not recommend it at this point.

Mr. WILLIAMS. Thank you very much.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Thank you, Mr. Chairman.

I congratulate each of our three witnesses on a very helpful statement, and I particularly want to welcome my own leader, Mr. Mayo.

Mr. Francis, you had a number of interesting things to say, toward the end of your paper, concerning the Fed's role in bailing out a major bank. You pointed out that you do not believe the System ought to subsidize inefficient management by making funds available at interest rates well below market rates. In the case of the recent Franklin National Bank in New York—where the Fed, I believe, put in $1.2 billion—the fact is, is it not, that these funds were made available through the discount window at about 8 percent, as opposed to the commercial rate which, for CD's, was about 11.75 percent?

Mr. FRANCIS. It would be my understanding that the advances through the New York bank were probably part at the 8-percent rate and part at 8.5 percent.

Mr. REUSS. You would, as you frequently do, dissent from that kind of a subsidy, would you not?

Mr. FRANCIS. I am not sure I understand your question. I would prefer not to have that in there—that subsidy in the discount rate—but I would not dissent, given the level of the discount rate, whatever it may be, from temporary assistance to save an institution that is said to have sufficient sound assets to become again a viable institution—which was said in that instance.

Mr. REUSS. Were not the main persons being protected, by the Fed making these discount window advances, the holders of large denomination certificates of deposit? Was not this action, in effect, giving them a deposit insurance which, of course, the FDIC does not give?

Mr. FRANCIS. I would view it as an effort on the part of the Fed, given the fact that the Comptroller of the Currency had said that there were sufficient sound assets in the bank to liquidate its obligations, that the Fed, in supplying funds through the discount window, would enable the bank to pay off some CD's and perhaps other obligations; but to also stay afloat, which it might not have been able to do otherwise.

Mr. REUSS. Have you read in the press, as I have, accounts to the effect that the Fed or the FDIC is going to be asked, in the event that the Franklin National—or what is left of it—is taken over by some other bank, to write off part of the debt?

Mr. FRANCIS. I have not been familiar with any suggestion that the Fed would be in a position that it would have to write off a part of the debt, no.

Mr. REUSS. If that is the way it would end up, that would not be a very good way of exercising the Fed's last resort powers, would it?

Mr. FRANCIS. I think if that is the way it ends up, it would end up in the category I think that I covered in my testimony: that I do not

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favor moving in and attempting to save an institution that is past redemption.

Mr. REUSS. One more question on this subject.

You go on to say, and I quote:

> The provision of funds through the Federal Reserve discount window should be matched by a sale of securities from the System's portfolio in order to prevent an expansion in the monetary base and in the money stock.

When the Fed put in $1.2 billion to come to the Franklin's rescue, there was not a corresponding sale of securities, was there?

Mr. FRANCIS. Probably not.

Mr. REUSS. There you would note a similar dissent, would you not?

Mr. FRANCIS. I would feel very strongly that where the Fed is justified in going into a situation of that kind, in that amount, and particularly during a period of excessive expansion of the monetary variables, I think that, yes, the offset should be made.

Mr. REUSS. One other question, Mr. Francis.

You dissent, I take it, from the current Federal Reserve practice of so-called even keeling a Treasury issue? You think it is not good policy to increase the money supply in order that the Treasury, when it needs to have recourse to the market, should have an easier time than it otherwise would have?

Mr. FRANCIS. Congressman Reuss, I am on record for a long period of time as not being in favor of the so-called even keeling operation.

Mr. REUSS. You convinced me. Have you convinced any of the other 11 Federal Reserve Board presidents or any of the 7 members of the Federal Reserve Board?

Mr. FRANCIS. I could not say, sir.

Mr. MORRIS. Mr. Reuss.

Mr. REUSS. Yes, Mr. Morris.

Mr. MORRIS. I share the same feeling on even keel; that we have done too much of it. I was Treasury Debt Manager in the Kennedy administration and I know we could get along if we priced our securities properly.

Mr. Mayo and I would like to correct one statement by our colleague. It is our impression that the money put in through the discount window to the Franklin National has been offset in open market operations.

Mr. MAYO. Not on a 1-for-1 basis, Congressman Reuss, so you could identify it; but in terms of a daily revision of the open market desk's appraisal of the situation on bank reserve requirements. The moment that $1 billion, or whatever the exact figure is, enters the picture, it is in that equation and is worked out through other reserve providing or reserve retracting activities. So, I think it is fair to say it has been offset.

Mr. REUSS. It was completely washed out?

Mr. ROUSSELOT. Will the gentleman yield at that point?

Mr. REUSS. My time is up; I cannot yield my time.

The CHAIRMAN. The time of the gentleman has expired.

Mrs. Heckler.

Mrs. HECKLER. Thank you, Mr. Chairman.

I would like to welcome our distinguished witnesses. Mr. Mayo, it is a pleasure to see you wearing a new hat. I especially welcome Mr. Morris, from Boston.

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Of course, your testimony raises a very broad gamut of issues that could be addressed fruitfully.

I particularly welcomed your statement, Mr. Mayo, relating to the significance of the congressional budget reform legislation. I think that it is far more significant than the Gulf of Tonkin resolution. It would be much more beneficial for the country, and I also hope that the Congress will have the will to implement it. I expect that it will, because I think the people are going to demand that.

The question that I would like to raise is one that perhaps relates to the area of most acute distress that I sense in Massachusetts and in my own district.

As you have said in your statement, Mr. Morris, the impact of the high interest rates, tight money, and so forth, is not evenly distributed. Unfortunately, while we should not learn bad lessons from bad law, it seems that we should have learned that the disproportionate burden which the thrift institutions and the housing industry have borne during similar periods of high interest rates and tight money, should have perhaps made us or made the Federal Reserve or made the country aware of the need for some strategy to prevent a recurrence. We have not developed that strategy, and now we are in a worse position than we were before. I am concerned about the viability of some of the thrift institutions.

Of course, some of the bankers, quite logically and understandably, complain about the disintermediation that they are suffering; and the potential home buyers and real estate brokers are making their complaints quite evident, as well.

One leading banker, whom I greatly respect, the president of a thrift institution in Massachusetts, has made a suggestion which I would like to have each of you gentlemen comment upon. His proposal would be the creation of a new class of deposit with interest exempt from Federal taxes which would bear an interest rate of about 6 percent; the funds from which would be mandated to go into the field of housing—the offering to be granted only by thrift institutions.

I wonder if any of you would be receptive to this idea. I wonder exactly how you would respond to it. Do you see the creation of a certificate of housing under such a mandate as possibly the answer to this great disintermediation and the competition for funds?

Mr. MORRIS. Mrs. Heckler, I do not. I would personally be opposed to any further proliferation of tax-exempt instruments because it does great damage to the equity of our tax structure.

I think there are two viable strategies; both have difficulties. I think in the past we have been trying to deal with the housing problem through various sorts of financial gimmicks which simply do not have the potential for meeting the problem. One necessary element in the strategy is to have a more even balance between monetary and fiscal policy. If we had at this period in time, say, a $10 or $15 billion surplus in the Federal budget, the current rate of monetary growth would be associated with a lower level of interest rates. I think the fact that we have relied almost exclusively on monetary policy as a restrictive instrument has put an undue burden on the housing industry and the thrift institutions.

The other strategy would be to restructure the institutions themselves. This will take time, but I think it is something that the Congress

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ought to give a lot of attention to. To restructure the character of the assets and the liabilities of the thrift institutions so that they are more viable in periods of sharp changes in short-term money rates. I think these are the only two strategies that are really going to work.

Mrs. HECKLER. How would you counsel the president of a thrift institution to compete under the present conditions today, tomorrow, or next week, with the disintermediation that is occurring?

Mr. MORRIS. He cannot restructure his institution overnight, but I think we have to give attention to diversifying both the assets and the liabilities of these institutions so that they can be more viable. But it is nothing that can be done overnight.

I think in periods such as this, we are going to have to depend on assistance to the thrift institutions in the event that they are pushed to the wall. I can assure you, Mrs. Heckler, that I have met with the savings bankers of Massachusetts and I have assured them that the Federal Reserve System is not going to stand by and let the thrift institutions suffer in this period.

Mrs. HECKLER. I thank the gentleman; my time has expired.

The CHAIRMAN. I am going to have to be on the floor when the House meets at 12 o'clock, and I will ask Mrs. Sullivan to preside.

In the meantime, I will ask unanimous consent to place in the record at this point the internal revenue collections of individual and corporate taxes from 1945 down to date.

[The information referred to by Chairman Patman follows:]

INTERNAL REVENUE COLLECTIONS OF INDIVIDUAL AND CORPORATE TAXES, SELECTED YEARS, 1945–73

[Billions of dollars]

Year	Total individual income taxes		Corporate profits taxes		Total
	Amount	Percent of total	Amount	Percent of total	
1945	$19.0	54	$16.0	46	$35.0
1950	17.2	61	10.9	39	28.0
1955	31.7	63	18.3	37	49.9
1960	44.9	67	22.2	33	67.1
1965	53.7	67	26.1	33	79.8
1970	103.7	75	35.0	25	138.7
1971	100.8	77	30.4	23	131.3
1972	108.9	76	34.9	24	143.8
1973	125.1	76	39.0	24	164.1

Source: Official Treasury statistics.

The CHAIRMAN. I just want to ask you one simple little question.

Do you agree with the few economists who are saying that the people are responsible for the present inflation?

Mr. MAYO. In one sense, Mr. Chairman, the people are responsible for everything—what else is there? We, as the people, elect the representatives that are sitting before us here. We elect the President of the United States. We make our decisions as to what we buy and what we sell. We make business decisions. We all like a higher standard of living. That is my interpretation of what Chairman Stein was trying to say.

The CHAIRMAN. Thank you.

Mrs. SULLIVAN [presiding]. Mr. St Germain.

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Mr. ST GERMAIN. Before the chairman leaves, I would like to make this observation: people do not elect the members of the Federal Reserve Board, so the people are not responsible for that.

Mr. Morris, you mentioned restructuring of the thrift institutions, as far as the assets and liabilities are concerned. We are all familiar with the financial institutions reform legislation that has been proposed which by trying to achieve lowest common denominator agreement, became quite controversial since many of the Hunt Commission suggestions were disregarded. I believe the Fed itself was not too happy with the eventual recommendations. It is a package which appears to give the commercials a little bit and the S. & L.'s a little. A few carrots here and a few carrots there. What concerns me is that, traditionally, the thrift institutions have provided the funding for home purchases. Restructuring of the assets and liabilities and conferring of additional powers, seems to add up in the long run to across-the-board commercial banks.

Do you not agree that we have to be very cautious in the way we proceed, to insure that we preserve the primary function of the thrift institutions; to wit, to take care of the moderate-income home purchaser?

Mr. MORRIS. Yes, sir; but I also have confidence in the marketplace. To the extent that the participation of thrift institutions in the mortgage market bill be diminished, if mortgage rates are competitive with other rates, we are going to see an enlargement in the participation of other institutions in the mortgage market.

One example is the insurance companies. Twenty or thirty years ago, the insurance companies participated on a large scale in the mortgage market. They withdrew from it because they found other instruments gave them a better return. I think that the market will respond. I am confident the market will respond and maintain an adequate supply of mortgage funds.

Mr. ST GERMAIN. That is a very simple solution, I must agree. But looking at the practicalities and realities of life; we were told during the testimony on the Citicorp notes a few days ago that S. & L.'s should be allowed to proceed in the same way as Citicorp. If they were given these powers we would end up with an effective mortgage rate of 11½ to 12 percent, given today's market. As a practical matter, what are you going to go for? A 75-year mortgage, or something of this sort? I mean, how can the man making $10,000 a year afford an 11- or 12-percent mortgage rate, on top of the fact that the price of housing has gone up at a figure approximately 6 percent per year for the past 5 or 6 years? These are things we have to face.

Mr. MORRIS. The most critical thing for the housing industry is to reduce the rate of inflation, because this will, in one stroke, slow down the rising cost of construction and reduce the mortgage rate at the same time; and both of these factors are important—it is not only the interest cost, but the rising cost of construction that I fear is going to drive our young generation coming into the labor force, out of any opportunity to buy a home in the United States.

Mr. ST GERMAIN. They will all be mobile homes.

Mr. MORRIS. So I think the thing the housing industry needs, the thing the thrift industry needs most is success in slowing down the rate of inflation.

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Mr. ST GERMAIN. You gentlemen have testified that it is not the consumer who is purchasing that much more—and I have seen the same studies. The number of units have been pretty much a constant. So that one wonders about the consequently increasing interest rate. Your consumers are not directly responsible, except they are paying more for energy, and more for food, and so forth. Essentially, it is the large corporate borrowings that are creating the shortage of money, and I find it difficult to understand why we have such large corporate demands on money, when the demand for additional units is not there. Is it for research and development? I mean, where is this demand coming from?

Mr. FRANCIS. I would like to respond to that question. I think that this relates to the excessive growth of aggregate demand that we have discussed here. With the long range, what I call excessive, rate of growth in the money supply, we have had in this country growth of demand for goods and services at rates greater than our ability to produce. When such a situation develops I would expect corporations to attempt to put into place new productive facilities in order to supply the goods that are sought by consumers.

At the same time we have gone through a special situation where various constraints have temporarily limited the ability of businesses to meet growing demand. The result has been that the prices of the available goods are bid up. Dollar sales rise while the amount of goods sold change little. Thus the large corporate borrowing, accelerating consumer prices, and the relatively unchanging rate of real consumption go hand in hand.

Mr. ST GERMAIN. Would the other gentlemen answer for the record when they get their transcripts?

[In response to the request of Mr. St Germain, the following replies were received for the record from Mr. Mayo and Mr. Morris:]

REPLY RECEIVED FROM MR. MAYO

The shortage of money or credit that you suggest is not caused by corporate borrowing. Rather, it results from inflation and the efforts of monetary policy to restrict the total supply of money and credit in order to reduce the inflationary pressures in the economy.

In an inflationary environment, the demands for credit from all sectors of the economy are strong. For businesses in particular, rising prices increase the demands for credit to finance necessary inventories and current operations and also to expand productive capacity to meet the expanded needs for goods and services.

REPLY RECEIVED FROM MR. MORRIS

While inflation generally increases business profits substantially, it increases the needs for business funds even more. For example, in 1973, corporate profits before taxes were $115 billion, a rise of $21 billion from 1972. Federal income taxes absorbed half of this rise, so that profits after taxes were up over $13 billion, a rise of over 25 percent, a large rise indeed.

But business need for funds to finance the added costs of inflation rose much more. The cost of inventories, as measured by the inventory valuation adjustment, rose $18 billion. Similar data on the impact of inflation on plant and equipment expenditures are not available, but the inflationary cost increase must have been at least $10 billion. Thus, profits after taxes increased by $13 billion, but inflation requirements absorbed about $28 billion more, leaving a net deficit of about $15 billion. So despite their handsome rise in profits, corporations were in a cash squeeze and they had to rely heavily on external funds to finance their operations.

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At times like this, corporations, like everyone else, have difficulties in acquiring external funds. Borrowing is cheaper, as a general rule, than selling capital stock. But as businesses rush in to borrow, interest rates rise tremendously, as we have seen, so borrowing became very expensive. Naturally corporations then consider selling stock. But the rise in interest rates tends to reduce the market prices of stock, and, as a result, those sources of funds become almost prohibitively expensive. Price/earnings ratios of even the blue chips have fallen to levels of eight or so which represents a cost of funds before taxes of almost 25 percent; lesser known corporations have to pay much more. In this situation, corporations must rely on bank loans and, if they are large enough, on commercial paper which is also expensive but does not involve a long-term cost burden.

If inflation could be halted, all these factors would swing the other way. Profits would be reduced, but not as much as the saving in inventory and capital outlay costs. Corporations could reduce their reliance on external funds; interest rates would fall and stock prices would rise. If they wished, corporations could then use these lower-cost external sources of funds to pay off bank loans and generally to strengthen their liquidity positions.

To summarize, inflation brings on the paradoxical situation where businesses make more money at the same time that they are being squeezed for money.

Mrs. Sullivan. Mr. Rousselot?

Mr. Rousselot. Thank you, Madam Chairman.

Mr. Morris, you and your colleague, when Mr. Reuss' time was cut off, you were discussing the Open Market Committee. You thought it did respond on the Franklin Bank. Could you, for the record, comment as to how that was achieved? I mean, I do not want to cut into other things, but I think we would be interested in knowing how that was done. Could you each respond to that?

Mr. Morris. Certainly.

[In response to the request of Mr. Rousselot, replies received from the witnesses for inclusion in the record may be found on page 399.]

Mr. Rousselot. Thank you.

First of all, I want to compliment each of you gentlemen on your testimony and your analysis of the problem of inflation and high interest rates, and I did have a chance to glance at each of your statements prior to coming today, and appreciate the chance to review them. I would like an answer from any one of the three of you. Did the Federal Reserve Board here in Washington make any effort to influence or coordinate your testimony before this committee?

Mr. Morris. No, sir. We did ask the research staff of the Federal Reserve Board to look over our comments, check any inaccuracies, but there was no censorship.

Mr. Rousselot. No; I am not suggesting censorship. I am just suggesting guidance.

Mr. Morris. In my case, I can assure you there was no guidance, nor were there any significant changes in the text I originally drew up.

Mr. Rousselot. Mr. Mayo?

Mr. Mayo. Mine were only editorial changes.

Mr. Rousselot. Editorial changes? What does that mean?

Mr. Mayo. I should say suggested changes in words—semantics—just in a few cases. There was nothing substantive changed, and the suggestions were only by the Board staff. To my knowledge, no Governor has ever seen my statement.

Mr. Morris. I might also add, sir, that we are completely free to reject any suggestions the Board staff puts forth.

Mr. Rousselot. Mr. Francis?

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Mr. FRANCIS. The Board staff did ask to see the statement. Mine was transmitted to them. There were some suggestions, but I have a sort of a country person feeling about the principles of appearing before a congressional group, and I think that when I am invited to do so, I am obligated to give you my views, and mine alone; and the statement you have is my original statement, without one word having been changed.

Mr. ROUSSELOT. Good. I appreciate that.

Mr. MAYO. That is true in my case, for all intents and purposes, too.

Mr. ROUSSELOT. My understanding is that there was a special meeting of the Board held this past Monday, July 15. Did any of the Governors discuss potential testimony before this committee? Was there any discussion about it?

Mr. MAYO. May I ask what you mean by potential testimony?

Mr. ROUSSELOT. Well, your potential testimony.

Mr. MAYO. Well, again, as we discussed here, there was a recognition of the fact in the meeting that you refer to that we are indeed part of a system, and that there is an inherent strength of what you might call joint decisionmaking, and the way that the Federal Open Market Committee is working on it, and that is the most important ingredient, and there is no disagreement among any of us on that. That is far more important than the differences that each of us may have with each other on detail.

Mr. ROUSSELOT. Then, is your answer that it was discussed in the meeting—your joint ideas?

Mr. MAYO. In a broad way.

Mr. ROUSSELOT. In a broad way it was discussed?

Mr. MORRIS. We did discuss Dr. Weintraub's proposals. We talked them back and forth over dinner. We are all going to make our independent statements for the record on his proposals, and I suspect that probably you will find a difference in my response and my colleague's, Mr. Francis.

Mr. ROUSSELOT. Yes, I noticed that. Then your statement is that, even though it was discussed on a joint basis in the meeting on Monday, July 15, this is just for the edification of each other? There was no attempt by any of the Governors to say, well, this is what we have been saying, and hopefully you will say the same thing, or what?

Mr. MORRIS. No, sir.

Mr. MAYO. No, sir.

Mr. ROUSSELOT. You actually, then, are independent operators, as it comes to your own statements?

Mr. MAYO. That is correct.

Mr. ROUSSELOT. Thank you, Madam Chairman.

[Congressman Rousselot submitted written interrogatories on this question to the witnesses. Their replies may be found on page 373.]

Mrs. SULLIVAN. Mr. Hanley?

Mr. HANLEY. Thank you, Madam Chairman.

Gentlemen, I too want to express my appreciation for your interest and your presentation this morning. I have always been puzzled at the general reluctance on the part of most money experts to associate inflation with the rate of interest, so I am delighted to note that apparently you three are tuned in on the same frequency, and observe a relationship there.

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Mr. Francis, I was delighted to hear you say that low rates of interest are desirable for the economy. I have always concurred with this, and I think if we look back down the road to around 1946, it is fair to say that the low rate of interest that prevailed, mandated in essence by the GI bill of rights, which as you know created the great homebuilding boom and the opportunity for business and industrial development; I believe that that act alone contributed so greatly to the economy that our Nation has enjoyed for better than two decades, up until the initiation of the inflationary cycle in the mid-1960's.

As I observe what is happening, I find it very disheartening, and I cannot be at all optimistic about the future of this economy. This, for instance, is evidenced by the most recent Commerce Department report with regard to the status of the gross national product, which, as you know, for two consecutive quarters—the first 3 months and the second 3 months of this year—has dipped. The professionals tell us that this is a true sign of recession. I think of the homebuilding industry in my particular community, and there has been some colloquy about the cost of homes, and I represent central New York, and in that particular area, over the course of the past 2 years, the cost of building a house has increased by 40 percent. To that, you add, if you can get a mortgage at the rate of interest prevalent today; the fact being, however, that mortgages are just about no longer available in that rather large area of central New York. In fact, the savings bank industry and the savings and loans have transmitted messages to me during the course of the last week or two that the overture on the part of the Citicorp is really the straw that is breaking their backs. The major bank in the area advised that due to it, they were no longer accepting mortgage applications, subsequent to the end of this month.

This produces a very difficult problem, and for these reasons, I am greatly concerned about the future of this economy, and our ability to avoid a depression.

My friend Mr. Mayo said that the ability to finance greases the wheels of our economy, and I am in complete agreement with you there. However, on the basis of the feedback that I get, this grease is no longer on the wheel, and I have talked with industries and businesses, and in particular those that have been affected by the energy crisis through no fault of their own. They go to the traditional lending institutions, and money is not available, or is available at a rate of interest which is impossible for them to digest. So they have to walk away from that lending institution, and perhaps proceed to file chapter 11 bankruptcy. We are hearing this virtually every day.

With that thought in mind—and I think of the colloquy back during the course of our deliberations on price and wage controls, and the possibility of a ceiling on interest rates—may I ask of each of you what your attitude on that possibility is?

Mr. Francis. Congressman, I think that an attempt to institute a ceiling on interest rates would probably go the way of other ceilings that have been attempted in this economy when it was under very expansionary pressures. I would go back to my original contention that there is one way to pull these interest rates down, and that is to slow up this inflation and to bring it under control.

Mr. Hanley. If you will yield at that point, I am reminded of another inconsistency. We talked about Secretary Simon, and his

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recent overture with regard to the reduction of Federal expenditures to bring about a halt in this inflationary cycle. On the other side of the spectrum, we hear the proposal of the President, whereas if enacted, the program would pump $10.8 billion into the troubled home mortgage market. Like me, I think you would observe quite an inconsistency here, because of the fact that number one, we do not have this $10.8 billion; and if enacted, we would have to take the borrowing route. As you know, we operate with a rather large deficit. So, to pick up this $10.8 billion, it appears to me it would be necessary for the U.S. Government to go to the well again, and sell U.S. Treasury bonds at the rate of interest currently appropriate.

So how, then, are we assisting the inflationary spiral? So we are talking out of both sides of our mouth. The Secretary of the Treasury versus the President; the Secretary embracing the conservative concept, and on the other hand, the President moving in this direction.

I am sorry that apparently time has about ended. I would like very much if, in writing, you would provide me with your comment on the inconsistency that I have related to you. I would appreciate that.

[In response to the request of Mr. Hanley, the following replies were received from the witnesses for inclusion in the record:]

Reply Received From Mr. Mayo

As I noted in my statement I believe that the deficit financing burden placed on the Federal Reserve has been a heavy one. My experience in various positions has led me to conclude that it occurs because of a fundamental flaw in governmental coordination of economic policy and public finance. The need to review all authorizations and proposals and their spending implications in totality, in terms of their effects on specific areas and on economic stabilization, is great. It is for this reason that I applaud Congress for establishing a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture and with its own analytical staff to lessen Congress' factual dependence on the Executive Branch.

The $10.8 billion you referred to, Mr. Hanley, does not represent an increase in borrowing of that amount by the Federal Government. The measure was primarily designed to subsidize below market rates on loans for, potentially, more than 300,000 units rather than to provide outright new credit extensions. This type of sectoral relief is an appropriate role of fiscal policy.

Reply Received From Mr. Francis

In analyzing the inflationary impact of Federal budget activities, it is essential to examine the extent to which the Federal Reserve indirectly finances such activities. Reducing Federal expenditures tends to reduce deficits, thereby removing upward pressure on interest rates and, according to past experience, tending to produce slower money growth. Federal lending programs, such as borrowing in national credit markets by the FNMA and relending these funds to the housing market, need not be inflationary, provided the Federal Reserve does not purchase the agency issues or attempt to resist any associated upward pressures on interest rates.

Reply Received From Mr. Morris

While the President's program to aid the housing markets may have a slightly expansionary impact, I do not believe the program should be described as "inconsistent" with the goal of curbing inflation. The difficulty is that while curtailing inflation is our current major objective, we have an additional objective of maintaining reasonable stability in the housing sector of the economy. Multiple objectives generally require multiple policies. When the Federal Reserve holds a tight rein on money and credit in order to reduce inflationary pressures, a dis-

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proportionate amount of the burden falls on the housing industry. This burden can be mitigated, although not eliminated, by programs designed to direct funds to the mortgage markets. So long as the Federal Reserve maintains moderate growth of *total* money and credit, the rechanneling of funds to housing need not have an inflationary impact.

Mrs. SULLIVAN. Mr. Frenzel?

Mr. FRENZEL. Madam Chairman, I would ask unanimous consent to ask four questions to which the panel might respond in writing, since the time is short.

Mrs. SULLIVAN. Because of the time factor—if you would just ask them.

Mr. FRENZEL. The first relates to the fact that we are always attacking our problems here in a piecemeal fashion. Today we could not complete the attack on a problem that vexed us, but I would like to have your opinion as to whether we would not be better advised to consider something like the Hunt Commission report, which looks at our entire financial system, rather than attacks on demand whenever one segment of our financial community is hurting, or one section of our economy is hurting.

The second question would relate to the possibility of a band-aid-type treatment that has been suggested; and that is the possibility of offering a tax credit for those people who invest in the thrifts. Hopefully, it would present some kind of basis against disintermediation, and assist us in the difficult housing areas.

Third, I would like to ask you, what are the kinds of interest rate increases that we have observed in the last couple of years? We know it happens to the big corporations, because they get the prime rate. But what happens to the small businessmen? My impression is that rather than a high rate, he does not get any money. Installment loans, I presume, or consumer-type loans, bank loans, revolving credit, small loans, and so on, probably do not change very much. Of course the home buyer most likely gets frozen out, rather than having his rate increased. I wonder if you would lay those out for me in order.

The final question relates to the open market operations and the control of the monetary supply by the Board. It seems to me that our ability to control is a lot less than many of us in Congress seem to believe. I wondered if you would comment on how tightly we can control, or how easy it is to achieve a target of increase or decrease in the money supply.

Madam Chairman, I thank you.

[In response to the questions above of Mr. Frenzel, the following replies were received from the witnesses for inclusion in the record:]

REPLY RECEIVED FROM MR. MAYO TO QUESTIONS OF MR. FRENZEL

Question 1. Should we consider a general rather than a piecemeal solution to the sectoral problems generated by anti-inflationary actions?

Answer. My view would be similar to that presented earlier by my colleague, Mr. Morris. Basically, the problem of differential sectoral impacts results from the necessity of waging an active war against inflation. With greater coordination between monetary and fiscal policy the dangers of developing inflationary situations would be lessened. Further, less reliance would have to be placed on monetary policies which in fighting inflation do result in short term increases in interest rates. And it is this increase in rates which causes more difficulties for some sectors of our economy than it does for others.

I also concur, however, with Mr. Morris' view that a full review—perhaps resulting in a restructuring of financial institutions—would be desirable. Such

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a review will take time but is far preferable to the use of piecemeal approaches which have the tendency in this complex and interrelated economy of ours to have unforeseen and frequently harmful impacts elsewhere in the economic system.

Question 2. Should a tax credit be given to those investing in thrift institutions?

Answer. I do not think that this would be the appropriate course to take. Not only does the use of tax exempt obligations damage the equity of our tax structure, but it also would distort the pattern of savings and financial flows to the detriment of the efficient working of our economy.

Question 3. What has been the pattern of interest rate increases by type of borrower?

Answer. On the basis of the information I have seen, smaller business firms have not been frozen out of the credit markets. They have had difficulties, of course, but so have many other borrowers.

It appears that the so-called "two-tier" rate structure under the Committee on Interest and Dividends was effective with rates rising less rapidly in bank financing for small borrowers than for large borrowers. We must remember, however, that rates vary greatly within any size group of borrowers on the basis of the risk to the lender. Consequently, the rates for "good" credit risk small borrowers and the availability of credit for small borrowers may actually be more favorable than it is for some large borrowers.

As to sectoral problems, such as housing, the problems of high rates and limited availability of credit, these are the result of many institutional factors. State usury ceilings have, for example, reduced the participation of lenders in some housing markets. It is because of these institutional factors that I suggested support earlier for the more extended review of institutional arrangements.

Question 4. How closely can we control the money supply?

Answer. As I indicated in my testimony and in responses to earlier questions, I am unwilling to support the use of a single target such as M_1 as a guide to monetary policy. In part, this position is based on my experience that close control of this aggregate for very short periods is difficult if not impossible. The longer the period over which control is to be exercised the greater are our chances of achieving a given M_1 growth. I would hasten to add, however, that agreement that control might be possible over a long period is not tantamount to accepting an immutable long-term path, fixed long before the period to which it applies, as a sole guide for monetary policy.

Reply Received From Mr. Francis

RESPONSE TO THE FIRST QUESTION OF MR. FRENZEL

I agree that much of our nation's financial problem lies in the structure and the restrictions imposed on our financial system. Rather than controlling money each time that the nation has experienced a crisis, a new flurry of controls have been placed on financial institutions, especially banks. These controls limit the viability and competitiveness of these institutions. We now control the activities in which they can participate, their office locations, their type of investments, rates paid on funds, and often the rates that borrowers can be charged is limited.

The Hunt Commission's proposal is consistent with the goal of freeing up our financial system and increasing competition among financial firms. It would reduce rigidities and provide for tax equality and greater uniformity of operating rules. It would provide for relatively free entry and exit. Such system would improve the services provided by our financial sector. We might experience an occasional failure; however, the maintenance of a set of anti-competitive regulations so strict that the weakest firms can survive is not consistent with provision of economically efficient financial services to the community.

RESPONSE TO THE SECOND QUESTION OF MR. FRENZEL

Rather than offering tax credits to savers at thrift institutions, I would suggest the removal of rate controls as indicated in the answer to Mr. Frenzel's first question, and loans by the Federal Home Loan Bank to those sound institutions which may face temporary liquidity problems. Some means providing relief from state usury laws would be also helpful.

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RESPONSE TO THE THIRD QUESTION OF MR. FRENZEL

Interest rates have generally increased to all users during the past two years. However, the state usury laws have no doubt been detrimental to the small businessman's access to credit markets. When such laws set a maximum rate that financial firms can charge, they will lend their funds to the safest borrowers and this is often the larger firms. In some states (for example, Missouri) corporations are exempt from the usury laws and financial firms may charge them the market rate. Since financial firms can make more profit by lending to corporations at the higher market rate, corporations will likely get the major portion of the available credit.

Another impediment to the small firm's access to credit is the restrictions on rates that financial firms can pay savers. Such restrictions reduce the amount of funds that people save through those agencies. Rather than placing savings at low rates with banks and savings and loan associations, many people will invest their funds directly in the capital markets, mortgages of friends, or real property. As a result, the total amount of loanable funds through those firms is limited. Larger corporations with their better credit worthiness may, however, go directly to the capital markets and sell debt instruments.

RESPONSE TO THE FOURTH QUESTION OF MR. FRENZEL

The degree to which the Federal Reserve can control the growth of the money stock is related to the length of time over which this control is to occur. Under present institutional conditions, I would expect to observe fairly large errors on a weekly or even monthly basis. However, extending the control period to a quarter or longer sharply reduces the expected errors. The Federal Reserve should be able to quite accurately determine the average growth path of money over a period as long as a year. The relevant comparison for a year would be the average level of money in the fourth quarter of one year compared to the average level of money in the fourth quarter of the following year.

The growth of money is very closely related to the growth of the monetary base. Unambiguously, the Federal Reserve can closely control the average growth of the monetary base over periods of a month or more.

One additional point. The Federal Reserve cannot control both interest rates and money growth at the same time. If the Federal Reserve seeks to restrict interest rate movements within a very narrow band, then at certain times a conflict would emerge with the desire to closely control the growth of the money stock.

Reply Received From Mr. Morris to Questions of Mr. Frenzel

ANSWER TO FIRST QUESTION

The integrated approach to the restructuring of our financial system espoused by the Hunt Commission is desirable for three reasons. First, such a general approach helps avoid the inequities which often result from "piecemeal" solutions. Second, a general approach should increase the efficiency of the entire financial system, thus encouraging saving, lending, and investing. Third, the Hunt Commission's integrated approach to financial problems insures an internal consistency to the overall solution such that one financial sector's remedies does not become another sector's disruptions.

ANSWER TO SECOND QUESTION

A tax credit for investments in thrift institutions is not advisable because it would open another loophole in our tax laws, running counter to the trend toward tax reform which I endorse. In addition, I am skeptical that such a tax credit would be effective in supporting the thrifts at the times it would be needed most. The situation is similar to that of the tax exemptions for state and local securities. When funds are easily available commercial banks buy large quantities of these securities to take advantage of the tax exemption. When funds are scarce the commercial banks reduce their participation in the tax-exempt market in order to meet loan demands, exacerbating the financing problems of state and local governments. I am on record as favoring a direct interest subsidy to state and local governments. If additional support is deemed necessary for the thrifts, I believe this direct approach would be more efficient and more fair.

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ANSWER TO THIRD QUESTION

Interest rates have increased for every class of borrower over the past two years. But, as you note, the interest rate on business loans under $10,000 rose from 7.3 to 10.5 percent between August 1972 and May 1974, while the rate on loans over $1,000,000 rose from 5.6 to 11.1 percent. At the same time banks have become more stringent in their non-interest requirements according to the Federal Reserve System's Survey of Lending Practices.

While the rate on small business loans was rising more slowly, the volume of new lending to small businesses decreased by 15 percent over the 1972 to 1974 period, while that going to large businesses increased by 91 percent. These observations are consistent with your suggestion that small business loans are more difficult to obtain, although other influences could also account for part of the results. As you suggest, the interest rate on consumer loans since 1972 has remained relatively stable, with the rate on credit card plans remaining right at 17.25 percent while the average rate on automobile credit rose little, from 10.0 to 10.6 percent. From all indications, consumer credit has been readily available in this period. The volume outstanding rose substantially in 1973 but has been pretty much on a plateau since, as auto sales have plummeted.

ANSWER TO FOURTH QUESTION

In the very short run, the rate of growth in the money supply is often dominated by random events. In a one-month time span, for example, there is no close relationship between a given input in reserves and the resulting output of M_1. However, these random short-term influences on the money supply do not cumulate. Therefore, while it is impossible to control the growth of the money stock in a one-month period, and while it is very difficult to control the growth of the money supply within reasonable tolerances over a period as short as three months, it is possible to do so over time spans of six months or longer.

Short-term variations in the rate of growth in the money stock do not have any great economic significance in themselves. However, to the extent that the short-term variations can be reduced in amplitude, our ability to hit longer term targets will be enhanced. The cost of greater short term stability in monetary growth will be increased instability in short-term money rates. This is a cost which I think the public and the Congress ought to accept in the interest of achieving more stable monetary growth rates.

Mrs. SULLIVAN. Mrs. Boggs?

Mrs. BOGGS. Thank you, Madam Chairman.

I want to thank all of you for being here, and for your wonderful testimony. I am smiling, because for several days, since I am the last one who has an opportunity of asking a question, I missed asking questions, and I thought I was going to be felled by the bell again. But one of the questions that I have been wanting to ask the last several days has been answered by Mr. Mayo, and that is because monetary policy alone has not been able to cure inflation, and because we must have the tandem of monetary and fiscal policy in order to accomplish the ends that we all seek, I do feel that the new Budget Committee is going to go a long ways in providing this dual monetary and fiscal policy; and I was very grateful that you did bring it out again in your testimony today, as you had earlier, when we were considering setting up an overall Budget Committee.

As we have said, we are elected, and the people are the cause of inflation, if they elect us; and we will indeed, I think, in cooperation with the Federal Reserve, be able to represent the people in a more effective fashion by having our own Budget Committee with the proper statistical help, and the proper staffing.

There is one question that I should not really be addressing to you, but since I have not had the opportunity of asking it earlier, I would like to ask, and if you would not mind writing your answer, about

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devaluation and its effect upon inflation. In earlier testimony this was mentioned over and over again in the various presentations, and I noticed in the Weintraub presentation, that one of the Governors had suggested that the Federal Reserve really had only a sideline role in any kind of input into the devaluation decision. I would like to know what advice was given, even in that sideline position.

Thank you very much.

[In response to the questions above of Mrs. Boggs, the following replies were received from the witnesses for inclusion in the record:]

REPLY RECEIVED FROM MR. MAYO

Question 1. What is the effect of devaluation on inflation?

Answer. As I indicated in my statement, one of the factors outside the influence of the Federal Reserve that played a role in our inflation of 1973-74 was successive devaluations of the dollar. The objective of devaluation is, of course, to improve a country's balance of trade. The initial impact is inflationary since it increases the prices of goods imported. In addition, if the economy is fully employed, the increase in foreign demand for the relatively cheaper goods here leads to additional pressures on the price of these goods and the resources which produce them.

Question 2. What input did the Federal Reserve have in the decisions concerning devaluations?

Answer. While international considerations are an important element in the domestic monetary policy decisions which I must make as a member of the FOMC, I would not because of the nature of my responsibilities be directly involved in providing input for this type of decision.

REPLY RECEIVED FROM MR. FRANCIS

The discussion between the Treasury and the Federal Reserve System about devaluation was carried on between the Board of Governors and the Treasury. I have no information about what specific recommendations were made.

While the Federal Reserve System may have had only a sideline role with respect to the decision about when and by how much to devalue, I believe monetary actions played an important role in setting the stage for the necessity to devalue. In my opinion, the breakdown in fixed exchange rates and devaluation of the dollar were directly related to inflation here and abroad. As I have stated elsewhere in my testimony, I believe excessive monetary growth was the dominant cause of the inflation, thereby creating the conditions that ultimately forced the decision to devalue the dollar.

REPLY RECEIVED FROM MR. MORRIS

Concerning the role of the Federal Reserve, I did not personally participate in any way in the decision to devalue the dollar. The Federal Reserve had taken no official position on devaluation and its official acceptance was not needed, so devaluation was accomplished without any action by the Federal Reserve. As to any sideline role which the Federal Reserve may have played, that question would have to be addressed to Chairman Burns.

With respect to the impact of devaluation on inflation, I do not believe we have a definite answer. With the dollar in an overvalued position, the dollar prices of imported products were kept below their true economic level. Therefore, when exchange rates were cut loose to vary flexibly, the first impact was a rise in the cost of most imports. It also lowered the foreign prices of our exports which increased exports and added to demand pressures thereby tending to raise domestic prices.

Various estimates have been made that devaluation has accounted for about one-fifth to one-sixth of the total rise in the consumer price index of about 25 percentage points or 20 percent, between August 1971 and June 1974. Even though devaluation caused additional inflation, some adjustment in exchange rates or in foreign trade was necessary. Foreign countries became increasingly

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reluctant to absorb over-valued dollars and the only alternatives were to devalue or to institute trade and other restrictions. In my opinion, devaluation was the lesser evil by far.

Mrs. SULLIVAN. Thank you, gentlemen. We are just about deserted, but we are going to have to go over to the House floor because the bells have rung. We appreciate your testimony. It has been very helpful. I do not think you have the answer, but neither do we, so let us just be hopeful.

We have some questions from other members which we would appreciate your answering for the record.

[The following are written questions submitted by Mr. Widnall to the witnesses, along with their answers:]

WRITTEN QUESTIONS SUBMITTED BY MR. WIDNALL TO WITNESSES

Mr. Mayo, on page 7 of your submitted statement, you state that our economy's inflation over the past 6 months has been caused by fiscal and monetary stimulus, the end of wage-price controls, shortages, and international developments. What I am especially interested about is the monetary stimulus you mentioned. I know that you think that the growth of the money supply during 1972 and the first part of 1973 was too rapid—it was, in fact, inflationary. I do not believe in looking back merely to criticize, but only to better understand what must be done in the future. What portion of the increase in the inflation rate was caused by the relatively easy monetary policy of the Federal Reserve?

REPLY RECEIVED FROM MR. MAYO

I do not believe that the proportional effects of various policies can be quantified. As I indicated in my statement, I do feel that there is a significant association between fiscal deficits and monetary policy actions. In the absence of deficits and thus a lessened burden on the Fed to see that the Treasury is successful in securing additional funds, there would in my view have been less monetary stimulus. I am sure I could not accurately or usefully reconstruct the decision I would have made in the absence of the deficit. Nor could I obviously do this for all of the others participating in the policy decisions.

In addition, I do not know how to untangle effectively all of the other special factors that influenced our decisions. Even our econometricians, as capable as they are, cannot unambiguously interpret the contribution of each factor.

Mr. Morris, on pages 8 and 9 of your submitted statement, you talk about the uneven impact of severe monetary restraint on the economy. You argue that a sharp rise in short-term money rates adversely affects thrift institutions, residential construction, security markets, and small businessmen. This, of course, is not news to me. What I am interested about is the way to make this impact less damaging to these sectors of our economy. You say that this goal can only be achieved by the balanced application of fiscal and monetary policy. This is an extremely general statement, and I would appreciate it if you could elaborate upon it.

REPLY RECEIVED FROM MR. MORRIS

Restrictive monetary policy affects primarily the credit markets and investment activity. Restrictive fiscal policy affects primarily the government sector through reduced government expenditures and the consumer sector through increased taxes. Given a targeted reduction in aggregate demand, the greater the amount of this reduction being effected through fiscal policy, the less the burden on restrictive monetary policy and the credit sensitive investment sector. Tighter fiscal policy means a smaller government deficit, less deficit financing, less pressure on credit markets, and more funds left over for private investment needs.

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Mr. Francis, on April 29th of this year, in a speech before the Steel Plate Fabricators Association, you said, and I quote: "Those of us who see aggregate demand as being very strong and inflation as the most serious problem would argue that the trend rate of money growth should be reduced immediately to about a 5 percent rate for the balance of the year." Today, less than 3 months after that speech, you have stressed the importance of a gradual reduction in the money supply growth rate. It seems to me that you have changed your mind in these last several weeks. Would you like to comment on this?

REPLY RECEIVED FROM MR. FRANCIS

My recommended course of money growth for the balance of the year in my address presented to the Steel Plate Fabricators Association on April 29, 1974, was based on information available at that time. From the first quarter of 1973 to the first quarter of 1974, M, had increased 5.7 percent, and weekly data for early April indicated that money growth was continuing at a somewhat more rapid rate. Therefore, I viewed my recommendation of a 5 percent growth of money to the end of the year as a gradual deceleration.

In the interval between the preparation of those remarks and the preparation of my testimony, two things occurred which would influence my recommendation at this time. First, there was a major upward revision to the money stock data and, second, approximately three months of additional data are available. So, at the time of preparing my testimony, indications were that the money stock had grown at a 6.7 percent annual rate from the first quarter of 1973 to the second quarter of 1974, and weekly data for June and early July suggested that its growth had continued to be rapid. Therefore, when I recommended a gradual deceleration, I had in mind approximately a one percent reduction in the rate of money growth for the balance of this year. This is the same magnitude of reduction as I had mentioned in my earlier address.

[The following are written questions submitted by Mr. Blackburn to the witnesses, along with their answers:]

WRITTEN QUESTIONS SUBMITTED BY MR. BLACKBURN TO WITNESSES

Question. Should the Fed limit the growth of money created by the expanded use of credit cards?

REPLY RECEIVED FROM MR. MAYO

No particular form of credit granting activity, which credit cards are, can be singled out as a reason for the expansion in the growth of money created. The extent to which the money supply expands depends on the reserve supplying activities of the Federal Reserve System. Restrictions on credit cards would be simply another type of credit allocation device.

REPLY RECEIVED FROM MR. FRANCIS

In analyzing the effect on monetary policy actions on output, prices and employment, it is important to make a distinction between money and credit. An increased use of credit cards involves an increase in the extension of credit, or at least a rechanneling of credit through this instrument; however, there is no evidence of a causal link leading from a change in one form of credit to the pace of economic activity. Credit extended through non-bank credit cards, such as American Express, Diners, Carte Blanche, and those issued by oil companies, simply represents loans by these companies to their customers and does not result in an increase in money creation. Use of bank credit cards, such as Master Charge and Bankamericard, increases loans by banks to their customers.

On the other hand, the amount of money in the economy—checking account deposits plus currency held by the public—is dominantly influenced by central bank policy actions. Furthermore, there is substantial empirical evidence demonstrating that growth in the nation's money stock has a significant influence on the rate of inflation, and, in the short-run, on the rate of output growth, and the level of employment. Since the increased use of credit cards represents a rechanneling of loanable funds to small consumers, the Federal Reserve should not, in my opinion, seek to limit the increased use of this means of credit extension.

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REPLY RECEIVED FROM MR. MORRIS

My answer is no. Credit cards presently account for less than 5 percent of all consumer credit and even this amount is partly a substitution for other types of consumer credit, so they pose no monetary control problem. While credit cards are extremely convenient, their impact on the monetary system is no different from that of other forms of consumer credit.

Question. When we speak of neutral monetary policy when we reach full employment: (1) How would you define full employment and neutral monetary policy? (2) Should not full employment be treated as 5 to 5.5 percent unemployment, in view of the floor of comfort now provided for the unemployed?

REPLY RECEIVED FROM MR. MORRIS

1. I would define full employment as the level of employment which is consistent with price stability or, at most, with a gentle rise in prices. A neutral monetary policy under these conditions would neither try to stimulate or restrain growth in the economy. Instead, monetary policy would keep the growth of the monetary aggregates at a rate consistent with our long-term real growth path.

2. Full employment should be treated at 4½–5% unemployment, but not because it is so comfortable to be unemployed. The changed age-sex composition of the labor force since the early 1960s has raised the level of unemployment consistent with full employment because those groups with the highest turnover rates have increased as a proportion of the labor force. In addition, capacity bottlenecks in a few basic industries have meant that a higher level of unemployment is required for price stability until investment increases the economy's capital stock in these fundamental areas.

Mrs. SULLIVAN. The committee stands in recess.

[Whereupon, at 12:20 p.m., the committee recessed, subject to the call of the Chair.]

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FEDERAL RESERVE POLICY AND INFLATION AND HIGH INTEREST RATES

TUESDAY, JULY 30, 1974

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128 Rayburn House Office Building, Hon. Wright Patman [chairman] presiding.

Present: Representatives Patman, Barrett, Sullivan, Reuss, Ashley, Stephens, St Germain, Gonzalez, Minish, Hanna, Annunzio, Rees, Hanley, Koch, Mitchell, Fauntroy, Young, Moakley, Boggs, Widnall, Johnson, Stanton, Blackburn, Brown, Williams, Wylie, Heckler, Rousselot, McKinney, Frenzel, Conlan, and Rinaldo.

The CHAIRMAN. The committee will please come to order.

We have quite a program today. In fact, we have Dr. Burns at 10 o'clock, and we have a markup of the Eximbank and the Eisenhower-Rayburn coin legislation. After the markup session we have a housing conference. We have been meeting on housing the last week or 10 days. We spent several hours a day some days. We have hopes that we will get that conference through probably tomorrow. We expect to work on it some today. It is a very important bill, the housing bill.

Dr. Burns, I wish you would give consideration to your statement. I have read it over. It is very good. From your viewpoint it is fine, and I do not object to that at all. I do not know of anyone who does not present things from their own viewpoint, and I am not criticizing you for that.

But it will be necessary for you to reduce the length of it, please, because we would not have time to end before 12 o'clock.

How much time could you reasonably get along with and present the questions you would like to present in the fashion you would like to present them? Would it be asking too much to say 30 minutes?

Dr. BURNS. I could not hear you, Mr. Chairman.

The CHAIRMAN. Would it be asking too much to ask you to see if you could not reduce your speech to 30 minutes?

Dr. BURNS. I could reduce it to any length.

The CHAIRMAN. The reason I say that is you will be interrogated by all members of the committee and you will have an opportunity to bring in most anything, I think, that you would care to bring in anyway.

Dr. BURNS. I would prefer to read my full statement, because it is addressed with some care to the questions that you, Mr. Chairman, have put to me. These questions, I must say, as I have told Dr. Weintraub, are very well put; that is, they go to the heart of monetary

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policy. Therefore, I would prefer to read my whole statement. I do not think it will take more than 30 minutes. But I can cut my time down to 30, 15, 10, 5, or zero.

The CHAIRMAN. We will accede to your request, and you can read it, but I want to read this statement first.

This morning we continue our hearings on monetary policy. We have before us Dr. Arthur Burns, Chairman of the Federal Reserve Board and one of the chief economic policymakers in this administration.

Four and one-half years ago, when Dr. Burns was appointed by President Nixon, I urged in various speeches that he be given the benefit of the doubt and that he be judged on his performance.

As Dr. Burns knows, I gave him personal assurance as chairman of this committee that I would do everything possible to make sure he had a chance to prove himself in the job before we started making judgments.

We have differences, Dr. Burns; we have had many differences. But I assure you that so far as I am concerned, I believe it is the same way for other members of the committee, these differences were on policies and not personal in any respect. Never has it been our intention to make any personal attack on you or any other member of the administration, because we are seeking information from you in the interest of the entire country. But we are now well into the fifth year of your performance, Dr. Burns, and as a committee of Congress with specific oversight functions over your agency, it is our responsibility to start making some evaluations.

Certainly, you have had a free hand, an independent hand, as the people at the Federal Reserve like to call it, to set the policies and to administer them.

It is to state the obvious to note, first, we have the highest interest rates in the history of the Nation with the housing industry in a near depression. In fact, most people claim it is in a depression right now, and millions of Americans priced out of opportunities for decent shelter.

Two, we have raging inflation. The current figures indicate something on the order of 12 percent on an annual basis.

Three, we have these storm clouds of recession and open talk of depression. We have serious disintermediation and liquidity problems in the financial community. In fact, it is difficult to find a good economic indicator. When we have conditions like this, it is incumbent upon the Congress to probe, to seek answers, to find out why. The policymakers who enjoy their glories when policies go well must bear under the responsibility without excessive buckpassing when the policies go sour.

It does not serve the reputation of Congress well when it continues to praise, to commend and congratulate in the face of economic realities of today. The people expect the Congress to hold the bureaucrats accountable when it has oversite functions, and carrying out this responsibility is not always pleasant. But we are operating a committee of the Congress with specific responsibility.

Frankly, Dr. Burns, I hope you will address your remarks here this morning to what your agency has done, is doing, and will do, and especially, what you expect to do about housing, unemployment, inflation, and high interest rates.

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We have other competent witnesses available to tell us about other branches and other departments and agencies. This morning we are interested in discussing the performance of your agency and the Federal Reserve Board and the Federal Reserve System as a whole.

In correspondence received by the committee and from individuals, we are often reminded we do not want our monetary policies run like the Penn Central Railroad policies are run.

Now, of course, that does not refer to any particular person or any particular policy. It just shows unrest in the country about monetary policies, especially when interest rates are about twice, almost twice as high as they have normally been in the history of the Nation.

So, Dr. Burns, we are delighted to have you, sir. As Chairman of the Federal Reserve Board, you have more to do with the monetary policy than anyone else in the United States, and we welcome your testimony and after, I will not ask you questions at first, as normally I do, but I would yield to different members of the committee from side to side. To give everyone a chance, we will go around under the 5-minute rule first, and then we will start over again. If we do not get through this morning, we will arrange for a time to continue. We apologize for not being able to get to you earlier as planned.

This is the third meeting that you have honored us with your presence. The other two you were unable to be heard because we had other things that we just had to get through—caucuses and bills on the floor we had to get passed; and we had some important laws that were expiring, and we had to go ahead and have hearings on them and get them through as quickly as possible, which we tried to do.

So we welcome you and look forward to your testimony, and you may proceed in your own way, sir.

Mr. WIDNALL. Will the gentleman yield?

The CHAIRMAN. I will yield.

Mr. WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, I want to join in welcoming you before the committee. You have always been most cooperative in coming up here and you have been a straight shooter. We expect you to do the same this morning. Thank you for coming.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. BURNS. I want to thank you, Mr. Chairman, for giving me this opportunity and in welcoming me here this morning.

I want to thank you, Mr. Widnall, and I want to thank you, Mr. Barrett, for your kindness in permitting me to go ahead with my statement. In due course I shall do what I can to deal with your questions.

I am pleased to appear before this committee today to discuss the six questions posed by Chairman Patman's letter of June 19, 1974. The several areas addressed by these questions are of great interest, particularly to professional economists. My comments on them convey the basic thinking of the Board of Governors, and will—I believe—be responsive to the committee's needs.

I must, however, go beyond a narrow or technical interpretation of these questions. Rapidly rising prices, rapidly rising wages, rapidly

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rising interest rates—these are the burning economic issues of our time. My testimony today will seek to identify the sources of this menacing inflationary problem and to outline the course that public policy must take to restore price stability.

The first question raised by Chairman Patman concerns the reliability of the tradeoff between inflation and unemployment—the so-called Phillips curve—as a guide for monetary policy. The discovery some years ago of a statistical correlation between the rate of inflation and the rate of unemployment seemed to offer a straightforward choice to policymakers. These early studies—using data first for the British economy, later for the United States and other economies—suggested that unemployment could be reduced if a nation were willing to put up with more inflation, and that advances in the general price level could be slowed down if a higher rate of unemployment were tolerated.

Further research and subsequent developments have indicated, however, that simple statistical correlations of this kind are misleading. The forces affecting economic activity and prices in a modern economy are far too complex to be described by a simple mathematical equation.

We found in 1970 and early 1971, for example, that increases in wage rates and prices may continue and even accelerate—in the face of rising unemployment and declining real output. The experience of the United States in this regard was not unique; similar developments occurred at about the same time in Canada and the United Kingdom.

We have also come to recognize that public policies that create excess aggregate demand, and thereby drive up wage rates and prices, will not result in any lasting reduction in unemployment. On the contrary, such policies—if long continued—lead ultimately to galloping inflation, to loss of confidence in the future, and to economic stagnation.

The central objective of monetary and fiscal policies should be to foster lasting prosperity—a prosperity in which men and women looking for work are able to find work; a prosperity in which incomes and savings are protected against inflation; a prosperity that can be enjoyed by all. Of late, such a prosperity has eluded us, because we have not yet found a way to bring an end to inflation.

Let me turn to your second question, concerning the benefits and risks involved in the Federal Reserve accommodating increases of the general price level that originate in supply shortfalls and other special events.

Prices in the United States have been affected heavily in the past several years by a variety of special factors. Disappointing harvests in 1972—both here and abroad—caused a sharp runup of food prices in 1973. Beginning in the fall of last year, the manipulation of petroleum shipments and prices by oil exporting countries led to huge increases in the price of gasoline, heating oil, and related products.

Furthermore, a worldwide boom in economic activity during 1972 and 1973 led to a bidding up of prices everywhere. In the United States, larger foreign orders for industrial materials, component parts, and capital equipment added to growing domestic demands. Pressures became particularly intense in the major materials industries—such as steel, aluminum, cement, paper—in which expansion of capacity had been limited in earlier years by low profits and environmental controls.

The impact of worldwide inflation was especially severe in the United States because of the decline in the exchange value of the dollar relative to other currencies. Besides stimulating our export trade,

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and thereby reinforcing the pressures of domestic demand on available resources, devaluation raised the dollar prices of imported products, and these effects spread through our markets.

More recently, the removal of controls over wages and prices has led to sharp upward adjustments in both our labor and commodity markets.

It has at times been suggested that monetary policy could have prevented these special factors from affecting significantly the average level of wholesale and consumer prices. That may well be true, but the cost of such a policy should not be underestimated. Last year, about 60 percent of the rise in consumer prices was accounted for by food and fuel; for wholesale prices, the proportion was even higher. To achieve stability in the average price level, it would therefore have been necessary to bring down very sharply the prices of other goods and services.

Prices of many commodities—particularly farm products and industrial raw materials—are established in highly competitive markets and are therefore capable of declining as well as rising. The prices of many other commodities and services that make up the gross national product, however, are nowadays rather inflexible in a downward direction, in large part because of the persistent upward push of labor costs and imperfect business competition. For these commodities, significant price declines could be achieved only by drastically restrictive policies—policies that would lead to widespread bankruptcies and mass unemployment. A monetary policy that sought to offset completely the effects on the average price level of the rising cost of food, petroleum products, and other commodities whose prices were so heavily influenced during the past 2 years by special factors, would clearly have been undesirable.

Nevertheless, monetary policy must not permit sufficient growth in money and credit supplies to accommodate all of the price increases that are directly or indirectly attributable to special factors. The rise in the price of petroleum, for example, has increased the costs of energy, plastics, petroleum-based chemicals, and other materials. Business firms will endeavor to pass these higher costs through to consumers. Workers, too, will bargain for larger wage increases, in order to compensate for declines in their real incomes. To the extent that wage increases outrun gains in productivity, business costs—and ultimately consumer prices—are driven up. Thus, in addition to their direct effects on prices, special factors may have large widespread secondary effects on the price level.

A monetary policy that accommodates all of these price increases could result in an endless cost-price spiral and a serious worsening of an already grave inflationary problem. The appropriate course for monetary policy is the middle ground. The price rigidities characteristic of modern industrialized economies must be recognized, but a full passthrough of all the price effects stemming from special factors must not be permitted.

The middle course of policy we have adopted has resulted in a growth rate of the narrowly defined money supply—currency and demand deposits—of about 6 percent during the past 12 months. This rate of growth is still too high for stability of average prices over the longer term. But moderation in the growth rate of money and credit

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supplies must be achieved gradually to avoid upsetting effects on the real economy. This is particularly true now, when price-cost relations are seriously distorted.

I turn now to Chairman Patman's third question, which relates to the positive elements and the risks involved in monetizing deficit spending. The simple fact is that financing Federal deficits by printing money involves risks, and the risks are grave.

Fortunately, since 1951, monetary policy in this country has not been conducted with an eye to providing a ready market for Treasury securities, or for financing Federal deficits. Considerations of this kind were an objective of Federal Reserve policy during World War II, when Treasury borrowing proceeded on an unprecedented scale in relation to the size of our economy. I doubt if such a policy was warranted even under wartime circumstances, and its continuation in the years immediately after the war was a very serious mistake. It led to excessive increases in borrowing by private firms, consumers, and State and local governments, and thus fueled the subsequent inflation.

The dangers inherent in this situation became acutely evident during the Korean war, when Federal deficits once again threatened. With the aid of prodding by the Congress, particularly by Senator Douglas, the Federal Reserve and the Treasury resolved their disagreements, and monetary policy returned to its traditional role of regulating the supply of money and credit in the interest of economic stability. Since then, the Treasury has financed its deficits at prevailing market interest rates in competition with other borrowers.

During periods of large Treasury financings, the Federal Reserve follows the practice of maintaining "even keel" in the money market—that is, we refrain from taking overt actions that market participants might interpret as a change in monetary policy. On some occasions, therefore, the maintenance of "even keel" has delayed the timing of changes in monetary policy. Treasury financing operations thus pose problems for monetary policy, particularly when they are large and frequent.

Federal deficit financing becomes a major source of economic and financial instability when it occurs during periods of high economic activity, as it has in recent years. The huge Federal deficits of the past decade have added enormously to aggregate demand for goods and services, and have thus been directly responsible for upward pressures on the price level. Heavy borrowing by the Federal sector has also been an important contributing factor to the persistent rise in interest rates, and to the strains that have at times developed in money and capital markets. Worse still, continuation of budget deficits has tended to undermine the confidence of the public in the capacity of our Government to deal with inflation.

If the present inflationary problem is to be solved, and interest rates brought down to reasonable levels, the Federal budget must be brought into better balance. This is the most important single step that could be taken to restore the confidence of people in their own and our Nation's economic future.

Let me turn, next, to the committee's fourth question, dealing with the benefits and risks of the Federal Reserve's fighting money market fires.

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As this committee well knows, the cardinal aim of monetary policy is maintenance of a financial environment in which our national objectives of full employment and price stability can be realized. For the most part, this responsibility is best achieved by striving for appropriate growth rates of the monetary aggregates, and letting financial markets take care of themselves.

The appropriate monetary growth rates will vary with economic conditions. They are apt to be higher during periods of economic weakness, when aggregate spending is in need of stimulus, than when the economy is booming and inflationary tendencies threaten economic stability. Special circumstances may, however, call for monetary growth rates that deviate from this general rule. For example, as noted in my response to the second question, the special factors giving rise to extraordinary price pressures during the past year or two have required toleration of a monetary growth rate that has been relatively high by historical standards.

There are times when responsibility for maintaining financial and economic stability requires the Federal Reserve to focus attention primarily on factors other than growth in the money supply or bank credit. The oldest and most traditional function of a central bank is to act as a lender of last resort—that is, to provide liquidity when dislocation of financial markets threatens serious damage to the economy. Acting in this capacity, the Federal Reserve, in the summer of 1970, warded off a developing liquidity crisis in the commercial paper market. This year, difficulties encountered by a large commercial bank led to rumors of widespread illiquidity of the commercial banking system. These concerns were reduced by timely Federal Reserve action at the discount window.

It so happens that in neither of these instances did the Federal Reserve's intervention result in a significant deviation of the monetary aggregates from desired growth rates. But let there be no mistake about our determination to deal with financial troubles. In the future, as in the past, we will surely not stand aloof and permit a crisis to develop out of devotion to this or that preconceived growth rate of the money supply.

The responsibility of the Federal Reserve for conditions in the money and capital markets goes beyond its historic function to act as lender of last resort. Monetary policies need to be implemented, I believe, in ways that avoid large and erratic fluctuations in interest rates and money market conditions.

From one month to the next, the public's demand for money is subject to variations that are usually of a shortrun nature. For example, a large tax refund, a retroactive increase in social security benefit payments, or a sizable disbursement by the Treasury of revenue-sharing funds may produce a temporary bulge in the demand for cash balances. If the Federal Reserve tried to maintain a rigid monetary growth rate in the face of such developments, interest rates could fluctuate widely, and to no good end. The costs of financial intermediation would be increased, and the course of monetary policy might be misinterpreted. To avoid these harmful effects, the Federal Reserve seeks to achieve desired growth rates of money and credit over relatively long periods. Experience over the past two decades suggests that even an abnormally large or abnormally small rate of

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growth of the money stock over a period of 6 months or so has a negligible effect on the course of the economy—provided it is subsequently offset.

We recognize, of course, that too much attention to preventing short-run fluctuations in interest rates could inadvertently cause the growth rate of money or credit to drift away from what is appropriate for the longer run. To guard against this possibility, the Federal Reserve, in early 1972, introduced a new set of procedures for implementing monetary policy. These procedures focus more attention on provision of bank reserves through open market operations at a pace consistent with desired growth rates of monetary and banking aggregates.

The new procedures have been helpful, but numerous problems of monetary control still remain. For example, a substantial part of the money supply is in the form of deposits at nonmember banks. As a consequence of this and other factors, there is considerable slippage between the supply of bank reserves controlled by the Federal Reserve and the Nation's money supply. Monetary control is therefore less precise than it could or should be. I would once again urge the Congress to correct this defect by extending the Federal Reserve's power over reserve requirements to all commercial banks.

Let me turn next to Chairman Patman's fifth question, which deals with the relationship that interest rates, the money supply, and the rate of inflation bear to one another.

Most interest rates in the United States are now at the highest levels in our history. There are some who believe that restrictive monetary and credit policies are responsible for this state of affairs. This view is erroneous. The basic reason why interest rates have risen to their present level is the accelerating pace of price advances over the past decade, so that we now find ourselves in the midst of a two-digit inflation.

Historical evidence—from other countries as well as our own—indicates beyond any doubt that inflation and high interest rates go together. The reasons are not hard to understand. In most countries throughout the Western World, inflationary expectations have become deeply imbedded in the calculations of lenders and borrowers. Lenders now reckon that loans will probably be repaid in dollars of lesser value, and they therefore hold out for nominal rates of interest high enough to assure them a reasonable real rate of return. Borrowers, on their part, are less resistant to rising costs of credit when they anticipate repayment in cheaper dollars.

Interest rates at anything like present levels are deplorable. They cause hardships to individuals and pose a threat to the viability of some of our industries and financial institutions. But we cannot realistically expect any lasting decline in the level of interest rates until inflation is brought under control.

History also indicates that high rates of inflation are typically accompanied by high growth rates in supplies of money and credit. But inflationary tendencies and monetary expansion are not as closely related as is sometimes imagined. For example, the econometric model of the St. Louis Federal Reserve Bank, which assigns a major role to growth of the money stock in movements of the general price level, has seriously underestimated the rate of inflation since the beginning of 1973. Simulations of the model, using the actual growth rates of the money supply since the first quarter of 1972, suggest that the rate of

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inflation during the past two quarters should have been a mere 3½ percent. Apparently, special factors—such as I mentioned previously—have been at work.

Inflationary processes are characterized by rising turnover rates of the existing stock of money as well as by relatively high rates of monetary expansion. Recent experience in the United States illustrates this fact. Over the past 10 years, the average annual increase in the money stock has been about 6 percent—a higher rate than in the previous decade. Since 1964, however, the income velocity of money—that is, the ratio of gross national product to the money stock—has risen at an average annual rate of about 2½ percent, thus contributing importantly to the inflationary problem.

The role of more rapid monetary turnover rates in inflationary processes warns against assuming any simple casual relation between monetary expansion and the rate of inflation either during long or short periods. Excessive increases in money and credit can be an initiating source of excess demand and a soaring price level. But the initiating force may primarily lie elsewhere, as has been the case in the inflation from which this country is now suffering.

The current inflationary problem emerged in the middle 1960's when our Government was pursuing a dangerously expansive fiscal policy. Massive tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by an explosion of Federal spending. The propensity of Federal expenditures to outrun the growth of revenue has continued into the 1970's. In the last 5 fiscal years, total Federal debt—including the obligations of the Federal credit agencies—has risen by more than $100 billion, a larger increase than in the previous 24 fiscal years.

Our underlying inflationary problem, I believe, stems in very large part from loose fiscal policies, but it has been greatly aggravated during the past year or two by the special factors mentioned earlier. From a purely theoretical point of view, it would have been possible for monetary policy to offset the influence that lax fiscal policies and the special factors have exerted on the general level of prices. One may, therefore, argue that relatively high rates of monetary expansion have been a permissive factor in the accelerated pace of inflation. I have no quarrel with this view. But an effort to use harsh policies of monetary restraint to offset the exceptionally powerful inflationary forces of recent years would have caused serious financial disorder and economic dislocation. That would not have been a sensible course for monetary policy.

The last question put to me deals with how monetary policy should be used to check inflation and bring interest rates down to reasonable levels.

The principal objective of monetary policy since late 1972 has been to combat the inflationary forces threatening our economy. To this end, supplies of money and credit have been restricted at a time when credit demands were booming. Inevitably, therefore, interest rates have risen. This unhappy consequence has led some observers to conclude that restrictive monetary policies are counterproductive—because rising interest rates are an added cost to businesses and thus may result in still higher prices.

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There is a grain of truth in this argument, but no more than that. For most businesses, interest costs are only a small fraction of total operating expenses. The direct effects of a restrictive monetary policy on costs and prices are therefore small. The indirect effects of a restrictive monetary policy on prices are far more important. When growth in supplies of money and credit is restrained, some business firms and consumers are discouraged by the high cost of credit from carrying through their plans to spend; others find it more difficult to obtain credit and therefore trim their spending; still others, reckoning that monetary restraint will cool off aggregate demand, curtail their outlays for goods and services even though they do not depend on the credit markets for spendable funds. In all these ways, a restrictive monetary policy helps to moderate aggregate spending and thus to reduce inflationary pressures.

In order to bring interest rates down to reasonable levels, we shall need to stay with a moderately restrictive monetary policy long enough to let the fires of inflation burn themselves out.

Progress can still be made this year in slowing the rate of price increase, and it is urgent that we do so. Inflation has been having debilitating effects on the purchasing power of consumers, on the efficiency of business enterprises, and on the condition of financial markets. The patience of the American people is wearing thin. Our social and political institutions cannot indefinitely withstand a continuation of the current inflationary spiral.

We must face squarely the magnitude of the task that lies ahead. A return to price stability will require a national commitment to fight inflation this year and in the years to come. Monetary policy must play a key role in this endeavor, and we, in the Federal Reserve, recognize that fact. We are determined to reduce, over time, the rate of monetary and credit expansion to a pace consistent with a stable price level.

Monetary policy, however, should not be relied upon exclusively in the fight against inflation. Fiscal restraint is also urgently needed. Strenuous efforts should be made to pare Federal budget expenditures, thus eliminating the deficit that seems likely in fiscal 1975. The Congress should resist any temptation to stimulate economic activity by a general tax cut or a new public works program. There may be justification for assistance to particular industries—such as housing—that are especially hard hit by a policy of monetary restraint. An expanded public service employment program may also be needed if unemployment rises further. But Government should not try to compensate fully for all the inconvenience or actual hardship that may ensue from its struggle against inflation. Public policy must not negate with one hand what it is doing with the other.

There are other actions that may be of some help in speeding the return to general price stability. For example, limited intervention in wage and price developments in pacesetting industries may result in considerable improvement of wage and price performance. I would urge the Congress to re-establish the Cost of Living Council and to empower it, as the need arises, to appoint ad hoc review boards that could delay wage and price increases in key industries, hold hearings, make recommendations, monitor results, issue reports, and thus bring

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the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power. Encouragement to capital investment by revising the structure of tax revenues may also be helpful, as would other efforts to enlarge our supply potential. For example, minimum wage laws could be modified to increase job opportunities for teenagers, and reforms are still needed to eliminate restrictive policies in the private sector—such as featherbedding and outdated building codes.

A national effort to end inflation requires explicit recognition of general price stability as a primary objective of public policy. This might best be done promptly through a concurrent resolution by the Congress, to be followed later by an appropriate amendment to the Employment Act of 1946. Such actions would heighten the resolve of the Congress and the Executive to weigh carefully the inflationary implications of all new programs and policies, including those that add to private costs as well as those that raise Federal expenditures. They would signal to our people, and to nations around the world, that the United States firmly intends to restore the conditions essential to a stable and lasting prosperity.

I want to thank you for the privilege, Mr. Chairman, of reading my whole statement.

The CHAIRMAN. Thank you, Dr. Burns, Your statement is very interesting. We will certainly give careful consideration to what you have said in this statement.

We will not start around the table under the 5-minute rule, and if the members will assist in maintaining that 5 minutes, so that all members may have a chance, it will be appreciated.

Mr. Barrett, since I am not asking any questions first, I will yield to you first.

Mr. BARRETT. Thank you, Mr. Chairman.

Dr. Burns, I listened to your testimony very carefully, and I thought it contained some differences with your economic adviser colleagues. The chief economic adviser to the President, Dr. Herbert Stein, has made a statement to the effect that the inflationary situation in the economy has been caused by the American people who did not seek or did not insist on a tax increase.

Do you agree with that kind of a statement?

Dr. BURNS. Well, I think that statement is much too brief. I do not know what the full thought of the man who made that statement might have been. Certainly, the American people have not been clamoring for a tax increase. On the other hand, I am not aware that governmental leaders have been urging that Federal revenues be sufficient to meet the steadily and sharply rising rate of governmental expenditures. I find it a little difficult, really, to place the blame for the inflation that we have been having on this group or that. As I survey the scene, I cannot help but feel that the Congress has been to blame, the President and the entire executive establishment has been to blame, business corporations have been to blame, and we at the Federal Reserve Board have also not been blameless. Therefore, my answer to your question is, the statement that you have quoted is much too simple an explanation.

Mr. BARRETT. Dr. Burns, I assume you know the concerns that the members of the committee have about the present mortgage money

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market. The recent issue of the Citicorp floating rate notes and the announced intention of other bank holding companies to issue similar instruments are going to further drain the available mortgage funds from the thrift institutions.

In your letter to me of July 22, and the statement from a member of the securities industry that there may be $10 to $15 billion of such instruments issued in the near future, it raises, I think, two questions:

First, do you not now believe that the Congress should act so as to give the regulatory agencies the necessary authority to exercise discretion in this area of the money market?

May I ask you the next question, and put them together? The second one:

Would you not agree to give the Federal Reserve the necessary discretionary authority to section 19(a) of the Federal Reserve Act, which should be amended?

I have offered a substitute to the bill here offered by the committee to give the three regulatory agencies some power to control the issuance of floating interests, and I would like to get your reaction on it.

Dr. BURNS. Thank you very much.

Let me answer your two questions as best I can. The position of the Federal Reserve Board at present is that the Congress would be well advised to wait a little while and see what our experience with issues such as Citicorp may be. This is the position of the Federal Reserve Board. We also recognize the great concern of the Congress that money may be drained in large amounts from thrift institutions and, therefore, the mortgage market, which is badly depressed at present, would suffer further shrinkage.

The CHAIRMAN. The time of the gentleman has expired.

Mr. BARRETT. Mr. Chairman, I ask unanimous consent to let the gentleman answer.

Dr. BURNS. I would love to finish my thought.

Mr. ROUSSELOT. Mr. Chairman, reserving the right to object, and I will not object—my only statement is, if you will allow other people to finish their questions the same as you are doing for Mr. Barrett, I will not object. Will you do that?

The CHAIRMAN. No, we cannot do that.

Mr. ROUSSELOT. Then I will object, then, if the chairman will allow other people the same courtesy that he is giving Mr. Barrett.

The CHAIRMAN. I congratulate the gentleman on assuming that attitude.

Mr. REES. Mr. Chairman, I ask unanimous consent that Dr. Burns be allowed to complete his statement, his answer to Mr. Barrett's question.

The CHAIRMAN. I hope you do not insist on that. We will have to do it for others. We will get back to you on the next round.

Mr. MITCHELL. Mr. Chairman?

The CHAIRMAN. We will never get through on a matter like this.

Mr. MITCHELL. Could we not establish a policy now that when a member has put a question and Dr. Burns is responding to that question, that he be allowed to finish the answer to that question? I think that is only fair.

Mr. ROUSSELOT. That is my point.

The CHAIRMAN. Should we have a limitation on it?

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Mr. MITCHELL. I am convinced that Dr. Burns will not protract his answers so that all the time will be taken up of the committee.

The CHAIRMAN. Mr. Mitchell makes a unanimous consent request. Is there objection?

Mr. STEPHENS. Reserving the right to object, and I would not object. I came today to hear Dr. Burns. I wish you would let Dr. Burns answer the question to a conclusion. I withdraw my objection.

The CHAIRMAN. The members will, of course, have another chance to ask him questions.

Is there objection? The Chair hears none. Go ahead, Dr. Burns.

Dr. BURNS. Out of respect for the wishes of the committee, I am going to try to be as brief as I can.

The CHAIRMAN. You may elaborate on your statement when you examine the transcript for your approval.

Dr. BURNS. Mr. Barrett asked whether I would agree to have the Congress give the Federal Reserve additional authority to deal with issues such as Citicorp. If it is the wish of the Congress to move along legislative lines, then I believe that amending section 19(a) would do it. A simpler way, perhaps, of achieving the same purpose would be to accede to the Senate Concurrent Resolution 103, which clarifies the legislative history of the current Federal Reserve Act in such a way as to give the Federal Reserve the power to regulate issues of the Citicorp type. I think that would be the simplest way of doing it, through that concurrent resolution. But amending section 19(a) would perform the same function. If you are going to legislate, I think that would be the best way to proceed.

Mr. BARRETT. Dr. Burns, would you please answer this question for the record.

The homebuilding industry and mortgage money market is like a sponge in our economy; when there is rampant inflation, interest rates climb and money gets tight. The homebuilding industry and mortgage money market are the first to feel the effects of such constraints and the last to recover when the situation slackens.

In the past, these cycles have run about a year. At the present, however, indications are that the cycle may last 4 years.

What are you, the Federal Reserve, and the Open Market Committee going to do to relieve the problems of housing during these 4 years?

[In response to the request of Mr. Barrett, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

The Federal Reserve will, as in the past, maintain an active interest in housing and residential finance during the years ahead. The Board believes that the most important single contribution that could be made in this period toward relieving problems associated with the stability of the housing industry would be to obtain better control over the forces of inflation. That is now the principal objective of monetary policy.

The basic goals of monetary policy, of course, are more general—to contribute to achieving high employment with sustainable growth, a stable dollar at home, and over-all balance in our financial transactions with other nations. In contrast to these goals, the Federal Reserve has no specific authority insofar as housing or other individual branches of the economy are concerned. Nevertheless, several aspects of the System's general responsibilities will undoubtedly have a direct bearing on housing and residential finance in the future.

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For example, the Federal Reserve purchases securities of Federal credit agencies, as well as direct Treasury debt, in the conduct of its open-market operations. Net purchases of FNMA, FHLBank, and Farmers Home Administration securities by the System totaled more than $1.3 billion in the first seven months of 1974, compared with $200 million in the same period of 1973. Further transactions in such securities will probably occur in the years ahead under carefully defined guidelines, designed to add breadth to this market without running the risk of dominating it.

Regulation of ceiling rates of interest on time and savings deposits of member banks also influences the state of housing finance. Gradual easing of Regulation Q ceilings on consumer time and savings deposits at member commercial banks, and similar action on rates paid by savings banks and S&Ls, may be possible in coming years, once a number of fundamental steps have been taken to strengthen our depositary institutions. Any such easing would, of course, increase the flow of savings to thrift institutions, and expand the potential supply of mortgage credit. In this connection, the Board continues to endorse the basic principles of the Report of the President's Commission on Financial Structure and Regulation (the Hunt Commission) and the general provisions of the Financial Institutions Act of 1973, many of which are of substantial significance for housing finance. Once appropriate broadened lending and investment powers have been secured for depositary institutions, it should then be feasible to gradually withdraw restrictions on interest rates paid on their deposit accounts, and to replace the statutory controls with standby powers to reimpose the ceilings in the event of unforeseen contingencies.

Additionally, the Federal Reserve continues to stand ready to provide emergency credit facilities, if needed, for financial institutions other than banks. Assurance that this backstop exists encourages lending institutions to make commitments of funds to the mortgage market.

Beyond these specific responsibilities, the Federal Reserve will continue, as the need may arise over the years ahead, to support appropriate policy actions through HUD, the Federal Home Loan Bank System, and the federal housing credit agencies to mitigate any undue burden on housing of generally restrictive credit conditions. The Federal Reserve, for example, actively encouraged the Administration's special housing policy actions announced May 10, 1974, making some $10.3 billion of additional funds available through the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks.

In addition, the Board may itself, from time to time, call the attention of the Congress to other measures that should be considered for strengthening housing finance or for stabilizing the housing market. As recently as March 1972, the Board transmitted to the Congress a comprehensive report on "Ways to Moderate Fluctuations in the Construction of Housing," and testimony on the report was later presented before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee.

While several proposals contained in the Board's 1972 report have since been adopted in some form, numerous others—such as the removal of legal and regulatory obstacles to flows of mortgage credit—remain to be implemented in whole or in part. Two high-priority Board recommendations yet to be adopted are the flexible use of a tax credit on business fixed investment in machinery and equipment, and provisions for wider use of variable-rate home mortgages under terms which would be fair to both the borrower and the lender.

The CHAIRMAN. All right.

Mr. Widnall?

Mr. WIDNALL. Dr. Burns, your statement is a curious combination of optimism and pessimism concerning our economic future. Perhaps this is the only realistic way to view the situation. However, there is one sentence in your testimony that causes me special concern. On page 19 you said, and I quote:

> Our social and political institutions cannot indefinitely withstand a continuation of the current inflationary spiral.

Because I respect and admire your abilities, not only as an economist, but also—and this is important—as a man of great social

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insight, I would appreciate it if you would elaborate on that statement.

Dr. BURNS. I will try to be brief.

If you turn to European countries that have practiced inflation, you find that inflation has had very injurious and disturbing consequences for the social and economic systems and the political system.

The CHAIRMAN. Let us have order, please.

Dr. BURNS. The collapse of Russia in 1917 was in part due to the huge inflation experienced by that country at that time. What happened in Nazi Germany during a most unhappy period for all of us is in large part traceable to the galloping inflation experienced in that country after World War I.

When you turn to Latin America, you find one revolution after another caused to a significant degree by the social upheaval, the misery, generated by inflation. Once inflation takes root in a country, and if government does not deal properly with it the road is wide open for demagogs to exploit the sense of frustration, the sense of misery, that is felt by many. These are some of the thoughts that ran through my mind when I wrote that sentence.

Mr. WIDNALL. Last week while testifying before this committee, Dr. David Eastburn, president of the Federal Reserve Bank of Philadelphia, expressed skepticism of a credit allocation scheme because of the problems of the workability and the enormous costs it might engender. What is your feeling on that subject?

Dr. BURNS. I share Dr. Eastburn's concern. I have just written Congressman Reuss a long letter dealing with the problem which I am sure he would be glad to share with members of this committee. I should say in fairness that in that letter, where I expressed the basic thinking of the Board on credit allocation, I also indicate that one of my colleagues on the Board, Governor Brimmer, has a different view, and Governor Brimmer will be writing to Congressman Reuss separately.

The concept of credit allocation implies a degree of knowledge of social priorities that I for one am quite certain that we at the Federal Reserve Board do not have. I think the Congress would not be well advised to give us a power that we simply do not know how to exercise properly. If we are to have credit allocation in this country, then I think credit allocation should proceed according to rules devised by the Congress. But there again, I must say, in all humility, that I am not at all sure that Congress has the wisdom to substitute its rules for the workings of the marketplace.

The CHAIRMAN. The time of the gentleman has expired.

Mr. WIDNALL. Thank you very much.

The CHAIRMAN. Mrs. Sullivan?

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Dr. Burns, I have a series of questions for you. But should my time run out, I will submit them, the unasked questions, to the reporter at that point, so that you may complete your answers in your copy of the transcript.

Dr. Burns, in your opinion is any form of credit today being extended in the United States in an excessive volume?

Dr. BURNS. Let me say this, that I have felt unhappy over the extremely rapid growth of loans by our commercial banks to busi-

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ness firms, that is, the rapid growth of business loans by commercial banks this year. This year during the first quarter, the rate of growth in business loans proceeded at an annual rate, I believe, of 22 percent, and during the second quarter at an annual rate of 23 percent. These are enormous increases. I think I can explain them up to a point. But I have been disturbed by the rapid advance in that sector.

Mrs. SULLIVAN. Well certainly, mortgage credit is not being extended in excessive volume, and I guess it is safe to say that securities credit, at least on common stocks, is not being extended in an excessive volume.

But how about the other specific areas that you mentioned—business, business loans? What about consumer credit?

Dr. BURNS. The rate of growth of consumer credit has tapered off rather sharply, and I am not concerned about that.

Mrs. SULLIVAN. Well, what about credit for speculating in commodity futures? Are any of these being extended in an excessive volume?

Dr. BURNS. I do not have any data. Whether they exist or not, I am not sure. I doubt it. In any event, I do not have any data on the amount of credit extended for that purpose.

Mrs. SULLIVAN. For commodity markets?

Dr. BURNS. I will look into that specifically. But I doubt if statistics on the subject are available.

[In response to the request of Mrs. Sullivan, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

I doubt that any appreciable volume of credit is being extended for the purpose of speculating in commodity futures. Banks would be extremely wary about making loans for that purpose. However, my response must remain conjectural, since no data are available on the amount of credit extended for that purpose.

The only information that we have relating specifically to the financing of commodity markets appears in the breakdown of business loans by industry of borrower that is reported weekly by about 160 of the largest banks in the country. This report includes a category for outstanding loans to "commodity dealers." The credit extended to these borrowers is used mainly to finance working inventories; little of it would be used for speculative acquisitions. Over the past year, loans to commodity dealers have expanded by about 15 per cent, or less than the increase in prices of raw commodities during that period.

Mrs. SULLIVAN. Would you say that at any time in the past 3½ years any form of credit was being extended in an excessive volume, and if so, in which areas or at which times?

You mentioned the commercial banks loaning to business. Is there anything else in the past 3½ years?

Dr. BURNS. I would say that consumer credit rose much too sharply during 1972 and part of 1973, but not now. Yet, I keep on being urged to do something about consumer credit at the present time. In the first place, we do not have the power under the law to do that on our own initiative. In the second place, if we had the power, this is not the time to use it. However, had we had the power, we probably should have used it in 1972 and early 1973.

Mrs. SULLIVAN. Well, Dr. Burns, I am sure you know why I am asking these questions.

Dr. BURNS. Yes, I think I do.

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Mrs. SULLIVAN. They refer to the specific language in the Credit Control Act of 1969.

Dr. BURNS. Yes.

Mrs. SULLIVAN. The Economic Stabilization Act of 1971, providing unprecedented powers to the President to control interest rates and the terms and conditions of any form of credit in the United States, and that authority has never been used. But under the Credit Control Act, the President could have the Federal Reserve Board regulate and control any or all extensions of credit.

Dr. BURNS. That is correct.

Mrs. SULLIVAN. Whenever he determines that such action is necessary or appropriate. I believe you told us early in 1970, after you took over as Chairman of the Federal Reserve, that you were mighty glad that law, the Credit Control Act of 1969, was on the books. I believe you testified on that before this committee, and this was shortly after President Nixon had denounced us for passing that law and attaching it to a bill that he could not veto. But nothing has been done under it.

Now, what I would like to ask, have you ever suggested to the President that he implement this law, or have you been convinced for the past 3½ years that no form of credit has been extended in an excessive volume contributing to the generation of inflation?

Dr. BURNS. At no time since the passage of the Credit Control Act of 1969 has the Federal Reserve Board petitioned the President to implement that legislation for any specific purpose.

Mrs. SULLIVAN. Thank you. My time has expired. I would love to explore that with you, but I will put it in the record.

[The following are written questions submitted by Mrs. Sullivan, along with Dr. Burns' answers:]

Question 1. Dr. Burns, under the Credit Control Act of 1969, when you felt consumer credit was excessive, could not the Fed have set a payment level or a percentage of credit allowed on the consumer item?

REPLY RECEIVED FROM DR. BURNS TO QUESTION 1 SUBMITTED BY MRS. SULLIVAN

Sec. 205 of the Credit Control Act provides that, under a specified set of circumstances, the President may authorize the Board of Governors "to regulate and control any or all extensions of credit". Sec. 206 of the Act further provides that the Board—if given this general authority by the President—may by regulation prescribe limits on a wide variety of the terms on which credit is extended, including interest rate, maturity, repayment schedule, and the amount of the initial loan.

The Federal Reserve could have set limits on the extension of consumer credit, if the President had been willing and able to give the Federal Reserve the authority, and if the Board had felt that consumer credit was being extended in excessive volume. The President could have granted that authority only under one specific condition: "that such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume".

Question 2. At the administration's request, we wrote different language into the Economic Stabilization Act of 1971 allowing the President, rather than the Fed, to regulate interest rates consistent with orderly economic growth, and President Nixon put you in charge of that. But again, nothing was done to regulate a single interest rate in any part of the economy.

Do you feel we had no choice in all of these past 3 or more years than to let interest rates drive us to the brink of disaster?

No President in our history had such powers—not even in wartime.

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REPLY RECEIVED FROM DR. BURNS TO QUESTION 2 SUBMITTED BY MRS. SULLIVAN

The deplorably high interest rates that have developed in recent years are fundamentally a reflection of the rapid inflation that has prevailed in the United States and other key countries of the world. When lenders foresee a period of persistent and substantial inflation ahead, in which the purchasing power of interest and principal payments is likely to be depreciating, they naturally try to protect against this risk by increasing their interest charges. Borrowers, on the other hand, are deterred less by high interest rates because the outlays financed on credit today may look inexpensive when compared with the much higher total costs expected for the same items in the future.

While the over-all interest rate level rose during the past three years as a result of inflation, certain measures were taken to alleviate the difficulties caused by rising market interest rates. As a result of an executive order issued pursuant to the Economic Stabilization Act, the Committee on Interest and Dividends undertook a voluntary program of interest restraint. The Committee concentrated on interest rates charged by banks and other financial institutions to small businesses, consumers, home buyers, and farmers—that is, to borrowers without significant access to alternative sources of funds. The Committee's program protected such borrowers against burdensome increases in interest costs in a period of rising open market rates.

The Committee recognized that open market rates are determined under highly competitive conditions and reflect daily changes in the supply of and demand for funds. Any attempt to control such rates would have distorted the flow of funds in the economy and would have interfered with monetary policies designed to deal with changing economic conditions. For example, efforts by the Committee to interfere with the market process by attempting to hold down market rates in an inflationary environment would have vitiated the restrictive effect of rising market interest rates on credit demands, would thereby have worsened inflationary pressures, and would, in the end, have caused interest rates to rise even more as inflation worsened.

As part of its activities, the Committee pioneered by recommending a dual prime rate to banks—one applicable to large businesses and one to small businesses. The interest rate on loans to small businesses and also the rates on loans to the other small borrowers who were of principal concern to the Committee were subject to special restraint, while movements in the large business prime rate were permitted to be more reflective of market interest rates. The interest rate criteria issued by the Committee specified that interest rate increases on smaller loans could be made only if fully justified by increases in costs of lendable funds to the extent that such increased costs were not offset by higher earnings on other loans and investments.

Interest rate data indicate that the interest rates subject to special restraint by the Committee rose decidedly less than open market rates or the large business prime rate during the two year period of strong upward interest rate pressures from the spring of 1972 to the spring of 1974. While the large business prime rate rose about 5¼ percentage points, rates charged by banks on small short-term business loans rose only about 2½ percentage points, on farm loans around 2 percentage points, on consumer loans less than ½ of a percentage point, and on home mortgages about 1¼ percentage points. Thus, small borrowers were to some degree protected in a difficult period, characterized by strong inflationary pressures and large credit demands.

But there are clear limitations on the extent to which particular interest rates can be regulated. If some rates are arbitrarily kept unduly low, lenders will shift their funds to other uses in a period of rising market interest rates, when the lenders, themselves have to bear an increasingly high interest cost in order to raise funds in the market. Moreover, it would be counter-productive to attempt to supply through monetary policy additional credit in an effort to lower interest rates generally in an inflationary environment. Such a policy would only make the inflation worse, and lenders would become even more unwilling to commit funds except at increasingly high interest rates while borrowers would accelerate credit demands for fear of higher costs later.

The solution to the problems of high interest rates is to control the basic cause of the high rates—that is, to control inflation. A number of specific factors—such as poor crop harvests in many key producing countries, and the decisions of oil-exporting nations to boost petroleum prices—have contributed to the rapid inflation of recent years. These factors have clearly been beyond our control. But

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the inflation from which we are suffering is also a result of inadequate economic stabilization policies. In recent years, Federal spending has risen swiftly, deficits have been chronic, and the public debt has mounted. While our present grave problem of inflation stems from many causes, inadequate fiscal discipline is prominent among them. Fiscal restraint would, in the past, have reduced Governmental demands on credit markets and thereby lessened interest rate pressures, and, if practiced, will do so in the future.

Question 3. **Do you agree with the view expressed by some Reserve bank presidents that over an 8 or 9-year period the rate of inflation is closely tied to money supply growth?**

Reply Received From Dr. Burns to Question 3 Submitted by Mrs. Sullivan

Most economists would agree that over long time periods changes in the money supply and changes in prices are related to one another. There is disagreement, however, on the length of the time period over which this relationship holds, and on how close a relation exists between money and prices. Professor Friedman, commenting on the relationship between money growth and prices in a recent letter to Senator Proxmire, noted that "this is an average relationship, not a precise relationship that can be expected to hold in exactly the same way in every month or year or even decade." The imprecision of this relationship is one reason why monetary policy does not seek to achieve a fixed growth rate in the money stock.

The Chairman. Mr. Johnson?

Mr. Johnson. Thank you, Dr. Burns.

As I have said, it is very refreshing to have you here today, and your statement certainly is a powerful statement. You have made some very strong statements, such as, in commenting on the fact that you helped save a large bank recently, that:

"In the future, as in the past, we will surely not stand aloof and permit a crisis to develop out of emotion to this or that preconceived growth rate of money supply."

What I want to ask is: Over the weekend somebody came to me and said, well, what are you fellows down there in Congress going to do to stop inflation, which is the stock question that we get wherever we go. In your statement I was looking to see what you think Congress can do—first of all, you say we must exercise fiscal restraint; second, not indulge in any tax cut, expand public service employment if we deem it necessary.

But I think the most significant statement that we should reestablish the Cost of Living Council. This spring I went along with those who did not want to reestablish the Cost of Living Council, thinking that this committee would exercise oversight and that we would watch raises in wages and prices and would act quickly. But I can see that we just do not simply seem to be equipped to do it.

You feel that we should reestablish the Cost of Living Council, and I notice what you have said does not give them any particular power, but you suggest to give them broad investigatory powers and that of making recommendations, and then making their findings public, which is a powerful weapon. Is that about what you have in mind?

Dr. Burns. That is correct. The only thing that I would add is that I would also reestablish the Construction Industry Stabilization Committee, which was a powerful force in keeping the rate of increase in construction wages within moderate bounds. You may recall that in 1969 and 1970 construction wages began skyrocketing—increases of 10, 15, 20, and 25 percent became rather commonplace, and these increases

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in the construction industry soon spread to manufacturing industries. We are in danger at the present time of going through, once again, that kind of experience. Therefore, reestablishment of the Construction Industry Stabilization Committee would, I think, be a salutary step.

Mr. JOHNSON. It is generally felt that one of the important reasons for the high rate of inflation in the United States is existence of even higher rates of inflation in most of the other countries in the world, and that is the reason we had so many foreign governments fall in the last 6 months. I notice their inflation rate was anywhere from 12 to 24 percent.

Can we realistically expect to retard our inflation rate at home when the rest of the world is experiencing rapid price increases?

Dr. BURNS. I would answer that question in the affirmative. For one thing, our example would be followed in very large part by the rest of the world. The world looks to us for leadership. Once we begin bringing our rate of inflation down through a policy of monetary and fiscal prudence, other countries will follow, I think, quite promptly.

Second, we must also bear in mind that foreign trade is a rather small factor in our economy. Though inflationary forces may come from the outside, they will ordinarily be a small factor in our total economic picture.

Mr. JOHNSON. What do you think of the statement by one of the presidents of your banks where he, in answer to another question, said, well, we, the Fed, are not the ones that are raising interest rates.

Do you have a comment on that statement?

Dr. BURNS. Well, I think that is basically true. Interest rates are established in our highly competitive money and capital markets. The Federal Reserve has not been starving this economy for money and credit. If anything, the rate of growth of money and credit has been a little too rapid. What has happened is that the demand has grown much more rapidly than the supply, and therefore, interest rates have shot up.

Mr. JOHNSON. Thank you. My time has expired.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

I will yield briefly to Mr. St Germain, who must be elsewhere in a moment.

Mr. ST GERMAIN. I thank the gentleman for yielding.

Chairman Burns, what would the attitude of the Federal Reserve Board be toward regulation of commercial paper, traditional commercial paper as defined in section 3(a)(3) of the Securities Act of 1933, under the Senate bill and under the proposed legislation in the House?

Dr. BURNS. Regulation of commercial paper?

Mr. ST GERMAIN. What is your attitude toward the regulation of commercial paper, as opposed to the regulation of notes like the Citicorp notes?

Dr. BURNS. The Board has not taken any position on the regulation of the commercial paper market as a whole. The Board has taken a certain position and has communicated with your chairman and Mr. Barrett on regulation of issues such as those by Citicorp and now proposed by Chase Manhattan Bank.

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Mr. ST GERMAIN. If you would, for the record—I do not want to impinge any further on Mr. Reuss' time—would you tell us what your attitude would be if the Senate resolution is adopted or if the legislation before the House committee is adopted?

Thank you.

[In response to the request of Mr. St Germain, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

The Board understands that the principal purpose of the legislation under consideration is to authorize the Board to regulate bank holding company note issues which are clearly directed to the individual saver-investor. Commercial paper has, however, historically only been sold in large denominations to sophisticated institutional investors. The legislative history of the 1969 amendment to section 19 makes clear that the Board was to have the authority to classify obligations of a bank holding company as deposits if the proceeds of the obligations were channeled by the parent holding company to a subsidiary bank. To the extent that proceeds from the sale of commercial paper by bank holding companies are so used, they are presently subject to reserve requirements applicable to member banks. The Board does not, however, understand the present amendment as being directed toward commercial paper issues and would not view its enactment as conferring any additional authority to regulate commercial paper issues by bank holding companies.

Mr. REUSS. Chairman Burns, a couple of months ago, before our International Finance Subcommittee, you educated me to good effect on budgetary matters. You pointed out that over the last 5 years the regular budget deficits have come to $68 billion, and now I quote you:

Troublesome enough, but when one takes into account outlays of Federal agencies not included in the budget, such as the Export-Import Bank, the total deficit for those 5 years comes to a staggering $109 billion.

I took in good heart your observation, and I am pleased to report that though Congress, as you know, for some reason back in 1971 took the Eximbank out of the budget where it had always been, the other day the committee, in marking up the bill, specifically provided that the Export-Import Bank should be back in the budget.

I think this is a good provision because, for example, in fiscal 1973 Exim disbursed $1.9 billion, but only got back in interest and principal $1.3 billion. So there was $600 million that really was a stimulus to the economy.

Do you share my feeling that we are making some progress in putting that back into the budget just like any other expenditure?

Dr. BURNS. I have testified on this question previously. I was opposed to taking the Export-Import Bank out of the Federal budget, and my view philosophically on that question has not changed.

The only hesitation that I would have at the present time is this: According to my understanding, Congress must act quickly on the Export-Import Bank legislation. I think action must be taken this month. If action is not taken, the Export-Import Bank would have to shut down. Whether you can carry through this reform, which I endorse, in such a short time, I would not know. But sooner or later, it ought to be done.

Mr. REUSS. I think we can provide it by supplemental appropriation funds to keep the Bank operating if it needs to be done.

Let me now turn to the very interesting discussion you had with Mr. Widnall and Mrs. Sullivan about credit allocation. I thank you for

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your letter, which has not reached me yet, but I certainly will share it with all my colleagues here. [See page 271.] You point out—and I think you are right—that the Fed does not feel up to being told that it must make these great social priority decisions.

I have, in the legislation I have submitted, tried to delineate what they ought to be. As you know, I have specifically said productive capital investment, low- and moderate-income housing, small business, and State and local governments should be preferred objects of credit allocation, which means that all the other things, like this 33-percent increase in inventory loans to business, would have less credit. The interest rate on these business loans would go up and that would serve an allocating function. I am pleased at your answer because it indicates to me that there is an area for discussion here, and we do intend to go into it at greater length.

I like too, and agree with, your urging on page 20 of your paper, where you say:

> I would urge the Congress to reestablish the Cost of Living Council and to empower it as the need arises to appoint a review board that could delay wage and price increases, monitor results, and so forth.

I like that recommendation. I would be disposed to take steps to do something about it tomorrow were it not for the fact that the President, last Thursday, came down very strongly against what he called "the discredited patent medicine of wage and price controls", which turns back or delays wage or price increases. A price-review board is, of course, a control. I think we need it.

I just want to share with you the fact that it is not easy for Congress to respond if it feels that at the end of the road what we do will not be welcome.

Dr. BURNS. I am not at all sure that my suggestion is inconsistent with the President's statement. Perhaps it is. I am not sure of that, though.

Mr. REUSS. Well, we will have to find out. If it is not inconsistent, let us get on with carrying out these things.

Thank you, Mr. Chairman.

[Mr. Reuss submitted the following letters for inclusion in the record from Chairman Burns and Governor Andrew F. Brimmer of the Federal Reserve Board. The letters comment on H.R. 15709, legislation which would amend the Federal Reserve Act to permit the Federal Reserve Board to allocate credit so as to serve national priority needs:]

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CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 29, 1974

The Honorable Henry S. Reuss
House of Representatives
Washington, D. C. 20515

Dear Mr. Reuss:

The Board welcomes the opportunity to comment on H. R. 15709, a bill which would amend the Federal Reserve Act to permit the Federal Reserve Board to allocate credit so as to serve national priority needs.

We recognize that monetary policy can have a differential impact on particular types of credit flows and, accordingly, that there is a continuing need to explore ways to minimize unwanted selective effects of general monetary restraint. The Board believes, however, that it would be inappropriate to grant the central bank discretionary power to allocate credit according to its judgment of national priority needs. The determination of national priority needs--that is, whether more or less credit should flow to housing, small business, agriculture, and so on--is highly important in a democracy, but it is unwise for a central bank to become involved in such questions. This responsibility may conflict with the critically important responsibility of providing the money and credit needed to promote economic growth with a minimum of inflation. We believe that the discretion of the central bank should be confined, in the main, to such matters of general monetary policy.

H. R. 15709, which would allow the Board to impose supplemental reserves and credits on member bank assets, would pose serious problems for monetary policy. These problems are analyzed in detail in several papers by the Board's staff in our publication Federal Reserve Staff Study: Ways to Moderate Fluctuations in Housing Construction, a copy of which we have enclosed for your convenience. A particularly troublesome problem would be that the imposition of reserve requirements and credits such as you have proposed would reduce the precision of Federal Reserve control over the stock of money and bank credit, since shifts in the level of required reserves would result from changes in the composition of bank asset portfolios.

Furthermore, the restructuring of member bank portfolios induced by these differential requirements would probably have only minimal effects on the flow of funds among the various sectors of the economy. To the extent that member banks sought more of any asset

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that qualified for a reserve credit, the yield on that asset would tend to decline and other lenders would tend to withdraw from that market. For those assets on which supplemental reserve requirements were applied, the costs of funds to borrowers at member banks would rise--and these borrowers would try to satisfy their credit needs from other sources. Thus, shifts in bank credit demands and supplies would tend to offset the effects that supplemental reserves and credits would have in changing member bank asset preferences.

Supplemental reserve requirements and credits on assets would also cause serious administrative problems for the Federal Reserve System. Member banks would have to devote large amounts of additional resources in order to supply detailed asset data. If reserve requirements on assets were to be calculated on a comparable basis with those on liabilities, such data would be needed on a daily basis. If the reserve credit or supplement were to apply over the entire life of an asset, as might be necessary, records would have to be kept for each and every asset on a bank's books over the life of those assets. There would also be enormous problems encountered in translating phrases such as "useful capital investment" into defensible operational categories of bank loans.

Finally, since the added costs implied by the reserve requirements on various assets and the need for additional detailed data would apply only to member banks, the competitive disadvantage of membership in the Federal Reserve System would be increased, thus aggravating an already serious problem. Even if the bill were extended to all commercial banks, these banks would be placed at a competitive disadvantage vis-a-vis other financial institutions. To avoid such effects, nonmember banks and nonbank institutions would need to be subjected to comparable incentives and disincentives.

In light of these considerations, the Board opposes the enactment of H. R. 15709. However, we recognize that our financial markets may not provide adequate supplies of credit for high priority uses, as judged by Congress. There are a number of Federal agencies that already exist for this purpose whose activities have proven constructive. For example, agencies such as the Federal Home Loan Bank System, FNMA, and GNMA have provided massive assistance to the housing industry in times of need. Further consideration should be given to encouraging additional lending to the mortgage market from private sources through a tax credit for interest income on residential mortgages. There are other Federal credit agencies that furnish credit to farmers and to small businesses, and still others

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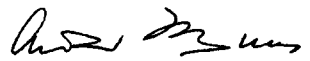
that make loans to students. These agencies have performed a vital service in rechanneling credit flows to high priority uses.

If the Congress should conclude that certain national priority needs deserve more ready access to sources of credit than now exist, we believe that the most direct, and probably also the best, means of accomplishing this objective would be to expand the scope of operations of existing Federal credit agencies in those areas, and to create new entities where they are needed. In the special area of housing and mortgage credit, the Board would suggest consideration of the several recommendations it made in its report to Congress in March 1972.

I hope that these comments, which represent the thinking of the Board, will be helpful to you and the House Committee on Banking and Currency. Governor Brimmer, however, has arrived at different conclusions, and I have suggested that he write you directly.

Sincerely yours,



Arthur F. Burns

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

ANDREW F. BRIMMER
MEMBER OF THE BOARD

August 5, 1974

The Honorable Henry S. Reuss
House of Representatives
Washington, D. C. 20515

Dear Congressman Reuss:

I am responding to your letter of July 10, 1974. You asked me (along with other Board Members) to comment on the legislation which you have introduced designed to empower the Federal Reserve Board to influence explicitly the sectoral distribution of bank credit. In a letter of July 29, 1974, Chairman Burns responded on behalf of the other Board Members. It was indicated that I would respond separately since I did not share the position adopted by the majority of the Board.

First of all, I wish to applaud your effort to provide the Federal Reserve with additional instruments which would enable the Board to cope more effectively with the distortion in the sectoral distribution of bank credit which typically occurs during periods of monetary restraint. I have also been troubled by the same range of difficulties which have concerned you. In fact, as long ago as April, 1970, I suggested that the Board be given authority to establish supplemental reserve requirements on bank assets. Such supplemental reserves would have been set on a differential basis -- thus allowing the Board to encourage banks to channel funds into areas of high national priority and to discourage bank credit lending in areas of lesser importance. In the Spring of 1971, the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs of the U. S. Senate held hearings on a bill containing many of the features of the proposal which I advanced. At that time, the majority of the Board also objected to being granted such authority. In appearing before the Subcommittee, I favored the idea; I still favor a similar attack on the problem.

Your proposed legislation is superior to the earlier approach because it would provide for the establishment of a system of both supplementary reserves and credits. This provision would endow the Board with a great deal of flexibility, and it would also deal with some reservations raised with respect to the earlier proposal.

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The Honorable Henry S. Reuss
Page two
August 5, 1974

The general nature of the problem on which you focus is widely understood. As you know, in a number of papers, I have documented the adverse effects of monetary restraint on sectoral credit flows. One of these was presented at the Annual Meeting of the American Finance Association in December, 1972. Another was presented at the American Economic Association Annual Meeting last December. I have enclosed copies of these papers for your information.

In essence, during a period of substantial monetary restraint, the resulting higher costs and lesser availability of bank credit strike different sectors of the economy most unevenly. In general, banks show a strong preference for lending to long-standing business customers (particularly large corporations) while other potential borrowers receive a reduced share of the available funds. At the same time, there is typically a sharp shift in the flow of funds away from housing, State and local governments, small business, finance companies, and farmers. In contrast, business borrowers are affected to a much lesser extent -- although the cost of funds to them does rise substantially.

Operating under your proposal, the Federal Reserve could provide a genuine incentive for banks to concentrate on socially desirable lending. It is true that, within the framework established by the bill, the Board would have a great deal of discretion to vary supplemental reserve requirements. However, no central bank credit would flow into particular sectors. Instead, by varying the structure of supplemental reserves or credits, the Board could induce banks to respond more explicitly to the high priority financing needs of the economy.

Over the last four years, during which I have been calling attention to the need for authority similar to that which you propose to give the Federal Reserve, I have encountered a number of reservations. These have been raised within the Federal Reserve System as well as by observers on the outside. Some of these were expressed by the majority of the Board in Chairman Burns' letter of July 29. I see no need to respond in detail to those reservations at this time. I would simply say that they do raise a number of issues on which you and your Committee ought to focus. For my part, while I recognize the basis of the reservations, I personally think that the benefits which would accrue from implementing the proposal outweigh the types of costs which others have identified. In a paper I gave in April, 1970, I did address myself to some of the (similar) objections which had been

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expressed at that time. Many of these reservations involve mainly technical issues. Consequently, the application of a reasonable amount of first-rate staff talent should result in their resolution. I also enclose a copy of that paper for your information.

In passing, I should note that the use of differential reserve requirements to influence sectoral credit flows is quite common among some foreign central banks. This is especially so among banks in developing countries. I summarized the experience of some of those foreign institutions in a paper which I delivered in Jamaica in 1970. I have also enclosed a copy of that paper.

Again, I applaud your efforts to have the Federal Reserve given additional instruments to deal more effectively with the adverse shifts in credit flows associated with monetary restraint.

Sincerely yours,

Arthur

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The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Thank you, Mr. Chairman.

Dr. Burns, on page 9 of your statement you point out that if the present inflationary problems are to be solved, and interest rates brought down to reasonable levels, the Federal budget must be brought into better balance. You go on to say this is the most single important step that could be taken to restore the confidence of people in their economic future.

The Secretary of the Treasury, it seems to me he went a step further than you do in urging upon Congress not a better balance, but a totally balanced budget, and if possible, a surplus, and I wondered if you agree with that view.

By saying "better balance" have you stayed away from the possibilities of a balanced budget?

Would you comment on that, please?

Dr. BURNS. I used the phrase "better balance." It is a vague phrase but I am glad to have the opportunity to clarify my thought. I would certainly favor, at a time like this, a budgetary surplus. We should have been running a budgetary surplus. I would favor that. However, I would be quite content if we could have a strict budget balance, neither a surplus nor a deficit; eliminating the deficit that is now projected would, I think, be an enormous step forward.

You refer to Secretary Simon. He is fully qualified to speak for himself and I do not want to speak for him, but I do think, that in the interest of the truth, I should say that the newspaper reports about Secretary Simon's views on the budget have not been correct. To the best of my knowledge—and I am quite sure I am well informed on this—Secretary Simon has not recommended a cut of $20 or $25 billion in this fiscal year's expenditure, nor has he recommended that the cuts be made in welfare programs.

This report, apparently, is based on a very tentative set of questions that Secretary Simon wrote out in a memorandum. That must be the source. But Secretary Simon is back in the country and he will speak for himself.

Mr. STANTON. Thank you.

Another question. On the bottom of page 19 you make your position on the general tax cut very clear and you say that the Congress should resist any temptations to stimulate economic activity by general tax cuts or new public works programs. I wonder, Doctor, on the next page over, you go on to say that this is not to say that we should not perhaps consider an expanded public service employment program. It may also be needed if unemployment rises further.

I would just be interested in your own differentiation between the two thoughts; one between an expanded public service employment program to curb unemployment, and your outright position against new public works programs?

Dr. BURNS. A public works program, if legislated today, would not produce any results for months. Ultimately, expenditures would rise in response to that legislation, and the great bulk of the expenditures under that legislation might well come at a time when the economy is again expanding vigorously. Therefore, the public works programs could add to our difficulties at later times. Public works, by and large, are costly. A long period must elapse before sites could be established,

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before contracts could be written. Then the construction period itself tends to be quite long. So, public works are a very clumsy tool. A public works program would be the right economic tool to stimulate the economy if we faced a long, drawn-out depression. But very few, if any, of us anticipate any such problem in this country. Therefore, I think we ought to get public works programs out of our minds.

By way of contrast, a public service employment program could be expanded rather promptly and cut back rather promptly. Not only would the timing be better, but the cost, in the end, would be very much smaller.

Mr. STANTON. Thank you very much.

The CHAIRMAN. Mr. Stephens.

Mr. STEPHENS. Thank you, Mr. Chairman.

Dr. Burns, in your statement, as has been repeated, you said you will oppose a tax cut; and we were just discussing the effect of an increased public works program.

What would be the effect on an income tax increase on the inflation and the economy?

Dr. BURNS. An income tax increase?

Mr. STEPHENS. Yes.

Dr. BURNS. Well, we have a sluggish economy; the confidence of the people is low. We have an unhappy country. To raise taxes at the present time could cause an increase in unemployment. It could choke off new investment plans by business firms. It could hurt consumer markets which are not flourishing at the present time. I would not do it.

Mr. STEPHENS. Several years ago, when Secretary Fowler was the Secretary of the Treasury, the administration advocated a tax reduction, and Congress went along with the idea of an income tax reduction.

In testifying before our committee in respect to that general program, Secretary Fowler pointed out that every time, historically, in the United States, that we had had a tax reduction, that the revenue of the United States had increased.

Would that have any effect if we should, say, reduce taxes a little further? Do you think that it would be true at this time that such a result might come about?

Dr. BURNS. Such a result might come about several years from now, but I would be greatly concerned about the intermediate period and the short-run effects, because this would mean at once a larger governmental deficit; therefore, more borrowing by the Federal Government; therefore, more pressure upon interest rates. I do not think we ought to take risks of that sort at the present time.

Mr. STEPHENS. You do not think it would result in an increase in the Federal income? Not maybe for the immediate tax future——

Dr. BURNS. It might if, let us say, we had a cut in taxes and if that cut in taxes were accompanied by a cut in expenditures. The effect might then be salutary immediately, but that is most unlikely to happen. I do think that our Federal deficits have been a major cause of the inflation that we have had, and it is high time that we got out of

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the habit. A tax cut at the present time would simply perpetuate the long series of deficits, so that people in our own country and people abroad, who have now greatly diminished confidence in our ability to manage our finances, would interpret such a tax cut to mean that we are going down the road of inflation at a still faster pace. I would not take that risk.

Mr. STEPHENS. Thank you very much. I yield back the balance of my time.

The CHAIRMAN. All right.

Mr. Blackburn.

Mr. BLACKBURN. Thank you, Mr. Chairman.

Dr. Burns, it is always a pleasure to have you before our committee. I would like to pose two questions to you at this time, not that they be answered, but when you prepare your answers to the total questioning, that you address yourself to these questions.

First of all, with the operation of inflation, combined with the graduated income tax, the result is that an ever greater share of GNP is going to be funneled through government.

I would like for you, in your prepared answers, to give me some suggestions as to how the Congress might deal with this problem—particularly those of us who feel that government should not dominate our whole economic structure. With the combination of these two factors as they now operate, we are heading in the direction toward more and more Government control of the economy.

Second, I would like for you to give us what you would consider to be a good definition of a balanced budget.

It seems to me that the unified budget as we now have it is not really a good reflection of the relationship between gross revenues and the cost of operation of the Government, when we take in trust accounts and income and then we do not have all the outlays. In fact, in my opinion, we should distinguish between expenditures for capital improvements and amortize them over a period of years, and the cost of operation of government, such as salaries and so forth.

[In response to the request of Mr. Blackburn, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

Answer to question 1. Inflation, in combination with the progressive income tax, causes an upward drift in income tax rates that increases the share of income going to government. It has been estimated that for every one per cent increase in taxable individual income, Federal income tax revenues increase by approximately 1.3 per cent. This characteristic of the income tax does have some desirable aspects because it reduces purchasing power in the hands of the public during periods of excess demand inflation. In fact, this "automatic stabilizing" property of the income tax has generally been viewed by economists as highly desirable. On the negative side, however, the increase in prices and consequent increase in real tax burdens tends to be permanent and, thus, can dull incentives to work and to invest, as well as cause individual hardships. In addition, the progressive income tax may encourage profligacy in government spending if tax rates are not reduced periodically. When inflation continues for a number of years, these defects in the progressive income tax can become quite burdensome.

Answer to question 2. No single budget concept is appropriate for all purposes. For analyzing the effect on the economy, I generally prefer more inclusive budget concepts that incorporate all those government spending programs that have an impact on private economic activity.

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When the unified budget was adopted, the spending of nearly all Federally owned agencies—including the trust funds—was included so that the true scope of the government activities could be seen. Since that time, however, some government-owned agencies, such as the Export-Import Bank and the Postal Service, have been largely excluded from the unified budget. In general, I am opposed to this concept of "off budget" agencies because it may lead to expenditures that are not carefully scrutinized, besides understanding the economic impact of the budget—especially on financial markets.

Also, "government sponsored agencies" are now being excluded from the unified budget because they are privately owned. Nevertheless, it is useful to include their activity in any assessment of the economic impact of the Federal sector because they, too, compete with private borrowers for financial resources, and their activities add to aggregate demand for goods and services.

In recent years, the Federal trust funds have generally experienced substantial surpluses on current account. As a result, the conversion from the old administrative budget that excluded the trust funds to the unified budget that incorporated them has reduced reported budget deficits substantially. While this inclusion of trust funds may be appropriate in assessing overall budget activity, it may have encouraged excessive growth of other outlays that are no longer balanced solely against non-trust funds receipts. A conversion to a capital budget would further reduce reported budget deficits and further understate the impact of the Federal sector of the economy. For this reason I oppose the suggestion that it be adopted as the official budget. In this period of rapid inflation, particularly, it would be unwise to employ an official budget concept that understates the impact of Federal spending on economic activity and prices.

Mr. BLACKBURN. Now, as I recall your testimony, your testimony was that the effective growth of money supply—that is, the narrow definition of money—has increased over the past year at the rate of about 6 percent. The Federal Reserve Board of St. Louis came up with an opinion that it was about 8 percent.

I do not want to get into a quibble about the differences in your respective opinions, but the gross national product for the last 6 months has actually decreased by one-half of 1 percent. So, any increase in money supply over the last 6 months is bound to have an inflationary effect, is it not?

Dr. BURNS. I do not think, as I have tried to indicate in my testimony, that there is a very close linkage in the short run between the rate of growth in the money supply and the rate of inflation.

Mr. BLACKBURN. You feel 6 months is a short term?

Dr. BURNS. Oh, yes.

Even over longer periods of time, the relationship is quite loose. I think that many economists have gotten into the habit of looking at the money supply and ignoring another factor, that certainly in the short run is far more important, and that is the rate of turnover of the existing stock of money. The fluctuations in the rate of turnover of money are simply enormous. I made brief reference to that in my testimony, and I will supply detailed data on that, because this is something that the committee should become thoroughly acquainted with.

We are all paying too much attention to the money supply and too little attention to the willingness of people to use the money that they have, in other words, the rate of turnover of the existing stock of money.

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[The following information subsequently was furnished by Dr. Burns:]

TABLE 1.—DATES WHEN THE GROWTH OF VELOCITY (RATIO OF GNP TO M_1) AT A COMPOUND ANNUAL RATE FELL WITHIN SELECTED RANGES, 1947:1 TO 1974:2

Less than −5 percent	−4.9 to −3 percent	−2.9 to 0 percent	0.1 to 2.9 percent	3 to 5 percent	5.1 to 10 percent		10.1 percent and greater
49:1	49:4	51:4	47:2	47:3	50:2	64:1	47:4
49:2	52:2	52:1	53:2	48:4	51:2	65:1	48:1
53:4	59:3	53:3	54:3	49:3	53:1	66:3	48:2
58:1	60:3	54:1	56:1	51:3	54:4	66:4	48:3
----	70:4	54:2	57:2	52:3	55:1	69:3	50:1
----	71:2	57:4	59:1	56:2	55:2	71:1	50:3
----	----	58:2	60:2	56:3	55:3	71:4	50:4
----	----	60:4	62:4	63:3	55:4	72:1	51:1
----	----	61:1	63:2	63:4	56:4	73:1	52:4
----	----	63:1	64:2	65:2	57:1	73:4	60:1
----	----	64:4	64:3	65:3	57:3		----
----	----	67:1	66:2	65:4	58:3		----
----	----	67:2	67:4	66:1	58:4		----
----	----	67:3	69:1	68:1	59:2		----
----	----	68:3	69:2	68:2	59:4		----
----	----	68:4	69:4	72:4	61:2		----
----	----	70:1	70:3	73:3	61:3		----
----	----	70:2	72:2	----	61:4		----
----	----	71:3	72:3	----	62:1		----
----	----	74:1	73:2	----	62:2		----
----	----	74:2	----	----	62:3		----
*4	*6	*21	*20	*17	*31		*10

*Total number of observations.

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TABLE 2.—DURATION OF VELOCITY (RATIO OF GNP TO M_1) GROWTH RATES, 1947:1 TO 1974:2

Less than −5 percent		−4.9 to −3 percent		−2.9 to 0 percent		0.1 to 2.9 percent		3 to 5 percent		5.1 to 10 percent		10.1 percent and over	
Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)	Beg. qtr.	Duration (qtrs.)
49:1	2	49:4	1	51:4	2	47:2	1	47:3	1	50:2	1	47:4	4
53:4	1	52:2	1	53:3	1	53:2	1	48:4	1	51:2	1	50:1	1
58:1	1	59:3	1	54:1	2	54:3	1	49:3	1	53:1	1	50:3	3
		60:3	1	57:4	1	56:1	1	51:3	1	54:4	5	52:4	1
		70:4	1	58:2	1	57:2	1	52:3	1	56:4	2	60:1	1
		71:2	1	60:4	2	59:1	1	56:2	2	57:3	1		
				63:1	1	60:2	1	63:3	2	58:3	2		
				64:4	1	62:4	1	65:2	4	59:2	1		
				67:1	3	63:2	1	68:1	2	59:4	1		
				68:3	2	64:2	2	72:4	1	61:2	6		
				70:1	2	66:2	1	73:3	1	64:1	1		
				71:3	1	67:4	1			65:1	1		
				74:1	2	69:1	2			66:3	2		
						69:4	1			69:3	1		
						70:3	1			71:1	1		
						72:2	2			71:4	2		
						73:2	1			73:1	1		
										73:4	1		

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TABLE 3.—CYCLICAL PEAKS AND TROUGHS CHOSEN FROM CHART OF PERCENT CHANGE IN VELOCITY (RATIO OF GNP TO M_1) 1947:1 TO 1974:2

Peak		Troughs	
Date	Percent change in velocity, A.R.	Date	Percent change in velocity, A.R.
47:4	16.9	49:1	−5.9
50:3	22.7	52:2	−3.7
52:4	10.2	53:4	−5.7
55:1	9.3	56:1	.4
56:4	6.7	58:1	−5.6
58:3	8.1	59:3	−4.3
60:1	12.6	60:3	−3.5
61:4	6.5	63:1	.5
64:1	5.5	64:4	−1.0
65:1	8.5	67:1	−2.1
69:3	5.6	70:4	−3.8
71:1	8.3	71:2	−3.1
73:1	7.9	74:1	−2.2

NBER PEAKS AND TROUGHS WITH CORRESPONDING PERCENT CHANGES IN VELOCITY (RATIO OF GNP OVER M_1) 1947:1 TO 1974:2

48:4	3.7	49:4	−3.2
53:3	−2.4	54:3	1.0
57:3	5.8	58:2	−1.3
60:2	2.0	61:1	−1.4
69:4	1.0	70:4	−3.8

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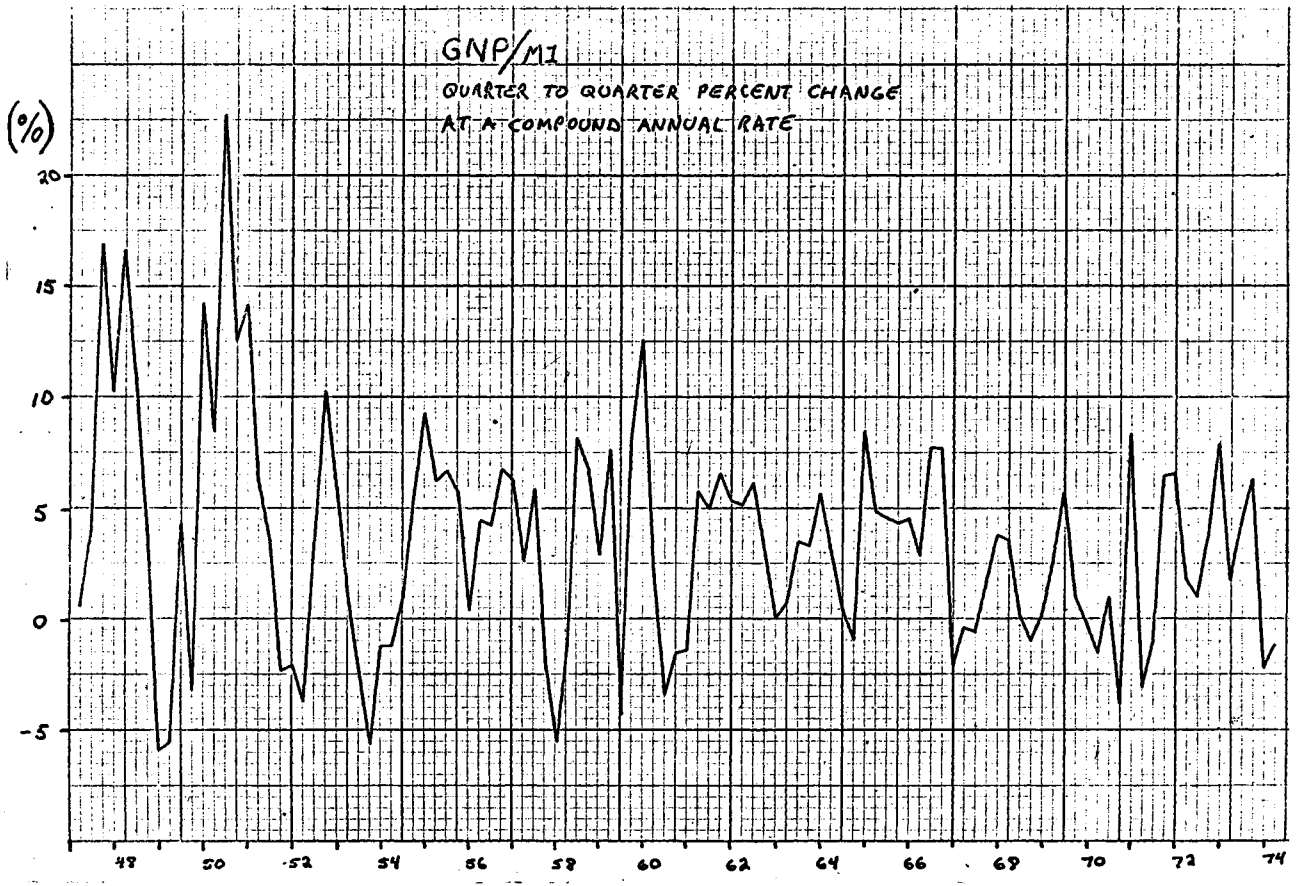

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Mr. BLACKBURN. I certainly agree with you, and I think that we are going to have to help to draw a more sophisticated definition of money supply.

It seems to me that many times we tend to oversimplify things in the Government, and we get so narrowly concerned with symptoms that we fail to really stand back and look at the causes of some of our problems. The President says we have got to encourage people to save more money. I think it is generally agreed that we need more capital to meet our capital needs in this country, but our present policies are discouraging savings. Because of the operation of regulation Q, the small depositor cannot receive enough earnings on his savings to offset the diminution in capital which is occurring by reason of inflation. Then, to add insult to injury, we tax him on the interest that he draws, as though he had earnings.

At the very least, it seems that if the Government allows inflation to occur at a rate of 7 percent, if the depositor gets only 7 percent on his money, we should not tax him on earnings, because he has not earned any money, he is just holding his own.

To me, the real problem is the operation of regulation Q. It seems to me that we ought to allow the small investor to obtain an economic rate on his money. By the operation of regulation Q, we are really discouraging the small depositor from accumulating any savings.

Do you have any comments on that?

Dr. BURNS. Well, I agree with you philosophically, and yet I find myself in the position of supporting regulation Q at a time like this.

Suppose the regulation Q were done away with entirely. I would then have fears about the continued viability of our savings and loan associations and our savings banks if that happened.

Mr. BLACKBURN. Suppose we gave them additional tax incentives?

My time has expired. Would you address yourself to that in your prepared answers? Because I do want to give some special attention to the housing industry.

[In response to the request of Mr. Blackburn, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

As a general principle, tax incentives can serve as a useful instrument of economic policy. They must be used carefully, however, because they tend to erode the nation's tax base and, in the absence of higher tax rates, to reduce the overall level of income tax receipts. In view of our present need for fiscal discipline to control inflation, an erosion of the tax base would be a step in the wrong direction. I would therefore be opposed at this time to the use of tax incentives to increase the yields that savers receive on deposits in banks and thrift institutions.

The best long-run solution to low interest returns on small thrift accounts is to raise Regulation Q ceilings. At the present time, however, thrift institutions could not afford a sharp upward adjustment in their interest costs, though there may be some steps that could usefully be taken even now to improve the ability of depositary institutions to compete for the savings of individuals.

The difficulties presently encountered by the depositary institutions in attracting and holding savings funds arise because of a mismatch of maturities between their assets and their liabilities. Public policy actions along the lines of those proposed in the Board's 1972 recommendations to Congress for moderating short-term fluctuations in the availability of housing finance (a copy of which is attached) would help to improve the ability of thrift institutions to function in a climate of fluctuating interest rates.

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Mr. BLACKBURN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. Thank you, Mr. Chairman. I thought I was going to have to be away.

I have two questions relating to a couple of statements on page 5. My first question focuses on your statement that: "the price of commodities, particularly farm products and raw materials, are established in highly competitive markets."

Dr. BURNS. I am sorry, I did not hear you.

Mr. ST GERMAIN. Page 5, your first sentence, where you refer to the price of commodities, foods.

I would ask you this: You know the producers, the farmers and the breeders, have continually stated to me during this period of increased costs, that they were not, in reality, getting a profit. Now we see a judgment of a substantial amount awarded against the A. & P. chain in California for their practices in this area, particularly with respect to the price of meat.

If this were followed through—and I understand it is going to be followed through—against other chainstores, would this not be an important factor to determine whether or not, in truth, the moneys or profit in the increased prices have filtered through not to the producer, the farmer, but rather to the middleman and the processor?

Dr. BURNS. I see your question. Let me just say two things quickly.

First, farm income rose dramatically last year. It rose far more sharply than the income of any other group of any size in our country.

Second, last year, for a time, retail margins became, under our system of controls, very narrow. Since the lifting of controls, retail margins have widened.

There undoubtedly are pockets of monopoly in our country. Your reference to a discovery of one such pocket is, I think, important. But while I would grant that we may have a problem in that area, I am not kid each other—a very terrible decline? In other words, the contrary, farm incomes have been flourishing. I say that in spite of the fact that in some branches of the farming industry, particularly cattle raising, things have not gone well at all this year.

Mr. ST GERMAIN. Then a few sentences further, you refer to imperfect business competition. I wonder if you would elaborate on that.

Dr. BURNS. You, yourself, have done that very well, Mr. Congressman. You have given a dramatic example—and of course there are numerous examples like that, no doubt. I think we need very strict enforcement, probably much stricter enforcement than we are getting, of our antitrust laws.

Mr. ST GERMAIN. However, the trend has been the other way, in the past 4 or 5 years, as far as the antitrust laws are concerned. The trend has been to sort of lay off.

Dr. BURNS. I think this is something that requires the attention of the Congress. Our antitrust laws must be enforced strictly, and if they are not strict enough, it is the duty of the Congress, I think, to make them stricter.

For example, I myself have long thought that violations of antitrust laws should be punished more heavily than they are, according to statutes at the present time. I would have more severe penalties than are written into the law at present.

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Mr. ST GERMAIN. Thank you. One last question: If there were to be other issues to follow Citicorp, of a similar nature, what, in your opinion, would be the effect on the stock market already in—let us not kid each other—a very terrible decline? In other words, the confidence of the investor has diminished tremendously. They are already having problems with new issues; and the income from investments has declined sharply. Would not the average investor, who has a certain amount of sophistication, prefer to go into an issue like Citicorp, or subsequent issues of that type, rather than to go into the stock market—considering what has been happening in the market over the past 12 or 14 months?

Dr. BURNS. I think that if issues of the Citicorp type were followed up by other bank holding companies, or for that matter, other institutions in the financial area or otherwise, undoubtedly, many small investors would turn to those issues rather than to the stock market. But I do not think that the weakness of the stock market can be dealt with by suppressing issues of the Citicorp type. If we want a stronger stock market, I think we will need, fundamentally, to have improved profits in your corporations. I think we will need to revise our capital gains tax legislation. I think that we will need to bring inflation under control so that interest rates, which have been serving to depress the stock market, may come down.

Mr. ST GERMAIN. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired.

Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Thank you, Dr. Burns, for being with us this morning. Following up on Mr. St Germain's questions regarding the Citicorp question, regardless of whether we go the Patman legislation route, the Barrett substitute route, or the Senate concurrent resolution route, it is not your desire or your intention, is it, to attempt to regulate usual commercial paper issued to finance normal business operations, is it? You are not seeking that authority, are you?

Dr. BURNS. No, we definitely are not.

Mr. BROWN. In other words, you would want that authority restricted basically to Citicorp type issues?

Dr. BURNS. If Congress is to legislate in that area, I think that is what the Congress should seek to accomplish.

Mr. BROWN. Even if it were left open, so that conceivably the language would permit you to regulate normal commercial paper, you would not intend to exercise that authority, is that right?

Dr. BURNS. We certainly would have no intention of doing that at the present time, no.

Mr. BROWN. Under what conditions do you see that you might want to?

Dr. BURNS. I do not know that I can visualize them; I am just being cautious in answering the question.

Mr. BROWN. Dr. Burns, I cannot remember the data, but there was an article by Milton Friedman, I believe, in one of the weekly magazines, in which he was somewhat critical of the way in which the Fed has exercised its lender of last resort authority. I believe it was his position that as such a lender, banks should have a basic right of access to you, rather than it being a privilege granted at the discre-

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tion of the Fed; and that it should not be, the borrowing should not be, at a discounted rate, but should be at market rates.

Would you care to comment on that?

Dr. BURNS. If I may, let me try and state Professor Friedman's position as I understand it—I think I do understand it.

Professor Friedman would do away with the discount window at the Federal Reserve banks entirely. Second, he believes that if, contrary to his own judgment, the discount window was kept open, we, at the Federal Reserve, should place the discount rate at a level that is close to the market level of interest rates. Since, in recent months, the discount rates has been well below short-term market interest rates generally, Professor Friedman argues that we, at the Federal Reserve, have been subsidizing those who have come to the discount window to borrow. That is his position, I believe.

Mr. BROWN. That is his position. What is your position with respect to his position?

Dr. BURNS. On the matter of subsidy, let me say only that we charge our borrowing banks, 8 or 8.5 percent—depending upon the kind of paper they submit—at the discount window. If, instead of lending on that paper, we invested in Treasury bills, the rate of return to the Federal Reserve would now be lower. So that in no sense can one argue that the taxpayer, through the Federal Reserve, has been subsidizing banks that borrow at the discount window. There has been no subsidy in that sense.

It has certainly been true that the discount rate has been below the market rate; it has been below the market rate by a wider margin than any that I can recall in our Nation's history. The reason has been that we, of the Federal Reserve, have been reluctant to push up the discount rate, and in the process become an active force in raising interest rates. To us, the rise in interest rates is a side effect, you see. It is something that we do not want to accomplish actively. It is not something that we seek.

Looking back, if you were to ask me, whether it would not have been somewhat better if we had raised the discount rate previously, I would probably answer the question in the affirmative. But at each point, we have been a little reluctant to push up the discount rate and thereby release market forces that may work in the direction of still higher interest rates.

Mr. BROWN. My time has expired, Dr. Burns.

The CHAIRMAN. The committee will stand in recess subject to the call of the Chair.

[Whereupon, at 12 noon, the committee recessed, to reconvene subject to the call of the Chair.]

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FEDERAL RESERVE POLICY, INFLATION, AND HIGH INTEREST RATES

THURSDAY, AUGUST 8, 1974

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman [chairman] presiding.

Present: Representatives Patman, Barrett, Sullivan, Stephens, Minish, Gettys, Koch, Cotter, Fauntroy, Young, Moakley, Stark, Boggs, Widnall, Johnson, Blackburn, Brown, Wylie, Heckler, Crane, Rousselot, Frenzel, Burgener, and Rinaldo.

QUESTIONING OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM—Resumed

The CHAIRMAN. The hearing will come to order.

Dr. Burns, I wrote you a letter last Friday or Saturday about an incident at the Chicago Reserve Bank. We had been advised by you that we could send our investigator to any Reserve bank and that we would be furnished information promptly. We had sent our investigator to Chicago to see all the vouchers and he almost got thrown out. You did not cooperate with us at all, the president of your bank, and we did not get information we desired. Of course, we will pursue now the information that you told us we can get from the gentleman who is your executive director, and if we do not get it, why, of course, we will take it up directly with you.

There is certain information that we want and we do not want to have to bother you with it every time.

Another thing—about the money that was furnished to the Franklin National Bank. How much was that, Dr. Burns, when they were about to go under, when they thought they were, when they had trouble with the solvency of the bank in May, I believe?

Dr. BURNS. I think the first loan was made on May 8. That is my recollection. That amount has changed from day to day, but the trend has been upward, though it has stabilized recently.

The CHAIRMAN. I understood you to say in conversation—if this should not be repeated, of course, you have a right to say so—that you furnished them $1,300 million.

Dr. BURNS. I have at no time disclosed the figure of our actual loan. If this is something that the committee would like to know, I would be pleased to answer that question in executive session.

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The CHAIRMAN. All right, sir. I will get in touch with you then, Dr. Burns.

Of course, that is just a typical question we will ask you. Another question will concern whether, with this bank in very bad condition, what the Federal Reserve did, gave the big CID holders the $100,000 or more notice, and they rushed in and cashed their CD's, and they came out whole on this.

Now then, when you furnished the money, it would appear that that money was really used to "bail out" the big fellows. They got their money.

Dr. BURNS. I think in due course you will want a thorough investigation of what happened in connection with Franklin National Bank.

The CHAIRMAN. We will.

Dr. BURNS. I and others of the Federal Reserve will testify and testify fully. I think that you, Mr. Chairman, and the members of your committee will be pleased with the performance of the Federal Reserve and its handling of this very sad episode.

The CHAIRMAN. I think I wrote you a letter on May 14 and sought information about the holding company and other things in connection with the Franklin National Bank. You wrote me back, I think, and said that you had furnished that. But we have never received that, Dr. Burns. I give that as typical of things that we will have to take up with this gentleman who you tell us will furnish the detailed information. Will he furnish all of the information that you would furnish us?

Dr. BURNS. Will who furnish?

The CHAIRMAN. The man that you said was your executive director for the Federal Reserve.

Dr. BURNS. I cannot say what he will furnish. Certainly, on administrative matters, he will not even come to me. He will furnish that. But if you ask questions of a policy nature, he will come to me.

The CHAIRMAN. This probably would be of a policy nature, and then we would take it up with you. That would be proper for us to do that, I assume.

Dr. BURNS. I cannot think of you, Mr. Chairman, doing anything improper.

The CHAIRMAN. Yes, sir. Now then, last year. You know you have insisted all along that these expenses—you have thousands of associations and chambers of commerce and clubs and tens of thousands of them that you contribute to over the years, and I know that you do that for the purpose of gaining goodwill——

Dr. BURNS. No. I must interrupt that. We do not do that for the purpose of gaining goodwill. The only goodwill that we need is your goodwill and that of your colleagues in the House of Representatives and in the Congress. We serve the public, Mr. Chairman.

The CHAIRMAN. You say you serve the public.

Dr. BURNS. Of course we do. Whom do you think we serve?

The CHAIRMAN. Well, why would you not just depend on us then if you serve the public?

Dr. BURNS. Why do I not just depend on you?

The CHAIRMAN. Why are you appealing to the public through all of these organizations like ladies' clubs and everything else you make

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contributions, and it runs in the millions of dollars. I see no reason for that at all.

Dr. BURNS. Mr. Chairman, if you want to discuss contributions, please let me know and I will come prepared to discuss contributions in detail.

The CHAIRMAN. Well, that is exactly what I want to know.

Dr. BURNS. Most of them, I am sure, are defensible. We have 28,000 employees. There is some carelessness now and then. It is painful to me when I discover it. I work hard at it. But when you want to examine me on questions like that, please let me know and I will come prepared.

The CHAIRMAN. Well, I am asking you now who to deal with when I do not want to bother you with trifling things, although they are important to us. So I will get in touch with this director that you told me to, and if it is a policy matter, of course, I will expect him to say it is a policy matter and if he cannot do it, then I will take it up with you. But we have not had a good line of communication with you, Dr. Burns. It has been kind of irritating to you, I know, for us to take all of these things up with you.

Dr. BURNS. No. I do not find it irritating. I do find that it takes a good deal of my time, but that is my job.

The CHAIRMAN. You know in the debate on the audit bill many Members said, "Now, Dr. Burns, he will furnish any Member of the House any information he may want to know about the Federal Reserve." You have a lot of friends like that. But, of course, I had not had that good luck myself and that is the reason I took note of it.

Dr. BURNS. Mr. Chairman, I wish you would ask me sometime how much time is devoted by my staff in answering your questions. I wish you would ask me that. I will furnish you with the answer promptly.

The CHAIRMAN. Since you brought that up, why would not the man in Chicago let my investigator have information? You told me he would.

Dr. BURNS. Well, I cannot answer that.

The CHAIRMAN. I wrote you a letter about it.

Dr. BURNS. Yes, you did, and I am looking into it. I have had a report from Chicago and I do not take it at face value. I have been told that a young man from your staff appeared and that he used language that could not possibly appear in print. Some ladies on our staff there were embarrassed and shocked.

I take all that with "a grain of salt." Possibly, these ladies needed some enrichment of their vocabulary. I do not know these facts. I will look into them in due course. I hope not to bother you with details like that.

The CHAIRMAN. Well, anyway, those are typical questions that we would ask you and we hope we get adequate consideration in the future, better consideration in the future, than our investigator got at the Chicago bank. We have never had any complaints about him.

Dr. BURNS. Mr. Chairman, if anyone from the Federal Reserve family was ungracious to any member of your staff or any member of your committee, this is something that I deplore and I am very sorry about.

The CHAIRMAN. We are not going to start out investigating these rabbit trails. I would consider that a rabbit trail. We will not investigate it further, but that is the way it was. Getting back to the

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Franklin, this $1.3 billion, you will not say publicly whether that is correct or not. You state that you are going to bail out other banks and that infers to me that you are adopting on your own a sort of an RFC, Reconstruction Finance Corporation, to bail out all the banks that get in trouble. I think personally that you need to have the authority of Congress to do that.

Dr. BURNS. Mr. Chairman, I do not think I have ever said that the Federal Reserve will bail out any and every bank.

The CHAIRMAN. I thought it was in the newspapers, I thought you did. Maybe I am wrong. I would just put these newspaper articles in the record.

This morning there is one, "The Federal Reserve Readies Emergency Loan Plan." Under this plan, you can get part of the money for Franklin National, from the $80 billion that you have in your portfolio in the New York Federal Reserve Bank.

Dr. BURNS. Mr. Chairman, we operate a bank. Every commercial bank, and ours is run on identical principles, has the power to lend money. In the process of lending money, it normally gives a deposit credit to the borrower. That deposit credit is not linked mechanically at all with the particular assets that it happens to have on hand.

The CHAIRMAN. Well, you would have to offset the loans by selling securities to keep from inflating the money supply. I can shorten this, Dr. Burns, by putting these articles in the record, and then you will know that we are going to interrogate you about it in the future. If we do not get the information from the Executive Director whose name you gave me—and I will ask the other members to use that name when they want information from the Federal Reserve, we will get in touch with you.

I have an article from this morning's edition of the Wall Street Journal, "Bank Dominos." That is the heading. I also have an article, "Arthur Burns: In a Tight Money Squeeze," in this morning's Washington Post. Also, another one in the Washington Post, "Federal Reserve Readies Emergency Loan Plan."

Without objection, I will place those in the record at this point, and you will see them and you will know the information that we will be asking you about in the future when we agree upon some time that is mutually satisfactory.

Mr. JOHNSON. Reserving the right to object, Mr. Chairman, and I will not object. But I personally cannot see any reason for cluttering up the record with a lot of newspaper stories by a number of writers who may or may not know what they are writing about and are just speculating on this, that, or the other thing. All those articles do is tend to inflame the Nation. At a time when we are at a critical economic crisis, I do not think we should be talking about a lot of banks going to fail.

I think we ought to be fortunate and glad that we have got the Federal Reserve System, that we have a Fed Chairman of it who has the courage to step forward when the need arises and do the job that is necessary in order to keep this country on a stable economic basis.

The CHAIRMAN. Without objection, they will be placed in the record.

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[Testimony resumes on p. 301.]

[The letters and articles referred to by Chairman Patman follow:]

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., May 14, 1974.

HON. ARTHUR F. BURNS,
Chairman, Board of Governors,
Federal Reserve Board, Washington, D.C.

DEAR DR. BURNS: As you are aware, I am deeply concerned about the various aspects of the Franklin National Bank case and the role of your agency in regulating this holding company. This bank and its holding company involve some of the basic problems attendant to holding company operations and the entry of foreign investments in the United States banking system.

As you should recall, I expressed my concern over the Franklin National Bank in a letter to you on July 19, 1972—approximately 22 months ago. This was at a time when a huge block of the outstanding common stock had just been acquired by a Liechtenstein-based corporation, Fasco International Holdings. My letter, a copy of which I am attaching, pointed out that this raised serious questions about the application of the Bank Holding Company Act in view of the fact that Fasco International controlled several big U.S. Corporations—corporations clearly outside the scope of permissible non-banking activities for a holding company. My letter asked for specific actions on the part of the Federal Reserve in connection with this Franklin National Bank case and I quote from the July 19, 1972 correspondence:

". . . since the Federal Reserve Board has the authority to administer this Act, it would be appreciated if you would inform me as to whether the Board feels that if present law is adequate, what it intends to do in the situation outlined above, and if the present law is not adequate, what legislative recommendations you would make."

In an answer to this letter dated August 2, 1972, you dodged the issue of "control" of the bank holding company by Fasco but promised an investigation into the matter. At that time, you informed me that the Fasco representatives "have promised to cooperate fully in providing such information as the Board may request."

That, Dr. Burns, was nearly two years ago and my files do not reflect the results of this investigation. Judging from your letter of August, 1972, your agency has apparently had access to all of the necessary data from Fasco and I assume that you have been on top of the situation throughout these many months.

Frankly, I must state that this appears to me to be an unusually long time to complete an investigation and this delay is particularly regrettable in view of the current troubles of Franklin National. While the Federal Reserve has delayed its findings and reports, there have been reports in the news media of attempts by Michele Sindona to restructure his control of Fasco International and other business interests. In fact, the Wall Street Journal of December 27, 1973 reported that these actions were being taken by Mr. Sindona for the purpose of escaping the strictures of the Bank Holding Company Act. A disinterested observer might conclude that the Federal Reserve was indeed holding up its decisions to allow Mr. Sindona to find the necessary loopholes. Perhaps there are other explanations and if so I hope that you will be kind enough to forward them to me at the earliest possible time.

In fact, Dr. Burns, I would like answers to these specific questions:

1. Why has the Federal Reserve delayed since my inquiry of July, 1972 to this date in making a determination of the application of the Bank Holding Company Act to Fasco and Franklin National?

2. In carrying out its investigation and in reviewing the information which your letter of August, 1972 said was being made available, did your agency discover any problems associated with the management and the operation of Franklin National and the holding company and if so what remedial steps were taken and what other banking agencies were informed?

3. Has the Federal Reserve determined what relationships may exist between Franklin National and any corporation owned and controlled by Fasco Inter-

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national and/or Mr. Sindona? In particular, are there any loans outstanding from Franklin International to Oxford Electric Corporation, Argus, Inc., Interphoto Corporation, the Canadian Seaway Hotel chain, or any other enterprises owned or controlled by Fasco International or Mr. Sindona? If the Federal Reserve has obtained such information I would appreciate it being forwarded to me.

As I stated earlier, this case covers two areas—holding companies and foreign investments in the United States banking system—which have concerned this Committee for some time. I have written you on numerous occasions about problems in both of these areas as your files reflect. In fact, in this particular case I wrote you in July of 1972 asking that the Bank Holding Company Act be applied as fully as possible to control the situation and I further asked you if there were additional legislative remedies which you might require in this case.

In conclusion, this appears to be another classic case of foot-dragging by a bank regulatory agency. While the record is certainly not complete at this point, it is a strong possibility that prompt and vigorous action by the Federal Reserve in applying the bank holding company regulations might have diminished some of the banking problems which have emerged.

Sincerely,

WRIGHT PATMAN, *Chairman.*

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., June 5, 1974.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Your letter of May 14 raises questions about the Board's responsibilities under the Bank Holding Company Act as they relate to Franklin New York Corporation, the parent of Franklin National Bank, and Fasco International Holding S. A.

Your concern about any undue delay is understandable, but the question to be resolved, namely, whether one company is exercising a controlling influence over the management policies of another organization, is highly complex when, as in this case, there is less than 25 per cent stock ownership. When there is control of less than 25 per cent of any voting shares, the Act provides that control can still exist either (1) when a company controls in any manner the election of a majority of the directors or trustees of the bank or company or (2) when the Board determines, after notice and opportunity for a hearing, that a company, directly or indirectly, exercises a controlling influence over the management or policies of the bank or company. In the latter case, as I indicated in my earlier letter, "simple, objective criteria for measuring the exercise of control" are lacking. Since actions suggesting control must be evidenced, considerable time often elapses before sufficient information is accumulated to allow the Board to determine whether commencement of a proceeding to determine control is justified.

The facts are that Fasco International Holding acquired about 21 per cent of the shares of Franklin New York Corporation in July 1972. In order to determine whether control existed despite the fact that less than 25 per cent of the voting shares were acquired, the Federal Reserve's staff then initiated a review of the actions of the corporations and their representatives which might indicate that control was being exercised over Franklin New York Corporation and, if so, whether such control was being exercised by a corporation and thus fell within the purview of the Act. While this assessment was in process, Franklin New York Corporation filed an application in August 1973 to acquire Talcott National Corporation from Fasco. Since this proposal raised new questions, and promised to yield new information, concerning the relationship between Franklin New York Corporation and Fasco, it was most appropriate for the Board to consider the control question at the same time it considered the Franklin application.

In connection with an amendment to the Franklin-Talcott proposal, Fasco applied in March 1974 to become a bank holding company. This filing by Fasco provided further information and gave the Board an opportunity to rule on the appropriateness of Fasco's becoming a bank holding company. It also obviated the need for separate consideration of the control question while the Franklin-Talcott application was pending. On May 1, 1974, the Board denied the latter application, thereby making Fasco's companion application moot.

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With the Franklin-Talcott application out of the way, the Board is continuing to devote attention to the question of the possible control relationship between Franklin and Fasco in the light of more recent events. In this connection, we are prepared to initiate a proceeding to determine if control is being exercised over Franklin by any corporation if such action appears warranted.

Thus throughout the period since July 1972, the Federal Reserve has explored the complex questions of control, and has carefully evaluated the voluminous material associated with the Franklin-Talcott and Fasco applications. The matter has been, and remaining matters will continue to be, under active consideration.

With respect to your second question, the Board's information concerning the financial problems of Franklin National Bank and its parent was derived from the Board's processing of the Franklin-Talcott application, not from the control investigation. Questions concerning control relate primarily to structural characteristics bearing on identification of the group that is making management decisions. They do not relate directly to the day-to-day financial condition of the organizations in question.

The information which the Board acquired in processing the Franklin-Talcott application came from the application itself, discussions with senior officers of the bank and holding company, together with examination reports of the Comptroller of the Currency, and related primarily to the financial condition of Franklin National Bank. Our overall findings led the Board to take specific action designed to strengthen the bank. On May 1, 1974, the Board denied the Franklin-Talcott application. The Board's denial order conveyed the view that the management of Franklin New York Corporation should devote its attention to its subsidiary bank and that "the acquisition of Talcott would be a complicating and diversionary factor."

With respect to your third question, information relative to outstanding loans by Franklin National Bank to enterprises owned or controlled by Fasco, or by any individual, comes from the Comptroller of the Currency, who, as primary supervisor, examines the bank directly. Information such as you seek, as well as information concerning the financial condition of the bank, should properly be sought from the Comptroller's office.

Sincerely yours,

ARTHUR F. BURNS.

JULY 19, 1972.

Hon. ARTHUR F. BURNS,
Chairman, Federal Reserve Board,
Federal Reserve System, Washington, D.C.

DEAR DR. BURNS: A recent report in the newspaper indicates that one of the largest bank holding companies in the State of New York, the Franklin New York Corporation, has had one million of its common shares, representing around 20 percent of its outstanding common stock, acquired by a Liechtenstein-based corporation, Fasco International Holdings. It has also been reported that Fasco International controls several U.S. corporations, including Oxford Electric Corp., Argus, Inc., Interphoto Corp. and the Canadian Seaway Hotel chain.

It seems to me that this acquisition raises some very serious questions related to the application of the Bank Holding Company Act as amended in 1970. If permitted to go unchallenged, it seems to me that control of American banks through a foreign holding company which also controls substantial nonbanking interests in the United States would tend to defeat the clear purpose of the holding company act to separate banking from nonbanking activities.

My feeling is that the 1970 amendments would enable the Federal Reserve to deal with the serious problems raised by such an acquisition as outlined above. However, since the Federal Reserve Board has the authority to administer this Act, it would be appreciated if you would inform me as to whether the Board feels that if present law is adequate, what it intends to do in the situation outlined above, and if the present law is not adequate, what legislative recommendations you would make.

Your attention to this matter is appreciated.

Sincerely yours,

WRIGHT PATMAN, *Chairman.*

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AUGUST 2, 1972.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing in reply to your letter of July 19 concerning the newspaper report of the acquisition of 21.6 per cent of the outstanding common shares and 18.37 per cent of the outstanding voting shares of a large New York bank holding company, Franklin New York Corp., by a foreign company, Fasco International Holding, S.A. ("Fasco").

You have questioned whether Fasco has become a bank holding company through the reported acquisition and, if so, whether it is engaged in nonbanking activities in the United States that are not permissible to bank holding companies under section 4 of the Bank Holding Company Act.

It appears that Fasco has certain affiliates in the United States that engage in the manufacture or sale of goods, an activity that is not permissible for bank holding companies. Under the Board's regulations, subsidiaries of foreign bank holding companies enjoy a limited exemption to engage in activities in the United States such as may be "incidental to their international or foreign business", but these "incidental" activities may not include the sale of goods or commodities.

It is not clear, however, whether Fasco has become a bank holding company through the reported acquisition. Under section 2(a)(1) of the Bank Holding Company Act, a company is a bank holding company if:

(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of a bank or a bank holding company;

(B) the company controls in any manner the election of a majority of the directors or trustees of a bank or a bank holding company; or

(C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of a bank or bank holding company.

From the information presently available to the Board, it appears that Fasco is a personal holding company of an Italian financier, Mr. Michele Sindona, and that its acquisition of shares of Franklin New York Corp. was undertaken on behalf of Mr. Sindona alone. The Board has no information suggesting that Fasco directly or indirectly owns, controls or has power to vote more than 25 per cent of any class of voting securities of Franklin New York Corp. or Franklin National Bank or controls in any manner the election of a majority of the directors of such bank holding company or bank. The question whether Fasco has control over Franklin New York Corp. or Franklin National Bank depends upon the Board's determination as to whether Fasco directly or indirectly exercises a controlling influence over the management or policies of such bank holding company or bank.

The fact that Fasco has acquired what may be the largest single block of voting shares of Franklin New York Corp. at a price substantially above market value is not sufficient by itself to show that Fasco exercises a controlling influence over the management or policies of the company or its subsidiary bank. However, the Board intends to obtain the information needed to exercise an informed judgment on the question of control. The rebuttable presumptions of control established in section 225.2(b) of the Board's Regulation Y and the guidelines issued to the Federal Reserve Banks at the time when such regulations were promulgated (36 Federal Register 18945, September 24, 1971) indicate the line of inquiry that the Board may be expected to take in investigating this matter.

The Board has already been in touch with representatives of Fasco through the Federal Reserve Bank of New York. The Fasco representatives have promised to cooperate fully in providing such information as the Board may request.

The Board's task of making individual factual findings on the issue whether a company is exercising a controlling influence over the management or policies of another company or bank is difficult in the absence of simple objective criteria for measuring the exercise of control. Nevertheless, until the Board has had more experience in administering the existing standard under the Bank Holding Company Act Amendments of 1970, it would seem premature to draw any conclusion regarding the adequacy of the present law in this respect.

Sincerely yours,

ARTHUR F. BURNS.

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U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., August 1, 1974.

HON. ARTHUR F. BURNS,
Chairman, Board of Governors, Federal Reserve System,
Federal Reserve Building, Washington, D.C.

DEAR MR. CHAIRMAN: On numerous occasions you and members of the Federal Reserve Board have stated that the Federal Reserve System always makes available to Congress complete information about the expenditures of the Federal Reserve Banks and their branches.

For instance, when Governor Mitchell appeared before the Banking and Currency Committee in October of last year in connection with the Federal Reserve Audit bill he stated, "the Board reports promptly and fully to special congressional inquiries, particularly those inquiries from congressional committees involving the systems, policies, operations and expenditures." Governor Mitchell further stated, "the Board reports directly to Congress and always stands ready to provide any information Congress seeks about expenditures of the System."

Such statements are indeed questionable in light of the Banking and Currency Committee's attempt to determine the types of expenditures which are involved in the various Federal Reserve Clubs throughout the System.

Just this week a Committee attempt to determine these expenditures was completely rebuffed by the Chicago Federal Reserve Bank in a manner which raises grave questions about the creditability of the Federal Reserve System.

On July 30 the Committee's Chief Investigator, Mr. Curtis Prins, at my direction visited the Federal Reserve Bank of Chicago to review various expenditures of that bank and its branches. He asked the bank's chief auditor for copies of vouchers of expenditures made by the Federal Reserve Club of the Chicago bank. He was told that such information would be provided the following morning.

The following morning, however, he was told by the bank's chief auditor that "upon instructions from the Federal Reserve Board I cannot let you see the expenditures." Mr. Prins then asked the auditor, Mr. Fred Dons, to provide him with a statement in writing stating that the bank would not provide the Committee with the information. Mr. Dons first agreed to sign such a statement, but when Mr. Prins presented him with a statement for signature, Mr. Dons stated he would not sign any statement until he had conferred with the bank's counsel.

Later at a meeting between Mr. Dons, Mr. Prins and the bank's counsel, Mr. William Gram, Mr. Prins again tried to obtain a written statement from either Mr. Gram or Mr. Dons stating that they would not make the information available.

The fact that Mr. Dons stated that he was withholding the information upon advice of the Federal Reserve Board is shocking since you have many times stated that the 12 Federal Reserve Banks are set up to operate autonomously but apparently that is not the case. In fact, it appears the Board is keeping a rather tight reign on the operations of the banks.

The withholding of information about Federal Reserve Clubs and their expenditures is extremely significant in light of Committee disclosures about how the system spends taxpayers' money. In recent years the Committee has found that Federal Reserve banks have spent thousands of dollars for art teachers, music teachers, bingo parties, card parties, theater parties, cocktail parties, picnics and other social activities for Federal Reserve employees. There has never been a clear justification of any of these expenses and it now appears that the Federal Reserve banks are moving to hide these expenditures rather than curtail such misuse of taxpayers' funds.

In 1972 only six Federal Reserve banks and fifteen branches provided funds for Federal Reserve Clubs. However, in 1973 ten of the twelve Federal Reserve banks had established Federal Reserve Club payments and twenty of twenty-four branches had also initiated club payments. In 1972 total payments to the Federal Reserve Clubs amounted to $85,032. In 1973 that figure had jumped to $159,579. It is interesting to note that one of the banks that began a Federal Reserve Club in 1973 was the Federal Reserve Bank of Chicago.

Since the publicly disclosed expenditures of the Federal Reserve System included thousands of dollars of highly questionable items, I can only wonder what type of expenditures are included in the Federal Reserve Club area.

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And the Federal Reserve Board's Watergate type tactic of "stonewalling" the Committee's attempt to audit these expenditures serves only to increase my belief that the Federal Reserve Club expenditures must indeed be of the most questionable nature.

Let me also point out another aspect of the Chicago Federal Reserve Bank's operation that troubles me. During President Mayo's appearance before the Committee I submitted a question to him concerning whether or not the Federal Reserve System was "an agency of the government, and in specific, of the Congress." President Mayo responded that the Federal Reserve was indeed an agency of the government. However, when the Committee's chief investigator questioned the Chicago Federal Reserve Bank's counsel about his refusal to turn over Federal Reserve Club expenditures he wanted to know why an employee of the United States Government would not cooperate with another employee of the United States Government. The bank counsel replied, "I don't work for the U.S. Government, I work for the Federal Reserve Bank of Chicago." This attitude is shocking and causes me to wonder if the bank's counsel is not an employee of the U.S. Government or at least feels he is not then with whom do his loyalties rest. The attitude by the bank's counsel, if shared by even a small segment of the bank's employees, could cause disastrous effects in the Federal Reserve's role in both regulating its member banks and handling monetary policy.

In light of the Board's stated policy of making all Federal Reserve expenditure records open to the Committee, may I request that you immediately make the expenditures of all Federal Reserve Clubs available to the Committee and that the Committee staff be given complete access to these records during their field investigations.

Sincerely,

WRIGHT PATMAN, *Chairman.*

[From the Wall Street Journal, Aug. 8, 1974]

BANK DOMINOS

In May, when the Franklin National Bank was on the verge of collapse, the Federal Reserve rushed into action with a $1.2 billion rescue operation. In June, when the largest private bank in West Germany—Herstatt—was on the verge of collapse, the Bundesbank considered a rescue operation and turned thumbs down.

The difference between the Fed and the Bundesbank, when faced with the same problem, gets down to the question of "confidence." The Fed, and the Bank of England for that matter, belong to the school that believes a bank, at least a big bank, shouldn't be allowed to go under or the public's confidence in banks generally will be undermined. The Bundesbank, on the other hand, believes that the public will have confidence in banks when banking is sound, and that banking diverges from "soundness" when those who run banks know there is a net under them.

Isn't it strange that the Socialists who run the West German economy insist that their banks meet the test of the marketplace, and the free enterprisers at the Fed want their banks, at least the big ones, kept out of harm's way in the market?

The banking community, here and abroad, would now be in a more promising condition if the Fed had followed the lead of those West German Socialists. The Franklin National should have been permitted to sink, victim of its excesses in "unauthorized currency trading." Its loan portfolio would have been peddled and its depositors paid off, and if there were anything left over, the shareholders would have divided that up. While we always dislike seeing shareholders damaged, the market system cannot function without downside risk to discipline managers.

There is a prevailing view that bankruptcy at Franklin National might have started a chain reaction, a falling of dominos, because of a public loss of confidence. Such things have happened in the past, of course, and a central bank should come to the rescue if otherwise sound banks start to fold from mass psychology rather than their own mistakes. But if this danger is overestimated and the panic button pushed at every sneeze, market discipline goes out the window.

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In fact, panic psychology would be likely to develop only if the Fed failed to facilitate liquidation of Franklin National to keep depositors from being squeezed.

The most positive and beneficial economic act taken by any Western government these past six months was the Bundesbank's decision to allow Herstatt to collapse. From that moment, bankers throughout the world became more interested in banking, and cut their cocktail hours accordingly. If it has previously taken a 2nd vice president to approve a $5 million loan, with a bonus triggered by his loan volume, it suddenly required a senior vice president to approve a $1 million loan, with no rewards for new business. Suddenly, nobody on that banking high wire could be quite sure there was a net below, a "lender of last resort."

The Fed fixed that up by taking care of Franklin National. The Bank of England put a net under the London banks. And Treasury Secretary Simon, while in London, heroically announced that the United States would supply liquidity in the event of falling dominos in the Eurodollar market.

The net effect of all these assurances has been unfortunate. On the assumption that central banks will bail out big banks, depositors are pulling out of small banks and regional banks and going with the big fellows. Eurodollar lending to any but the 40 largest banks in the West is almost nonexistent. All the distortions are perverse. A risky bank that is "big" is to be preferred to a sound bank that is small. The small, sound bank thus loses out in the competition for funds and, at best, becomes smaller. The big bank gets funds easier and becomes riskier.

What can be done to correct this condition? There are only two alternatives. The Bundesbank can announce, along with the Bank of England and the Fed, that all banks, big and small, will be rescued when parlous conditions occur. Of course, this would invite longer cocktail hours, decision-making by the 3rd vice presidents, and in no time at all a string of Franklin Nationals.

The other alternative is for the other central banks to join the Bundesbank in pulling the net from under all the banks, big and small, inviting lenders to search out not big banks, but sound ones. If there is going to be a shake-out in the banking industry, it would grieve us enormously if it took place after governments ensured that the first to go would be small in size and not necessarily small in quality. A shake-out should start with the imprudent and ill-managed, whether big or small.

[From the Washington Post, Aug. 8, 1974]

Federal Reserve Readies Emergency Loan Plan

(By Joseph R. Slevin)

The Federal Reserve System is tuning up a multibillion-dollar emergency loan program to assure that the U.S. will not be hit by a wave of bank and business failures.

It has the legal authority, the responsibility and the money and has been checking out its operating machinery so it will be ready if the need arises.

No one at the Federal Reserve is expecting a major failure but the markets are jittery and have been close to panic in recent weeks and the emergency lights could begin flashing at any time.

There have been speculative excesses. Money is tight. The great fear is that lenders suddenly will decide that a major bank or industrial corporation no longer is safe and will pull out their money.

Federal Reserve Board Chairman Arthur Burns insists that the chances that the Fed will have to activate its emergency plans are "most remote" but he declares that its resources will be "fully adequate" if an emergency comes.

The Fed demonstrated its muscle when it began pumping more than a billion dollars of emergency loans into the collapsing Franklin National Bank last May.

Franklin had been the 20th biggest bank in the country but big corporations pulled out hundreds of thousands of dollars after it became known that it had suffered large foreign exchange losses.

Fed officials are quick to stress that it won't save any bank or business but only a solvent one that is hit by a liquidity squeeze. The modern-day run on Franklin is said to be a classic illustration of their point.

Franklin has many excellent loans and substantial amounts of high-grade collateral but there was no way it could have raised new deposits from wary private lenders to replace the money the corporations withdrew.

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A Fed decision to allow Franklin to go under would have had a devastating impact both here and abroad.

Franklin is a major borrower from banks and business firms. If it had closed its doors, vast sums would have been frozen. Banks throughout the world suddenly would have found their sources of funds drying up because lenders no longer would have been willing to put their money at risk.

The Fed is prepared to do as much for other solvent banks as it did for Franklin.

It also has considered how it can assist a suddenly squeezed savings and loan association or mutual savings bank. Officials believe it would help a savings and loan through a regional Federal Home Loan Bank while aid to a savings bank would be channeled through a commercial bank.

Emergency assistance to a business corporation would be provided under little known and never used Sec. 13 of the Federal Reserve Act.

Action could be taken reasonably quickly but not easily. Fed officials hope they will hear about any emergency problem in time.

Assistance will have to be recommended by directors of a regional Federal Reserve Bank. In addition, five of the seven Federal Reserve Board governors will have to find that the firm is credit-worthy, has acceptable collateral and cannot obtain credit from private sources and that its collapse would create a crisis for its industry or the national economy.

The Fed is the U.S. lender of last resort. The tests for helping a stricken company aren't easy. The power is there, however, and that is good reason for a strained, jittery financial system to breathe a bit easier.

[From the Washington Post, Aug. 8, 1974]

Arthur Burns: In a Tight Money Squeeze

(By Hobart Rowen)

The name you hear most frequently in Wall Street is not Richard Nixon's or that of the next President, Gerald Ford. It is Arthur F. Burns, the white-haired chairman of the Federal Reserve Board, who simultaneously is blamed for the present critical shape of financial markets and looked to as the ultimate restorer of the nation's economic health. As the man who doles out the money, he is the devil and the savior rolled into one.

Every word that Burns says is parsed and analyzed for its meaning. Did the powerful chairman of the central bank say money policy would continue to be tight, or tighter? Is his latest warning on the evils of inflation more serious in tone than the last?

Will the Fed ride to the rescue of banks or corporations short of liquid reserves, but technically solvent, as it did in the case of the Franklin National Bank?

Bankers and financial men don't hate Burns with the passion of a George Meany, who says Burns hasn't had a single new economic idea in the past five years.

But there is a widespread view among them that the Federal Reserve Board sadly missed its timing in 1972. "Arthur got the anti-inflation fervor too late," says one critic who, nevertheless, is a great admirer of Burns. His theory—quite the opposite of Meany's—is that Burns continued a liberal money policy too long.

"Burns should have told the banks to slow down their loans, to quit advertising the availability of consumer credit—in other words, to be more prudent," says one Burns critic.

"Instead, he became too oriented to the money supply. In effect, he said 'We'll supply the money, and let the market ration credit.' "

Burns agrees with Chase Manhattan Bank chairman David Rockefeller that some banks have now gotten themselves out on a limb with loans that may be of dubious quality. This week, in testimony before the Joint Economic Committee, Burns said that "some carelessness crept into our financial system," and that some banks had indulged in "financial adventuring."

On Capitol Hill, Burns is shown the greatest deference by senators and representatives who normally are jealous of their prerogatives. They are polite and rarely criticize him, although many agree with economist Walter Heller (and George Meany) that the Burns money policy is too stringent and threatens recession.

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Canny politician that he is, Burns takes pains to stroke the congressional ego, testifying patiently and for long hours, willingly repeating himself to a committee member wandering to a hearing (or who didn't get the drift first time around).

Only Arthur Burns could have deftly sidetracked as determined an inquisitor as Sen. William Proxmire, who wondered this week whether Alan Greenspan was worthy to be designated chairman of the Council of Economic Advisers inasmuch as he is a vigorous opponent of the antitrust laws.

"Senator," Burns responded benignly, "Alan Greenspan was one of my students and I never criticize any of my former students—I love them all."

The message that Burns is imparting to the Congress and to financial markets is a mixture of a sober—almost gloomy—analysis of prospective economic troubles, coupled with a pledge that the Federal Reserve—as a "lender of last resort"—will not allow things to get so bad that there will be a money drought, that is to say, a policy so tight that it creates an absolute shortage of money to grease the nation's financial machinery.

But Burns, in contrast to the Nixon party line, is not optimistic that serious price inflation will abate in the second half of this year. He thinks it "plausible" that the rate of real economic growth for the next six months could be as little as zero to 2 per cent—a range which implies that 1974 as a whole will show a drop in activity from 1973.

Burns readily concedes that a change of leadership in the White House will provide a psychological thrust forward. A new administration under Ford would not be overwhelmed—as Nixon was—with Watergate, the cover-up, the legal defense. As far back as June 23, 1972, as the fateful tape of that day's conversation with Haldeman shows, President Nixon couldn't be concerned with the float of the British pound and didn't give an (expletive deleted) about the Italian lira.

A President Ford, however, could concentrate on the economy. He could even declare a National Economic Emergency with no suspicion that he is trying to distract attention from Watergate. Broadened in perspective and coverage, an economic summit might yield a balanced approach to economic problems, and take Arthur Burns off the tight money hook.

The CHAIRMAN. I assure the gentleman that these are constructive statements and I call them to your attention.

Anyway, Dr. Burns, I will yield to the other members here and let them interrogate you at this point. We did not get through the other day and that is the reason we asked you to come back.

The first one, I think, on our side is Mr. Minish, and on this side I think it is Mr. Wylie and then Mrs. Heckler. She just came in. She would be next after you.

All right, Mr. Minish.

Mr. MINISH. Thank you, Mr. Chairman.

Dr. Burns, correct me if I am wrong, but I believe that you indicated or made a statement that the energy crisis has contributed to our inflation.

Is that correct, sir?

Dr. BURNS. That is correct, yes.

Mr. MINISH. The oil companies are making profits that are astronomical and I think we can agree on that. Then we have the problem of Mr. Sawhill, who suffers from a disease that whenever he gets on TV he just has to say that the price of oil and gasoline will go up, notwithstanding the profits of the oil companies.

I was just wondering whether you can bring any influence on this individual or someone in the administration to be more concerned with the rising cost of gasoline, fuel oil, and heating oil and to work toward getting these corporations to cut their prices in view of their astronomical profits. I would like your opinion on that, sir.

Dr. BURNS. I am concerned about the excessive profits of the oil companies. I am very much concerned about that. However, as far as

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the prices of gasoline and heating oil and petroleum products generally are concerned, I feel that in the absence of rationing—and we do not have a rationing system—price has to perform a rationing function, and that a high price leads to conservation in the use of petroleum products. This, I think, is important.

Actually, if you look around the world you will find that the price of petroleum products, gasoline, heating oil, et cetera, is a good deal lower in our country than practically anywhere in the world. In fact, I cannot think of any country where the price is lower.

You will also find that after the oil-exporting countries began manipulating the price of oil, which resulted in a close to quadrupling of the price of crude oil, that the leading industrial countries around the world increased their taxes on gasoline.

Why did they do that? They did that in the interest of reducing consumption. They did that in the interest of reducing their imports of oil products and thereby helping to protect their balance of payments.

So what concerns me, to come back to your question, is first, the level of profits in that industry. I share your concern about that, but I do not share your concern under present circumstances about the high price of gasoline, and other petroleum products. The high price serves a function of reducing demand. The only other way of doing it would be to introduce formal rationing through coupons, et cetera.

Mr. MINISH. Do you not think that when a company like Exxon reported $750 million in the first quarter and then was found to have set aside $400 million in profits, do you not think they ought to reduce the price rather than increase it?

There are people who use gasoline, not for enjoyment or joy riding—they need the car for work.

Dr. BURNS. I realize that. I am not being very successful in conveying my thought to you.

I see great difficulties around the world because of the unconscionable and extortionate increase in the price of crude oil. The world has to adjust to it if our monetary system is not to break down. How can we do it?

First, I think, by conserving oil products, using less. That will put certain pressure on the market and the oil-exporting countries may find that they will have to lower the price.

Second, I think we have to push ahead with Project Independence. That has been going much too slowly.

And third, I feel that it is the business of the world's oil-consuming nations to get together. Just as the oil-exporting countries have formed a cartel to raise the price of oil, so the oil-consuming countries need to get together.

In addressing myself to your question, I was concerned solely with the conservation problem. We began conserving gasoline pretty well, you see, through various devices. We are doing it solely through the market, and doing it through the market means that the price has to be high. That is the way the rationing takes place, through the marketplace.

Mr. MINISH. Thank you, Dr. Burns.

That is all, Mr. Chairman.

The CHAIRMAN. All right then. Mr. Wylie.

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Mr. WYLIE. Thank you, Mr. Chairman.

Chairman Burns, I was pleased to see your picture on the front page of Business Week recently and to have you characterized as the man who has emerged as perhaps the only authentic expert in the economic policy arena. I might add that I spoke to a group of Ohio bankers yesterday and many of them feel the same way. So they are looking to you for guidance during this time of economic crisis, Mr. Chairman.

The thrust of these hearings has been that the so-called money supply problem in the United States is directly responsible for many of our economic ills. Now even the most dyed-in-the-wool monetarists agree that there are other factors influencing our economy, such as fiscal excesses, although some would claim that this effect is the result of monetarizing the debt.

It seems to me that the Fed is the closest thing we have to a central bank and can have a strong but not absolute influence on the economy by influencing our money supply. Now just as the Fed cannot control the money supply absolutely, the Fed cannot take all the blame or credit, it seems to me, for failures or successes. I, for one, would oppose total and complete control of money supply in any single place.

Would you comment on the manner and guidelines for the Federal Reserve decisionmaking process and actions in pursuing money supply goals? In other words, what process do you go through when you decide you are going to have an expansionary monetary policy or a moderate monetary policy or a restricted monetary policy? I am asking the question because it came to me yesterday at our meeting, as I say, out in Ohio. Bankers are interested in knowing what your guidelines might be. There is a shortage of money at the present time as far as commercial banks are concerned and yet there are more pressures for credit than ever before. Would you please comment, Dr. Burns?

Dr. BURNS. Well, we have been passing through a period when the demand for credit is enormous. The demand has been particularly strong for business loans. The Federal Reserve has continued to use its power to expand the money supply. We have, however, sought to moderate the rate of growth of the money supply so that the rate of growth of the money supply would be below the rate of growth of the gross national product but still somewhat above the rate of growth that would be needed for a time of general price stability.

In other words, we try to pursue a middle course. If we kept on the present track and permitted the money supply to grow year in and year out at something like 5½ or 6 percent, we would be virtually guaranteeing a continuance of inflation for this country, not in any particular month or year or two but over the long run.

Our objective, therefore, is to bring the rate of growth down, but to do it gradually because we are well aware of the fact that the demand for credit is very strong. It will take time to unwind the inflationary process that is underway.

Some price increases in our economy are unavoidable. Take the case of public utilities, for example. The price of fuel has gone up sharply. Other costs have gone up very sharply. Interest rates have gone up sharply. These public utilities are subject now to a very strong cost-price squeeze. Actually, utilities over the country of late

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have been cutting back on their investment plans, and that does not bode well for this country's future. Utility rates simply have to go up, not in every part of the country but in many parts of the country.

This is one example of many where price increases must take place because of earlier cost increases and the cost increases still going on.

So the short answer to your question is, to repeat, that we are seeking a rate of monetary growth that, on the one hand, is well below the rate of growth in the dollar value of the gross national product, but on the other hand, well above the rate of growth that would be needed over the long run to maintain a stable price level in the country.

Mr. WYLIE. Thank you. Earlier in your testimony you said that over the past 12 months the money supply has grown at an annual rate of approximately 6 percent, and this was a decrease from 8 percent the previous year, and yet, credit demands were stronger this year than they were last year with less money being available.

There have been several recent newspaper articles that indicate that many commercial banks are way overextended and our chairman, Mr. Patman, got into this a little earlier this morning with reference to the Franklin National Bank situation. There are indications from newspaper articles that a number of American banks lost heavily when the Germans' Bankhaus Herstatt, failed.

Would you care to comment on the financial health of the domestic financial banking system in the United States?

The CHAIRMAN. The time of the gentleman has expired, but you may go ahead, Dr. Burns, and answer his questions.

Dr. BURNS. I think that, by and large, our banking system is entirely sound, but we have had some carelessness creep into a number of our banking institutions, which have allowed their capital positions to erode and which have permitted themselves to rely excessively on borrowed funds such as Eurodollars and certificates of deposits and overnight Federal funds. This condition will need to be corrected, and there are defects in our regulatory system that will need to be corrected.

In due course I am going to come before this committee and present some significant legislation on banking reform.

Mr. WYLIE. I thank the Chairman.

The CHAIRMAN. Mr. Gettys.

Mr. GETTYS. Thank you, Mr. Chairman.

Dr. Burns, we all appreciate your appearance here this morning, sir. We have been discussing for years whether high interest rates are a cause of or a result of inflation. Would you give your concurrent views on that question, sir?

Dr. BURNS. Well, I dealt with that question in the statement that I gave to the committee at the last hearing. The short answer is that interest rates, to a very small degree, intensify inflation. There is a grain of truth in the allegation that is so frequently made that when interest rates rise, the costs of business enterprise also rise and prices follow suit.

There is some truth in that, but only a grain of truth. Preponderantly, the effect of higher interest rates is to reduce the demand for credit and thereby to reduce the demand for goods and services. High interest rates are simply a symptom of reduced availability of credit. With borrowing tapering off, the demand for goods and services tends to taper off and, therefore, the pressure on resources is reduced. Funda-

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mentally, therefore, high interest rates serve to reduce the rate of inflation rather than to raise it.

Let me make one other statement. Interest rates are a cost of doing business. Of course they are. Wages are a cost of doing business. Of course they are. On the average in our country, for every dollar paid by business firms in interest, $20, $25, or $30 are paid in wages. I find it very curious that so much emphasis is placed by many on interest rates as a price-raising factor, and that the role of wages as a price-raising factor is slighted.

Mr. GETTYS. Do you consider, Dr. Burns, that the present high interest rates are effectively reducing inflationary pressures?

Dr. BURNS. Yes, they are. I gave some testimony on that 2 days ago before the Joint Economic Committee. If I may, let me read a sentence or two from that statement.

Evidence is accumulating that the restrictive policy pursued by the Federal Reserve is helping to moderate aggregate demand by reducing the availability of credit to potential borrowers and disciplining inflationary psychology. In the first half of last year, the credit extended to private domestic borrowers increased at an annual rate of $165 billion and amounted to about 14½ percent of the private component of the gross national product. Estimates for the first half of this year suggest that the rate of aggregate private credit expansion has fallen to about $145 billion or 11½ percent of private GNP.

Mr. GETTYS. Thank you, sir. One other brief question: Would the allocation of credit serve a useful purpose at this time, sir?

Dr. BURNS. Well, if we knew how to do it, it might, but I think when we speak of allocation of credit, we are speaking of an enormously difficult undertaking and one that might easily make things worse rather than better.

Mr. GETTYS. Thank you.

If I have time left, Mr. Chairman, I would yield to my good friend from Ohio, Mr. Wylie.

Mr. WYLIE. I thank the gentleman for yielding.

The CHAIRMAN. He has 30 seconds.

Mr. WYLIE. Dr. Burns, you indicated earlier that monetary policy cannot do it alone, that the fight against inflation cannot be won through a monetary policy alone. Further you said that fiscal policy must be changed.

I have introduced H.R. 15375 which, simply stated, would say that the Federal Government through Congress could not spend more than it takes in and would reduce the Federal debt by 2 percent for this fiscal year.

What do you think of my bill, Dr. Burns?

The CHAIRMAN. The time of the gentleman has expired.

Mr. WYLIE. Could he answer the question, Mr. Chairman?

The CHAIRMAN. All right. The time has expired, but go ahead and answer it.

Dr. BURNS. I like the direction of your thinking, Congressman Wylie. As to the specific proposal, I would like to reflect on that before I would comment.

The CHAIRMAN. All right, sir.

Mrs. Heckler.

Mrs. HECKLER. Thank you, Mr. Chairman.

Thank you, Dr. Burns. It is always worthwhile to listen to your point of view. I would say that your spearheading the fight against

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inflation is positively what the current situation requires. I certainly join you in the effort.

However, my particular concern about the inflationary spiral relates to one sector of the economy. People in my district are generally in support of a fight against inflation. I think the recognition on the grassroots level has increased substantially. While we are told we must all bite the bullet, it is quite apparent that the housing industry is supposed to swallow the bullet. As a member of the Housing Subcommittee, I have to express my deep concern over what I consider to be the disproportionate share of the burden which the housing industry is bearing.

I have talked to home buyers who cannot purchase a home, realtors out of work, carpenters, construction workers at the low-income level. We hear about the high salaries and wages which some construction workers enjoy, but not all of them have that same benefit; there are many who just scrape by or earn at most a very meager income.

Mortgage lenders are concerned that, in general, builders and everyone else associated with housing are in a desperate situation.

I think part of the problem is that not only the current policy bears down excessively heavily on the housing industry, but also that in the policymaking structure housing is not represented. They are merely the scapegoats of a decision and not participants in the decision-making. It seems to me that there are questions about how far we can go. Is there any way to redress the inequities of this situation?

If the housing industry had not always been the shock troops of tight money, we might find ourselves understandably bewildered. But this has been a pattern that has repeated itself many times in recent years.

Why is it that the brilliant minds, at the Federal Reserve and elsewhere, have not developed a strategy to create equity in terms of bearing the brunt of the tight money policy?

I question how far we are going to let the whole thing go. In Massachusetts, housing starts dropped in 1 month 10 percent from May to June; residential construction is down 44 percent below a year ago; commercial construction, down 48 percent; mortgage money outflow from S. & L.'s in Massachusetts in June was $6.8 million; that was the poorest month since 1969. S. & L. new receipts for the first 6 months of 1974 in Massachusetts are 24 percent below a year ago.

I do not know what the specific figures on unemployment in the construction industry are, but we are seeing nationwide concern with the rising unemployment levels. I would like to see the figures on unemployment in construction-related jobs. I think it would be really shocking.

The question is, how far will we allow housing to slide? How much unemployment in the construction industry can we tolerate?

How high can the mortgage rates go and still have any housing at all, and how much disintermediation will the thrift institutions be expected to bear?

Is there a trigger point? Is there any point at which we can say, enough, or too much, and do something for housing? Is there any way out of this quandary?

Dr. BURNS. Mrs. Heckler, you have made an excellent statement about the condition of the homebuilding industry and the condition

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of our thrift institutions. I can only commend you for everything you have said.

As you have noted, the problem of the housing industry is one of very long standing. It has been a prince and pauper industry throughout modern times. The fluctuations in homebuilding have been large. This has been true not only of our country; it has been true of every country of the world, including, interestingly enough, socialist economies which engage in planning and scheduling. Presumably, one might think, they could stabilize the industry. They have not succeeded.

What I am trying to say is merely that this is a problem of long standing that many men have studied, and tried to deal with. The success that we have had so far has been quite limited.

You may recall that at the time of my confirmation hearing in the Senate for the post that I now hold, I was asked a question about housing. It so happens that I began studying the homebuilding industry and its financial problems some 50 years ago. In that time, I have learned a little about its problems. I indicated to the Senate Banking Committee it was my fervent hope, while I am in this post, to make some contribution to the solution of this problem.

One of the first things I did was to organize a rather comprehensive study of home mortgage financing, its instability and how it might be dealt with. I drew not only on my own sizable and very competent staff, but we brought in some 20 specialists, as I recall, to work on this problem.

By March 1972, we had completed our inquiries and submitted a report to the Congress. We made various recommendations for dealing with this problem before we reached another crisis in the homebuilding industry.

Whether that report was good or not is something that others can judge better, certainly more objectively, than I can. But I had hoped, and I still hope very much, that the Congress would take that report seriously, so that it would serve as a point of departure for a thorough critical examination of the problems of that industry; and if the proposals brought forward by the Federal Reserve Board were deemed inadequate or defective, that in the process of holding hearings and deliberating on the problem, better thoughts would come to the surface. Unfortunately, this report has received very little attention. I still think it deserves a better fate than it has received.

I am only at the beginning of answering your question. The chairman is exercising his authority very properly; I would only ask the privilege of expanding these inadequate comments so that I come to grips with your question.

The CHAIRMAN. Without objection, so ordered.

[In response to the request of Mrs. Heckler, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

The Federal Reserve Board's recommendations for moderating fluctuations in housing construction were sent to Congress in March of 1972, along with an extensive study by the Federal Reserve Staff on this subject. These recommendations included a number of institutional changes that would have helped to avoid the present dire shortage of mortgage credit.

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As developments this year have made clear, steps are still needed to strengthen the ability of depositary institutions to attract and hold consumer savings when yields are rising on market securities. The thrift institutions are particularly vulnerable at such times because of the maturity imbalance between their assets, which consist essentially of long-term loans with fixed yields, and their liabilities, which are short-term. While some progress has been made in correcting this disparity, more might be accomplished by relaxing deposit rate ceilings in ways that would allow greater incentives for savers to deposit funds for longer periods.

Some benefit would also accrue from shortening the average life of the earning assets of thrift institutions, although any sizable move in this direction should come only after careful consideration of the potential impact on the long-run supply of mortgage credit. Some benefits along this line would be gained by authorizing the thrift institutions to place a somewhat greater share of their earning assets in short-term consumer loans. Their earnings would then respond better to changes in market interest rates, and they would be in a better position to adjust the rates they pay on deposits so as to maintain their savings flows.

Another useful step would be to enable all depositary institutions to offer home mortgages with variable interest rates and attendant consumer safeguards, side by side with the traditional fixed-rate mortgage. Since the variable rate mortgage would result in more flexible average earnings rates, the institutions could compete more effectively for deposits. Greater stability of deposit flows would yield greater cyclical stability in the availability of mortgage credit without affecting adversely the long-run supply of mortgage funds. It would probably take a decade or more for variable rate mortgages to become a subtantial factor in the portfolios of depositary institutions. But over time such loans have the potential for helping to smooth out flow of funds into home loans, and their encouragement deserves careful consideration.

By making greater use of fiscal tools, sectors of the economy that are now relatively immune to monetary policies would come to bear a more equitable share of restraint during periods of excess aggregate demand. For this reason, the Federal Reserve Board would once again recommend flexible use of an investment tax credit as a means of promoting greater stability in outlays by business firms for machinery and equipment. Such expenditures are large, cyclically volatile, and—unlike housing—relatively insensitive to monetary policy.

Further steps could also be taken to remove legislative and regulatory constraints that at times discourage mortgage investment. For example, interest rate ceilings on FHA-insured and VA-guaranteed mortgage loans—intended as protection for home buyers—have meant that in practice such financing periodically dries up, or becomes available only if the seller is willing to pay several "points" as a loan fee. In recent years, administrative adjustments in the ceiling rates have been more frequent, so that these ceilings have less often given rise to a blockage of mortgage funds. However, if Congress abolished the ceilings altogether, or tied them directly to market interest rates, the States might be encouraged to take similar action with respect to their usury laws, which still serve to block flows of funds into mortgages when over-all demands for credit are high.

Other changes in Federal legislation that would also be of some help include the granting of authority to the Federal Reserve to lend to member commercial banks on the basis of mortgage collateral at the regular discount rate, permitting national bank investment in real estate loans based solely on considerations of safety and soundness; and relaxation of geographical restrictions on conventional mortgage loans of Federal savings and loan associations, which could lead to similar liberalization of state laws.

The CHAIRMAN. You see, we are trying to divide time between all the members.

Dr. BURNS. I understand your position perfectly, Mr. Chairman.

Mr. COTTER. Mr. Chairman, I am very much interested in this.

The CHAIRMAN. Mr. Koch is next.

Mrs. HECKLER. Mr. Chairman, may I be recognized for a unanimous-consent request?

The CHAIRMAN. Certainly.

Mrs. HECKLER. I would ask unanimous consent that this study which Dr. Burns has alluded to will be a part of the record so that we will have the opportunity to consider it in depth.

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The CHAIRMAN. Without objection, so ordered.

[In response to the request of Mrs. Heckler, the study referred to by Dr. Burns, "Ways to Moderate Fluctuations in the Construction of Housing", published in December 1972, is retained in the committee's file. A summary report from the Federal Reserve Bulletin for March 1972, may be found on page 477.]

Mr. COTTER. Mr. Chairman, I am very much interested in the line of questioning by Mrs. Heckler. As a matter of fact, I was going to pursue it, and I would yield my 5 minutes to allow Dr. Burns to continue.

The CHAIRMAN. Mr. Koch is next.

Mr. KOCH. Well, I would defer for this.

The CHAIRMAN. If you want your time, you had better take it.

Mr. KOCH. Mr. Chairman, I am trying to oblige Mr. Cotter and Mrs. Heckler. Could the chairman not come back to me by unanimous consent?

The CHAIRMAN. All right. Without objection, it will be done this time, but we cannot make a habit of it, because we are trying to divide the time so each member will have at least 5 minutes. All right, go ahead, Mr. Cotter.

Mr. COTTER. Dr. Burns, if you could, please summarize some of the proposals you made in your report of March 1972, as relating to the housing industry.

Dr. BURNS. The two most important proposals in that report were, first, that we change the investment tax credit from the fixed rate to a variable rate and thereby release funds at certain times to homebuilding, funds that now go into business investment.

The second major proposal was to permit and encourage variable rate mortgages. There were a dozen proposals of lesser importance, and I will not take time to summarize those. The entire report will be put in the record. I would like to deal with Mrs. Heckler's questions more specifically now.

I think we have to ask ourselves the question, What is wrong with our homebuilding industry at the present time? Why is it in such a bad slump? The depression that you pictured we recognize; it is more severe in some States than in others, and it is particularly severe in your State, Mrs. Heckler. Why is the industry in difficulty?

First, I would say the industry is in difficulty because the purchasing power of the average workingman of this country has eroded during the past year as a result of the inflation. His purchasing power, the ability to buy goods and services, is 5 percent lower now than it was a year ago. This has caused a reduction in the demand for housing, just as it has caused a reduction in the demand for automobiles, the demand for appliances, and big-ticket items generally. That is one cause.

Second, the price of land and construction costs generally have been rising sharply. The high price of homes is simply pricing many even of our middle-income families out of the market.

Third, the gasoline shortage, uncertainty about its price and availability in the future, has caused some decline in the demand for housing. People are less willing today, not knowing what the future may be in this regard, to buy a home or to build a home 20, 30, or 40 miles away from the place where they work.

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Fourth and finally, in some parts of the country, we have had overbuilding. The proof of that is that vacancy rates for the Nation as a whole are higher than they have been in some 5 or 6 years.

Now, then, I come——

Mrs. HECKLER. Would the gentleman from Connecticut yield?

Mr. COTTER. Certainly.

Mrs. HECKLER. Mr. Chairman, would it be possible for you to list those areas in which there has been overbuilding?

Dr. BURNS. Yes, I will do that. The figures are less detailed than I would like, but we can do it by broad geographic regions.

[In response to the request of Mrs. Heckler, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

Nationally, rental vacancy rates in the second quarter of this year averaged 6.3 per cent—the highest for any second quarter in the past seven years. Second quarter home-owner vacancy rates have also risen to 1.1 per cent, as against 0.9 per cent a year earlier. Vacancy rates in most Census regions have risen over the past year, as the attached table indicates, but the rise has been most marked in the South.

While recent vacancy rates are still well below the post World War II peaks reached during 1965, the over-all number of units (especially apartments) still under construction has remained very substantial—at a level of about 1.5 million this summer. Also, merchant builders' inventories of single-family dwellings for sale at mid-year approximate 10 months supply at prevailing rates of sale. This compares with about 8 months supply in the second quarter of 1973 and with fewer than 6 months supply in most other recent years.

RESIDENTIAL VACANCY RATES

[In percent]

	Average for the 2d quarter				
	1965	1971	1972	1973	1974
Rental units	8.2	5.3	5.5	5.8	6.3
Northeast	5.3	3.0	3.0	3.7	4.0
North-central	7.1	5.3	6.7	5.7	6.4
South	8.5	7.2	6.9	7.2	7.9
West	12.6	5.6	5.7	7.0	6.8
Homeowner units	1.5	.9	1.0	.9	1.1
Northeast	.7	.7	.5	.6	.6
North-central	1.0	.7	1.0	.9	1.0
South	1.9	1.3	1.1	1.0	1.4
West	1.9	1.0	1.4	1.2	1.3

Dr. BURNS. Now, I come to interest rates and the availability of mortgage credit. Interest rates, on mortgages for homes are now 9 percent, 9½ percent. They have risen very materially. This is a further discouraging factor coming on top of the difficulties from which the homebuilding industry was already suffering. Then, some States have usury laws, so that people who are willing to pay the market interest rate and to build or buy are prevented, in effect, from doing so.

Finally, what can one do about it, and what can the Federal Reserve do about it, and what has the Federal Reserve been doing about it?

First, let me talk about the Federal Reserve, and then I will talk about the Government in general. Or I can invert the order, if you would prefer.

Mrs. HECKLER. No; I would like that order.

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Dr. BURNS. All right. What is the Federal Reserve doing about it?

Well, we have no specific authority, as you know, in the housing area. I think that in fighting inflation, as we are at the present time, we are making a major contribution not only to the economy of this country and the restoration of its strength, but also to the economics of the homebuilding industry. Unless or until inflation is brought under control, homebuilding, I am convinced, will be in difficulty.

Look at what is happening now to construction wages. Construction wages recently have been going up at an enormous rate, and we are on the threshold of a repetition of the cycle that we had in 1969 to 1970 when construction wages——

The CHAIRMAN. Mr. Cotter's time has expired.

Dr. BURNS. May I finish my sentence? When construction wages rose in different localities 10, 15, 20, 25, and 30 percent. Before very long, the enormous increases in the construction industry spread to our manufacturing plants and across the country.

We are on the threshold of a repetition of that cycle, and it is very dangerous. The recent closing down of the Construction Industry Stabilization Committee—and I believe one of your constitutents, John Dunlop, ran that committee, and he ran it well—I think was a great mistake.

The CHAIRMAN. All right.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Dr. BURNS. May I just say one more word? I still have not finished answering Mrs. Heckler. She deserves an answer, and she will get it from me in the record.

The CHAIRMAN. We appreciate your suggestion. I wish we could just give unlimited time.

Dr. BURNS. I appreciate your problem, Mr. Chairman.

The CHAIRMAN. We cannot just turn everyone loose, as much as we would like to. We would like to hear you all day, but we just cannot do it.

All right, Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

I want to welcome Dr. Burns back before the committee. I would like to yield to my distinguished colleague from Massachusetts initially here for another inquiry.

Mrs. HECKLER. I thank the gentleman for yielding.

I would just like to make public a suggestion that I made to you, Dr. Burns, privately. I do think the exclusion of the housing sector from the considerations of the Federal Reserve Board is a glaring omission, and I feel that since the housing industry does face the prospect of carrying the heaviest burden, as I have suggested to you privately, I would like to have this record show that I request that consideration be given to having a representative of the housing industry on the Federal Reserve Board, so that this industry can be represented while the decisions are made. Perhaps some equity, or greater equity, can be restored to the system.

I thank the gentleman for yielding.

Mr. CRANE. Dr. Burns, I unfortunately do not have your initial statement from last week when you were here, and I did not get the opportunity at that time to question you.

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A question that was on my mind, and I think is on the minds of quite a number of people, is about a kind of tangential reference you made in your statement to the Franklin Bank situation. Then somewhat further on, you did make a comment, as I recall, to the effect that the Federal Reserve System would not permit any kind of massive dislocation in the banking industry. I am sure that remark was designed to allay some of the apprehensions that many people had evidently felt because of Franklin and then Herstatt, plus a great many rumors that I know you are aware of concerning the condition of banking generally in this country.

The question I have is, what is the capacity of the Federal Reserve System to deal with this? I mean, how many banks with problems similar to Franklin's could the Fed salvage?

Dr. BURNS. I do not know that I could answer that numerically. Your question is hypothetical. I think our banks by and large are in sound condition, and I do not expect another Franklin. If we have bad luck and another Franklin or even two come along, we can deal with that very easily.

Mr. CRANE. I am glad to hear you say that, because, as you know, coming from the State of Illinois and the Chicago area, there have been some rumors that have been injurious, you know, to some of our banks in Chicago. These rumors have been unsubstantiated, to the best of my knowledge, by the facts. So I am grateful to have you make that a part of the record, that with your expertise and knowledge, you know that most of these rumors are unsubstantiated and unreliable.

One other thing that I want to commend you for, but on the other hand was a source of concern to all of us, was your commencement talk at Illinois College in Jacksonville where I think you put your finger on something. You paraphrased, as I recall, a statement attributed to John Maynard Keynes, who said that there is no subtler or surer way to overturn existing society than to debauch its currency. It engages, Keynes said, all of the hidden forces of economic law on the side of destruction in a way that not 1 man in 1,000 can diagnose. I presume he was talking about money policies run amok and the threat that that represents to all other institutions in society.

Would you elaborate just very briefly on some of those comments you made at Illinois College? How portentous is the situation in your eyes right now?

Dr. BURNS. I think that the history of many nations around the world demonstrates quite conclusively that when people lose confidence in their currency, a social and political upheaval tends to follow. You may recall what happened in Europe after World War I, in Russia, in Germany, in Austria. These countries went through a rampant inflation, and the entire social and political system was changed, largely as a result of the misery and inequities and frustrations brought about by inflation.

The history of Latin America, most recently the history of Chile, indicates what happens when inflation begins to gallop in a country. It is no accident that when China moved over into the Communist sector, the shift to communism was preceded by a rampant inflation. We have had several changes in governments in Europe this very year as a result of the inflation experienced by these countries.

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There is a great deal of unhappiness in our country over inflation. I think this is the one problem that concerns the general public more than any other. People feel frustrated; they feel helpless. They do not know how to plan their lives as they used to. When people begin thinking about their country in that way, great political uncertainties may develop, and the outcome may be bad for our future.

These are the thoughts that ran through my mind when I wrote that address.

Mr. CRANE. My time has expired, Dr. Burns.

I thank you for that.

The CHAIRMAN. All right.

Mr. Koch.

Mr. KOCH. Thank you, Mr. Chairman.

Chairman Burns, as you know, it is a pleasure for me and the members of this committee to welcome you.

I would like to get your comments further on this question of loss of confidence in currency and all of the ramifications that poses. In particular, I would like to focus on an area of the economy which relates to the small saver.

The other day I noticed you proposed a public works project or an unemployment project—I do not know the exact term—but it provided 800,000 or 900,000 jobs for the unemployed because of the inflationary consequences to employment. I am in support of providing jobs.

But I want to get to another sector, which relates to the people who put money in banks, the small saver. I would ask whether or not we could not apply the index theory concept to the question of small accounts. What I mean by that is, is it not possible, either through the private banking institutions, to provide that an individual who places a sum of money in an account—and there might have to be restrictions as to the size—that when he draws that money out, it will have true current value, whether it is a year later or 10 years later, plus some reasonable interest? We now know that we are discussing what everyone has come to take as an acceptable term, "two-digit inflation," it is as though by calling it two-digit inflation, it does not have the severe consequences that it might otherwise have. It is sort of a benign term, but devastating on the economy.

When someone places money in an account now, two things happen. One, he gets about 5¾ percent interest. Two-digit inflation means that when he draws that money out a year later, he in fact has suffered a net loss.

Dr. BURNS. He also has to pay income tax on that.

Mr. KOCH. Exactly, and in addition, pay an income tax on that net loss, so to speak. That is an outrage. So what I am asking is this: If you would comment on the feasibility of either a governmental program or a program through the private banking institutions which would permit an assured return, so to speak, in the sense that the small saver would get back true dollars plus some modest interest when he withdraws it.

Is it feasible? Have other countries done it?

Dr. BURNS. The only country that I know which has fully developed and pursued a plan of this sort is Brazil. When you say, is it feasible, I must respond that it could prove very injurious at the present time.

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I recognize your quest for justice and it is a thoroughly civilized and laudable objective. But let us think of what this would mean.

Here you have a savings bank which is paying its depositors 5 or 5½ percent. You have an inflation rate of 10 or 12 percent. Indexing would mean that the interest rate paid to depositors would have to be 15 or 17 percent. If the savings bank paid interest of 15 to 17 percent, it would have to charge the borrowers on mortgages not 15 to 17 percent, but 17 to 19 percent.

Mr. KOCH. May I break in?

Let us get rid of this question of the small saver having to subsidize mortgages. We need mortgage money and let it come from the Government, either by way of a subsidy or by way of making the money available. To talk about it in terms that the small saver has to subsidize those people who want to go out and buy houses seems to me outrageous.

Dr. BURNS. We will put the mortgage market to one side.

Mr. KOCH. Because it is inflammatory.

Dr. BURNS. Yes, we will put it to one side. In some fashion it is going to be taken care of. Our savings banks at the present time, in addition to investing in mortgages, invest heavily in corporate bonds. In fact, they have been moving more and more heavily into corporate financing. A triple-A bond today will yield something like 10 percent, and how is the savings bank going to pay 15 to 17 percent? Let us look at our savings and loan associations. On any new mortgages—well, that is going to be taken care of in some fashion. They now have outstanding mortgages in their portfolio at 4, 5, 6, and 7 percent. How can they possibly pay such rates of interest?

Mr. KOCH. Dr. Burns, if we do not provide some assurance to the small saver that a year hence or 10 years hence his money is not going to be depleted by virtue of just simply sitting in that account, does that not in fact create the loss of confidence and should not every small saver go out and buy something with those moneys—I mean, something physical that will appreciate with value rather than having it sit in the account and incur a loss?

As we have just suggested, he will lose by virtue of the factors you have discussed.

Dr. BURNS. True, the little saver is in real difficulty. For that matter, the big saver is in difficulty, too.

The CHAIRMAN. The time of the gentleman has expired.

Mr. Rousselot?

Mr. ROUSSELOT. Mr. Chairman, thank you for your very careful recognition.

Chairman Burns, I am very appreciative of some of the comments you have made in your initial statement and wish to commend you for it, especially your statement that strenuous efforts should be made to pare the Federal budget expenditures, thus eliminating the deficit that seems likely in fiscal 1975. I think we can learn a lot on this committee from that statement, on the basis that a housing bill has just come out of conference that is roughly $2 billion over what it was when it left the House, and maybe we can practice some restraint ourselves. When that comes back to the House, we will see how many are willing to do it.

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In any regard, I was appreciative of many of your statements about ways to cope with inflation, and I hope that we as a Congress are willing to abide by some of your suggestions.

Mr. Chairman, I ask unanimous consent to submit for Dr. Burns a substantial number of questions that I have, and I will try to get through several of them. Obviously, he cannot answer all of them, because I have a substantial number.

The CHAIRMAN. Without objection, so ordered. Each member of the committee shall have that privilege, and each witness will have the privilege, Dr. Burns, of extending his remarks and inserting unrelated matter in order to make points and clarify the situation.

[The written questions submitted by Congressman Rousselot, and the response to the questions by Dr. Burns, may be found on page 414.]

Mr. ROUSSELOT. Mr. Chairman, I appreciate your additional comments.

Chairman Burns, on July 17 and 18, as you are well aware, this committee heard the views of 6 of the 12 Federal Reserve regional bank presidents concerning the relationship between inflation, high interest rates, and monetary policies. I have three questions I would like to briefly discuss with you. I will read all three of them, because I studied their testimony very carefully, and then we will ask for a general response, the best you can summarize it:

One, did the Federal Reserve Board of Governors or its staff make any effort to influence, change, or coordinate the testimony of the presidents before this committee?

Two, were any of the presidents required to submit the text of their testimony to the Board or its staff in advance for review?

Three, was a special meeting of the Board held on Monday, July 15, 1974, and if so, which Governors and presidents participated, and was the content of the presidents' testimony before this committee discussed?

That is a general area of discussion. Do you want to make any comments on that series of questions, and you would certainly have full rein to respond in detail by letter if you wish.

Dr. BURNS. Let me make a general comment, and then I will address myself, if time permits—it probably will not, unfortunately, the way things are going—to your questions. I will not be able to answer your question concerning July 15 until I refresh my memory concerning precisely what happened on July 15.

Mr. ROUSSELOT. In view of recent events, I think that would probably be a good idea to refresh your memory. I am speaking of testimony taken in the Senate.

Dr. BURNS. I think every one of us at all times ought to know what he is talking about. I have a certain policy. I will tell you what it is. When I have to make a speech, to make a statement before a congressional committee not involving the Board—and I do have to testify as an individual before some congressional committees—what I do almost invariably is to present my paper to members of my staff, to my fellow Governors, and I invite their criticisms. I want their suggestions, and I want them to pick up any factual errors that I might be making.

Mr. ROUSSELOT. If I can interject, that is very understandable. All of us on this committee, many of us do the same thing with our own staffs. My question relates to the presidents of the regional banks.

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Dr. BURNS. I am well aware of your question. Not only do I follow this practice, but I encourage all of my colleagues to do likewise. We have no rigid requirements along these lines. I am not a censor; I have been brought up in a university, and I respect individuals and their thoughts.

You want to know, did the Federal Reserve make any effort to change or coordinate testimony. Let me tell you that I, even as of today, have not read the statements prepared by the Federal Reserve bank presidents who testified.

Mr. ROUSSELOT. Do you think any of your staff members might have?

Dr. BURNS. Oh, yes. The Director of Research did do that.

Mr. ROUSSELOT. What is his name?

Dr. BURNS. His name is Mr. Partee. He did that with a view to calling factual errors to the attention of the bank presidents, and with a view to avoiding unnecessary or dubious arguments. Now, what he did——

Mr. ROUSSELOT. At this point, Mr. Chairman, if I could interject, I would like to provide for the record the statement of Mr. Francis and the suggestions that Mr. Partee made relating to that statement when he appeared before this committee.

The CHAIRMAN. Do you want that included in the record?

Mr. ROUSSELOT. Absolutely.

The CHAIRMAN. Without objection, so ordered.

[The statement referred to by Mr. Rousselot of Darryl R. Francis, president of the Federal Reserve Bank of St. Louis, and the mark-up of this statement as per Mr. Partee's suggestions, may be found on pages 380 and 389.]

Mr. ROUSSELOT. I clearly want to be fair to the chairman and make sure that he has adequate and full time to respond to this question, because I know it is highly detailed and I fully appreciate that the staff of the Federal Reserve Board clearly helps the regional bank presidents. I understand that. I do not think that is highly unusual.

The question really relates to the degree of influence, coordination, et cetera.

Dr. BURNS. Well, the Governors had nothing to do with that. Mr. Partee looked after that in his own fashion. He is a thoroughly responsible man. He gave suggestions. Now, you had some other questions.

Mr. ROUSSELOT. I have a question relating to a Wall Street Journal article that appeared today, entitled "Bank Dominoes," and I ask that this be submitted in the record, and I would appreciate the chairman's response to some of the questions raised by the Wall Street Journal.

The CHAIRMAN. Without objection, so ordered.

[The article referred to, "Bank Dominos" from the Wall Street Journal of August 8, 1974, was submitted earlier in the record by Chairman Patman and may be found on page 298.]

Dr. BURNS. I would like to answer that question, since it appeared in this morning's paper, in one sentence, if I may.

The CHAIRMAN. All right, you may do so, Dr. Burns. If you could be specific without doing violence to your answer, because we are under pressure.

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Dr. BURNS. I ask the privilege of answering that question today since it is in today's paper. That editorial will be discussed widely. I need one sentence only.

The CHAIRMAN. All right, go ahead, sir. Go ahead and use that one sentence or any more if you want to.

Dr. BURNS. In the case of Herstatt, the Germans had an insolvent bank; in the case of Franklin National, we had a solvent bank faced with a serious liquidity problem. That distinction is not made by the Wall Street Journal in its editorial. It is a very basic distinction.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

The CHAIRMAN. All right, Mr. Fauntroy?

Mr. FAUNTROY. Thank you, Mr. Chairman.

Dr. Burns, I simply have two questions on the rising interest rates:

First, to what extent do unsecured lines of credit manifested either through bank notes or overdraft checking accounts tend to do two things: first, to maintain high interest rates and acceptance by the public of those high interest rates; and second, tend to contribute to inflationary pressures and a reallocation of resources toward nonproductive sectors of the economy?

Dr. BURNS. I do not believe that lines of credit as such, whether secured or unsecured, have any influence in these directions.

Mr. FAUNTROY. I see. I suspect that you would not be prepared to impose any credit controls in a selective fashion to diminish demands on the luxury items in the economy.

Dr. BURNS. No, I would not favor that at the present time; no. Consumer credit is not expanding rapidly at the present time. Consumer credit did expand very rapidly in 1972 and early 1973. At that time control over consumer credit might have been justified. I think it would be very difficult to make out a case for it right now.

Mr. FAUNTROY. Dr. Burns, would you be kind enough to use the remaining 3 minutes of my time to answer Mrs. Heckler's question?

Dr. BURNS. Answer who?

Mr. FAUNTROY. Answer Mrs. Heckler's question.

Dr. BURNS. Yes. To go back to housing, you are familiar no doubt with the program that the President announced on May 10. That program called for an expansion of Ginnie Mae's tandem plan; it called for an equivalent plan to be executed through the Federal Home Loan Mortgage Corporation in the case of conventional mortgages, and it also called, third, for subsidized loans by Federal home loan banks to savings and loan associations.

That was a sizable program, and I think it has made a contribution. My friends in the homebuilding industry indicate that it has. This is one thing that was done.

Second, the Federal Housing Administration is processing applications faster than it did, and this has been helpful. Also, in two of our States, Maryland and Illinois, usury ceilings have been lifted, and this has helped the housing industry somewhat.

Unfortunately, the housing bill which the Congress has had under consideration has been held up much too long, and there are several parts of that housing bill that could be very helpful to the homebuilding industry.

It is regrettable that housing legislation has been delayed so long. The maximum amount on FHA-insured home loans under existing

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law is $33,000. That will be raised under the legislation that you are considering, and it should be raised considerably. If that had been done months ago, homebuilding activity would be significantly higher than it is now. That does not help the poor family. I understand that. I am talking about activity in the homebuilding industry.

Next, take Ginnie Mae's authority. Ginnie Mae's authority to acquire larger sized FHA or VA loans is expiring in October. That date is approaching. This is hampering Ginnie Mae's program. That should have been done long ago, and I hope that time will not be lost further.

There are other features of the housing bill that will be helpful to the homebuilding industry, and now we come to the question, will that be enough? Well, it is a difficult question of judgment. The administration has presented a plan for providing an interest tax credit for residential mortgage investment. I think this is a proposal that deserves very serious consideration by the Congress. That is, since any investor in a residential mortgage would receive an interest tax credit, that would tend to stimulate investment in mortgages by all types of financial institutions and individuals.

I think it would be helpful if the Congress gave authority to mortgage lenders to offer variable rate mortgages on FHA and VA loans. Also, if homebuilding does not revive soon, the Congress might want to consider legislation under which the home loan banks may be able to make loans to savings and loan associations on a subsidized basis. They have been doing it out of their own resources, but an appropriation might be needed for the purpose. This is not a measure that I would recommend at the present time, but it is a measure that I would study at the present time with a view to drawing contingency plans.

It is a depressed industry, and it is not all that clear that the bottom of that depression has been reached. These are some of the thoughts that I have about the homebuilding industry.

We at the Federal Reserve have been doing what we can, considering our authority. Our most important contribution, I think, is to continue in fighting inflation. That is the fundamental answer to the problem.

We have also been in the market supporting Federal housing agency issues, and we have been buying them in large amounts. This year thus far, the Federal Reserve System has bought housing agency issues in an amount of $1.3 billion. Last year in the same period, the amount of purchases came to only $200 million.

We have made plans, contingency plans, to provide backstop lending for the Federal Home Loan Bank System, if it comes to that. I hope that this will never be necessary. But if it does become necessary, we will be ready.

I personnally have been quite active. I got Citicorp to modify the terms of its proposed floating rate in a manner that should be helpful to the thrift institutions. My Board and the System have been giving a good deal of attention to the problems of the REIT industry—that is, real estate investment trusts.

The CHAIRMAN. The time of the gentleman has expired.

All right, Mr. Frenzel?

Mr. FRENZEL. Thank you, Mr. Chairman.

Thank you for your testimony, Dr. Burns.

Does your Board foresee any important change in its monetary policy for the short run?

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Dr. BURNS. The answer to that question is "No."

Mr. FRENZEL. Thank you.

Dr. Burns, you have been identified as the No. 1 inflation fighter in Washington and you are so saluted by me. More recently, and joined by Secretary Simon, your advice to us has been that the Federal Reserve cannot do it alone through restrictive monetary policies. Your advice further has been that unless Congress exercises some willpower over its spending we could never conquer inflation. I note in the last couple of months the Congress has passed an Agriculture appropriation of 14 percent over last year; the State, Commerce, and Justice appropriation—no new programs, nothing exciting in there—10 percent more than last year; our legislative appropriation went over to the Senate with $100 million more. It came back with $100 million more in it. Our military appropriation must be up $10 billion over last year by the time we add up all the segments. The HEW bill has got to be a billion dollars over the budget.

It looks to me like Congress is running a policy which goes exactly counter to your suggestions and to the——

The CHAIRMAN. Let us have order, please. Let us have order in the committee. Will the members please assist the chairman in keeping order, and also the staff?

Thank you, sir. Go ahead.

Mr. FRENZEL. It looks to me as though Congress' policies are running exactly counter to your advice and counter to the policies that you have set up. It looks to me as though Congress is pursuing a 100 percent proinflation policy. Lately we have passed a Budget Reform Act for which we all had great hopes. But based on Congress' performance in the last 2 months, I have become very discouraged. I would like your opinion as to whether that act is really going to give us any help.

Could you comment on that, please?

Dr. BURNS. Well, I am very hopeful that the budget reform bill will enable the Congress to bring Federal spending finally under decent control. Whether it will or not will depend, of course, on the willingness of the Members of the Congress to abide by the rather strict rules prescribed by that legislation.

Also, I believe that it will be about 2 years before that legislation is truly operative. We have a difficult 2 years ahead, and we have to get along with such tools as we now have.

Mr. FRENZEL. Could I interrupt there and ask a further question?

I agree for the whole process. But there is a feature within the bill through which the Chief Executive can return to the Congress individual items for rescission or deferral, which it seems to me might be a good technique for putting Congress' feet to the fire and a way that has not been available before.

Do you think that will be helpful?

Dr. BURNS. It should be. Whether it will be or not, will depend entirely on our willingness as a people, within the Congress, within the executive, to live by the rules that are so beautifully enunciated in that legislation. The evidence thus far, as you have suggested, is not entirely persuasive. I think that we are living with delusions about Federal finances.

Take fiscal year 1974. I hear it said time and again, that we came pretty close to having a balanced budget. We had a deficit of merely

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$3.5 billion. I would say two things about that. First, in view of the condition of the Nation's economy during that fiscal year taken as a whole, particularly the high rate of inflation that we were experiencing, we should have had a sizable surplus.

Second, I would say, that the figure of $3.5 billion does not present the full facts. If you add in, as you should, the off-budget outlays which are increasing, and if you add in also the outlays of Government-sponsored corporations, you get a deficit for fiscal 1974 not of $3.5 billion but a deficit of $21 billion.

The CHAIRMAN. The time of the gentleman has expired.

Mr. FRENZEL. I thank the chairman. My 2 minutes seem to be up. I would like to have the chairman comment in his remarks as to whether we should preempt State usury rates and whether or not we do have too much indexation already built into our cost of living agreements throughout the public and private sector, and particularly in our tax system.

The CHAIRMAN. Go ahead and answer, Dr. Burns. He asked you about the usury rate.

Dr. BURNS. Pardon?

The CHAIRMAN. He asked you about the usury rate. John Winthrop Wright, a famous consultant and analyst on the market, testified yesterday that he favored a 10 percent interest rate. It should not be higher than 10 percent. I think that is what Mr. Frenzel is asking you about, if you favor that.

Mr. FRENZEL. Mr. Chairman, my question was that if we gave the S & L's and savings banks all the money in the world they still could not make loans in my State and many others because of usury rates. My question was, to Dr. Burns, would it help if a Federal law preempted those usury laws and wiped them off the books?

Dr. BURNS. I would answer in one word. Yes.

The CHAIRMAN. All right.

Mr. Young?

Mr. YOUNG. Yes, Mr. Chairman. I hardly know where to start. But picking up on the business of Federal spending, and the concern about the Federal debt, and our taking the blame in Congress for much of the inflation; I guess I bolt against that a little bit, because we have got a private corporate debt of $100 billion plus. We have got significant infusions of foreign capital coming into this country, especially leaving the Eurodollar market, and coming into American banks largely because they think you are going to keep American banks straight, or solvent. With all of that foreign capital coming into our economy, and with the tremendous private debt, I wonder if either your monetary policy or our control of Federal spending really have any impact upon—I mean, have any possibility of dealing with—the kind of world inflation situation we find ourselves in.

Dr. BURNS. Well, as far as the inflow of funds from abroad, actually, this year, we have had an outflow of funds from this country through our banks that has exceeded the inflow; and the outflow, or the excess, for the first 5 or 6 months of this year, was about $2 billion. I do not think this has been a major factor one way or another, so far.

When you speak of corporate debt—and, if you like, corporate debt financing—it is enormous. You are entirely right about that. But individual corporations do not have any responsibility for maintaining

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a stable or prosperous economy. The Congress does, the Federal Reserve does, the Executive does. Our Government, as such, does have that obligation. Government is supposed to provide a balance wheel To the extent that there are excesses in the private sector, Government should seek to offset them where it cannot prevent them. Therefore, I do attach great importance to the state of the Federal budget, and I do attach great importance to the policies of the Federal Reserve.

Mr. YOUNG. When you use the term, the Government must provide the balance wheel, I am reminded of my colleague, Mr. Rousselot, being upset about a housing bill coming up a little high—back from the Senate, that is—which I would tend to think would help to be a balance wheel in this economy, versus an enormous defense appropriation which we passed a couple of days ago that meets no particular consumer need. I see the military complex, basically, as being something we are subsidizing to provide jobs. But while we are providing a Federal subsidy to provide jobs, we are not really meeting very much in terms of consumer demand, as we would with a $2 billion housing bill. I wonder if you would comment on the kinds of spending that we do, and are there some kinds of spending that contribute more to inflation than others?

Dr. BURNS. I know very little about the details of the military budget, but I do not look upon the military budget—and I do not think any one of us should—as a way of subsidizing or providing jobs. I look upon the military budget as a way of providing security for this country in a very dangerous world. I think that we must always remember that the first function of Government, throughout history, has been to defend the country against foreign aggressors, and to maintain civil order. That is the first claim on governmental budgets.

Mr. YOUNG. I would agree. But I would contend that the enemies of this country now are using economic means more than military means.

Dr. BURNS. To the extent that that is true, it is the business of the Congress to search out the facts, and never to permit our national security considerations to be corrupted by influences of that kind.

There is one element of truth that I am aware of in your statement, and there may well be others that I do not know anything about. I am not an expert on military matters. We do have military bases in this country that are not needed and should be closed down. They have been maintained because of the pressure from local communities where those bases are. I think that is unfortunate, and I think we ought to put an end to it.

Mr. YOUNG. Let me just move on to one other thing, because in your letter to Mr. Mayo of the Chicago Federal Reserve, you came a little close to the suggestion that maybe there should be some social responsibility to the allocation of funds by banks. It says that, "While funds should normally flow to uses offering greater returns, I believe that it is important that each banker realize that continued availability of credit to local activities may well, in the longer run, yield a greater total return to the economy of his community, and thus to his bank as well."

Dr. BURNS. This was a letter which I addressed to about four, five, or six of our bank presidents in cattle-raising areas because of a difficulty that was brought to my attention of financing feeder lots and cattle raising generally——

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Mr. YOUNG. I am suggesting that this is a good thing, and that perhaps, if the Fed is going to be bailing out banks, that there ought to be some guidelines of social responsibility.

Dr. BURNS. I have got to say a word about that. We are not bailing out banks. We will lend only to a solvent bank. If a bank is insolvent, we would not lend it one penny—large or small. If a bank is solvent, and is faced with a liquidity squeeze, we as a central bank will respect the most traditional function of a central bank, which is to serve as a lender of last resort. In that special sense, we help banks.

The CHAIRMAN. The time of the gentleman has expired.

All right, Mr. Burgener.

Mr. BURGENER. Thank you, Mr. Chairman. Dr. Burns, it is a privilege to have you here. I would like to explore with you, for a moment or two, the Eurodollar situation.

We had a witness here yesterday, a very interesting one. Would you follow with me, please, a transaction? I go into a London bank, and I deposit $100,000 with a check from a New York bank, and I open an account, and I think I understand that. That is a transfer of money from here to there.

If I go into the same bank, and I want to open an account in dollars—I do not have any dollars, but I have collateral—they loan me $100,000, then I open my account. This witness yesterday alleged that that money was created then, right then and there, that $100,000. Is that so? Or did they have to have $100,000 in the bank of somebody else's, or theirs, to open my account?

Do you follow what I am saying? I am trying to understand what Eurodollars are.

Dr. BURNS. Well, the heart of your question, as I understand it, is when you go to your bank and borrow $100,000, and the bank credits your account to that amount, is the bank creating money in the process? The answer to that question is yes. But now, can the bank do that? Whether a bank can do that or not depends on the condition of its reserves, and depends on its ability—if its reserves are inadequate—to raise funds in the market.

Mr. BURGENER. The witness, if I may interrupt—the witness alleged yesterday that these loans, or the dollars credited to my account over there, were not backed by any reserves of any kind.

Dr. BURNS. All that he would have to do is talk to any banker, who would tell him how stiff the reserve requirements of the Federal Reserve are.

Mr. BURGENER. I am talking of a foreign bank, Dr. Burns; a foreign bank, not a domiciled bank, a foreign bank.

Dr. BURNS. If you go to a foreign bank——

Mr. BURGENER. Yes.

Dr. BURNS. You are going to borrow the money from a foreign bank?

Mr. BURGENER. That is right, and I am going to open an account; and I am going to pledge collateral, and they give me $100,000.

Dr. BURNS. The foreign bank has a reserve requirement. It may not be imposed by law in the given country. Usually it is, but where it is not imposed by law, it will be imposed by business—banking prudence.

Mr. BURGENER. His point was that there is an immense build-up of Eurodollars under no control of any kind by us, and that they are highly inflationary, and contribute to our high cost of living. That is

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greatly oversimplified, I am sure, but do you consider the Eurodollar a big problem, or a factor in our inflation?

Dr. BURNS. I think there are problems connected with the Eurodollar markets, yes. But when you ask, is this a significant factor in our inflation, I would say no.

Mr. BURGENER. Thank you.

Dr. BURNS. Significant factors in our inflation include various special factors that have hurt us, such as the bad harvests and the foreign oil. But the basic factors are the state of the Federal budget, and what we at the Federal Reserve do with regard to money and credit.

Mr. BURGENER. A second question, if I have a moment, is on wages and the construction industry. In my county, in San Diego, unemployment in that industry is about 30 percent, very high. Carpenters are getting about $10 an hour. They are striking; they have been striking a long time for $13 an hour, which they will probably get. I admit, that sounds like a lot of money. Ten dollars is $400 a week, or $20,000 a year, but we all know they do not work 50 weeks a year. They probably work 50, 60, 70 percent of the year, so we are losing immense productivity. Part of that is because of lack of mortgage money, part of it is because of severe environmental restrictions, some of which are overdue. What kind of jawboning can we do, what did we do that you mentioned about Dr. Dunlop, to get the construction industry more productive, so that the rates will not have to go so high?

Dr. BURNS. Dr. Dunlop met with the heads of the construction unions, and with building contractors; he tried to influence their behavior, and he was very successful. As I noted before, I think it is a great pity that the Construction Industry Stabilization Committee is no longer functioning, and I think it would be highly desirable to reestablish it.

Mr. BURGENER. Did it go out with the end of price control? Was it an adjunct?

Dr. BURNS. That is right, and to reestablish it would—I believe—take legislative action. It perhaps could be done under Presidential authority, without legislative action, but I think having legislative sanction would be the preferable way of doing it.

Mr. BURGENER. What I am trying to get at, I think our carpenters would rather work 50 weeks a year at $10 an hour than half that number of hours at $13 an hour, and that is productivity. We are losing it, and we have got to do something.

Thank you.

The CHAIRMAN. Thank you, sir.

Mr. Moakley?

Mr. MOAKLEY. Thank you very much, Mr. Chairman, and thank you once again, Dr. Burns, for coming back to our committee so many times to finish your statements.

I noted with interest your testimony before the Joint Economic Committee the other day, in which I believe you departed from the stable administration policy, where you were advocating support for public service employment jobs. Did I detect that?

Dr. BURNS. Yes. I advocated a contingency plan for expanding public service employment.

Mr. MOAKLEY. I also note that many statements were made that the Government just cannot spend any more money, because of our inflation. What effect would these public service jobs have on our economy?

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Dr. BURNS. The plan that I sketched before the Joint Economic Committee would be triggered by a 6-percent rate of unemployment over a period of 3 months. When unemployment reaches that level, it would become a matter of grave social concern, and I do not think the Government can stand by and do nothing about it. Public service employment has the desirable feature that it can be triggered in and triggered out as conditions develop, so the need may be for a very short period. Also, public service employment has the feature that it can be expanded in the particular areas where unemployment is largest.

I would hope that if a plan of this sort, or if legislation along these lines, is adopted, that steps would also be taken to raise a little additional revenue, which we can do, and to cut back on other parts of our Federal spending program.

Mr. MOAKLEY. Would you consider cleaning up our environment, or building additional housing units, in the area of public service?

Dr. BURNS. I would not consider building additional housing units as coming under that category. But I think public service employment could help in cleaning up our environment.

Mr. MOAKLEY. You say if the unemployment goes over 6 percent in some areas, this would be the triggering device? Did you have any firm figures on the amount of money that would be spent in certain areas? Was there any ceiling?

Dr. BURNS. This would depend on the Congress. Under the public service employment legislation that we have on the books, under the existing legislation, the average wage per year has amounted to $8,000. I would lower that average wage substantially in the kind of legislation that I am suggesting. In other words, the important thing, as I see it, is to provide jobs, to enable people to tide over a period of difficulty, rather than to provide a high rate of pay. So I would lower that figure from $8,000 to $5,000 or $6,000.

Mr. MOAKLEY. Dr. Burns, would this be similar, somewhat, to the days when I was a youngster, the WPA projects?

Dr. BURNS. I think it would be similar. I would like to think it could be administered more wisely, and that these triggering-out devices would insure that the program did not last any longer than this abnormal period of unemployment, if we get into that period. We may not get there. I would have it on the statute books, to take care of a contingency.

Mr. MOAKLEY. In what kind of area would you be talking about when you talk about 6-percent unemployment? Would you be talking about a market area, a city, a State? What geographical limitations?

Dr. BURNS. The 6-percent unemployment rate is a national figure, a national average.

Mr. MOAKLEY. For instance, in the Boston area, I think our unemployment is somewhere between—oh, 6¾ and 7¾ percent. You know, we have had the closing of the naval bases and other industries that were dependent upon the naval base for their existence. Our unemployment rate is well over 6 percent. But you would say that it would have to be a nationwide 6 percent?

Dr. BURNS. I think that is the way I would do it, yes. However, in areas where unemployment is particularly heavy, as it is in New England, there I would move in more promptly and on a much larger

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scale than in other parts of the country, such as the South, where unemployment is much lower.

Mr. MOAKLEY. Doctor, in your capacity as Chairman of the Board of Governors, what emergency powers do you have to stabilize inflation?

Dr. BURNS. The legislation is not written in that manner. We do have powers under the law to influence the volume of the growth, the expansion, of the money supply and bank credit.

The CHAIRMAN. The time of the gentleman has expired.

Mr. MOAKLEY. Mr. Chairman, I would appreciate the complete answer that Dr. Burns was about to give to my question.

Dr. BURNS. By influencing the rate of growth of the money supply, and the rate of growth of bank credit, we do release forces that have, after some lag, an effect on the general price level.

Mr. MOAKLEY. Thank you very much.

The CHAIRMAN. When you examine your transcript for approval, you may enlarge upon your testimony, if you desire, on this point. It is a very important point; I realize that.

Dr. BURNS. Thank you.

The CHAIRMAN. Mr. Rinaldo?

Mr. RINALDO. Thank you, Mr. Chairman. I certainly want to extend my thanks and gratitude to Dr. Burns for so patiently answering these many questions. But certainly, I think you recognized the importance of them. To me, this hearing is the most important kind we can hold in this Congress, providing that effective action does follow the hearings; and the suggestions that you make to combat what I consider the number one problem facing our country today, at least the number one problem facing my district, and that is the problem of the economy, the problem of inflation, the problem of paychecks that are being stretched to the breaking point, and the problem of people that cannot make ends meet. One of the reasons this hearing was called was to investigate the relationship between unemployment and inflation.

Federal Reserve Board Governor Andrew Brimmer has recently conducted some studies with the Federal Reserve's econometric models, and he concluded that, to bring the Consumer Price Index down to 4 percent by December 1975, by using only fiscal and monetary restraint, and not price controls, would mean raising the unemployment rate substantially above 6 percent.

On page 2 of your testimony, while talking specifically about the tradeoff on unemployment and inflation, you say, and I quote, "The forces affecting economic activity and prices in a modern economy are far too complex to be described by a simple mathematical equation." Does the Brimmer study fit your description of a simple mathematical equation, or can we view the results of his research as an accurate assessment of the situation?

Dr. BURNS. I hesitate to answer the question, because I have not reviewed Governor Brimmer's study with sufficient care to be sure that my answer will do his study full justice. My impression is that Governor Brimmer's statement, to which you refer, is based on a mathematical model.

Mr. RINALDO. To save time, would you be good enough, or kind enough, to answer the question for the record, and then maybe in the short period of time allotted to me, I can get on to another question?

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[In response to the request of Mr. Rinaldo, the following information was submitted for the record by Dr. Burns:]

REPLY RECEIVED FROM DR. BURNS

Governor Brimmer's comment on the possible effects on unemployment of efforts to reduce the rate of inflation to 4 percent by the end of 1975 was based on simulations of a large-scale mathematical model. The model contains not just one equation relating the unemployment rate to the rate of inflation, but a large number of equations that describe relationships among many economic and financial variables. Any mathematical model of this kind is based on average relationships that have existed in the past, and that may have only limited application to the present or the future. It is my view that the forces affecting economic activity and prices in a modern economy are far too complex to be described either by a simple mathematical equation or by a large number of them.

Mr. RINALDO. Last April 30, you and Dr. Dunlop spoke here in response to a few questions about wage and price controls. Of course on April 30 we saw the need of those controls. With the large rise in the cost of living during the past several months, workers are now trying to increase their real wages, and in many cases justifiably so. I cannot completely disagree with them. I understand why they are doing this. On page 4 of your statement, you said, and I am going to quote you again, "The removal of controls over wages and prices has led to sharp upward adjustments in both our labor and commodity markets." Kenneth Rush, testifying before the Joint Economic Committee on July 29, said that recently negotiated wage settlements have been running well over 10 percent. Some economists figure that if the 8 percent average wage increases of 1974 leap to 12 percent next year, inflation may follow suit, and rise at a 1 to 2 percent faster rate than the expected rate of 7 percent in the fourth quarter of this year.

This type of wage-induced inflation is different from the kind that follows commodity shortages, to be sure. Wage increases put money in the hands of people, and with this money, what they in effect do is, as I understand the economy, is bid up prices by spending more of the disposable income that is available to each of the individuals in question.

What, if any, is the type of reaction the Federal Reserve Board has, and you have in particular, to this type of situation, because we are certainly confronted with it?

Dr. BURNS. I have felt for some years that while we must rely primarily on prudent monetary and fiscal policies in our efforts to achieve some approximation to general price stability, I have also felt that we will need to develop an income policy in our country. I see no escape from the fact that we have in our society some abuses of economic power by business firms and by trade unions. We have antitrust laws to deal with business abuses, abuses of business power. I think that the penalties under our antitrust laws are much too weak, and there is some question in my mind as to whether the antitrust laws are being enforced with sufficient vigor. Reforms are needed in that direction, but, in addition, I think it would be helpful to reestablish at this time the Cost of Living Council, and to empower that Council to establish, on an ad hoc basis, review boards to deal with a wage problem or a price problem in a pacesetting industry when there is some suggestion or belief that there may be an abuse of economic power, market power.

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This could mean that, for a brief period, say 30 to 45 days, the wage increase that is projected, or the price increase that is projected, would not go into effect. The ad hoc board would have the authority to conduct hearings, to make recommendations. It would not have any enforcement power. The Cost of Living Council would monitor the results, and determine the degree of compliance with the recommendations. Reliance would be placed on the force of public opinion, which I think is still a vital force in our society.

Mr. RINALDO. Thank you very much, Dr. Burns.

The CHAIRMAN. The gentleman's time has expired.

Mr. Stark?

Mr. STARK. Welcome back, Doctor; and I am concerned by your optimistic reaction that the banking, and particularly the savings and loan industry, do not need bailing out, and I would take exception to your remarks. Franklin National, I would submit, was bankrupt by any standard accounting practice. If you are willing to value their assets at market value, and not at book, they would have had to be liquidated. In the banking industry we carry bonds and loans which you and I both know could not be sold, in some cases, for half of their carrying value.

The savings and loan industry in this country is technically bankrupt. If they had to sell their mortgages in the marketplace at a price to yield return that is commensurate with what anybody would invest today, there is not one of them that would not be 20 or 30 percent in their capital. They would be wiped out, and as you have aptly pointed out, the Federal Home Loan Bank Board could very well have some serious liquidity problems if withdrawals continue. But if you go right to your own July weekly condition of large commercial banks, there are $294 billion worth of loans, and $41 billion worth of munis, most of which will tend to be long-term, and most of which are deeply discounted, for $335 billion worth of assets. There is only $33 billion worth of capital in these large banks.

In any State with a 10 percent usury law, on a day when Fed funds are selling for 12 percent, I would submit there is a very good possibility that the bank is technically insolvent. You and I both know that it is very unlikely that all this would happen at once. But when Secretary Simon is overseas telling people that he is going to provide the liquidity for any Eurodollar crisis, when you have investors lining up to buy our Government securities at 8 and 9 percent, and they are taking it out of savings and loans at 7; short of printing money, the only thing we have left is the confidence that you instill. I am afraid there is nobody else in the administration who understands economics that can instill that confidence.

Our confidence is only as good as our ability to control inflation, and here we have the Hobson's problem. It has got to end, and yet it is not. Without really strict controls and increased taxes on corporations and higher income for individuals, I just cannot conceive of our being able to handle a liquidity crisis and control inflation. On this I would invite your comment, because I am not confident. I would not want to be the one to start a run on banks and savings and loans, but on the other hand, I do not like this impression that they are all that solvent. Technically, I do not think that is true.

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Dr. BURNS. I think the picture that you have drawn is based on hypothetical conditions.

Mr. STARK. Not necessarily with the savings and loan industry. I will grant you that it may be for large commercial banks.

Dr. BURNS. Take the savings and loan industry. The difficulty with our savings and loan industry is that the inflow of funds is now a mere trickle. In the month of July, the inflow of funds amounted to, on an overall basis, an annual rate of growth of 3 percent; in June, 8 percent; in May, 2 percent. When the rate of growth of net inflow of funds is that low, you will have some savings and loan associations that are actually losing money; that is, where we have an actual outflow. There are many such savings and loan associations. But they are not in financial trouble.

The homebuilding industry, however, is in trouble because the net inflow on an overall basis is so small that many savings and loan associations are experiencing an actual outflow. Financially, these institutions are quite comfortable, but they are not in a position to make mortgage loans.

Mr. STARK. But they are only comfortable, sir, if you continue to value their assets at that book figure, which we both know is completely unrealistic because of this unusual situation and high interest rates. Therefore they need discounts.

Dr. BURNS. It is an accounting convention. You are asking the question what would the value of the assets look like if you dropped that accounting convention. What reason is there for dropping the accounting convention?

Mr. STARK. Because we may have to liquidate loans to meet outflow.

Dr. BURNS. Let us look at this.

Mr. ROUSSELOT. Mr. Chairman, I ask unanimous consent that he be allowed to finish this question.

The CHAIRMAN. Go ahead and answer the question, Dr. Burns.

Dr. BURNS. Let us think of a particular savings and loan association, where money is flowing out in large volume. That savings and loan association will have some liquid assets, but they are small for most associations, 5, 6, 7 percent, in some instances less than that.

What can that association do? Sell off its mortgages, 4½ percent mortgages, that it has in its portfolio? It would have to take a huge loss. That association can turn to the Federal home loan bank, and it can borrow from the Federal home loan bank. It will not encounter any difficulty in doing so.

Assume that the outflow spreads and there are many associations faced with such a problem. This is making a very extreme assumption. I do not think we are going to have anything like it. But let us just assume it happens.

The Federal home loan bank can lend up to a point; it can go into the market and borrow. But suppose—I am going to follow this to the limit now. But suppose that the demand on the home loan banks is large and keeps growing. Then the home loan banks may find that their ability to borrow in the market is practically at an end.

In that case, they have a line of credit with the Treasury. All right, now. The Treasury may be having difficulties of its own at that time. If we ever reach that position, the Federal Reserve has a contingency plan worked out with the Federal home loan bank system that can be put into operation to handle a crisis problem of that sort.

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The CHAIRMAN. Mrs. Boggs.

Mrs. BOGGS. Thank you, Mr. Chairman.

Thank you, Dr. Burns, so much for being here. We hate to impose so much on your time, but all of us are frustrated at trying to rebuild the confidence in the Government while trying to handle the problems in our own home districts.

I am very interested in the savings and loan problem, and if Mr. Stark has any further question, I would be glad to yield some of my time to him.

Mr. STARK. I thank my colleague very much.

I want to hasten to add that Dr. Burns is right, that these things tend to be hypothetical. If we are going to try to shore up the Eurodollar in the market at ever-increasing prices, there is an ever-decreasing ability on the part of the savings and loan to even pay the interest. The problem, I am sure we both agree, is inflation. However, I would still dispute whether Franklin was a solvent organization. I don't think that bank could have been sold to another bank in the free market. Its assets could not have realized anywhere near enough to cover its liabilities.

Dr. BURNS. I looked into that question. We do not regulate that bank.

Mr. STARK. I understand that.

Dr. BURNS. It is regulated by the Comptroller of the Currency. We have a definitive statement from the Comptroller on that issue. I consulted with private bankers who helped me look into this situation.

Mr. STARK. I appreciate that. Thank you very much.

Mr. BLACKBURN. If the gentlewoman would yield.

Mrs. BOGGS. I would be glad to yield.

Mr. BLACKBURN. I appreciate your yielding; because we talked about the outflow of capital from the savings and loans, and I think this is a very easily understood phenomenon when we have inflation running at 7½, perhaps 8, percent a year, and we are limiting the return on deposits to what, 5¾ percent or something, so that a saver is not receiving enough earnings to offset the diminution in his principal that is taking place by reason of inflation.

Now we have the Federal Government issuing Treasury notes that are selling at 7½ or 8 percent, 9 percent interest. Any rational person is going to be inclined to take his money out of the savings and loans and put it in Treasury notes.

It seems to me at the very least regulation Q should be very drastically revised, if not abolished. I am wondering, would it be wise to provide that there would be no income taxes on interest when interest is not sufficient to offset the diminution in principal?

I just wondered if you thought that might be some approach, because no rational person is going to be happy about seeing his principal shrink at 7 percent and he receives 5¾ percent interest, and then we tax him as though he has earned money and he has lost money. I think it is a double insult.

What would be your thoughts to some sort of special tax treatment under such circumstances?

Dr. BURNS. I am not in favor of tax reductions now, even for very worthy causes. I think the time will come when we ought to consider

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your suggestion seriously, Mr. Blackburn. I would not do it now, in view of the condition of our national economy and the condition of our national budget.

Earlier I made the comment that we congratulate ourselves, or some of us do, that the Federal budget deficit last fiscal year was only $3.5 billion. It should have been a sizable surplus. Actually, when you keep books the way I do, the budget deficit was not $3.5 but $21 billion.

Mr. BLACKBURN. I agree with you.

The CHAIRMAN. The time of the gentlewoman has expired.

It is now time that I may use, but I will ask very few questions. I will yield then to Mr. Widnall, and then I will yield to Mr. Stephens.

Dr. Burns, you answered Mr. Frenzel that you were opposed to the usury laws. Is that correct?

Dr. BURNS. I am sorry, I did not hear you, Mr. Chairman. That I was opposed to what?

The CHAIRMAN. To the usury laws in the States.

Dr. BURNS. Oh, yes.

The CHAIRMAN. And the National Government, too.

Dr. BURNS. Yes.

The CHAIRMAN. Do you mean you are against any usury laws?

Dr. BURNS. My general thinking runs in that direction, yes.

The CHAIRMAN. I am sorry to hear you say that. That indicates to me, in my book, that we could not properly protect the poor and the poverty-stricken people against these loan sharks, we could not unless we had some kind of usury law. I am sorry to hear the Chairman of the Federal Reserve Board take the position that he is against them. Anyway, I will not pursue that. That is a matter entirely up to you.

The multinational banks in foreign countries, we have lots of them in every country in the world, big banks have. Lots of money flows out of the parent banks, say, the Chase Manhattan or First National City or different ones, to these branch banks in foreign countries.

Is it true that we have no supervisory power over these branch banks in foreign countries through our regulatory agencies in this country?

Dr. BURNS. No; that is not true. We have supervisory power over the banks of this country and over the branches that they have abroad.

The CHAIRMAN. Do we have supervisory control over the foreign banks in this country, like in New York and Illinois and a few States where they have so many?

Dr. BURNS. There our supervisory power is negligible. We need legislation, and the Federal Reserve is almost ready to propose legislation.

The CHAIRMAN. I wonder why you do not, Dr. Burns. You know, the multinational corporations and multinational banks, I think, have abused their powers all over the world and against the interest of the United States. Do you not feel that way about it?

Dr. BURNS. I think there have been abuses. But the reason why we have not proposed the legislation sooner is that we have tried to work out legislation in a thorough, professional manner. We have explored the legislation that we are working on with foreign central banks and foreign government officials. There is no use coming before the Congress and giving you a bill which is going to cause all kinds of problems, political and economic. We are almost ready with the legislation.

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The CHAIRMAN. I believe it is the wrong step not to have any legislation at all, and we have suffered many years from these abuses.

I notice you state, Dr. Burns, that on the housing, that the Federal Reserve has no specific authority in the housing field. I am disappointed in your statement there. Usually I agree with you on most things, but on that thing and on usury, I just do not do it. I just do not agree with you.

Why do you not ask for more authority in the housing field? You are very familiar with it, and you know that there are all kinds of abuses. Several times before our committee when we asked you, you would say you had no specific authority in the housing field. Why do you not ask for it? The Congress would be very quick to give it to you.

Dr. BURNS. We submitted a report to the Congress in March 1972, that I hope the Congress will consider before too many months pass.

The CHAIRMAN. I believe that is the first time that specifically has been brought to my attention. I did not know that you did that. I was here in 1972.

Dr. BURNS. I assure you, Mr. Chairman, that your office received more than one copy of that report.

The CHAIRMAN. I wish you would specifically remind us what you think should be done on that, and also these multinational banks and the multinational corporations. There are abuses there, I think, that we could afford to lay aside other things and take up. Anyway, I will not take up your time on that.

Mr. Widnall, would you like to ask any questions?

Mr. WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, you have been giving us a very fine group of statements, on extremely important things with respect to our national economy. As always, you have been very forthright with us. I, for one, appreciate the contributions you have been making.

On page 15 of your testimony, you stated that—and I quote—"Simulations of the model using the actual growth rate of the money supply since the first quarter of 1972 suggest that the rate of inflation during the past two quarters should have been a mere 3½ percent." Furthermore, you said that "special factors" were the major causes of the inflation rate during the last 6 months.

In view of the fact that a 3½-percent inflation rate would be acceptable to most economists, politicians, and American consumers, are you contending that our level of money growth in January of 1972 would have been appropriate if these unforeseen special factors had not emerged?

Dr. BURNS. No, I would not say that. What I tried to do in that passage was to call the attention of the members of this committee to the fact that, while the amount of money is important, the willingness to use the existing stock of money is also important, and over short periods much more important.

The money stock is fairly stable in comparison with the rate of turnover of money balances—which reflects the willingness to use money. In recent discussions, economists, I believe, have exaggerated the importance of the rate of growth of money during short periods and underestimated the importance of the willingness to use such

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money as is available. Factors outside the monetary sphere can affect importantly the rate of money use. In my statement, I tried to call attention to these special factors and also to the role that budget deficits play in the inflationary process.

We have been trying to achieve a rate of growth of the money supply that would foster a return to general stability in the price level. This has required, in view of the special factors presently affecting prices, a middle course for monetary policy. The rate of growth of the money supply has been below the rate of growth of the dollar value of the gross national product, but it has been above the rate of growth of the money supply that would be needed to obtain and maintain a stable price level in the long run. We have been in between those limits.

Mr. WIDNALL. Do you not really believe that one of the major factors in our problem today has been the overextension of credit?

Dr. BURNS. Yes.

Mr. WIDNALL. This has come in in many ways. It has come in through the abnormal use of credit cards; it has come in through the extension of activities on the part of many major operations, the thirst for bigness on the part of corporations, on the part of banks, where the success of the activity is measured in the millions of assets or hundreds of millions of assets and not on the job that is being done for the community and the Nation. Is that not partially true?

Dr. BURNS. Oh, I think that is very—of course it is true. Yes.

Mr. WIDNALL. I am not going to ask you any more questions. A lot has been covered by our colleagues here, and I think there are some very important things that you have stated that are in the record right now. Thank you for coming, Dr. Burns.

The CHAIRMAN. Now, then, we have just been given notice that we have this election bill up under the 5-minute rule, and we are going to have to suspend. But I want to recognize Mr. Stephens, because he has been here all morning, and he must be recognized.

So go ahead, Mr. Stephens, and when you get through, we will have to adjourn.

Mr. STEPHENS. Thank you, Mr. Chairman. I appreciate your consideration.

I have not minded at all waiting here and listening, because it has been to my profit to listen, where sometimes when I talk I do not get quite as much benefit as I do when I listen.

My concern, at least, because of the importunities that have come my way in recent weeks, has been on the competition for the savings dollar. One of the things that has been pointed out is now the small saver, the little investor, they say is more sophisticated, and he is going to put his savings at a place where he thinks he is getting a better return.

I was amazed when I saw the lines last week lined up when the offerings were made by the Treasury Department at a 9 percent rate of interest.

I happened to be looking at television when one of the reporters put his microphone in the mouth of this lady, almost in her mouth like they always do, and asked her where she got the money from. She said, "Why, from my savings account, because it does not pay as much."

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I am not sure that there is as much sophistication as there might be. As I understand it, the Treasury has offered a $1,000 denomination at 9 percent.

They are offering that on a bid basis. What these people that lined up may not have understood—at least, I do not think they did—was that 9 percent interest is not the full return. They, for $1,000, may have to pay $1,100 on a bid, and that they are not taking into consideration at all the fact that they have a yield, not the interest rate, but what they are going to actually make. Then, in addition to that, those obligations are for a longer period of time than 6 months at the savings and loan at 5½ percent. Competition for the savings dollar is partly based upon misapprehension, misunderstanding by the investors.

I know how you testified before us on the Citicorp issues. But what has concerned me so much is the fact, the actual fact, that at the withdrawal period which took place as of the 30th of June of this year one of the two savings and loan associations in my hometown had almost $½ million in withdrawals, net, and they have no ability out of incoming deposits to make a housing loan. The only way that they can make a housing loan now would be to borrow through the privileges of the Federal Home Loan Bank Board or wait until their monthly payments build up their revolving fund so that they can make a housing loan.

So the cost of the house is not so much a problem with them and with the person who wants to buy a house. The problem is getting the money from the lending institution, even on a house that is for the moderate and a little bit higher income level. That is where I guess I find myself most concerned, rather than with some of the other things that you point out are inflationary.

I would like to, if anything that I have said would give you some comment to make on what we need, really, to do about this competition for the savings dollar—that is the whole underlying factor, though, in the Citicorp; that is part of the trouble with the stock market, is the competition for savings. Of course, regulation Q is a usury law. It is a usury law that we have enacted.

When we talk about usury laws, in its real analysis, a usury law is a price control, because it is the price of money. But I do not know whether I have given anything except the concern as to what you think we might do to reduce this competition for savings dollars.

Dr. BURNS. We cannot neglect the position of our thrift institutions. They are in difficulty. Therefore, I would continue with regulation Q under present conditions. However, I would consider some modification of regulation Q under which savings and loan associations, if they so chose, could put out issues of the Citicorp type up to a small fraction of their assets.

Mr. STEPHENS. Would that be with the rate that would vary with the Federal money?

Dr. BURNS. Yes, some plan like that that would increase their competitive power, but they could do that only to a small degree. They would need, I believe, statutory authority for it. I think also that our savings and loan associations should be encouraged to make variable rate mortgages. However, some safeguards are needed for that.

The CHAIRMAN. To establish variable interest rates, Doctor?

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Dr. BURNS. That is right. Where the interest rate paid by the borrower would vary.

Mr. STEPHENS. Mr. Chairman, I know my time has expired, but I would like to get an explanation or an understanding of what you mean by a variable rate.

Would that mean that if I borrowed the money from savings and loan on July 1, on my home, and the contractual interest rate was 8 percent or 9 percent, and then you had a fluctuation in interest rates 2 years from now, that I would either go up or down on the interest rate? A new contract would be provided?

Dr. BURNS. That is right. That could be done, you see, either by varying the size of the monthly payment or by lengthening the period over which you make these monthly payments. The second would be the easier way of doing it for most people.

There are safeguards that are necessary if the variable rate mortgage is going to spread. Those safeguards should be written into legislation if we are going to move in that direction.

The CHAIRMAN. We will have to recess. The alternative is an afternoon session. I doubt the wisdom of trying it, because we have this election bill up under the 5-minute rule now, and I do not believe we could get back here at 2:30 or 3:30 or even 4 p.m. I have no assurance that we would get out at 6 p.m. because it looks that kind of late.

So our alternative is to recess the committee, and if we need Dr. Burns back, if there is any real demand for him to come back, we will get with you, Dr. Burns, and see if we can agree on a time.

Mr. BROWN. Mr. Chairman, before you adjourn the meeting, I have an article here entitled, "Burns Urges White House to Push Drive on Inflation, but Sees Long Battle Ahead." I think it would be good to have it in the record.

I ask unanimous consent that it be put in the committee record.

The CHAIRMAN. All right.

Without objection, so ordered.

[The article referred to by Mr. Brown follows:]

[From the Wall Street Journal, Aug. 7, 1974]

BURNS URGES WHITE HOUSE TO PUSH DRIVE ON INFLATION, BUT SEES LONG BATTLE AHEAD

Federal Reserve Chairman Arthur Burns urged the White House to take a "little more energetic action" to slow price boosts. But he also conceded that the nation's anti-inflation battle will last "two years anyhow, and it may last a great deal longer."

Asserting he is "an impatient man," the nation's central banker said the Nixon administration should help curb inflation and deal with other economic ills by paring the federal budget for the current year as much as $10 billion, by uniting with other nations to force world oil prices down, and by reestablishing the Cost of Living Council and permitting it to delay big wage and price increases.

Testifying before the Joint Economic Committee, Mr. Burns emphasized that he believes the economy "is being attended to" in the White House, but he indicated the attention to corraling inflationary forces is insufficient. In response to questions, he said the President's Watergate troubles are "adding to the uncertainty" in financial markets over the administration's ability to fight inflation. "That's my own impression," he said, adding, however, that he has found it difficult to document that belief.

The Fed chairman said that during the recent House Judiciary Committee hearings, he watched with "special care" the foreign exchange market. "It was remarkably stable, and the dollar actually strengthened," he said, indicating that the response was surprising.

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Mr. Burns said the Reserve Board will continue its tight monetary policies short of causing a credit crunch, and he said "evidence is accumulating" that the Fed's restrictive policies already are helping to moderate credit demand. He added that businesses have found it more difficult to obtain bank loans and that securities markets have been less receptive to their need for funds.

But declaring that the general public "doesn't really understand monetary policy," Mr. Burns said he favors more budget-cutting measures to slow inflation. "The public understands that reduction in federal spending will mean a reduction in aggregate demand for goods and services. They also can understand when the government has a balanced budget, it doesn't need to enter the (money) market to borrow," he said.

"For a time, we should be prepared to tolerate a slower rate of economic growth and a higher rate of unemployment than any of us would like. A period of slow growth is needed to permit an unwinding of the inflationary processes that have been built into our economy through years of neglect," Mr. Burns said.

If the nation's jobless rate hits 6% however, Mr. Burns said he favors a $4 billion public service employment program by the government that would provide jobs for 800,000 persons.

Mr. Burns voiced a much deeper concern over the effects of sky-high world oil prices on international financial markets than other government officials have expressed publicly, including Treasury Secretary William E. Simon. He said that unless foreign oil prices drop significantly, he "cannot be optimistic" about the ability of financial markets to manage the recycling of the huge surpluses of oil-producing nations to countries experiencing big international payments deficits.

The Fed chairman urged a stronger fuel-conservation program in the U.S. and also the formation of an alliance of oil-consuming countries to bring oil producers "to the path of reason" through common economic policy and through "political devices." Such an alliance, consisting of the U.S. and 11 other industrialized nations, has already been approved in principle. The agreement calls for member nations to conserve and share petroleum supplies in the event of a new energy crisis.

During a 2½-hour question-and-answer period, Mr. Burns made these additional points:

—The administration must move swiftly to aid the troubled utilities industry by boosting the investment tax credit for utilities to 7% from 4%, by urging regulators to speed up rate-increase approvals, and by advising bankers to provide temporary financing to utilities pending their ability to obtain more permanent financing from the bond market.

—The Fed staff is drawing up some proposals for "drastic changes" in the federal bank regulatory structure that he will propose to Congress probably later this year.

—He would favor establishment of an advisory council on bank credit policy but would oppose strongly any bid to force the Fed to allocate credit.

—Prices of industrial raw materials should register declines "of some magnitude" in coming months as world economics continue to slacken.

—The Fed is considering a separate discount rate, which is the fee it charges on loans to member commercial banks that would apply to long-term loans rather than to the standard loans of just a few days or so. The new rate, which presumably would be higher than the rate on short-term loans, would be available for loan situations like that involving troubled Franklin National Bank, which has borrowed millions of Fed funds to help it stay alive.

Mrs. BOGGS. Mr. Chairman, may I make a comment?

The CHAIRMAN. Yes.

Mrs. BOGGS. I would just like to tell Dr. Burns that the interest shown in the budget committee membership by the Members of the Democratic caucus, I think, assures him and the other members of the executive branch and the Federal Reserve that there is very strong feeling in the Congress for fiscal responsibility, that there are many people who are anxious to become members of the budget committee, willing to give up other committee assignments for which they have worked for many years in order to give full time to the budget committee.

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I think that any kind of overspending that results in upping the average from last year has really been the result of inflation and devaluation of the dollar. I do think that when you have conditions where we must solve our problems by a tandem arrangement of monetary and fiscal policies, that you are going to find a great deal of responsiveness in the Congress for insuring fiscal responsibility.

The CHAIRMAN. Dr. Burns, for myself and the committee, we desire to thank you for your attendance and your testimony. We have appreciated it very much, and it will be carefully considered in our considerations of any legislation to come before us. Thank you very much, sir.

Dr. BURNS. Thank you very much for your courtesy, Mr. Chairman.

[Whereupon, at 12:15 p.m., the committee was recessed subject to the call of the Chair.]

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STATEMENT OF DAVID I. MEISELMAN, PROFESSOR OF ECONOMICS, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSTY

[Dr. David I. Meiselman, professor of economics, Virginia Polytechnic Institute and State University was scheduled to testify on August 7, 1974. Time constraints prevented Dr. Meiselman from being heard. His statement follows:]

I am David Meiselman, and I am a professor of economics at Virginia Polytechnic Institute and State University where I am also director of its new Northern Virginia Graduate Program in Economics located in Reston, Va. I have devoted most of my professional career to the study of money and its relationship to business and financial conditions. I appreciate the opportunity to appear before the Banking and Currency Committee in its hearings on Federal Reserve policy and inflation and high interest rates.

The Banking and Currency Committee is to be highly commended for undertaking staff studies and hearings on the role of the Federal Reserve policy in inflation and high interest rates. I share the general view that inflation is the country's number one economic problem, that inappropriate public policy is the major source of inflation, and that high and rising interest rates have hurt many Americans. It is most welcome that the committee is now considering these problems and their relationship to Federal Reserve policy. The problems are serious, the Congress has unique responsibility in the areas of money and of Federal Reserve policy, and I believe that inappropriate Federal Reserve policy has played a major role in causing both inflation and high interest rates. I also believe there is no effective way to reduce inflation or high interest rates unless there is a marked change in Fed policy.

The Federal Reserve is a creature of Congress and reports to the Congress. The notion that the Federal Reserve is independent is to be interpreted only in the sense that under the law the Federal Reserve is independent of the executive branch of the Government, but not the legislative branch. In that sense, the Federal Reserve is different from most Agencies involved in making and carrying out public policy, especially where economic policy is concerned. This is why I firmly believe that close accountability to the Congress by the Federal Reserve for their conduct of monetary policy is essential. For if the Federal Reserve is not held accountable by the Congress, then, we must ask, to whom, this side of Heaven, are they accountable? By the same token, we must also ask to whom the Federal Reserve should turn for guidelines in the use of the vast monetary powers delegated to them by Congress?

I have read the staff report on Federal Reserve policy and inflation and high interest rates and I wish to commend the committee and its staff for the report's high level of technical skill and objectivity in preparing an excellent and apt analysis. The findings of the report are consistent with some of the best research on the role of monetary policy

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in determining prices and interest rates which has been done by a large and growing number of independent scholars, especially in the past 10 or 15 years.

Much of this research has added still more evidence about the central role of the nominal quantity of money in determining nominal gross national product as well as the crucial importance of money in determining the level of prices, especially secular changes in prices. I believe that the long-period relationship between money and prices is the single most tested and verified proposition in all of economics, covering a wider range of economic experience in time, place, and circumstances than any other, and with essentially the same results. I have prepared several charts to summarize these relationships, especially for the recent history of the United States. They differ from historic norms only in that year-to-year changes in GNP and in the price level are still more closely linked to money than in the past.

The stock of money is controlled by the Federal Reserve. Federal Reserve actions, primarily open market operations, impact directly on the monetary base, sometimes called high-powered money, which is mainly composed of Federal Reserve credit. In turn, changes in the stock of money closely follow changes in the monetary base, although on a week-to-week or month-to-month basis it is important to note that there may be some temporary looseness in this connection. Although the Federal Reserve has the power and ability to control money it may not do so, preferring instead to control interest rates, so-called money market conditions, or perhaps other things. The Fed cannot effectively have both money supply and interest rate targets. It has tried to do both, and in the process has generally achieved neither.

Chart 1 shows the close year-to-year relationship between the narrow M_1 measure of money (currency in the hands of the public plus all commercial bank demand deposits) and nominal GNP. The result is virtually a perfect correlation between the two.

Chart 2 shows the same close year-to-year relationship between the broad M_2 measure of money (currency in the hands of the public plus all commercial bank deposits other than large certificates of deposit) and nominal GNP. Again, the result is close to a perfect correlation. Both M_1 and M_2 measures of money yield excellent predictions of GNP. This is the main reason that many economists believe that the quantity of money is of crucial significance in determining GNP, that differences between the effects of the two measures of money are minor indeed, and that it makes little difference which measure is used either to predict GNP or to control it.

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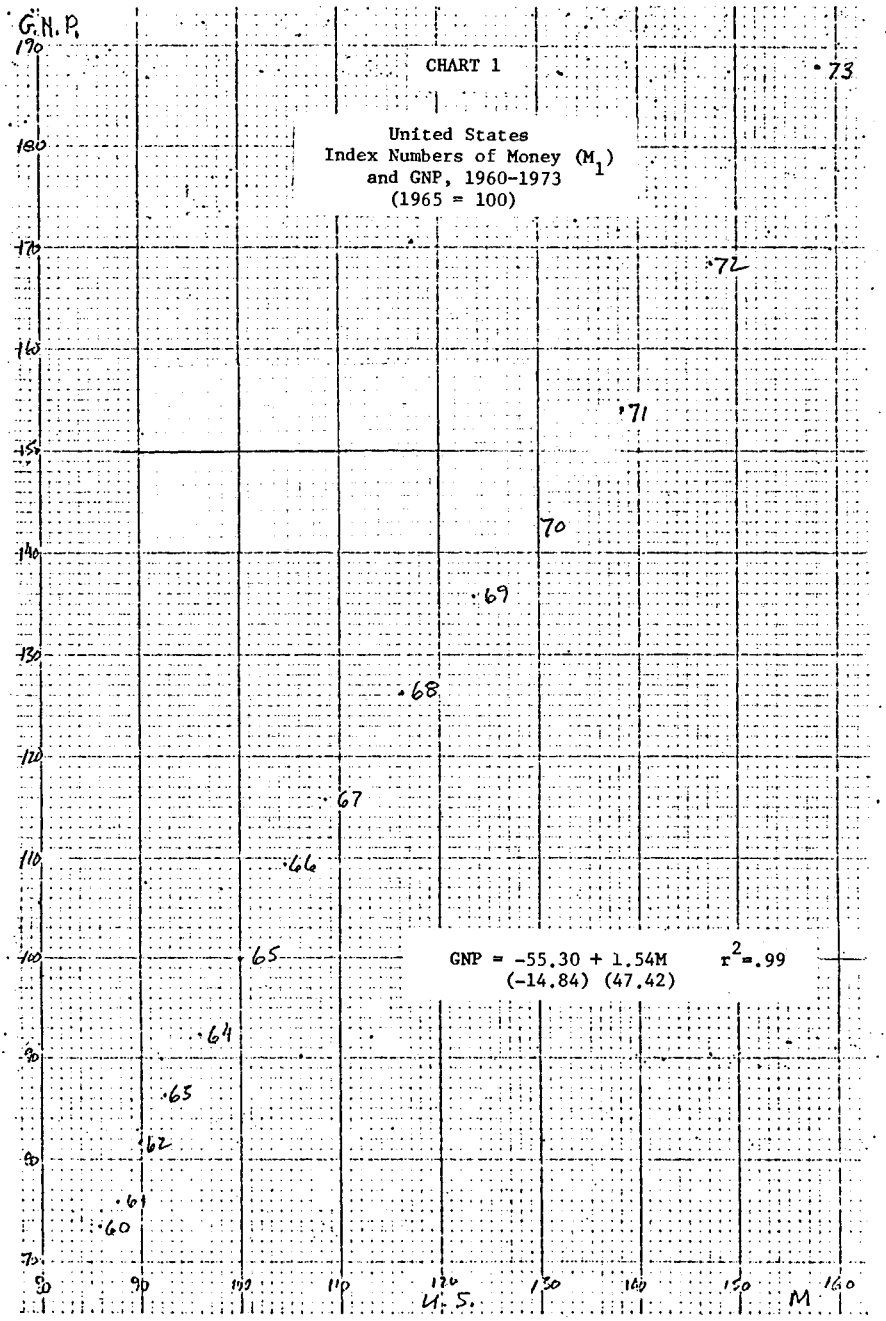

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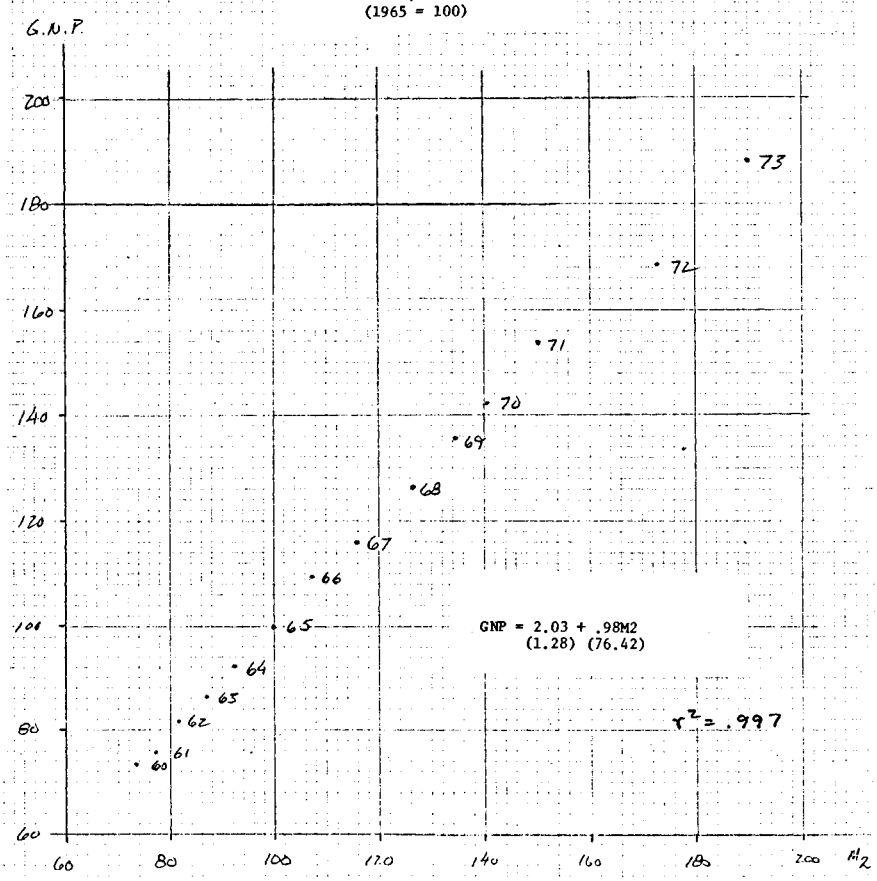
CHART 2

United States
Index Numbers of Money (M_2)
and GNP, 1960–1973
(1965 = 100)



Nominal gross national product can change when there is either a change in output or prices, or both. Although there is a dependable link between money and nominal GNP, there is no simple way to know how the effect of monetary change will be divided between changes in prices and changes in output. When we are close to full employment or capacity, it is clear that increases in money at a faster rate than the growth of capacity output cannot effectively increase output and can only lead to price increases. When there is much slack in the economy, increases in nominal GNP are likely to be composed of a larger proportion of real output and smaller proportion of price increases. Unfortunately, there is yet no good theory or evidence to yield clear-cut general answers on this important question.

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However, changes in money tend to have output or employment responses before price responses in many sectors of the economy and for the economy as a whole. This means that when there is slack in the economy, monetary expansion leads, first, to the good results of increased output and employment before the later bad results of higher prices. On the other hand, monetary restriction may correspondingly lead, first, to the bad results of reduced output and employment before the later good results of moderating inflation. I believe that this asymmetry has been a major factor in the inflationary bias of public policy.

These considerations also argue for moderate and relatively steady rates of monetary growth, the avoidance of the stop-go actions that have characterized Federal Reserve policy in the past, and resistance to the temptation to increase money at a very rapid pace when there is slack in the economy or to step sharply on the monetary brakes when there is unacceptable inflation.

There is much evidence that we have inflation when money increases faster than output, that prices fall when money falls relative to output, and that the price level tends to be stable when the ratio of money to real output is stable. (This relationship follows mathematically from a stable ratio of money to nominal GNP.) I know of no important exception in the last 400 years to the rule that changes in the price level stem primarily from changes in the nominal stock of money per unit of output.

Chart 3 shows what has happened to these relationships in the United States since 1960 when M_2 is used as a measure of money. We see a very close relationship between money per unit of output and prices, here, the Consumer Price Index. Consistent with earlier norms, the rapid rise in prices in recent years was caused by the sharp increase in money per unit of output. Since 1971 both the narrow M_1 and the broad M_2 measures of money have been rising at the fastest rate since World War II. Not surprisingly, prices have also been rising at the fastest rate since 1946.

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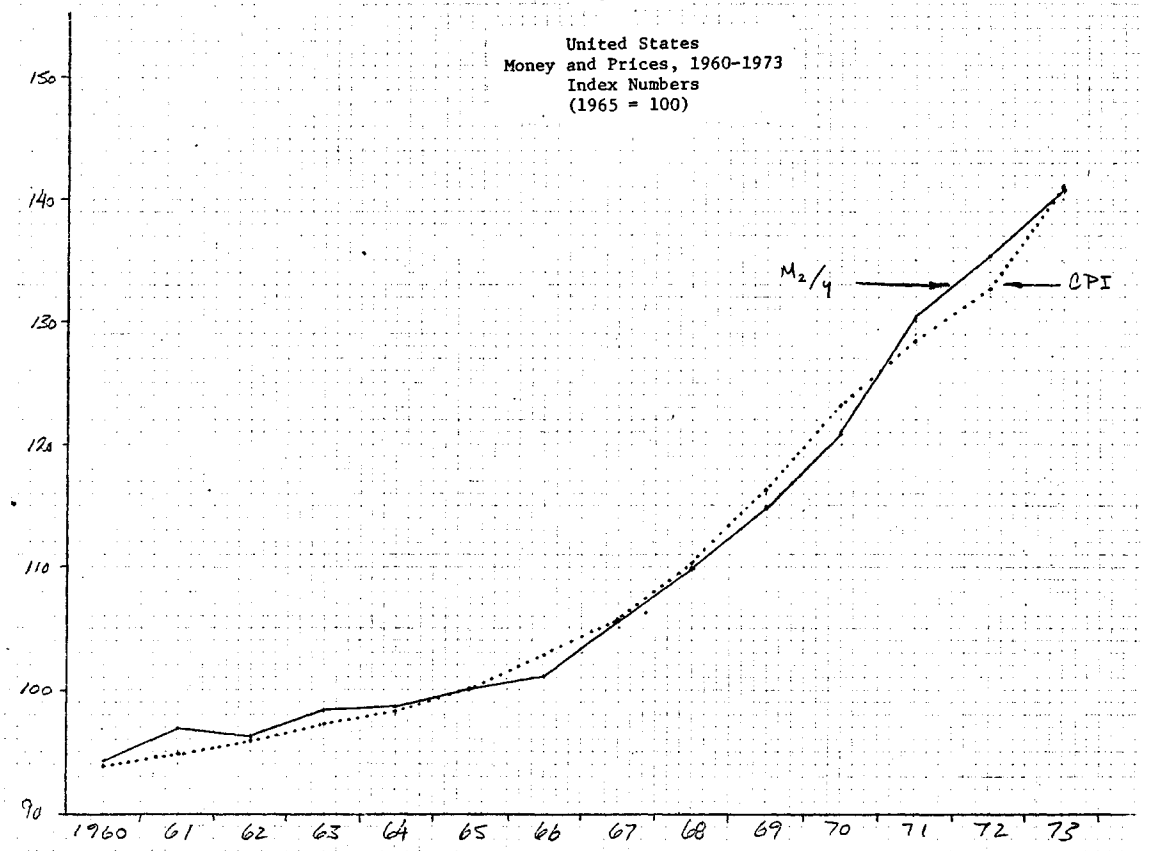
CHART 3

United States
Money and Prices, 1960-1973
Index Numbers
(1965 = 100)



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Recent research I have done on worldwide inflation shows essentially the same links between money per unit of output and prices for foreign countries as in the United States. I cannot go into these details in my brief presentation except to note that, as in the United States, the increase in the ratio of money to output that caused the acceleration of inflation since early 1973 stemmed primarily from increases in money rather than decreases in output resulting from such frequently cited events as the disappearance of anchovies off the coast of Peru or the operations of the OPEC oil cartel. To be sure, there was some reduction in the output of petroleum and chickenfeed, which explains why these prices increased relative to other prices. But aggregate output in the United States and throughout the world tended to increase, especially through yearend 1973, despite isolated examples of reductions in supplies of a handful of products. Thus the increase in the ratio of money to output was largely the result of sharp increases in money rather than decreases in output.

We have essentially the same relationships if we use the M_1 measure of money, provided we take into account the long-period upward drift in M_1 velocity, the ratio of GNP to M_1. Since at least 1960 M_2 velocity has been close to a constant. In the 1960's M_1 velocity increased an average of 2.7 percent per year, and the very same long-period drift continues in the 1970's. Therefore, we would have essentially the same general relationship between prices and M_1 per unit of output with this simple adjustment. (I have spared you these additional statistical operations but I would be pleased to make them available to the committee and staff.)

Despite the shocks the economy suffered in the first half of 1974 from the impacts of the OPEC oil cartel and the Arab oil embargo, the same relationships between money per unit of output and prices have continued to hold. In the first half of 1974 the monetary base increased at an annual rate of 8.2 percent, M_1 increased 7.1 percent and M_2, 9.0 percent. All of these measures were somewhat higher than they were for 1973.

Preliminary estimates for real GNP in the first half of 1974 show output declining at the annual rate of 4.0 percent, mostly associated with the decline in automobile production in the first quarter of the year. In combination with M_2 increasing at 9.0 percent, the 4.0 percent decline in output should result in price increases at the rate of roughly 13.0 percent. Prices, of course, have been increasing at about 12.5 percent, which is very close indeed, especially for such short-period relations using preliminary and seasonably adjusted data. For the M_1 increase of 7.1 percent, we must add the 2.7 percent trend rise in velocity, which also gives us reasonably close predictions of the actual inflation rate, closer I may add than most of the standard economic forecasts which depend on other and more complex tools.

I regret to add that despite repeated announcements of intent, there is yet no clear evidence of any significant shift in the Federal Reserve actions responsible for this poor record.

In the past year there have been many claims that the major source of inflation has come from abroad, that inflation has been imported rather than produced domestically. Since we cut our monetary ties to gold in 1968, the U.S. money supply has been almost wholly the con-

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sequence of Fed actions alone. Thus, if U.S. inflation originates abroad it is necessary to have a corresponding decline in output generated from outside the United States. This would be reflected in a change in the terms of trade, import prices relative to export prices, weighted by the relative share of exports in our GNP. This measure indicates how much more we have to give up in the way of exports to pay for our imports. Exporting more to acquire the same goods is the equivalent of a decline in our productivity and output. With a given money stock, adverse movements in the terms of trade tend to cause a rise in the price level because of the resulting increase in money per unit of output.

My colleague, Wilson Schmidt, has made some rough calculations along these lines and informs me that there are some weaknesses in the data with respect to coverage and concept. In any event, over the 1971–73 period the U.S. terms of trade declined 5.6 percent. In 1973 exports were 7.9 percent of GNP. Thus, over 2 years prices were less than half of 1 percent higher than they otherwise would have been in the absence of the change in the terms of trade, hardly a major factor.

In the first 4 months of 1974 the terms of trade deteriorated sharply as a result of the oil cartel's increase in the prices of imported petroleum. According to Department of Commerce figures, the terms of trade deteriorated by 15.5 percent. Exports also increased to 9.6 percent of GNP. Taking the two together we find that real output fell by 1.5 percent on this account over the period, with prices correspondingly higher. Over this 4-month period the Consumer Prive Index increased 3.9 percent and the wholesale price index 10.2 percent. Although sharply higher prices for imports were more important than previously, again, the major element in U.S. inflation was domestic. To be sure, the inflation rate would have moderated had there been no runup of oil prices, but in the interest of correct labeling, I would suggest that the speedup of inflation since 1972 be tagged "Made on Constitution Avenue" rather than "Imported from Saudi Arabia."

I may add that even with current excessively high rates of monetary expansion that the present rate of inflation is likely to moderate before the end of the year especially if real GNP declines no further.

I turn now to the question of high interest rates and the relationship of high interest rates to Federal Reserve policy and inflation. Although there is growing understanding of the connections between money and interest rates, there is still widespread confusion between cause and effect. It turns out that an expansionary monetary policy tends to drive up market interest rates, not lower them, and a contractionary policy tends to lower market rates, not raise them.

The main reason is that more money leads to more spending. Unless output also increases to absorb the full expenditures, prices also rise. Even if interest rates had fallen as the initial impact of the increase in money, rates will start to rise as people become more eager to borrow but less willing to lend because of the depreciation in the value of their money. Interest rates rise to incorporate the inflation, especially as people come to anticipate future inflation. Thus, rising interest rates are the consequence of money-induced inflation. The opposite holds

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for reductions in money-causing deflation. This is why easy money leads to tight credit, and tight money leads to easy credit. This is why countries with much inflation have high interest rates and why countries with little inflation have low interest rates. This is why interest rates were so low in the 1930's following the reduction in the money supply that was the major cause of the Great Depression and the associated decline in prices. This is also why interest rates are now so high.

Chart 4 shows the historic relationship between prices and bond yields since 1857. The year-to-year association is not always close, but there is a close connection between long swings of prices (which are related to long swings of money per unit of output) and long swings of interest rates. Again, it appears that recent experience on a year-to-year basis is even closer to these norms than before. In addition, the lag between prices and interest rates have become much shorter.

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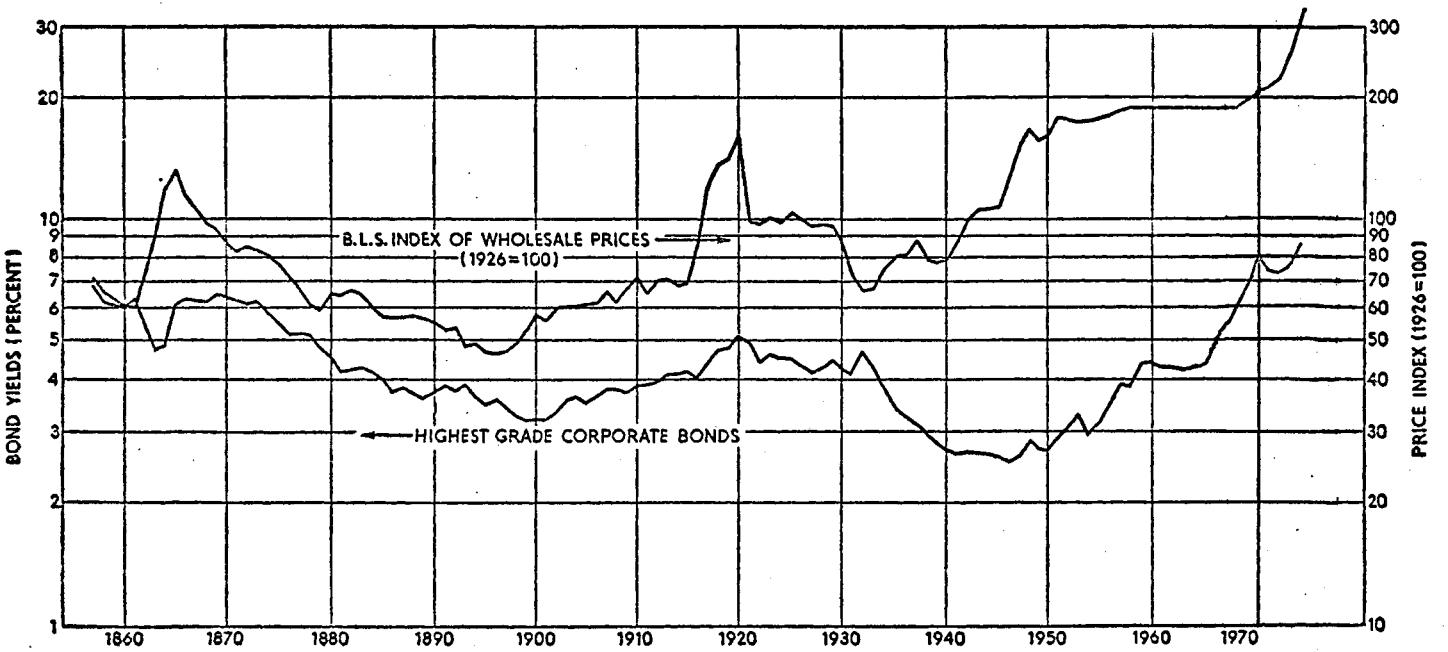
CHART 4

U.S. PRICES AND BOND YIELDS, 1857-1974



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Several years ago the Joint Economic Committee recommended that the Federal Reserve follow monetary policy guidelines that the growth of the narrow M_1 measure of money be kept within the limits of 2 percent to 6 percent. In retrospect, we would have avoided much of our current problem with inflation and high interest rates if these guidelines had been followed. I may also add that the only extended period in recent years when M_1 growth fell below 2 percent at annual rates was in the second half of 1969, which was followed closely by the subsequent recession of November 1969, to November 1970.

We need a slower and steadier growth of money to restrain inflation and to smooth out the most troublesome business cycle fluctuations which are the result of erratic and excessively expansionary or contractionary monetary policies.

Wage and price controls, monitors, jawboning, alarms, distress signals, commissions and the like are not the answer. If monetary growth is not slowed, they cannot succeed. If monetary growth is slowed, they are superfluous.

To insure that a slower and steadier growth of money be achieved, I would recommend that this committee and the Congress give consideration to mandating rather than merely recommending appropriate limits on monetary change, that the narrow M_1 measure of money be increased month by month in the range of 2 percent to 4 percent at annual rates. I would recommend that these lower rates of monetary growth be achieved gradually and systematically over at least a 2-year period in order to moderate the effects of the transition on employment and output, for experience indicates that a sharp reduction in monetary growth, even to achieve the desirable end of slowing inflation, is likely to cause a recession.

Finally, one useful result of this mandated policy would be an immediate and permanent decline in interest rates, even prior to any substantial reduction in inflation. Large numbers of investors have prudently become close Federal Reserve watchers in recent years and have come to follow the general analysis I have outlined. With the assurance that the law required a slower and steadier rate of monetary growth, I have every reason to believe that the inflationary expectations that have caused the current high interest rates will be altered, causing a sharp reduction in rates, especially on intermediate and long-term loans and securities, including mortgage rates. Bond prices will rise. For the same reasons, stock prices would also increase.

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ADDITIONAL QUESTIONS

I

THE FEDERAL RESERVE'S SECURITIES PORTFOLIO

[The following are written questions concerning the Federal Reserve's securities portfolio which were submitted by Chairman Patman to the Reserve bank presidents, along with their replies:]

1. The Federal Reserve now holds in its portfolio nearly $85 billion of U.S. Government securities including Federal Agency issues. From year-end 1964 to year-end 1973 the System's holdings of Government securities more than doubled (from just over $37 billion to nearly $80 billion).

Question (a). What effects did the enormous and rapid increase in the Federal Reserve's holdings of Government securities have on M_1 growth and the rate of rise of the CPI since 1964?

Question (b). What obligations did the Federal Reserve issue in building up its portfolio to the present level? Is it correct to say that the balance sheet liabilities corresponding to the Government securities account are currency in circulation and member bank reserves, with the former being quantitatively more important by about 7 to 3?

Question (c). Is the Federal Reserve an agency of the Government and in specific of the Congress?

Question (d). In his interview with President Morris, Dr. Weintraub asked whether "the Federal Reserve might give away this portfolio to the banks?" President Morris replied: "Give away this portfolio to the banks? That's absolutely absurd. We are not empowered under law to give away anything that's owned by the United States Government."

Dr. Weintraub then said: "This is in fact owned by the United States Government?" President Morris then said: "This portfolio is owned by the United States Government through the Federal Reserve System as an instrumentality of the government."

Do you agree with this view on the ownership of the portfolio?

Question (e). Responding to a question by Congressman Burgener, President Hayes said of currency issued by the Federal Reserve that "it's also an obligation of the U.S. Government." Do you agree with this view?

Response of President Hayes

Answer to question 1(a). Increases in central bank assets—including Federal Reserve's holdings of Government securities—will tend to be reflected in an expansion of bank credit and the money supply. The relationship, however, involves a highly complex set of financial and economic interrelations. As a result, the effect of a given increase in Federal Reserve security holdings on a particular monetary measure such as M1 is neither immediate, constant, nor precisely predictable, even in the long run. Many factors influence the outcome. Over the period mentioned by Chairman Patman, from the end of 1964 to the end of 1973, Federal Reserve security holdings rose by about $43 billion, or about 117 percent. Over the same period, M1 rose about $108 billion, or about 66 percent. (Over this same period, the consumer price index rose about 48 percent.)

With regard to the relationship between increases in Federal Reserve security holdings and money supply, it should be noted first that while Federal Reserve purchases of securities increase member bank reserves, other factors may be absorbing reserves so that not all of the reserve increase produced by the Federal Reserve's purchases is available to support money supply growth. Thus, from the end of 1964 to the end of 1973, Federal Reserve gold holdings declined more than $3 billion and this absorbed a portion of the reserves provided by the rise in the Federal Reserve securities portfolio over the period. Moreover, a large part of the increase in the Federal Reserve securities portfolio was needed to

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replace the reserves absorbed through an increase of currency in circulation—nearly $33 billion over the nine year period. While the increase in currency in circulation of course constituted part of the rise in money supply, it may be noted that money supply increases in the form of currency generate a relatively greater reserve need than do the money supply increases in the form of deposit growth; currency expansion absorbs an equal dollar amount of reserves while bank deposit expansion requires only a fractional reserve increase. The relatively rapid increase in the currency component of M1 compared with the demand deposit component from 1964 to 1973 (80 percent compared with 62 percent) helps to explain the sharper rate of growth in Federal Reserve security holdings compared with M1 growth. In addition to supporting expansion in M1, reserve growth over the period also went in part to meet requirements behind time deposits in various forms.

Thus, the relationship between Federal Reserve security holdings and M1 depends on such factors as (1) desires of the public to hold currency; (2) the extent to which the banks want to use increases in reserves to increase excess reserves, to repay borrowings from the Federal Reserve, or to increase holdings of earning assets; (3) the proportions of the various types of bank deposits the public wants to hold; (4) the levels of reserve requirement ratios imposed on the various types of deposits; and (5) the proportions of its deposits the public wishes to hold in small and large, member and nonmember banks. Since all these factors are capable of considerable variation over time—depending upon the habits of the banks and the public, the state of general economic conditions, interest rates, and other factors—there is no constant relationship between Federal Reserve security holdings and the level of M1, even though an increase in security holdings does tend to generate some increase in the level of M1.

With regard to the impact on the consumer price index of the increase in Federal Reserve holdings of Government securities and its expansionary effect on the money supply, it is apparent from past experience that a broad long-run relationship does exist between trends in monetary expansion and the behavior of prices. As I noted in my statement to the Committee, over long periods of time, price stability requires a rate of money and credit growth commensurate with the economy's capacity to produce. Nevertheless, it is an oversimplification to attribute all fluctuations in prices to the behavior of the money supply. Among the many nonmonetary developments that can powerfully influence the behavior of prices for periods as long as one, two, or more years, are supply shortages—as in the recent fuel and food cases—and the behavior of foreign exchange rates—as in the case of the overall depreciation of the dollar since early 1971. This depreciation has acted to raise the dollar prices of imported goods as well as the prices of goods produced in the United States and sold in both domestic and foreign markets. Among the several influences adding to inflation, the role of excessively stimulative fiscal policy has been one of the most significant.

Answer to question 1(b). The Federal Reserve System over the years has expanded its portfolio of U.S. Government and Agency securities through open market purchases for the System Open Market Account. Payments for such purchases are made by crediting the account of the seller's bank at the Federal Reserve, thus immediately increasing member-bank reserves at the Federal Reserve. These member-bank reserve accounts are of course a liability of the Federal Reserve. Further, the banks from time to time exchange part of their reserve deposits for currency in response to their needs for vault cash. The demand for vault cash, in turn, is a function of the nonbank public's demand for coins and currency. The bulk of the public's cash holdings now consists of Federal Reserve notes, which, like the member-bank reserve accounts, are also a liability of the Federal Reserve.

As can be seen in the Statement of Condition of the Federal Reserve Banks (copy attached), they have many asset items other than holdings of Treasury and Agency securities, and many liabilities other than member-bank reserves and Federal Reserve notes. But, in general, it is quite correct to say that the great bulk of Federal Reserve's Government securities account finds its counterpart on the liabilities side in currency in circulation (including banks' vault cash) and member bank deposits. As of June 30, Federal Reserve holdings of Treasury and Agency securities totaled about $83.6 billion, or about 78 percent of total assets. Federal Reserve notes and member bank deposits totaled about $94.9 billion, or about 88 percent of total liabilities and capital accounts. Federal

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Reserve notes amounted to about $65.3 billion, while member bank deposits amounted to about $29.6 billion. Thus, notes were roughly 2.2 times the amount of member bank deposits, or a ratio of approximately 7 to 3.

[The Statement of Condition of the Federal Reserve Banks referred to above follows:]

FEDERAL RESERVE BANKS—JULY 1974

CONSOLIDATED STATEMENT OF CONDITION OF ALL FEDERAL RESERVE BANKS

[In millions of dollars]

Item	Wednesday					End of month		
	1974					1974		1973
	June 26	June 19	June 12	June 5	May 29	June 30	May 31	June 30
ASSETS								
Gold certificate account	11,460	11,460	11,460	11,460	11,460	11,460	11,460	10,303
Special drawing rights certificate account	400	400	400	400	400	400	400	400
Cash	216	216	211	210	215	218	223	305
Loans:								
Member bank borrowings	2,979	2,486	3,157	2,710	4,711	3,209	3,298	1,770
Other								
Acceptances:								
Bought outright	96	95	95	100	100	97	97	66
Held under repurchase agreements	161		301		250	207	276	
Federal agency obligations:								
Bought outright	2,549	2,549	2,549	2,621	2,621	2,858	2,621	1,449
Held under repurchase agreements	534		511		701	270	642	
U.S. Government securities:								
Bought outright:								
Bills	37,089	37,396	35,877	34,700	37,718	37,274	37,818	34,247
Certificates:								
Special								
Other								
Notes	39,533	39,533	39,533	39,533	39,365	39,692	39,533	37,111
Bonds	2,805	2,805	2,805	2,805	2,767	2,822	2,805	3,664
Total bought outright	79,427	79,734	[2] 78,215	[2] 77,038	79,850	79,788	80,156	75,022
Held under repurchase agreements	1,045		1,714		2,081	696	1,239	
Total U.S. Government securities	80,472	79,734	79,929	77,038	81,931	80,484	81,395	75,022
Total loans and securities	86,791	84,864	86,542	82,469	90,314	87,125	88,329	78,307
Cash items in process of collection	8,165	9,006	7,902	8,375	8,619	7,240	6,966	7,319
Bank premises	238	238	236	237	236	239	236	204
Other assets:								
Denominated in foreign currencies	69	71	63	63	16	90	63	4
All other	889	825	791	778	671	935	716	927
Total assets	108,228	107,080	107,605	103,992	111,931	107,707	108,393	97,769
LIABILITIES								
F.R. notes	65,453	65,523	65,701	65,284	65,009	65,295	64,732	59,807
Deposits:								
Member bank reserves	30,055	27,744	31,257	27,896	33,534	29,623	31,012	24,818
U.S. Treasury—General account	2,693	2,946	906	1,340	2,333	2,919	3,133	4,039
Foreign	282	753	359	330	315	364	429	334
Other: All other	699	695	650	683	642	762	667	717
Total deposits	33,729	32,138	33,172	30,249	36,824	33,688	35,241	29,908
eferred availability cash items	5,760	6,278	5,631	5,528	6,454	5,405	5,041	5,271
Other liabilities and accrued dividends	1,125	1,094	1,149	1,105	1,458	1,101	1,160	799
Total liabilities	106,067	105,033	105,653	102,166	109,745	105,489	106,174	95,785

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FEDERAL RESERVE BANKS—JULY 1974

CONSOLIDATED STATEMENT OF CONDITION OF ALL FEDERAL RESERVE BANKS—Continued
[In millions of dollars]

Item	Wednesday					End of month		
	1974					1974		1973
	June 26	June 19	June 12	June 5	May 29	June 30	May 31	June 30
CAPITAL ACCOUNTS								
Capital paid in	876	876	875	873	873	878	874	820
Surplus	844	844	844	844	844	844	844	793
Other capital accounts	441	327	233	109	469	496	501	371
Total liabilities and capital accounts	108,228	107,080	107,605	103,992	111,931	107,707	108,393	97,769
Contingent liability on acceptances purchased for foreign correspondents	769	762	724	725	735	795	732	395
Marketable U.S. Government securities held in custody for foreign and international accounts	29,310	29,164	28,724	28,639	28,104	29,637	28,454	29,278
FEDERAL RESERVE NOTES—FEDERAL RESERVE AGENTS' ACCOUNTS								
F.R. notes outstanding (issued to Bank)	69,698	69,366	69,215	68,851	68,622	69,490	68,827	63,653
Collateral held against notes outstanding:								
Gold certificate account	2,175	1,975	2,175	2,135	2,235	2,175	2,235	2,155
U.S. Government securities	68,295	68,365	68,065	67,615	67,515	68,295	67,515	62,645
Total collateral	70,470	70,340	70,240	69,750	69,750	70,470	69,750	64,800

Answer to question 1(c). This is, of course, a question that has been raised more than once, within the Congress and outside it. It would be difficult to improve on the answer given by the *Report of the Subcommittee on General Credit Control and Debt Management* of the Joint Committee on the Economic Report, Congress of the United States (1952).[1]

The Subcommittee unanimously concluded:

> As far as the Board of Governors is concerned, there seems to be no clearly adjudicated answer to this question. But, while the question itself is an open one, it appears that the practical issues usually debated under this head have been judicially determined, so that the question is not really an important one. The Subcommittee was much impressed in this connection by the testimony of Mr. Wilmerding, who, after stating that "* * * it is impossible to return a clear answer to the question * * * about the Board's status," continued (Hearings, pp 7753–754):
>
> Fortunately, from a practical standpoint it is not important that a clear answer be given. Let it be conceded for purposes of argument that the Federal Reserve Board, unlike the Federal Trade Commission, is a part of the executive branch. Would such a status alter in any practical way the relationship which has been established by statute between the Board and the President of the United States? In particular, would it give to the President, under the Constitution, a power to interfere with, set aside, correct, or revise, the decision of the Board in any matter which has been committed by Congress to the Board's exclusive jurisdiction?

[1] The members of the Subcommittee were Representatives Wright Patman (Chairman), Richard Bolling, and Jesse P. Wolcott, and Senators Paul H. Douglas and Ralph E. Flanders.

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> This question, I submit, can be answered with a categorical negative. A long line of opinions by the Attorneys General, acquiesced in by the Presidents, corroborated by the action of Congress, and the proposition that, when the execution of a law has been committed by Congress to the exclusive jurisdiction of a subordinate department or officer of the Executive, the interference of the President with such execution, either in the form of direction beforehand or revision and reversal afterward, so far from being permitted by the Constitution, would be a usurpation on the part of the President which the subordinate department or officer would not be bound to respect. In such cases the duty of the President to take care that the laws be faithfully executed extends no further than to see that the officers to whom Congress has given an exclusive jurisdiction perform their duties honestly and capably. If they do not, he must, under the Constitution, remove them and appoint others in their stead, but, in the words of one of the Presidents, "he cannot override their decisions and ought not to interfere in their deliberations."
>
> In the light of these considerations it is evident that the question of the status of the Federal Reserve Board is purely academic. Congress has committed certain business to the exclusive jurisdiction of that Board, and this business it must perform under the responsibility of its trust and not by direction of the President. The case is the same whether the Board be considered in or out of the executive branch.

The case of the Federal Reserve banks is harder to define. The presidents of the Federal Reserve banks, in answer to a question whether they considered the banks to be part of the United States Government or part of the private economy, said (*Compendium*, p. 649):

> In our opinion Federal Reserve banks are partially part of the private economy and are part of the functioning of the Government (although not technically a part of the Government).

Much evidence was introduced on this subject and appears in the *Compendium* and the *Hearings*. There are many things to be taken into consideration. The stock of the Federal Reserve banks is owned by their member banks. But the capital so contributed is a negligible proportion of the assets of the banks and is limited to a fixed return, however great may be the profits of the Reserve banks. The Reserve banks are given sweeping exemptions from taxation. But, Congress can and has given equally sweeping exemptions to private corporations. The majority of the directors of each Federal Reserve bank is elected by its member banks. But, the power of the directors to direct is limited; the principal policy decisions are made or dominated by the Board of Governors, which is appointed by the President with the consent of the Senate. On the whole, the Subcommittee sees no objection to this hard-to-define position of the Federal Reserve banks. The Federal Reserve System has been a helpful institutional development. Its roots are sunk deeply in the American economy and it has borne good fruit. This is more important than that each portion of it be subject to classification by species and genus according to the rules of a textbook on public administration.

But, one fact with respect to the legal status of the Federal Reserve banks stands out, and it is the only fact of importance. Congress created the Federal Reserve banks and Congress can dissolve them or can change their constitution at will. On dissolution the entire surplus of the banks would become by law the property of the United States. Ultimately they are creatures of Congress.

Answer to question 1(d). As a kind of shorthand, general and perhaps simplified response to a technically complex question, I would be willing to concur. The second paragraph of Section 7 of the Federal Reserve Act provides, in part, "Should a Federal Reserve Bank be dissolved or go into liquidation, any surplus remaining, after the payment of all debts, dividend requirements as hereinbefore provided, and the par value of the stock, shall be paid to and become the property of the United States...."

The Federal Reservce Act also provides (fourth paragraph of Section 16) that Federal Reserve notes are "a first and paramount lien on all the assets of such bank" (i.e., the Federal Reserve Bank of issue).

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The second paragraph of Section 11 of the Federal Reserve Act states that the Board of Governors of the Federal Reserve System "shall publish once each week a statement showing the condition of each Federal Reserve Bank and a consolidated statement for all Federal Reserve Banks. Such statements shall show in detail the assets and liabilities of the Federal Reserve Banks, single and combined, and shall furnish full information regarding the character of the money held as reserve and the amount, nature and maturities of the paper and other investments owned or held by Federal Reserve Banks." In accordance with that requirement, there is published each week a statement of condition for each Reserve Bank and a consolidated statement for all 12 Banks; those statements show Government securities as assets of the Banks, with balances of various depositors, bank notes, and capital as the major liabilities as offsetting claims against the assets.

It is undoubtedly true, as President Morris said, that the Federal Reserve Banks could not give away to the member banks, or anyone else, their portfolio of Government securities (or any other assets). But, if the so-called "cashless society" that some people talked about several years ago were to come to pass, then people and businesses would deposit Federal Reserve notes in their banks, who would have no desire to hold them in their vaults, and would deposit them for credit to their reserve accounts. If the Federal Open Market Committee, in an inflationary period like the present, did not wish to permit a large amount of excess reserves on which bank credit could be greatly expanded, it would presumably sell Government securities at the best available price in the open market. Since payment would be made to the Federal Reserve by a charge to the reserve accounts of the banks buying the securities, or whose depositors buy them, the undesired bulge of reserves would be eliminated. But obviously the securities would not be given away; they would be sold for value, and the ultimate buyers might or might not be commercial banks.

Answer to question 1(e). The first paragraph of Section 16 of the Federal Reserve Act states unambiguously that Federal Reserve notes "shall be obligations of the United States".

The legal status of Federal Reserve notes, however, is far more complicated than is conveyed by this simple and clear statutory provision. Such notes are also the obligations of the Federal Reserve Bank of issue, a first and paramount lien on all the assets of the issuing bank (Federal Reserve Act, paragraph 4). As of June 30, 1974, the 12 Federal Reserve Banks had less than $65.3 billion of notes outstanding and total assets of $107.7 billion. Federal Reserve notes are fully collateralized by, among other things, the Government securities pledged by the Federal Reserve Banks in order to obtain such notes from the Federal Reserve Agent (Federal Reserve Act Section 16, paragraphs 2 and 4). In this connection, the fifth paragraph of Section 16 states that "Any Federal Reserve bank may at any time reduce its liability for outstanding Federal Reserve notes by depositing with the Federal Reserve agent its Federal Reserve notes, gold certificates, Special Drawing Right certificates, or lawful money of the United States."

Any characterization of Federal Reserve notes must also take cognizance of their attributes as currency of the United States. Federal Reserve notes, of course, are "legal tender for all debts, public and private . . ." (31 U.S.C. § 392)

Response of President Balles

Answer to question 1(a). Federal Reserve purchases of Government securities are the principal vehicle by which the System creates new member bank reserves. These reserves, in turn, can support a multiple expansion of loans and investments by the banking system, creating in the process a multiple expansion of new deposits. In June 1974 every dollar of member bank reserves supported approximately $13 of member bank demand, time or savings deposits. This ratio of reserves to total deposits depends upon a complex set of factors; the difference between reserve requirements on various types of demand and time deposits, the size of these deposits, and even the size of the banks in which the deposits are held. The ratio is further complicated because deposits held outside of member banks are indirectly supported by member bank reserves.

The ratio of total member bank deposits subject to reserve requirements to total member bank reserves, has increased at a relatively stable rate since 1960, as is shown in the accompanying table. One major reason for the increase

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in the ratio is the declining proportion of demand deposits to total time and savings deposits at member banks; time deposits have a lower required reserve ratio than do demand deposits. (The former type of deposit includes negotiable certificates of deposit.) The ratio of demand deposits to total time and savings fell from about 1.68 in mid-1960, to 0.55 in mid-1973. This shift reflects a number of competitive innovations, such as expanded use of negotiable certificates of deposit, that commercial banks have made since 1960 to attract and hold funds. Thus, while the principal source of the rise in the money stock (however defined) since 1964 has been a rise in member bank reserves, this rate of growth has been increased by a rise in the reserve multipliers related to competitive innovations by commercial banks.

MEMBER BANK RESERVE OF DEPOSITS

SEASONALLY ADJUSTED, JUNE 1960 TO JUNE 1974

[In billions of dollars]

Year	Member bank reserves [1] (1)	Total member bank deposits subject to reserve requirements (2)	Ratio of member bank deposits subject to reserve requirements to total member bank reserves (2) ÷ (1) (3)
1959	18.56	157.8	8.502
1960	18.41	157.6	8.561
1961	19.12	168.3	8.802
1962	20.02	182.5	9.116
1963	19.84	195.9	9.874
1964	20.59	210.3	10.214
1965	21.79	229.5	10.532
1966	22.66	246.5	10.878
1967	23.67	262.5	11.090
1968	25.98	282.8	10.885
1969	27.94	296.2	10.601
1970	28.03	294.4	10.503
1971	30.54	345.3	11.306
1972	33.03	381.3	11.544
1973	32.46	428.9	13.213
1974 [2]	36.72	472.8	12.874

[1] Adjusted for reserve requirement changes in order to maintain a consistent series, reflecting latest reserve requirements
[2] 1st 6 mo.

The relationship between rates of growth in the money supply and changes in consumer prices may vary in different time periods. In the short run, movement in the CPI often is explained by phenomena other than an expansion of M_1. Wage and price freezes and rapid changes in the supply of raw materials and finished goods have major effects on the CPI. However, in the long run, general price increases are primarily a monetary phenomenon. The Consumer Price Index is but one of many measures of changes in the current level of prices. Broader based measures, such as the GNP price deflator, are less sensitive to transitory influences, but even here the short-run relationship between money growth and changes in the general price level is not constant.

Although the close long-run link between money and prices is well established in both economic theory and statistical studies, it is not the only factor governing Federal Reserve Policy. The Federal Reserve System must take account of the high priority which the Congress and the Administration have assigned to full employment and economic growth objectives, which in some circumstances has conflicted with the objectives of stable prices. It is vital that this matter be thoroughly appreciated, not only by the Congress and the Administration, but also by the business and financial community and the general public. It is only in this way that we can get support for the belt-tightening measures needed to overcome the corrosive problem of rampant inflation and sky-high interest rates.

Answer to question 1(b). In building up its portfolio of Government securities, the Federal Reserve issued deposit liabilities, owned principally by member banks, and Federal Reserve notes (currency). However, it is not entirely correct to say that the balance sheet liabilities corresponding to the Government securities account are currency in circulation and member bank reserves, because the

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Federal Reserve has other assets such as gold, special drawing rights and loans to member banks; one cannot identify specific liabilities that correspond to each of the Federal Reserve's assets (such as its portfolio of Government securities). Nevertheless, the largest single asset in the Federal Reserve's portfolio is Government securities, and growth in that asset is roughly proportional to the growth in the Federal Reserve's liabilities. Currency and member bank reserves constitute most, but not all, of the Federal Reserve's liabilities. The ratio of currency to member bank reserves is approximately 7 to 3.

Answer to question 1(c). The Federal Reserve was created by an act of Congress with powers and duties specified by Federal law, and in this sense it is an agent of the Congress and ultimately responsible to the Congress. When established in 1913, the Federal Reserve was deliberately given a status of independence within the Government in order to free it from day-to-day political influence. Specifically, the System was made independent of the executive branch and responsible to Congress. Congress, in turn, delegated broad powers to the System to formulate monetary policy in a way that would best contribute to national economic goals. I believe that this arrangement has been a major source of strength for the Federal Reserve over the years, and has enabled it to formulate and implement monetary policy to serve the nation's best long-run economic interests.

Answer to question 1(d). The Federal Reserve System's portfolio of Government securities is an asset of the Federal Reserve Banks. In the event of the dissolution or liquidation of a Federal Reserve Bank, the Federal Reserve Act stipulates that surplus assets remaining become the property of the U.S. Government.

Answer to question 1(e). In a technical sense, Federal Reserve Notes are a liability or an obligation of the Federal Reserve Banks. Under the Constitution, the Congress was given the power "to coin money and determine the value thereof," but it has delegated much of this power to the Federal Reserve. Through this delegation, currency issued by the Federal Reserve would become a direct obligation of the U.S. Government in the event of dissolution of the Federal Reserve System. Currency, however, is a special form of "obligation"; it serves as a means of payment for goods and services, and unlike other liabilities of the Federal Reserve (and the Government) it has an infinite maturity and carries no interest.

Response of President Eastburn

Answer to question 1(a). As a proximate cause, the relatively rapid growth in Government security holdings largely explains the rapid growth in the money supply (measured as either M_1 or M_2) between 1964 and the end of 1973. That is, the growth in Federal Reserve holdings of its primary assets, Government securities, corresponded essentially with the growth in its primary liabilities, Federal Reserve notes and member bank reserves. These liabilities in turn were the primary determinents of the growth in the money supply over the period of consideration.

As for the impact of the growth in M_1 on the CPI, I stated in my testimony that the increasing rate of inflation over the past ten years could not have been sustained without the accompanying increase in the rate of monetary expansion. Over the long term, a sustained increase in the *growth* of the money supply is almost certain to produce depreciation in the *value* of money, that is, inflation. However, while price stability is an important goal of monetary policy, I don't intend my conclusion necessarily to be an indictment of Federal Reserve policy over the past decade. Evaluating monetary policy would necessitate looking at all the objectives of policy as well as taking account of the social and political environment in which policy must operate.

Answer to question 1(b). The issuance of Federal Reserve notes and member bank reserve deposits accounted for about 90 percent of the increase in the Federal Reserve's liabilities over the past decade and, hence, primarily accounts for the obligations issued in building up its portfolio to the present level.

As to whether the Fed's assets, "Government securities," correspond with its liabilities, currency and member bank reserves, I must heed the accountant's warning not to associate particular assets with particular liabilities on any balance sheet. However, because of the quantitative importance of reserves

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and currency growth, I think it would be substantially correct to argue that the rise in Government securities holdings has been largely financed through issuance of these liabilities. Currency in circulation is about 7/3 as large as member bank reserves *on deposit with the Fed* (that is, member bank reserves other than vault cash).

Answer to question 1(c). The Board of Governors is a Federal agency in the sense that it is a means or agency used by the Federal Government to carry out fundamental governmental policy. It has final accountability to the Congress by virtue of the congressional mandate to make a full report annually of its operations to the Speaker of the House of Representatives. Federal Reserve Banks, on the other hand, are not Federal agencies, but are in a stricter sense Federal instrumentalities in carrying out fiscal agency functions of the U.S. Government.

Answer to question 1(d). I agree that the U.S. Government is the beneficial owner of the portfolio in the sense that it is the recipient of the proceeds of the portfolio after deduction of expenses and payment of dividends on Federal Reserve Bank stock. It also has the residual right to the portfolio in the event of dissolution, since all property of the Federal Reserve Banks, after the payments mentioned above, would become property of the U.S. Government rather than be distributable to the member banks owning stock of the Federal Reserve Banks.

However, equitable ownership of the portfolio is in the Federal Reserve with the portfolio managed and controlled by the Open Market Committee.

Answer to question 1(e). Yes. The Federal Reserve Banks become primarily liable for their note issue, even though the notes are collateralized by U.S. Government or agency obligations. Moreover, the Congress has specifically provided that " . . . the said notes shall be obligations of the United States . . ." (12 U.S.C. 411).

The nature of the Government's obligation is to some extent secondary, as the Government obligations used to collateralize the notes would be used to make good the comparable value of notes issued by the Reserve Bank. It is not likely that the Government would be required to assume any further risk because of its guarantee of the Federal Reserve notes.

Response of President Francis

Answer to question 1(a). From the fourth quarter of 1964 to the second quarter of 1974, the increase in the Federal Reserve Banks' holdings of Government securities was approximately equal to the increase of the monetary base. Over this same interval, Federal Reserve Banks' holdings of Government securities increased $46.6 billion, the monetary base increased $46.6 billion, and the narrowly-defined money stock (M_1) increased $111.9 billion. On a seasonally adjusted basis, the increase in M_1 was at an average 5.8 percent annual rate, over two and one-half times as fast as the average rate of money growth in the preceding ten years. As a result, the average annual rate of increase in the CPI was 4.8 percent from the fourth quarter of 1964 to the second quarter of 1974, over three times as fast as in the preceding ten years.

Answer to question 1(b). When the Federal Reserve System purchases Government securities in the open market it pays for the securities by issuing checks drawn on itself. When sellers of the securities deposit the checks in member banks they receive a credit to their demand deposit accounts. Then, when the member banks send the checks to a Federal Reserve Bank for collection, they receive a credit to their reserve accounts, which are liabilities of the Federal Reserve System. The end result of this process is the creation of a Federal Reserve Bank liability (member bank reserves) much the same as the liability incurred in issuing Federal Reserve Notes.

It is not correct to say that the balance sheet liabilities corresponding to the Government securities account are currency in circulation and member bank reserves. At the present time, the sum of currency in circulation and member bank reserves is 1.24 times as large as the Federal Reserve holdings of Government securities. It is correct to say that currency in circulation and member bank reserves corresponds to the monetary base which is a consolidation of the monetary balance sheets of the U.S. Treasury and the Federal Reserve System. It is not correct to say that currency in circulation, because it is the larger, is quantitatively more important than member bank reserves.

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Answer to question 1(c). The Federal Reserve Banks are corporations chartered under an Act of Congress. The corporate structure is unique in that the power to control, and the beneficial ownership of assets, by the shareholding banks are limited. Since the structure is unique, it is not possible to give a single answer for all purposes as to whether the Federal Reserve Banks are agencies of the Government. Rather, each particular law referring to Government agencies or instrumentalities must be examined to determine whether it was intended to include the Federal Reserve Banks. Under Sec. 15 of the Federal Reserve Act and the direction of the Secretary of the Treasury, the Federal Reserve Banks are Fiscal Agents of the United States.

Answer to question 1(d). The portfolio of U.S. Government securities is owned by the twelve corporate Federal Reserve Banks, each having an undivided interest in the portfolio. As long as the corporations exist, no other parties have claim upon the securities in the portfolio. In the event a Federal Reserve Bank were to be dissolved or go into liquidation, any assets remaining after the payment of debts, dividend requirements and the par value of the stock would become the property of the United States. To this extent, I agree that the portfolio is beneficially owned by the United States through the instrumenalities of the Federal Reserve Banks.

Answer to question 1(e). Sec. 16 of the Federal Reserve Act states that Federal Reserve notes "shall be obligations of the United States." I agree with the statement made by President Hayes.

Response of President Mayo

Answer to question 1(a). The Federal Reserve System is charged with the responsibility by Congress to regulate, in the public interest, the volume and availability of money. The System, operating through its reserve supplying activities, has attempted to meet these responsibilities. Since the purchase of Government securities is the major way of providing reserves, meeting the economy's expanded needs for money as they have grown has resulted in additions to the System's holding of Government securities. While possible, it would have been neither practical nor efficient to provide these reserves by other means.

The relationship between the System's holdings of Government securities and inflation is more complex. Open market operations are only one, albeit important, element in the policy implementation process; a number of instruments can be used. The significant and relevant issue relates to the more general relationships between monetary policy actions and prices.

I feel, Mr. Chairman, that my views on this more general question have been indicated in my testimony and my statement which is part of the record.

Answer to question 1(b). In purchasing Government securities in the open market, the Federal Reserve issues an obligation to the seller in the form of a deposit on our books in the name of the seller's bank. Thus, as a result of this process, the Federal Reserve obtains an asset (a Government security) offsetting the liability to the seller. Government securities make up the bulk of the assets of the Federal Reserve System while Federal Reserve notes and member banks' deposits account for the majority of the System's liabilities.

Answer to question 1(c). Yes, the Federal Reserve was established by Congress and given responsibility to exercise important functions relating to the supply of money and credit.

Answer to question 1(d). As I indicated in my response to your first question, Government securities are held as a result of System reserve supplying activities. They have an important functional role for the Federal Reserve System in meeting its responsibilities and thus remain until redeemed by the Treasury as an asset of a Congressional created agency.

Answer to question 1(e). Federal Reserve notes are direct liabilities of the Federal Reserve banks but remain a U.S. Government obligation since their issuance takes place under the delegation of responsibility given by Congress.

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Response of President Morris

Answer to question 1(a). The increase in Federal Reserve holdings of Government securities has been the main factor leading to the increase in the monetary base which supports the money supply of the country. As the value of expenditures, as measured by GNP, grows, the money supply and the monetary base grow more or less in proportion. Gross National Product actually slightly more than doubled from 1964 to 1973 so it is not surprising that the money supply and the monetary base rose substantially. Actually the money supply did not double but rose by only about 65% over this period. With the money supply rising less than GNP the difference was made up by velocity, of course, which rose by almost one-quarter.

Unfortunately, part of the increase in total money expenditures in the nation reflected increases in the CPI. The CPI rose by 43 percent during this period while GNP in constant prices increased by almost 45%. There is no doubt that we could have limited the rise in the CPI over this period by limiting growth in the monetary base. However, additional restraint on growth in the monetary base and the money supply would have also reduced growth in real GNP and raised the average level of unemployment. This is a tradeoff we are constantly facing and we have to make decisions based on our best judgment about it.

Answer to question 1(b). It is correct to say that the balance sheet liabilities of the Federal Reserve System corresponding to the asset, Government securities, are primarily currency in circulation and secondarily member bank reserves. Except for some minor accounts, an increase in the Federal Reserve's portfolio or in its discounting will be matched by increases in currency in circulation and member bank reserves. Of the roughly $43 billion increase in Federal Reserve holdings of Government securities from 1964 to 1973, increases in currency in circulation represented $32 billion while the remainder went to increase member bank reserve balances.

Answer to question 1(c). The Federal Reserve is an independent instrumentality of the United States Government. It is not a part of the Executive Branch of the Government, but is responsible to the Congress.

Answer to question 1(d). Yes. Since the Federal Reserve System is an instrumentality of the Federal Government, all of its assets are owned by the U.S. Government and all of its liabilities are obligations of the U.S. Government. In 1973 the Federal Reserve System had $4,897 million of income from the interest it received on its holdings of U.S. Government securities, $109 million of income from loans to member banks, and $11 million from miscellaneous sources. In that year the System had expenditures of $495 million, paid out $49 million for a 6 percent dividend on member bank holdings of Federal Reserve stock in accordance with statutory requirements, and transferred another $51 million to surplus. Eighty-nine percent of the System's income from securities, or $4,341 million, was recycled back to the U.S. Treasury. In effect, therefore, the U.S. Government received almost nine-tenths of the interest income generated by the System's portfolio of U.S. Government securities.

Answer to question 1(e). Currency issued by the Federal Reserve is, in the first instance, a liability of the Federal Reserve System, secured by the assets of the Federal Reserve System. But just as the residual claimant to any assets of the Federal Reserve System is the United States Government, the ultimate guarantor of the Federal Reserve Notes is also the United States Government.

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ADDITIONAL QUESTIONS

II

THE STAFF RECOMMENDATIONS

[The following is a written question concerning the staff recommendations submitted by Mrs. Sullivan to Federal Defense witnesses, along with their replies:]

I think you gentlemen are familiar with the staff recommendations that were made by Dr. Robert Weintraub, staff economist of the House Banking and Currency Committee on July 16, 1974. I would like to have your comments on those recommendations.

Dr. Weintraub's first recommendation states: ". . . let the Federal Reserve annually request from the Congress permission to operate within specified M–1 growth guidelines, which, to retain limited flexibility to deal with short-run problems, could be expressed in terms of the behavior of year-to-year growth for the next 12 months. (Targets would be set for each of the next 12 months in terms of percentage changes from the same month a year ago.)"

"Let Congress hold hearings on the Federal Reserve's recommendations. The Federal Reserve should spell out the implications of alternative target M–1 growth paths on unemployment, interest rates, and such priority concerns as housing. Congress can then approve or modify the recommendations as desired. If within the next 12 months the Federal Reserve wants to operate outside the established guidelines, it can request that special hearings be held for the purpose of relaxing the guidelines."

Response of President Hayes

This is a response to the request of Representative Sullivan for comments on the monetary policy recommendations included in the "Report of Federal Reserve Policy and Inflation and High Interest Rates", dated July 16, 1974, prepared by Dr. Robert Weintraub for the House Committee on Banking and Currency.

As I understand it, the broad thrust of Dr. Weintraub's first recommendation is that Congress undertake periodically to formulate guidelines for monetary policy. Given Congress' constitutional responsibilities in this area and the highly important public interest implications of monetary policy, there can be little doubt that Congress should be somehow better informed about the monetary policy process. If there is any way that we can be of help we would, of course, be pleased.

At the same time, however, I have serious reservations about several specific features of Dr. Weintraub's money-supply growth guidelines, and would urge the Congress to approach this matter with great caution. There should be no illusions that procedural changes will automatically result in improved monetary policy performance. In particular, I feel quite strongly that narrow and rigidly defined guidelines would prove both unachievable and undesirable in the face of the constant ebb and flow of economic developments with which monetary policy must cope.

Perhaps my views in this regard can be best illustrated by discussing those features of Dr. Weintraub's recommendation about which I have the strongest reservations. First of all, his recommendation presupposes a knowledge of the economy, and of the effects of monetary policy on the level of economic activity, that we simply do not enjoy. There is no question, for example, that the record of economic forecasters, both governmental and private, has been very unsatisfactory over the past two years or so. The strength of demand pressures in the economy

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in the latter part of 1972 and in early 1973 was seriously underestimated, while the "slack" of unemployed human and material resources was overestimated, by most economists. And, over the past year, inflation has been much worse than almost anyone expected. While no one can be expected to forecast crop failures and oil embargoes, it is unfortunately true that even in the absence of such unpredictable events our economic foresight is quite limited. Given the difficulty of forecasting economic developments, it seems clear that monetary policy should be given ample leeway to adjust to unforeseen and unexpected developments. Such flexibility has, in fact, always been regarded as one of the principal virtues of monetary policy.

Thus, I would suggest that any monetary-policy guidelines that the Congress might want to develop or approve should be framed in broad general terms with ample scope for the prompt adjustment of policy to changes in the economic situation. In my opinion, the monthly money-supply growth-rate guidelines recommended by Dr. Weintraub are much too restrictive in this respect. They would put monetary policy in a straightjacket so tight as to hamper timely and effective responses to new developments. While Dr. Weintraub suggests that the Federal Reserve could request special Congressional hearings to change the guidelines, I fear that under the guidelines he proposes we would have to spend a good deal of our time, and of the time of the Congress, in special hearings seeking changes in the guidelines. More liberal and flexible guidelines than those suggested by Dr. Weintraub would provide for both adequate Congressional oversight of monetary policy goals and for the timely adjustment of policy to unforeseen developments.

In this regard, I should note that Dr. Weintraub's suggestion that the Federal Reserve present Congress with alternative monetary-policy scenarios, spelling out "the implications of alternative target M–1 growth plans on unemployment, interest rates, and such priority concerns as housing," and as an aid to the Congress in selecting policy guidelines, also suggests a better understanding of the economy and monetary policy than we in fact possess. My experience on the Federal Open Market Committee (FOMC), where we often try to follow such a procedure, is not very encouraging. All too often the economy departs significantly from the scenario expected on the basis of the monetary policy actually implemented. While such exercises are useful in considering monetary policy options, they can never be taken too seriously as firm guides to policy.

Second, I also have serious reservations about attempting to frame monetary policy guidelines in terms of any single variable, such as the narrow money supply (M–1) recommended for this purpose by Dr. Weintraub. Monetary economists are divided on the question of whether the narrow money supply is the best indicator of the thrust of monetary policy. Moreover, most of us in the Federal Reserve have never believed that we could fulfill our responsibilities if we confined ourselves to the single-minded pursuit of one target variable, be it the narrow money supply or any other variable. We believe our financial system is simply too complex for any single target variable always to provide an adequate measure of the thrust and impact of monetary policy. This is not to deny the important role of the money supply in the monetary policy process, but only to point out that it is not unique in this respect. I very much doubt, for example, that the Congress would want the Federal Reserve to focus on the growth of the money supply to the extent that it ignores interest-rate developments and their effects on our financial institutions. Thus, I would suggest that any monetary policy guidelines considered by the Congress should not be concerned exclusively with the money supply, but should also take into consideration the behavior of such important variables as bank reserves, bank credit and interest rates.

Third, the *monthly* money supply growth rate target proposed by Dr. Weintraub assumes a degree of short-run control of the money supply that the Federal Reserve does not possess. While Dr. Weintraub refers to "year-to-year growth" in connection with his proposed money-supply target, his proposal seems to contemplate setting such a target for each month of the year. Since past behavior is of course given at any point in time, this proposal appears to be equivalent to setting month-by-month growth-rate targets for the money supply. For example, a target for next month's money stock of 6 percent greater than the year-earlier level implies a particular monthly growth rate depending upon the growth which actually occurred during the preceding eleven months. If, for instance, the growth of the money stock during those eleven months had been at an annual rate of 5.8 percent, the 6 percent year-to-year target would imply a target annual growth rate of 8.2 percent for the coming month. If, on

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the other hand, the money stock had actually grown at an annual rate of 6.2 percent over the prior eleven months, the 6 percent target would imply a target of only 3.8 percent for the coming month. Furthermore, with the monthly targets expressed in terms of constant growth from year-earlier levels, any random fluctuations in the growth of the money stock in one year would be built into the targets for the following year.

There is, to my knowledge, no evidence whatsoever that the Federal Reserve can control the money supply with any precision at all on a monthly basis, even if it is prepared to pursue this end regardless of the consequences for interest rates and financial markets. Indeed, there is much evidence that our ability to control the money supply even on a quarterly basis is subject to a substantial amount of slippage. However, this lack of short-run control over the money supply may not be as serious as it might seem. It appears that monthly and quarterly deviations of the money supply from target growth paths have little, if any, impact on the economy, provided that they are subsequently offset. In other words, the growth of the money supply over periods of six to twelve months, where our control is considerably greater, seems to be of much more importance for the economy than the short-run fluctuations which Dr. Weintraub would have us attempt to control.

Response of President Balles

When Congress and the Administration established the Federal Reserve in 1913, it deliberately was given a status of independence within the Government, in order to free it from day-to-day political influence. Specifically, the System was made independent of the Executive Branch and responsible to Congress. In turn, Congress delegated broad powers to the System to formulate monetary policy in a way that would best contribute to national economic goals, by insulating it from short-term political pressures or partisan considerations. Senator Carter Glass, the architect of the original Federal Reserve Act, hoped that the System would act as a "Supreme Court of Finance." This hope has been largely fulfilled over the years, and the measure of independence given to the Federal Reserve has facilitated the implementation of the System's objectives and afforded it a considerable degree of success in coping with a variety of serious problems.

There is sound historical basis for insulating the formulation of monetary policy from short-term political pressures, especially in view of the failure of fiscal policy in recent years to contribute to economic stabilization efforts. (Budget deficits in 14 of the last 15 years have been a significant factor contributing to inflation and high interest rates and have rendered the task of monetary policy far more difficult.) It is my view that it would be premature at this time, and quite possibly undesirable at any time in the future, to impose a Congressional mandate on the permissible growth in M_1, the narrowly-defined money supply.

There are three reasons underlying my view. First, although M_1 is of central importance, it is by no means the only aggregate or consideration of importance to the Federal Reserve. During the current year, for example, both M_2 and M_3 have been growing more rapidly than M_1. M_1 is currency and demand deposits in the hands of the nonbank public; M_2 adds to M_1 the time deposits of commercial banks exclusive of large CD's; M_3 adds to M_2 the time and savings deposits of thrift institutions. Moreover, while M_1 has been a valuable indicator of monetary influences in the past, future developments in our dynamic financial system, developments partly technological in nature, may be such as to render M_1 less useful. Forces upon M_1 as an operating constraint should be predicated upon a continual and demonstrable test of its usefulness.

Secondly, unless or until there is proven success in the formulation of fiscal policy by the Congress, under the recently enacted budget reform act of 1974, it would be unduly risky to expose monetary policy to the same strong inflationary bias that has characterized fiscal policy. As things now stand, monetary policy is the only viable instrument of public policy in combatting inflation.

Finally, Congress should consider most carefully whether it wishes to be exposed to the pressures from constituents for easy money that would inevitably develop if it were in the position of making detailed decisions on rates of money growth. The "popular" thing to do would usually be to make credit cheap and readily available, but over the longer term this could create tremendous inflationary pressures.

36-714—74——24

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Response of President Eastburn

PROPOSAL NO. 1.—ESTABLISH TARGET M_1 GUIDELINES

As I indicated in my prepared remarks, the Federal Reserve is a creature of Congress and accountable to Congress. How should Congress exercise this accountability? That, I think, is one issue raised by Dr. Weintraub's proposal to treat monetary policy like fiscal policy in having the Federal Reserve seek *advance* permission from the Congress for a specified range of growth for M_1.

History provides ample evidence of the wisdom of granting central banks some degree of independence within government. One reason is that overly rapid monetary expansion yields apparent benefits at first but exacts costs later. It initially produces low interest rates, low unemployment and a booming housing sector. Only later does it push interest rates and unemployment up and housing down. In short, prudent monetary policy requires taking a long view. In determining monetary policy the Federal Reserve, therefore, should be insulated from the swings and pressures of partisan politics.

Implementation of the proposal would fly in the face of this important lesson of history and make it impossible for the Federal Reserve to conduct monetary policy in the long-run interest of the public.

A second disadvantage of the proposal goes to the state of the art of monetary policy. Desirable as it might be to predict policy in advance and to adhere closely to the prescribed plan, no one now has the ability to do this. Provision of ranges makes this scheme more feasible, but the ranges would have to be so wide as to be virtually meaningless. If it is true that the Federal Reserve lacks the expertise to devise and carry out the plan, it would also be questionable whether Congress could exercise the necessary judgment to evaluate the Federal Reserve's proposals.

Response of President Francis

Dr. Weintraub's three proposals for revising the process of monetary policy decisions contain much that I can agree with, but they also contain some points with which I disagree. I fully agree with one central theme of Dr. Weintraub's recommendations, that the Federal Reserve System should pick a longer-run target for monetary growth (at least one year) and then stick to that target unless there are extremely important reasons for deviating from the target path. I have often suggested that the Federal Reserve should use a longer-term planning horizon. In recent years some progress has been made in that direction, but I believe the Federal Reserve is still too prone to react to short-term factors such as interest rate movements, and, hence, move off its longer-run money supply path.

My main area of disagreement would be with the proposal that guidelines for monetary policy be specified annually by Congress after open hearings. Although I have dissented from past policy actions and I have often spoken out against the course of monetary actions during the time I have served as President of the Federal Reserve Bank of St. Louis, I am not convinced that this part of Dr. Weintraub's proposal would improve policy results. I believe that a strong independent central bank is crucial to limiting inflation. Traditionally, the central bank is the one institution which has shown primary interest in resisting inflation. There are always pressures for more spending without the willingness to pay the price of higher deficit spending. In many foreign countries the independence of the central bank is much more restricted and it is difficult to separate the central bank from the Treasury, or the central bank has only a minor voice in actual policy decisions. I do not find that the record of anti-inflation policy in these countries is any better than in the United States.

I would support a recommendation that members of the FOMC testify about their outlook for the economy before a Congressional Committee at the start of each year. The purpose of this testimony would only be to better inform Congress about the effect of *possible* policy actions on the economy. If Congress would make it very clear to the Federal Resereve that it was willing to accept the short-run upward pressures on interest rates and the possible temporary rise in unemployment necessary in a determined fight against inflation, then I would expect that the Federal Reserve would follow the monetary policy necessary to achieve the goal of slowing inflation.

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Response of President Mayo

1. RECOMMENDATION TO ESTABLISH TARGET M_1 GUIDELINES

I find this suggestion deceptively simple. It ignores many complications and restrictions that make it impractical. M_1 is only one element in a vast set of information relevant to the conduct of monetary policy. Specifying only an M_1 guideline presumes a certainty of knowledge on the significance of this measure for economic stabilization that simply does not exist. As everyone is aware, there is no unanimous view even among academics as to the appropriateness of using M_1 as the sole target for policy under all circumstances. We are all uphappy with the current inflation but that does not mean that a monetarist prescription is called for.

I am particularly disturbed by the implication that monetary policy be assigned the objective of achieving some measure that is in itself an extremely narrow concept rather than the objective of assisting in the achievement of our goals in employment, prices and economic growth. To argue that such an objective as M_1 can be assigned to the Fed because some feel that their experiments show a relationship between M_1 and our national economic goals, seems to me to be asking that we now proceed to conduct an experiment which would toy playfully with our economy and indeed with the welfare of our citizens. It is inconceivable to me that we should do so on the strength of the evidence available so far—especially when it appears to me that a majority of professional opinion would clearly reject such a guideline even in theory.

From what we do know about the variability of the relationship between M_1 and our economic goals and the potential for unexpected shifts due to unusual factors and expectational and attitudinal factors, Federal Reserve responses must be uninhibited. The Congress has delegated the monetary policy function to the Federal Reserve. The Fed, in turn, is and should continue to be accountable for its performance relative to national economic goals and not simply to a statistical measure.

I find the suggestion that Congressional action in the monetary policy area should be parallel to its newly-formulated budget reform structure rests on rather tenuous reasoning. Congressional budget reform is, in my opinion, a laudable effort to coordinate an existing helter-skelter system of expenditure authorizations. The focus is on control of specific dollars where the Congress has a specific responsibility which it cannot delegate. Monetary policy, on the other hand, can—and is—almost fully delegated because of the day-by-day evolution of its goals and their execution, with Congressional review after the fact to make sure that the public interest is being appropriately served. I do not believe that the Congress has the time, expertise or willingness to monitor monetary policy, particularly when many goals, not just one, are appropriate. It would make the policy determination process tortuous and time consuming.

Response of President Morris

The first of Dr. Weintraub's proposals is intended to provide an improved format for the Congressional oversight of monetary policy. While I sympathize with the objective. I also recognize a number of operational problems which would be associated with the implementation of this proposal.

Monetary policy decisions are difficult decisions because they necessarily involve trade-offs between policy objectives which in the short-run are typically incompatible. My colleague, Mr. Francis, made the point during the hearing, which I can accept as a theoretical proposition, that in the long run high employment, a low inflation rate and low interest rates are not necessarily incompatible. Unfortunately, in the long run, as Lord Keynes said, "we are all dead." In the short-run context within which monetary policy decisions must be made, difficult trade-offs will almost always be required. To the extent that the Weintraub format could provide the Federal Reserve with better Congressional guidance on these difficult trade-offs, it would be helpful.

However, I foresee a great many problems in attempting to implement the proposal. First, there are problems arising from the state of the forecasting art. Presumably, the Federal Reserve, under the proposal, would meet with the Congressional Committees in January, present its proposed growth path for

36-714—74——25

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money and its estimates of the growth rate for real GNP, the level of unemployment, the inflation rate and the pattern of interest rate behavior associated with that money growth path. The Committees would then make judgments as to whether that growth path reflected acceptable trade-offs or whether a higher or lower path was to be preferred. The difficulty is that we do not have the capability to generate a reliable set of estimates for the full year ahead.

In recent years our forecasts of real GNP and unemployment have been fairly good, but our forecasts of inflation and interest rates have usually been wide of the mark. We often find that we cannot accurately estimate the interest rate implications of a given money growth path one month ahead, much less one year ahead. This means that we could not give the Congress, among other things, an accurate projection of the consequences of the policy path for the thrift institutions and the housing industry.

Because our forecasting ability is limited, the optimum money growth path cannot be determined with precision a year in advance. This means that the bands of acceptability around the growth path would have to be quite wide. For example if the path were to be 5% for M_1, the acceptable range would have to be at least as wide as 3% to 8%. Another reason why a wide band would be essential is that the Federal Reserve must always have complete freedom to deal with potential financial panics. It would be extremely dangerous for the country if the Federal Reserve were ever in a position in which it was necessary for it to subordinate its "lender of last resort function" to any other consideration. Time is of the essence in dealing with problems of financial instability, and the Federal Reserve must always be in a position to move within a matter of hours to counter such instability should it arise.

If the acceptable range of M_1 growth were to be as wide as 3% to 8%, which I think it must be, the Congressional Committees might feel a bit frustrated in the sense that they would be establishing ranges beyond which the Federal Reserve would not contemplate moving in any event.

In summary, while I sympathize with the objective of this first proposal, I simply do not believe it is workable.

Response of Chairman Burns

Adoption of the first recommendation would have the effect of shifting a major share of the responsibility for deciding current monetary policy from the Federal Reserve to Congress. While Congress would request the Federal Reserve to recommend a particular growth path for the narrowly-defined money stock, the ultimate decision on the target path would rest with Congress. Once the path was established, the Federal Reserve would be expected to achieve it, unless at a subsequent Congressional hearing the Federal Reserve could make a case for modifying the target.

The Congress might find it possible to manage monetary policy if there were a simple, fixed, and well understood relation between the growth of the money supply and economic activity, and between growth in money and the behavior of prices. Unfortunately, this is not the case, spending decisions and prices are heavily influenced by the willingness to use money (its rate of turnover), quite apart from the quantity of money. It is impossible to predict with any confidence what monetary growth rate would be needed to finance a given increase in the dollar value of the gross national product for as long as a year in the future.

The particular growth rate of money consistent with the maintenance of economic stability will differ from one set of economic circumstances to another. Not infrequently, the rate of monetary expansion required to achieve our national economic objectives changes abruptly, because of unexpected disturbances in financial markets or anticipated developments in the nonfinancial sectors of the economy. Such events may stem from any number of circumstances—such as the poor crop harvests of 1972 that sent food prices skyrocketing, or the manipulation of petroleum supplies and prices by oil-exporting nations that began in the fall of 1973. Or they may arise from cyclical movements in the domestic economy that are not foreseen.

The ability of the Federal Reserve to respond promptly to such events contributes importantly to reducing economic and financial instability to manageable proportions. The loss of flexibility that would ensue if the path of monetary growth were predetermined for a year would thus seriously weaken our instruments of economic stabilization policy.

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The first staff recommendation is defective in still other respects. It acknowledges that, in implementing the proposed guidelines for growth in M_1, the Federal Reserve would need "some limited flexibility to deal with short run problems". In fact, however, the proposal hardly meets this test. If growth targets for M_1 in each month of the year were related to levels that prevailed 12 months before, assurance of achieving the targets would probably require an effort by the Federal Reserve to fix average growth rates of the money supply not just for the year as a whole, but for the short run month-to-month periods in between as well.

Our control of the money stock is, however, very imperfect in the short run. Inevitably, therefore, actual growth in money balances would deviate from the targeted path as the year progressed. That fact would be evident to financial market participants, and it would also be evident to them that our efforts to get back on target would have major implications for the future behavior of interest rates. A road map to the course of interest rates would be a rich treasure to sophisticated market speculators, at the expense of those less able to interpret the effects of monetary policy on financial markets.

Dr. Weintraub's second recommendation states: ". . . let Federal Reserve policymakers, be responsible *as individuals* for reviewing last year's money supply behavior, explaining its consequences and specifying what changes they now would make in that behavior if they could go back and change their past decisions. (A single review could be submitted if there was no disagreement. But all Presidents and Governors should be required to explicitly state their concurrence.)"

Response of President Hayes

Dr. Weintraub's second and third recommendations are both designed, in his words, "to permit Congress and the public to better utilize the candor, knowledge, and courage of individual Federal Reserve policymakers." In attempting to achieve this goal, Dr. Weintraub's second recommendation would have individual Federal Reserve policymakers conduct, in effect, an annual postmortem on monetary policy.[2] As you know, the Federal Reserve Board submits to Congress a systematic review of monetary policy and its consequences quarterly and the annual reports of the individual Federal Reserve banks also cover the same ground. All of us in the Federal Reserve of course seek to benefit from our experience, including especially our mistakes, but there may be room for improvement in this respect.

Perhaps more attention should be given to the differences in analysis and interpretation among policymakers, differences that naturally tend to be submerged in the consenses policy in effect at any given moment. I do not mean to suggest, however, that present procedures stifle public dissent on policy by Federal Reserve officials. As you know, dissenting opinions on monetary policy in the FOMC become a matter of public record within three months. In addition, Federal Reserve policymakers have ample opportunity to state their views on policy issues in numerous public statements and speeches as well as in the various publications of the Board of Governors and of the individual Reserve Banks. Thus, as I see it, the principal advantage of Dr. Weintraub's suggestion would be to provide a common forum in which differing views on monetary policy might be explained and discussed.

Two further comments on this recommendation may be in order. First, it should be clear at this point that I do not agree with Dr. Weintraub's suggestion that a review of monetary policy during the past year should be confined to the behavior of the money supply. As explained above, I believe that this is too narrow a focus in which to formulate and evaluate monetary policy. Second, policy decisions can almost always be improved in retrospect, when many of the uncertainties confronting policymakers at the time when a decision has to be made have been resolved. Thus, I am not convinced that much is to be gained by following Dr. Weintraub's suggestion of having policymakers discuss in retrospect how they would change their past decisions. It would seem much more useful and meaningful to apply lessons learned from the past to current and future monetary policy than to spend time looking back at some hypothetical "might have been".

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Response of President Balles

I can see little basis for the present proposal, since I believe that individual members of the Federal Open Market Committee are presently responsible *as individuals* for the decisions they make in the FOMC.

The policy record, published three months after each FOMC meeting, contains a compendium of relevant economic information available to the FOMC at the time of its meetings, a summary of the discussion of this information by members of the Committee, and a report of any policy actions taken, together with dissenting votes, if any, and the reasons for such dissent. In addition, Reserve Bank Presidents and members of the Board of Governors frequently give speeches in which they make public their individual views and differences of opinion on important economic issues. Finally, individual members of the FOMC are called to testify before Congressional Committees to analyze the successes and failures of past monetary policies in the manner of the House Banking and Currency Committee hearings in July of 1974. Questions similar to those posed in the present staff proposal were put to members of the FOMC in the July 1974 hearings and, in my opinion, were answered with appropriate "candor, knowledge and courage."

Response of President Eastburn

PROPOSAL NO. 2.—REVIEW LAST YEAR'S M_1 BEHAVIOR AND ITS CONSEQUENCES

Dr. Weintraub's suggestion overlooks an essential element of monetary policy. This is the process of group decision-making. The great strength of the Federal Reserve lies in the pluralistic nature of its deliberations, the contribution of diverse viewpoints in solving a common problem. It is appropriate, therefore, that the policy record of the FOMC states the majority view, but with ample provision for dissenting opinions.

I believe that Dr. Weintraub's proposal is not well advised in most circumstances. On the other hand, a major principle underlying the organization of the System is the dispersion of power and authority. The Boards of Directors and Presidents of Federal Reserve Banks have been given certain powers by law. It is entirely appropriate for Congress to call on these elements of the System as often as it believes desirable to obtain a fuller appreciation of diversity of views within the System.

One further point. I believe a good part of Dr. Weintraub's concern could be resolved if the Federal Reserve were to put forth at frequent intervals a meaningful, evaluative analysis of policy problems and decisions. At present material released to the public tends to be either simply descriptive or defensive of actions taken. A fuller analysis of pros and cons of various alternative actions would help to bring out the fact that policy is never monolithic in nature and that there is much more room for differing opinions.

Response of President Francis

I would support the recommendation for an annual review of Federal Reserve policy actions involving all members of the Federal Open Market Committee. All policymakers, including all members of the FOMC, should be subject to public questioning about their policy decisions. FOMC decisions are committee decisions and all members of the FOMC share the responsibility for these decisions.

Response of President Mayo

2. RECOMMENDATION FOR INDIVIDUAL FOMC MEMBER REVIEW OF PRIOR YEAR DECISIONS

Federal Reserve policy makers are responsible as individuals to provide their very best in the way of input into the monetary policy formulation. They are, therefore, responsible for a record of *joint* accomplishment which is *the* important end result. Separate records of individual opinion are only of secondary significance. Under current procedures, those disagreeing with the majority

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can register a dissenting opinion published as part of the policy record. Thus, in effect, a review already exists. No purpose is served by asking for specific comments on money supply behavior since, as I have argued elsewhere, our objective must be national economic goals and not an intermediate target measure.

I do not see any reason—nothing to be gained—for individuals to second-guess past decisions on the basis of subsequent information. The decision must be considered in the light of the information available at the time. Retrospective review is and certainly will continue to be made by each policy maker as he attempts to improve his contribution to the policy decision-making process.

Response of President Morris

The second of Dr. Weintraub's proposals would require individual Federal Reserve policy makers to review the preceding year's money supply behavior, to explain its consequences and to specify what changes they would make in that behavior if they could go back and change their past decisions. While there may be some merit in the Federal Open Market Committee, as a group, providing such a document to Congressional Committees annually, I see no purpose to be served in individual Monday morning quarterbacking by each member of the Committee. If a FOMC member wishes to dissent from a course of policy action, the time to do it is at the time the decision is made. In fact, a review of the record will show that FOMC members have not been reluctant to record their dissents from policy actions at the time decisions were made. This is the time, and the only time in my judgment, in which individual dissents serve a constructive purpose. I would not, therefore, support this proposal.

Response of Chairman Burns

The second staff recommendation is both unnecessary and undesirable. The record of policy actions of the Federal Open Market Committee is regularly published in the Federal Reserve *Bulletin* 90 days following each Committee meeting. The voting record of every member of the Committee is listed for each policy action taken, and when an individual member dissents from the action taken, the reasons underlying the dissent are usually indicated. Similarly, decisions of the Board of Governors that do not become public immediately—such as action on the discount rate or on reserve requirements—are reported fully in the Board's Annual Report covering the preceding calendar year. In this case, too, dissenting votes are permitted to include the specific reasoning of the dissenting members.

The System also reports extensively on the past performance of monetary and financial developments in relation to the behavior of the economy. We are accountable to the Congress and we are available at any time to give our views on the state of the economy and explain the monetary policy actions taken by the System. Twice a year, I appear regularly before the Joint Economic Committee, and I also meet frequently with both the House and Senate Banking Committees to discuss monetary and economic developments. Also, the Board staff prepares a quarterly report of monetary and financial developments at the request of the Joint Economic Committee, and the Board's Annual Report contains a comprehensive review of the economic and financial developments of the previous year, along with a discussion of the monetary actions that were undertaken.

What is proposed by this second recommendation is a review of the year, after the fact, by individual policymakers. The practical content of such a review would, I believe, be unrewarding. All of us would do things somewhat differently if we could relieve the event with perfect hindsight. No doubt many policymakers would propose different policies than had in fact been followed, and there would be points of difference from one policymaker to another. But I doubt that much would be learned by requiring individual policymakers to air their varied dissents from the past course of policy, and I am afraid the Congerss and the public would be confused by all this.

The strength of the policymaking procedures of the Federal Reserve lies not in the isolated wisdom of individual policymakers, but in the fact that a group of intelligent men—reasoning together, analyzing evidence, and deliberating together—can reach a judgment that fits the particular circumstances of the economy better than would the decisions of any one or two of three of them. That

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valued asset might be destroyed by a system that emphasized the airing of diversity, rather than agreement, in the conduct of monetary policy.

Dr. Weintraub's third and final recommendation states: ". . . let the full minutes of the Open Market Committee meetings be made public immediately or at most six months after they are held, deleting until another six months has elapsed all so-called sensitive discussions."

Response of President Hayes

I cannot agree with Dr. Weintraub's final recommendation, which would have the full minutes of FOMC meetings made public within a time span of no more than six to twelve months. My objection here reflects my concern that sensitive discussions with foreign central banks and officials would be precluded if they could not be assured of complete confidentiality for a substantial period of time.

Moreover, I do not see any real need for the immediate release of the FOMC's full minutes. The Federal Reserve publishes a rather detailed record of the policy action taken at each FOMC meeting within approximately 90 days of each meeting. This record includes not only a summary of the economic and financial conditions influencing the FOMC's decisions, but also the short-run targets it has agreed upon for the money supply, various other monetary aggregates, and money market interest rates. The record of policy actions, as noted above, also includes any dissents to the agreed-upon policy along with a summary statement of why the FOMC member in question dissented from the majority's policy decision. Thus, I believe that the published record of policy actions sets forth fairly and adequately differing views among Federal Reserve policymakers. In these circumstances, the benefits of the early publication of the FOMC's full minutes would seem to be minimal, and to be heavily outweighed by the damage that such early publication could do to our relations with foreign monetary authorities.

I hope that you will find these comments on Dr. Weintraub's recommendations helpful. I think that the Committee's hearings on monetary policy were beneficial to all concerned, and I am pleased that the Congress is taking such a lively interest in monetary policy. I know that to many people this is an arcane subject and I welcome such opportunities to try to explain what we in the Federal Reserve are attempting to accomplish.

Response of President Balles

As I noted in my response to the second staff proposal, there presently is a substantial amount of disclosure with respect to FOMC deliberations three months after a meeting occurs. The published policy record of the FOMC presents all questions of fact known to the FOMC as of the meeting date, summarizes the discussion of the members, and gives the policy recommendation, including a quantitative statement of the short-run growth rate targets for the monetary aggregates. This policy record clearly indicates which voting members of the FOMC approved and which disapproved of the final recommendation, and the reasons for dissenting votes if any were cast.

The publication of the full and detailed minutes of the FOMC would add relatively little to the substantive understanding of the issues discussed, and would have two undesirable effects, even with a one-year delay in publication. First, it could prove embarrassing to other central banks when the discussion turned to international issues. More importantly, disclosure of such deliberations may limit the ability of the United States to offer the assurance of strict confidence in dealings with other central banks, which is absolutely essential to effective bargaining and to the resolution of many international financial problems. Second, complete candor untempered by considerations of political problems is essential to meaningful and frank deliberations. From time to time it is necessary to discuss in detail the implications for the economy and for monetary policy of programs and policies of the Administration and the Congress. If the detailed minutes were divulged within a shorter time frame than is presently used (i.e., 5 years), discussion might be inhibited, and the FOMC would be immersed more deeply in the political arena with undesirable consequences for the effective formulation and implementation of monetary policy.

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Response of President Eastburn

PROPOSAL NO. 3—MAKE THE FOMC'S MINUTES PUBLIC IMMEDIATELY OR AT MOST SIX MONTHS AFTER THE MEETINGS, DELAYING FOR ANOTHER SIX MONTHS SENSITIVE DISCUSSIONS

I believe Dr. Weintraub's proposal for full disclosure of FOMC memoranda of discussion within six months goes further than is prudent. It is important that a balance be struck between full disclosure and the confidentiality necessary to foster honest debate and exchange of information among FOMC members.

The public, in my judgment, likely would benefit from earlier knowledge of current policy decisions than it now gets.[1] This objective could be achieved without immediately revealing in full detail the deliberations within the Committee. The FOMC could announce its quantitative policy targets with necessary explanatory text with less delay than is now the case. The policy record could continue to include views of dissenting members.

How soon these quantitative targets and policy text should be released is debatable. One approach would be to reduce the 90-day delay to 60 days for a period of six months. If there were no major adverse consequences, then the delay could be reduced to 30 days.

The FOMC memoranda of discussion should continue to be published with a five-year lag. In addition, we should continue to delete sensitive material (such as that involving foreign governments) from the published version. Immediate release of the full discussion is undesirable because it would inhibit forthright policy discussion to the detriment of effective policy.

Response of President Francis

I agree with Dr. Weintraub's proposal for release of the FOMC minutes after a six-month interval. If this policy were followed, the policy positions of each member of the FOMC would be a matter of public record. Hence, any testimony by FOMC members before a Congressional Committee could be limited to responding to specific questions about their published policy positions.

I have long held the view that it would be beneficial to release very shortly after each FOMC meeting a complete specification of the short-run and long-run operating targets for Federal Reserve policy. I do not see how this information would in any way benefit a special class of money market participants. I agree with the view expressed by President Mayo of the Federal Reserve Bank of Chicago during his interview with Dr. Weintraub, namely, that:

> . . . The market indeed does have a fairly full understanding as to what the factors are in monetary policy that are going to lead to specific steps by the Federal Reserve. This happens to be a product, in part, of the fact that many of these people who are in the market, and in the position of making markets, have at one time either worked in the Treasury or in the Federal Reserve. *Indeed there is also cross-fertilization the other way.* So it is no great secret as to how you interpret what the Fed is doing and indeed is trying to do. A number of the leading writers in New York—the Lehman Letter, Lanston's Letter and so forth —are written by former Treasury, former Federal Reserve people, and they're very good in interpreting these things.

By making complete information about the Federal Reserve's intended policy actions available to the market, I believe that market participants could structure their portfolio decisions with greater certainty and this would eliminate pressures that arise in the financial markets as market participants try to "second guess" monetary policy actions.

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[1] A summary of FOMC decisions is normally released after a delay of about 90 days. Memoranda of discussion are released usually after a five-year delay with certain sensitive material, for example, certain references to foreign governments, deleted.

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Response of President Mayo

PROPOSAL NO. 3—RECOMMENDATION ON THE DISCLOSURE OF THE FOMC MINUTES IMMEDIATELY OR SIX MONTHS AFTER THE MEETING

The policy action record is currently published three months after the Federal Open Market Committee meeting. This record details the bases for the decision, provides quantitative targets for the period and indicates the dissents, if any, and the reasons for them. Thus, full disclosure is already made on all relevant policy elements.

Response of President Morris

The third proposal of Dr. Weintraub is that the full minutes of the FOMC meetings be made public immediately or at most six months after they are held, deleting until another six months has elapsed all so-called sensitive discussions. While I favor the maximum feasible disclosure of Federal Reserve policies and operations, I do not think that disclosure of the full minutes of the meetings shortly after the meetings were held would be in the public interest. Such disclosure would greatly inhibit free discussion at meetings and encourage decision making outside of the meetings. It is necessary to strike a balance between the confidentiality needed to insure adequate internal discussion and the disclosure needed to insure adequate public understanding of policy and Federal Reserve accountability. The public's need is met by the Policy Record published for each FOMC meeting. As you know, the Policy Record for each meeting is released approximately 90 days after the date of the meeting and we have been expanding the content of this document. Beginning in 1974, the Policy Record of the FOMC now contains the numerical specifications that guide open market operations in the period between Committee meetings for M_1, M_2, RPD's and the Federal Funds rate. I believe, personally, that we could safely shorten the time lag involved in publishing the Policy Record from 90 days to 60 days. However, for the reasons stated, I would oppose the publication of the minutes.

Response of Chairman Burns

The third staff recommendation—to release the minutes of Federal Open Market Committee meetings immediately, or within six months time—could seriously damage the conduct of monetary policy, even if the disclosure of "so-called sensitive discussions" were deferred somewhat longer. Immediate disclosure of the decisions of the FOMC would give an enormous advantage to sophisticated financial investors, who would realize much more quickly than would the general public the implications of these decisions for the near-term course of interest rates and financial asset prices. Based on this knowledge, they would take action in the securities markets for their own personal gain. Such personal enrichment would come at the expense of other, less knowledgeable, individuals who could not react quickly enough to avoid financial losses. Such inequities could hardly be countenanced.

Withholding publication of the FOMC minutes for 6 months would avoid most problems of that kind, but a longer lag than 6 months is needed for other reasons. The FOMC is a deliberative body. Its members must speak frankly to one another regarding activities of the Administration, of the Congress, of foreign central banks and foreign governments. If a nearly verbatim record of these remarks were released in a short period of time, it might produce great embarrassment. Knowledge of this fact would prohibit the candid and open discussion that is essential to sound judgments on monetary policy. Some information would inevitably be withheld, and the positions espoused by individual policymakers would almost certainly be influenced to a degree by the knowledge that they would be made public shortly.

Delayed publication of the full minutes of FOMC meetings is not a serious omission from the standpoint of public understanding of monetary policy. Other FOMC releases keep the public fully informed of Committee actions on a much more timely basis. The Committee policy record, in particular, provides a full report—within 90 days of each meeting—explaining the essentials of Committee actions and the reasons behind them.

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ADDITIONAL QUESTIONS
III

POSSIBLE EFFORTS TO INFLUENCE AND COORDINATE THE TESTIMONY OF THE RESERVE BANK PRESIDENTS

On July 18, 1974, Congressman John H. Rousselot explored the question of possible efforts by the Federal Reserve Board to influence and coordinate the testimony of Reserve bank presidents before the committee. The pertinent dialogs follow:

Mr. ROUSSELOT. Thank you.

First of all, I want to compliment each of you gentlemen on your testimony and your analysis of the problem of inflation and high interest rates, and I did have a chance to glance at each of your statements prior to coming today, and appreciate the chance to review them. I would like an answer from any one of the three of you; did the Federal Reserve Board here in Washington make any effort to influence or coordinate your testimony before this Committee?

Mr. MORRIS. No, sir. We did ask the research staff of the Federal Reserve Board to look over our comments, check any inaccuracies, but there was no censorship.

Mr. ROUSSELOT. No; I am not suggesting censorship. I am just suggesting guidance.

Mr. MORRIS. In my case, I can assure you there was no guidance, nor were there any significant changes in the text I originally drew up.

Mr. ROUSSELOT. Mr. Mayo?

Mr. MAYO. Mine were only editorial changes.

Mr. ROUSSELOT. Editorial changes? What does that mean?

Mr. MAYO. I should say changes in words—semantics—just in a few cases. There was nothing substantive changed, and the suggestions were only by the Board staff. To my knowledge, no Governor has ever seen my statement.

Mr. MORRIS. I might also add, sir; that we are completely free to reject any suggestions the Board staff put forth.

Mr. ROUSSELOT. Mr. Francis?

Mr. FRANCIS. The Board staff did ask to see the statement. Mine was transmitted to them. There were some suggestions, but I have a sort of a country person feeling about the principles of appearing before a Congressional group, and I think that when I am invited to do so, I am obligated to give you my views, and mine alone; and the statement you have is my original statement, without one word having been changed.

Mr. ROUSSELOT. Good. I appreciate that.

Mr. MAYO. That is true in my case, for all intents and purposes, too.

Mr. ROUSSELOT. My understanding is that there was a special meeting of the Board held this past Monday, July 15. Did any of the Governors discuss potential testimony before this Committee? Was there any discussion about it?

Mr. MAYO. May I ask what you mean by potential testimony?

Mr. ROUSSELOT. Well, your potential testimony.

Mr. MAYO. Well, again, as we discussed here, there was a recognition of the fact in the meeting that you refer to that we are indeed part of a system, and that there is an inherent strength of what you might call joint decision-making, and the way that the Federal Open Market Committee is working on it, and that is the most important ingredient, and there is no disagreement among any of us on that. That is far more important than the differences that each of us may have with each other on detail.

Mr. ROUSSELOT. Then, is your answer that it was discussed in the meeting—your joint ideas?

Mr. MAYO. In a broad way.

Mr. ROUSSELOT. In a broad way it was discussed?

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Mr. MORRIS. We did discuss Dr. Weintraub's proposals. We talked them back and forth over dinner. But we are all going to make our independent statements for the record on his proposals, and I suspect that probably you will find a difference in my response and my colleague's, Mr. Francis'.

Mr. ROUSSELOT. Yes; I noticed that.

Then your statement is that, even though it was discussed on a joint basis in the meeting on Monday, July 15, this is just for the edification of each other? There was no attempt by any of the governors to say, well, this is what we have been saying, and hopefully you will say the same thing, or what?

Mr. MORRIS. No, sir.

Mr. MAYO. No, sir.

Mr. ROUSSELOT. You actually, then, are independent operators, as it comes to your own statements?

Mr. MAYO. That is correct.

Mr. ROUSSELOT. Thank you, Madame Chairman.

There follows now written questions on this matter submitted by Congressman Rousselot to Presidents Hayes, Balles, Eastburn, Francis, Mayo, and Morris and their replies.

I. During the questioning of Presidents Mayo, Morris, and Francis by the Committee on Banking and Currency on July 18, 1974, I asked several questions regarding a possible effort by the Federal Reserve Board to influence or to coordinate the testimony of regional bank Presidents before the Committee. In order to explore this issue more thoroughly, I have prepared a series of questions addressed to all six Presidents who testified before the Committee.

The answers to these questions are particularly important in light of the recommendations which Dr. Robert Weintraub, Staff Economist for the Committee, made at the conclusion of his report that the minutes of the Open Market Committee be made public and that Federal Reserve policymakers individually make an annual review of their decisions in order to "permit Congress and the public to better utilize the candor, knowledge, and courage of individual Federal Reserve policymakers."

Question 1. With respect to the series of interviews of regional bank Presidents conducted by Dr. Robert Weintraub, was any effort made by the Governors or by the staff of the Federal Reserve Board to discourage your participation or to influence the content of your responses to anticipated questions?

Question 2. With respect to the testimony which you gave before the Committee on Banking and Currency, was any effort made by the Governors or by the staff of the Federal Reserve Board to influence or to coordinate your testimony?

Question 3. With respect to any testimony which you may have submitted to the Governors or to the staff of the Federal Reserve Board for "technical," "editorial," or other changes, is there any reason why your own staff was unable to make whatever changes may have been necessary without consulting the Governors or staff of the Federal Reserve Board?

Question 4. Do you usually submit advance drafts of your public speeches to the Governors or to the staff of the Federal Reserve Board for their review?

Question 5. Was a special meeting of the Federal Reserve Board held in Washington on Monday, July 15, the day before the Committee began its hearings on the relationship between Federal Rserve policy, inflation, and high interest rates?

(a) If so, which Governors, Presidents, and staff members participated?

(b) Was the content of your testimony discussed?

(c) Was any attempt made to explain the position of the Board of Governors, its Chairman, or its staff on the substantive issues expected to be raised at the hearings?

Question 6. Did you submit any version of your testimony (preliminary or final) to the Governors or to the staff of the Federal Reserve Board for their review?

(a) At whose initiative was it made?

(b) Was a dealine set for such submission, and, if so, what was the date?

(c) Which individuals at the Federal Reserve Board reviewed your testimony?

(d) What changes did they request or suggest that you make?

(e) What actual changes did you make in your testimony before submitting it to the Committee?

Question 7. At any time prior to your appearance before the Committee, in connection with your interviews with Dr. Weintraub or with the scheduling, preparation, or submission of your testimony to the Committee, were you in any

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way threatened with reprisal, including loss of privileges, such as the privilege of attending meetings of the Open Market Committee (if not a voting member), removal from office, or reduction in your Bank's budget or research staff?

Question 8. At any time prior to your appearance before the Committee, did you have any contact with any directors of your Bank concerning your testimony or concerning any possible problems arising from or relating to it?

Response of President Hayes

Answer to question 1. No effort was made by any Governor or by any of the staff of the Board to discourage my participation or to influence the content of my responses.

Answer to question 2. Interpreting this question to apply to the prepared statement I submitted to the Committee, orally in an informal summary and in full in written form for the record, I can assure you there was no attempt by any Governor or any of the Board's staff to "coordinate" my views. Several suggestions for changes in wording were made to me, three of which I accepted in part, and these suggestions are discussed in the response to question 6.

Answer to question 3. Since I was out of the country while arrangements for my appearance before the Committee were made early in July, and I did not return until July 13, my staff commenced the preparation of my statement during my absence. It was, therefore, responsible for the "technical" and "editorial" content of the statement. However, just as I solicit comments, suggestions, and criticism from my associates at the Bank on letters and other material I prepare myself, so I am glad to consider comments from the Board and its staff. (See also response to the next question.)

Answer to question 4. I have made it a practice during my 18 years as President of the Federal Reserve Bank of New York to send advance drafts of my public speeches to the Chairman of the Board of Governors and to the Secretary of the Treasury, asking for their comments and suggestions. I have given serious consideration to any suggestions they have made, sometimes accepting them, sometimes modifying my wording on the basis of their suggestions, and sometimes rejecting them.

Answer to question 5. I interpret the question to refer to a meeting at the Federal Reserve Board and there was such a meeting on the morning of July 15.

Answer to question 5(a). To the best of my recollection, there were present Chairman Burns, Governor Wallich, Mr. Partee (Managing Director for Research and Economic Policy), Mr. Coyne (Assistant to the Board), Mr. Rippey (Assistant to the Board) and several of the Presidents of the Federal Reserve Banks.

Answer to question 5(b). There was a general discussion of the probable lines of questioning on issues that members of the Committee might be expected to pursue. Later that day, at dinner, there was a review by Mr. Partee of the recommendations that Dr. Weintraub was making in his report to the Committee. There was a general discussion of those recommendations, most of it (as you might expect) critical.

Answer to questions 6(a) and (b). Yes, a copy of a preliminary draft version of my prepared statement for use at the Committee's hearing was submitted to the Board's staff. On July 8, my office (in my absence) received a wire message from Mr. David C. Melnicoff, the Board of Governors' Managing Director for Operations and Supervision, confirming that arrangements had been made with the House Committee on Banking and Currency for six of the Reserve Bank Presidents to testify at hearings on July 17 and 18, and adding "we look forward to receiving your draft statement which we hope to return with any comments to seminar on Monday the 15th at 9 a.m." An early draft of statement was sent to the Board on July 10, although my associates continued to work on wording, seeking to clarify the views expressed and to improve expression of the thoughts.

Answer to question 6(c). To the best of my knowledge, the draft of prepared statement was reviewed only by J. Charles Partee, Managing Director for Research and Economic Policy.

Answer to questions 6(d) and (e). To the best of my recollection, Mr. Partee suggested about half a dozen changes in the draft text; I made three changes in wording as a result of those suggestions. Although I did not make notes of those suggestions by Mr. Partee that I rejected, I am attaching a copy of the statement as submitted to the Committee which identifies those changes I did make

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on the basis of Mr. Partee's suggestions. I should explain that my staff continued to work on the draft sent to the Board on July 10, so that a second draft I received for review on my return July 13 to the United States reflected more than a dozen changes made to refine wording and clarify expression of thought. In my review on July 13 and 14, before the meeting in Washington on July 15, I made some further revisions. Accordingly, it should be clear that the draft statement I discussed with Mr. Partee contained a number of differences from the initial draft sent to the Board on July 10.

Answer to question 7. No pressure of any sort was put upon me, nor was I threatened with any reprisals.

Answer to question 8. I had no such contact with any directors.

The changes made on the basis of Mr. Partee's suggestions, as identified by President Hayes, are as follows. (Italicized words were added and bracketed words deleted.)

1. Indeed, I think there have clearly been times, particularly in 1968 and in 1972, when monetary policy has been *rather* too expansionary.
2. Certainly, our present situation of unemployment in excess of 5 per cent, coupled with *the escalation of inflation rates that we have witnessed*, [a peacetime inflation of virtually unprecedented rapidity] strongly suggests that this process has been at work over the past decade.
3. Indeed, as I indicated earlier, I think monetary policy has clearly been *somewhat* too expansionist at times over the past decade.

Response of President Balles

Answer to question 1. No.

Answer to question 2. No.

Answer to question 3. The Research staff at the Federal Reserve Bank of San Francisco provided valuable assistance in preparing the testimony I presented to the House Banking and Currency Committee. This staff is perfectly capable of providing such assistance when and where needed, however they, like myself, are accustomed to drawing on the resources of the entire Federal Reserve System when it is convenient and appropriate to do so. Testimony on subjects as important as the ones addressed at the July 17–18, 1974 Hearings of the Banking and Currency Committee, in our view, warranted utilization of the widest range of expertise available to us. The free interchange of ideas among the Reserve Banks and the Board of Governors is a major source of strength for the Federal Reserve System as a whole. However, I wish to make it clear that the ideas contained in the testimony I delivered to the House Banking and Currency Committee on July 17, 1974 are my own and that I assume personal responsibility for every word of it.

Answer to question 4. My Research staff generally send drafts of my public speeches, after review and approval by me, to the staff of the Board of Governors for comment. Although we do not accept all suggestions received in this process, many speech drafts are improved by this exchange of ideas.

Answer to question 5. I am not aware that any special meeting of the "Federal Reserve Board" was held on Monday, July 15 for any purpose. I attended four meetings that day:

i. At *9:00 a.m.* the six Federal Reserve Bank Presidents who were to testify before the House Banking and Currency Committee met for about an hour to discuss the Hearing scheduled for July 17–18.

Answer to question 5(a). According to my recollection, Chairman Burns and Governor Holland attended for a short period, and Governor Wallich attended the full meeting. Reserve Bank Presidents attending were Messrs. Balles, Eastburn, Francis, Hayes, Morris and Mayo. Staff attending were (Board's staff) Messrs. Partee, Rippey and Coyne, and (Reserve Banks) Messrs. Sims, Boehne, Jordan, Rassmick, Eisenmenger, and Scheld.

Answer to question 5(b). I summarized the remarks I planned to make in my testimony, but there was no discussion of it.

Answer to question 5(c). I do not recall any such attempt:

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ii. At *12:00 noon* I attended a meeting of the System Steering Committee on International Banking Regulation, and at *3:00 p.m.* I attended a meeting of Reserve Bank Presidents with representatives of the Board's Division of Reserve Bank Operations to discuss Reserve Bank Budgets. Neither of the meetings had any relation to the hearing.

iii. At *6:00 p.m.* I attended a dinner with Reserve Bank Presidents and members of the Board of Governors, which is done periodically throughout the year. Following the dinner, there was an extensive discussion of the problems of monetary policy in recent years. Additionally, there was a "roundtable" discussion of the recommendations made by Dr. Robert Weintraub, staff economist of the House Committee on Banking and Currency, regarding monetary policy formulations, the scheduled testimony of individual Reserve Bank Presidents was not discussed, nor was there any effort by the members of the Board of Governors or its staff to set forth a position on substantive issues likely to be raised in the hearings.

Answer to question 6. Yes.

Answer to question 6(a). I understand that Chairman Burns initiated the request, but it was relayed to me by Mr. Partee through Mr. Sims, the Senior Research officer at the Federal Reserve Bank of San Francisco.

Answer to question 6(b). A draft was requested by July 9, 1974. However, this date proved inconvenient for me, and so my draft testimony was not sent to Chairman Burns until July 11.

Answer to question 6(c). To the best of my knowledge, only Mr. Partee, Director of the Board's Division of Research and Statistics.

Answer to question 6(d). The few suggested changes were of an editorial nature and are indicated in the attached copy of the final version of my testimony, on which the language of the first draft has been handwritten. I accepted these suggestions.

Answer to question 6(e). See attached copy of draft sent by wire to the Board of Governors. I made numerous editorial changes and a few substantive changes at my own initiative, after sending the first draft. For this reason, I request that the first draft not be a part of the printed record. (The draft is retained in the committee's files.)

Answer to question 7. No.

Answer to question 8. No. At our regular Directors' conference call meeting on July 3, 1974, I mentioned the fact that I would testify before the House Banking and Currency Committee, but there was no discussion of this point.

The changes made on the basis of Mr. Partee's suggestions, as identified by President Balles, are as follows. (Italicized words were added and bracketed words deleted.)

1. What has led to this worldwide inflation? *Some* [many] observers would cite excessive monetary and fiscal expansion as the major immediate cause.

2. However, one element which has not received as much attention as it deserves is the breakdown of the Bretton Woods System, and the *decline in recent years in* [general loss of] foreign confidence in the U.S. dollar.

3. This movement out of dollars [was] accelerated in *the period after* [August 1971 when] the U.S. suspended convertibility of the dollar into gold *in August 1971.*

4. Since the early 1960s, the "full employment" goal in the U.S. generally has contemplated an unemployment rate of 4 percent *or less.*

5. This, of course, is not to imply that monetary and fiscal policy should never be used to help *deal with* [solve] unemployment.

6. In a very real sense, the double-digit inflation and accompanying high interest rates from which we are now suffering reflect inflationary policies of the past, the symptom of which were temporarily suppressed during the period August 1971 to *early 1973* [April 1974] by wage and price controls under various programs.

7. High and rising interest rates have taken their toll on financial markets. To the man in the street, some of the most obvious results have been the decline in the stock market and *the sharply reduced supply of funds for home loans at* [the disintermediation from] savings institutions.

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Response of President Eastburn

Answer to question 1. No.

Answer to question 2. Yes. The details of the effort to influence and coordinate the contents of my testimony are spelled out below in the answer to questtions 5 and 6.

Answer to question 3. I have full confidence in my staff's ability to review my testimony and to suggest changes. However, I have no objections to receiving comments from the Board of Governors or its staff.

Answer to question 4. I usually forward to the Board of Governors a copy of my major public speeches about the time of delivery.

Answer to question 5. I know of no special meeting of the full Board. There was, however, a meeting of some of the Governors, Presidents and staff.

Answer to question 5(a). My best recollection is that Chairman Burns, Governor Wallich, plus Messrs. Partee, Melnicoff, Burke, McWhirter, Coyne, Rippey of the Board staff attended. Also, in addition to me, Reserve Bank Presidents Morris, Hayes, Mayo, Francis and Balles attended, along with staff members Jordan (St. Louis), Scheld (Chicago), and Sims (San Francisco).

Answer to question 5(b). Yes. I summarized the content of my testimony, but there were no comments from the other participants.

Answer to question 5(c). No, there was no attempt to explain the substantive position of the Board, the Chairman, or the staff of issues. However, there was a discussion of the kinds of questions that might be raised, the style in which they might be asked, and the style in which they might be answered.

Answer to question 6. Yes.

Answer to question 6(a). Mr. Melnicoff's.

Answer to question 6(b). Yes, July 9, 1974 was set for initial submission date. Final draft was due July 15, 1974.

Answer to question 6(c). To my knowledge, Mr. Partee reviewed my testimony. There may have been others who reviewed my testimony of whom I am unaware.

Answer to question 6(d).
(i) To clarify the statement in the original draft (p. 2) to the effect that "the basic cause of inflation is monetary."
(ii) To indicate that the Federal Reserve is concerned with the "*effects* of high and rising interest rates" (p. 2).
(iii) To suggest that exploration of possibilities for allocating credit should proceed over a period of time (p. 7).

Answer to question 6(e). Each of these suggestions was agreeable to me and so I made the necessary changes.

Answer to question 7. No.

Answer to question 8. No.

The changes made on the basis of Mr. Partee's suggestions, as identified by President Eastburn, are as follows. (Italicized words were added and bracketed words deleted.)

1. Our current inflation has many causes, but it is helpful to divide them into two main aspects. One aspect involves extraordinary events such as crop failures, oil embargoes, and dollar devaluations. They come and go and often not much can be done about them. Beef prices skyrocket then taper off; wheat supplies diminish then expand; anchovies disappear from the coast of Peru and then reappear. If we are lucky, these phenomena occur at different times. In the last couple of years we have been unlucky; many extraordinary events have occurred together.

A second aspect is monetary. [The basic cause of inflation is monetary.] Whatever immediate events may cause prices to rise—including shortages and higher wage costs—a higher price level cannot be sustained without sufficient money. In retrospect it would have been better if money had not grown so rapidly over much of the past decade.

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2. In more recent periods, the Federal Reserve partly reflecting views of Congress has been concerned about *the effects of* high and rising interest rates.

3. [Sixth, selective credit controls are less necessary if general monetary and fiscal policies are doing their jobs. Historically, resort has been made to selective controls usually when general policies have proved deficient. To the extent, therefore, that we can avoid inflation through general monetary and fiscal policy, we have less reason to be concerned with the allocation of credit.]

I conclude from all this that [possibilities for] *over time, the question of* allocating credit should be [explored] *studied* further, Our analysis to date, however, suggests serious problems. *Perhaps the most important point is that if we can avoid inflation through general monetary and fiscal policy, we have less reason to be concerned with the allocation of credit. A* [And in any case, a] program of credit allocation is no substitute for responsible policy in dealing with the overall supply of money and credit.

Response of President Francis

Answer to question 1. No.

Answer to question 2. On June 26 there was a conference telephone hookup between the Presidents scheduled to testify and Messrs. Melnicoff, Partee, and Rippey of the Board staff.[1] In this call, each President was asked to send a copy of his prepared testimony to Chairman Burns by July 9, and was told that within a week thereafter, each would receive such comments and suggestions for changes as the Board staff might wish to offer. We were also told that there would be a meeting at the Board on Monday, July 15, to discuss the testimony and possible questions that might arise during the hearing (See answer to question No. 5 below). We were told that we would be provided with secretarial and duplicating facilities at the Board to facilitate delivery of our prepared statements to the Committee in their final form.

Answer to question 3. Our staff is, in my opinion, the finest of its kind, and I have complete confidence in them. They made many changes as the statement went through several draft stages. No statement is ever perfect, but in the form in which it was delivered to the Committee, it came as close as I knew how, to saying what I wanted to say. Neither the Board nor its staff was consulted.

Answer to question 4. I always send copies of my public speeches to the Board in their final form. However, they have not been delivered in advance simply because they normally undergo changes by me or our staff until the day before delivery. Recently however, I was told that Chairman Burns had taken exception to some statements contained in one of my speeches and I was instructed to send the text of future speeches to the Board staff in advance, by wire if necessary, so that they could be examined before delivery. Since I have not given any public speeches from a prepared text since that time, I have not had occasion to respond to this request.

Answer to question 5(a). There was a meeting at 9:00 a.m. on the morning of July 15, 1974 in the offices of the Board of Governors of the Federal Reserve System. It is my recollection that in addition to myself the following persons were present for at least part of the meeting:

Arthur F. Burns, Chairman, Board of Governors, and Federal Open Market Committee.
Henry C. Wallich, Member, Board of Governors, and Federal Open Market Committee.
Alfred Hayes, President, Federal Reserve Bank of New York, and Vice Chairman, Federal Open Market Committee.
John J. Balles, President, Federal Reserve Bank of San Francisco.
David P. Eastburn, President, Federal Reserve Bank of Philadelphia.
Robert P. Mayo, President, Federal Reserve Bank of Chicago.
Frank E. Morris, President, Federal Reserve Bank of Boston.
Richard A. Debs, First Vice President, Federal Reserve Bank of New York.
J. Charles Partee, Managing Director for Research and Economic Policy, Board of Governors.

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[1] J. Charles Partee, Managing Director for Research and Economic Policy, Board of Governors; David C. Melnicoff, Managing Director for Operations and Supervision, Board of Governors; and John S. Rippey, Assistant to the Board.

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David C. Melnicoff, Managing Director for Operations and Supervision, Board of Governors.
Ronald G. Burke, Director, Division of Federal Reserve Bank Operations, Board of Governors.
E. Maurice McWhirter, Associate Director, Division of Federal Reserve Bank Operations, Board of Governors.
Joseph R. Coyne, Assistant to the Board.
John S. Rippey, Assistant to the Board.
Jerry L. Jordan, Vice President, Federal Reserve Bank of St. Louis.
Kent O. Sims, Senior Vice President, Federal Reserve Bank of San Francisco.
Karl A. Scheld, Senior Vice President and Director of Research, Federal Reserve Bank of Chicago.

There was also a dinner meeting on the evening of July 15 at the Board of Governors building attended by all members of the Board, and all Reserve Bank Presidents, as well as a few senior members of the Board staff.

Asnwer to question 5(b). At the morning meeting, remarks were made regarding questions that might arise in the course of the hearings, and each of the Federal Reserve Bank presidents summarized the general thrust of his prepared testimony. The specific recommendations made by Dr. Robert Weintraub to the House Banking and Currency Committee were discussed at the evening meeting.

Answer to question 5(c). The views of the Board regarding the special borrowing of the Franklin National Bank were discussed. The views were essentially those stated in a New York Times article by Mr. Ed Dale appearing in the July 15 issue.

Regarding a possible question as to whether our statements were "cleared", it was suggested that we say they were sent to the Board staff for comment, some were taken and some were rejected, and each should emphasize that it was his own statement and views.

Regarding any possible questions about lobbying activities related to the GAO audit bill, it was suggested that no lobbying had occurred, that the System was opposed to such an audit, but, if inevitable, the Ashley Amendment would be acceptable.

Answer to question 6:

(a) Yes, presumably at Chairman Burns' initiative, since Mr. Partee asked that I send a draft version to the Chairman.

(b) The date which the testimony was to be received at the Board was July 9.

(c) Mr. Partee and possibly others.

(d) Changes suggested by the Board and staff were transmitted by wire from Mr. Partee on July 11. A copy is attached.

(e) None.

Answer to question 7. There were no direct or implied threats of any kind made in specific connection with my appearance before the Committee or in connection with the interview conducted by Dr. Weintraub.

Answer to question 8. As stated above, my prepared testimony was sent as requested, to reach the Board by July 9. On July 11, at a regular monthly meeting of our Board of Directors, I briefed the seven directors present on the sequence of events, and read to them verbatim my prepared statement. I told them that I had no intention of changing anything in the statement, and I asked whether it contained anything to which they, individually, and as a Board, could not give an unqualified endorsement. I was assured that, to a man, they stood behind my statement and supported my decision not to change it.

There follows the testimony of President Francis as it was submitted to the Federal Reserve Board on July 9, 1974, and subsequently given to the committee on July 18, 1974. Immediately thereafter follows a "mark-up" of this testimony incorporating the suggestions made by Mr. Partee in his telegram of July 11, 1974:

PREPARED STATEMENT OF DARRYL R. FRANCIS, PRESIDENT, FEDERAL RESERVE BANK OF ST. LOUIS

Mr. Chairman and members of the committee: I am pleased to have this opportunity to present my views regarding our country's inflation and high interest

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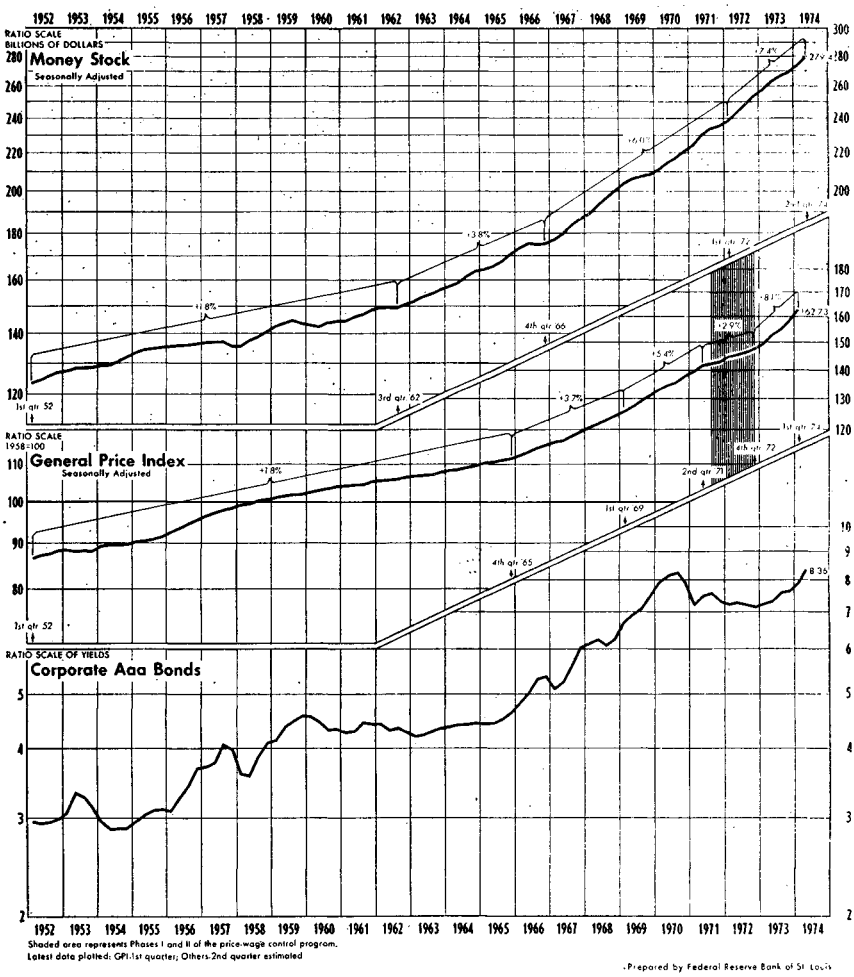
rates and the role of monetary policy in dealing with these and other economic problems.

My position regarding the cause of inflation and high market interest rates is that they both stem from the same source—an excessive trend rate of expansion of the nation's money stock. Monetary policy, therefore, can contribute to solving both of these problems over a period of a few years by fostering a non-inflationary rate of growth of the money supply.

I believe that the historically rapid rate of money growth of the past few years has caused an excessive rate of expansion of total spending in the economy. Since rapid money growth has stimulated a growth in demand for goods and services at rates much faster than our ability to produce, inflation has resulted.

The relationship between expansion of the money stock and the rate of inflation is illustrated in Chart 1. The money stock, defined as demand deposits and currency held by the nonbank public, increased slowly from early 1952 to late 1962. Since then, the average rate of money growth has persistently accelerated. As indicated in Chart 1, the general price index, measured by the GNP deflator, has risen, with a few quarters lag, at rates similar to growth of the money stock (except during Phases I and II of the price and wage controls when reported prices were artificially held down).

Chart I



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High and rising market rates of interest go hand-in-hand with a high and accelerating rate of inflation. This is because lenders and borrowers of funds take into consideration their expectations with reference to the future rate of inflation. Lenders desire a market rate of interest which provides them a real rate of return plus a premium based on their expectations regarding the future rate of inflation. Also, during inflation borrowers are willing to pay a higher market rate of interest because they expect the prices of their products to rise, and they wish to avoid the higher construction and other costs associated with delaying new projects. Thus, the interaction of demand and supply in the market for funds during a period of inflation results in market interest rates which embody an inflation premium.

This response of interest rates to inflation is illustrated in Chart 1. During the period of a slowly rising general price level in the 1950's, and early 1960's, the seasoned corporate Aaa bond rate rose slowly until 1959 and subsequently remained little changed through 1965. Then, with accelerating inflation, this average of highest quality long-term market interest rates rose steadily for five years. It was relatively stable in 1971 and 1972, probably reflecting expectations of less rapid inflation as a result of Phases I and II of the price and wage control program. During that period the reported rate of inflation decreased to less than 3 percent. However, the renewed acceleration of inflation since early 1973 has been accompanied by a gradual, but marked, increase in the corporate Aaa bond rate.

According to my view of the relationships which run from an increase in the trend growth of money, to a higher rate of inflation, to higher market rates of interest, present high interest rates do not indicate restrictive monetary actions. On the contrary, they are the result of excessively expansionary monetary actions since the early 1960's.

A natural question to be asked at this point is, "What has caused the observed trend growth of money?" My view is that growth of the monetary base is the prime determinant of growth of the money stock. The major sources of growth in the base are changes in the volume of Federal Government debt purchased by the Federal Reserve System on the open market, and occasional changes in the quantity or price of gold held by the Treasury. A change in the monetary base changes the amount of reserves in the banking system, which changes the amount of deposits created by commercial banks.

Movements in the narrowly defined money stock over extended periods of time are closely associated with movements in the monetary base, Tiers 4 and 5 of Chart 2 illustrate this very close relationship, while the top three tiers show the relation between growth of the outstanding Federal Government debt and that portion held by the Federal Reserve System.

In my opinion, the actions that led to the acceleration in growth of the monetary base and money supply since the early 1960's occurred as a result of: (1) excessive preoccupation with the prevailing level of market interest rates; (2) the occurrence of large deficits in the Federal Government budget; and (3) shifting emphasis of policy actions because of an apparent short-run trade-off between inflation and unemployment.

Some people believe that the Federal Reserve System has a high degree of control over market interest rates. They argue that System open market purchases and sales of Government securities should be so conducted as to assure that unduly high market interest rates do not choke-off growth of output and employment. Throughout most of the 1960's, and to some extent in the 1970's, the published *Record of Policy Actions of the Federal Open Market Committee* indicates that the conduct of open market transactions was influenced, in considerable measure, by these two propositions. Once accelerating inflation started in the mid-1960's, and market interest rates began to rise reflecting an inflation premium, the System purchased Government securities in increasing quantities in an attempt to hold interest rates at the then prevailing levels. Such purchases resulted in rapid growth in both the monetary base and the money stock. In spite of the efforts to maintain a prevailing level, market interest rates continued to rise.

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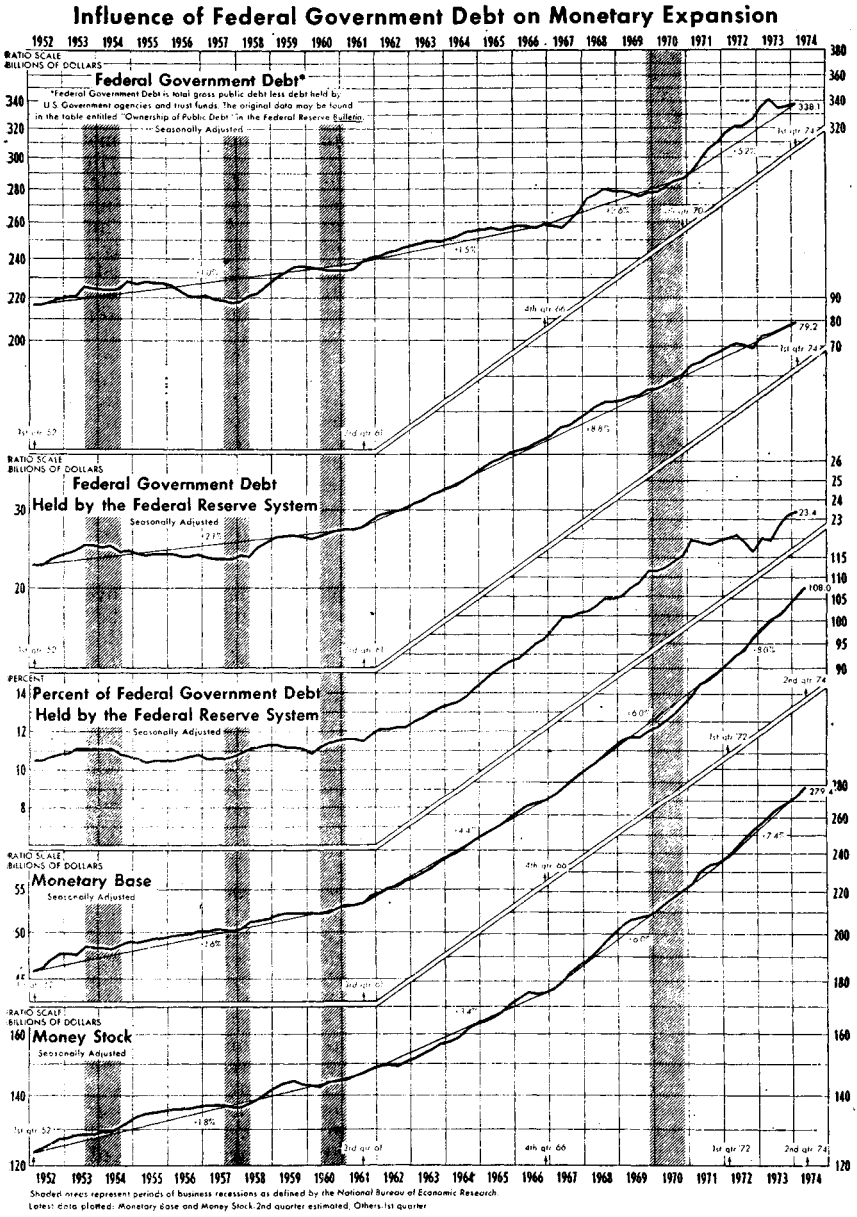
Chart 2



I accept neither the proposition that the Federal Reserve can control market interest rates nor that the high market interest rates have acted to choke-off economic expansion. Past experience, in my opinion, indicates quite conclusively that the Federal Reserve has little ability to control the level of market interest rates for any extended period of time. Experience also indicates, for both this and other countries, that growth of total spending has been retarded very little by high interest rates. On the other hand, attempts to resist upward movements in market interest rates have resulted in faster growth of money.

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Another concern which has been expressed about market interest rates is that they should be controlled in order to prevent dislocations in the flows of funds to savings institutions, the housing industry, and state and local governments. In addition, there is a commonly-held view that small businesses, farmers, and the average consumer should not have to pay high interest rates when they borrow. The published policy *Record* indicates that the Federal Reserve responded to such concerns at various times over the past ten years, especially following the credit crunches of 1966 and 1969–70.

Good though the intentions may have been, I am convinced that monetary actions based on these views have been self-defeating. As explained earlier, such attempts to maintain nominal interest rates below their free market level in a period of inflationary upward pressure has resulted in accelerating money growth, an acceleration in inflation, and still higher interest rates. Thus, those presumed to be protected by such a course of monetary actions actually turn out to be worse off—they end up with both more inflation and higher interest rates.

Another concern regarding market interest rates relates to the Federal Reserve's role in the orderly marketing of U.S. Government debt. This refers to the so-called "even-keel" operations, which have had a long tradition in central banking. When new Government securities are issued, there is additional demand for credit and temporary upward pressure on market interest rates normally occurs. Since changes in interest rates traditionally have been viewed as interfering with the orderly process of marketing new issues, fluctuations of market rates during the financing period have been limited by purchases of securities on the open market which, in turn, add to the monetary base.

The published *Record* indicates that during much of the period of accelerating inflation System open market operations were constrained by "even-keel" considerations. Furthermore, System purchases of securities during even-keel periods were not *fully* offset by subsequent sales and, as a result, money growth accelerated.

This process, in effect, has resulted in at least partial financing of Government deficits through the creation of money rather than borrowing from the private sector. In many other countries the same result has occurred by the simple and direct expedient of the Government printing the money which is then spent on goods and services.

Since the direct method of printing money to finance Government expenditures is prohibited in the U.S., the monetization of Government deficits has occurred indirectly. Our deficit spending is always financed, at least initially, through the sale of new Government securities to the public. But when the Federal Reserve System buys outstanding securities from the public, a part of the Government debt is ultimately being financed by the creation of new money. This is because the Federal Reserve System pays for the securities purchased on the open market by creating a credit to member bank reserve accounts, which increases the monetary base and money held by the public.

Charts 2 and 3 illustrate the results of the process described above. The increases in Government debt and the amounts of debt that have been purchased by the public and the Federal Reserve System are shown in the first column of Chart 3. The proportion of debt bought by the Federal Reserve has been increasing except for the 1971–72 period when substantial amounts were acquired by foreigners. The second column for each time period indicates that changes in the monetary base have closely paralleled Federal Reserve purchases of Government securities. It is this closeness that illustrates monetization of the Government debt. The resulting increases in the monetary base, of course, lead to the expansion of the money stock, which is illustrated in the third column.

I doubt that monetization of debt has been a conscious act on the part of the Government or on the part of the Federal Reserve System. Rather, I believe the reason it has occurred lies in the relative visibility of the three methods of financing Government expenditures—taxes, borrowing from the public, and indirect debt monetization. Elements of our society have been continually demanding additional services from the Government, such as more defense, more social security, more medical security, and so forth. Since these services absorb resources which are limited, someone has to give up resources from other productive uses.

When these additional services are paid for with increased taxes, the real resource cost is clearly visible to all taxpayers since they find their disposable income reduced. When they are financed by borrowing from the public, the effect is immediately felt by those competing for funds in capital markets and is visible in the form of higher interest rates. But in the case of debt monetization, the immediate and even the short-run impact is neither an increase in taxes, nor an

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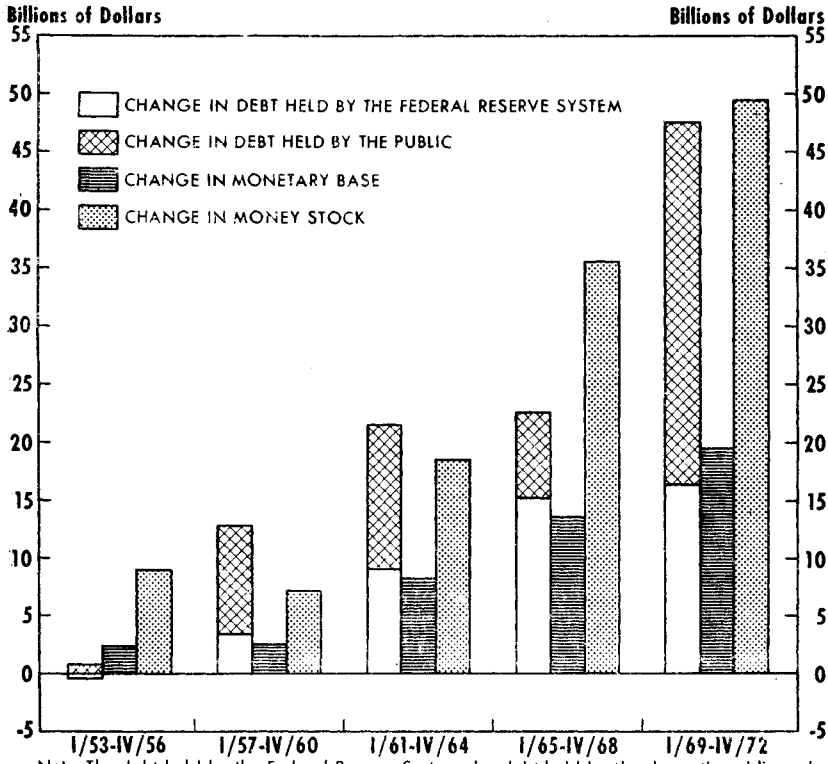
CHART 3

Growth of Government Debt and Money



Note: The debt held by the Federal Reserve System plus debt held by the domestic public and foreigners is net government debt, which is equal to total gross public debt minus debt held by Government agencies and trusts. The monetary base is net monetary liabilities of the Government. The money stock (M_1) is defined as demand deposits plus currency held by the public. Each of the five groups of bars depict level changes from the beginning to the end of the period indicated. All data are seasonally adjusted.

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increase in interest rates. And yet, real resources still are being transferred from private to Government use. The ultimate effect of this method of financing Government expenditures is manifested in an increase in the price level—inflation—and this occurs only after a substantial lag. It is the lack of immediate visibility of the costs associated with this method of financing, I believe, that has contributed to the process of inflation. Once the inflation has been generated, a substantial period of time is required to reverse it, and unfortunately this can be accomplished only by incurring costs of lost output and higher unemployment.

Thus, over short periods of time it has appeared that debt monetization gives society something for nothing. And although this alternative may not have been chosen consciously and the actions which monetized the debt may not have been taken for that purpose, the excessive concern over market interest rates and the occurrence of large Government deficits led to this course of action.

I can find no benefits accruing to the whole of society from debt monetization, but the risks are very serious and can be expressed in one word—inflation. In the way that I have described above, to a considerable extent since the mid-1960's deficit spending financed indirectly by Federal Reserve purchases of securities on the open market has meant an increase in money which has exceeded the growth in our output potential, and therefore has been inflationary.

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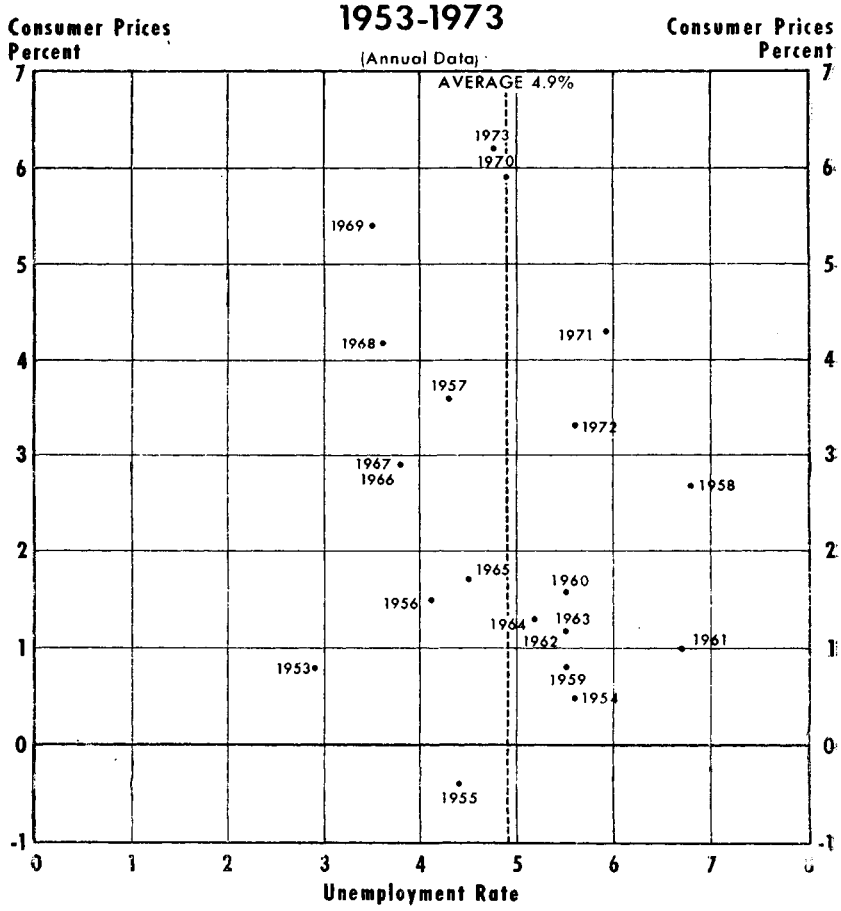
Turning to another issue, it is my belief that shifting emphasis of monetary actions because of a presumed trade-off between inflation and unemployment has contributed to the rapid monetary expansion. The idea of a trade-off between unemployment and inflation typically assumes that high rates of unemployment are associated with low inflation, and low rates of unemployment are associated with high rates of inflation. This view has led some analysts to argue that policy actions can assist the economy in achieving an acceptable combination of unemployment and inflation.

However, experience indicates that the unemployment-inflation trade-off, if it exists at all, is purely a short-run phenomenon. Chart 4 demonstrates that there exists no long-run relationship between the unemployment rate and the level of inflation. The only striking features I find are that since 1952 the yearly average unemployment rate has clustered around its average (4.9 percent) for the whole period, and the rate of inflation, regardless of the level of the unemployment rate, has moved progressively higher since the mid-1960's.

Chart 4

Prices and Unemployment
1953-1973



Source: U.S. Department of Labor

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In the past, emphasis of monetary policy actions has, at various times, shifted between reducing inflation and reducing the unemployment rate. For example, according to the published policy *Record*, since the early-1960's (except 1966 and 1969) a primary goal was lower unemployment, and expansionary monetary policies were adopted to achieve it. In 1966 and 1969 emphasis was on achieving lower rates of inflation, and restrictive monetary policies were accordingly adopted. However, on balance the actions taken in the past decade resulted in periods of rapid monetary growth which were longer than those of slower growth, and the result was a rising average growth rate of the money stock. More recently the emphasis of the adopted policies again has been to reduce inflation, but the actions taken thus far have not resulted in a reduction in the average growth rate of the money supply.

It is my view that there will always be some normal rate of unemployment as new workers enter the labor market, as relative demands and supplies for labor services change, and as workers simply leave present jobs to find more rewarding ones elsewhere. Such a level is not necessarily desirable, but rather it is a level determined by the normal functioning of our product and labor markets, given existing institutional and social conditions.

Monetary actions cannot influence this normal level of unemployment; other policies are necessary to attack that problem. As a matter of fact, monetary actions taken in an effort to reduce unemployment have contributed to increased inflationary pressures. Subsequent attempts to arrest inflation have temporarily fostered increased unemployment *in addition to* the normal amount consistent with existing labor market conditions.

My analysis of the unemployment-inflation trade-off leads me to conclude that it is non-existent, except possibly for very short intervals of time. Therefore, with relatively stable monetary growth over a long period, I believe it would be possible to have an essentially stable average level of prices, and this could be accomplished without accepting a permanently higher unemployment rate. The desire to reduce the average level of unemployment should be approached through programs which reduce or eliminate institutional rigidities and barriers to entry in labor markets, which provide job training, and which improve information regarding job availability.

In recent months a new proposal has been advanced which, if adopted, would most likely lead to further acceleration in the rate of monetary expansion, thereby adding to inflationary pressures. It has been suggested that it is appropriate for monetary and fiscal authorities to stimulate aggregate demand during periods when domestic production is curtailed by some special event, such as the oil boycott, or when foreign demand for a specific product, like wheat, increases suddenly. The argument is that the resulting price pressure from such nonrecurring events is inevitable and that an expansionary aggregate demand program is required to protect employment in the case of a decrease in domestic production, and to protect consumer buying power in the case of an increase in foreign demand. Unfortunately, the probability of achieving either of these goals with stimulative monetary actions is very small and the costs in terms of accelerated inflation are certain.

The main point to keep in mind is that the forces that cause prices to rise in a specific market are very different from those which cause inflation—a persistent rise in the average price of all items traded in the economy. The prices of individual items rise and fall continuously, and an increase in a particular price, even if it is the price of an important budget item like food, is not necessarily an indication of general inflationary pressures. In the absence of additional monetary stimulus to aggregate demand, price increases in specific markets are a signal that either the demand or supply conditions, or both, have changed; not that total demand for all goods and services has increased. Such price increases serve a very useful function of allocating scarce resources according to consumer preferences.

An increase in foreign demand for American products is not inflationary per se. It represents a shift in the *composition* of demand for our output, but not an inflationary increase in aggregate demand. Inflation would occur if monetary actions were taken in order to accommodate the price pressure in individual commodity markets. In the case of some unforeseen event, such as a domestic crop failure or an embargo on imports of raw materials, the productive capacity of the economy is reduced. Most of the time the effect is temporary, but, as in the case of the oil embargo, the effect can be long-lasting. There is little that an increase in aggregate demand can do to stimulate more production in such a situation.

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In my opinion, a monetary policy which results in an increased growth of the money stock has no role to play in accommodating the relative price effects of autonomous changes in demand or supply in specific markets. Such monetary actions would only raise the overall rate of inflation. Temporary gains in output and employment might be achieved, but the ultimate effect would be only on the rate of change of prices in general.

I now turn to my final topic—the contribution that monetary policy can make to reducing the rate of inflation and lowering market interest rates. My views on this topic should by now be very obvious; monetary actions can, and must, make a positive contribution. The interests of the whole economy would be best served if the trend growth rate of the money stock were to be gradually, but persistently, reduced from the high rates experienced in the recent past. I believe that, once we achieved and maintained a 2 to 3 percent rate of money growth, both the rate of inflation and the level of interest rates would ultimately decline to their levels of the early 1960's.

I believe such a policy of gradual, rather than abrupt, reduction in the rate of monetary expansion from the high average rate so far in the 1970's, would not have severely adverse effects on the growth of output and employment. Such a gradual policy would probably mean, however, that the period of combatting inflation and high interest rates would extend through the balance of the 1970's.

Some analysts believe that if the Federal Reserve sought to control the rate of growth of the money supply within a fairly narrow range, unacceptable short-run fluctuations in short-term interest rates would be generated. I do not believe that it is necessary for the Federal Reserve to intervene systematically in financial markets in order to maintain orderly conditions.

It seems to me that there are three basic parts to this argument regarding the desirability of actions to smooth short-run interest rate fluctuations. First, the argument assumes that Federal Reserve actions in the past have in fact reduced short-run fluctuations in short-term interest rates compared to what they otherwise would have been. As far as I am aware, there is no substantial body of empirical evidence supporting this claim. There is, however, a large and growing body of evidence suggesting that highly organized financial markets by themselves do not generate excessive and unwarranted short-run interest rate fluctuations.

Second, this argument assumes that by stabilizing short-term rates the System can, in the short-run, stabilize intermediate and long-term interest rates. Again, I am not aware of any empirical evidence in support of this proposition.

Third, this position assumes that short-run fluctuations in interest rates have a significant impact on the ultimate goals of stabilization policy—namely, price stability, a high level of employment, and economic growth. I know of no reason to believe that moderating short-run fluctuations in short-term interest rates has any significant stabilizing influence on prices, output, or employment. Even within the context of the well-known econometric forecasting models, stabilization of short-term interest rates has almost no stabilizing influence on prices, output, or employment.

Some would oppose my recommended course of monetary policy on the grounds that it would not allow the Federal Reserve to perform its responsibility of a lender of last resort; so I want to make my views clear on this point. I believe it is possible that the failure of a major bank or other corporation can, at times, disrupt the smooth functioning of our financial markets. In my opinion, the Federal Reserve has an obligation to prevent the temporary problems of a major institution from affecting financial markets and perhaps even affecting the economy.

At the same time, however, I do not think that the System should subsidize inefficient management by making funds available at interest rates well below market rates, or be concerned about the losses that stockholders of a basically unsound institution might suffer. In the long-run, such actions can only weaken, rather than strengthen, the financial system, as well as the business community at large.

Any temporary assistance to a basically sound institution should be unwound in a relatively short period of time. At the same time, the provision of funds through the Federal Reserve discount window should be matched by a sale of securities from the System's portfolio in order to prevent an expansion in the monetary base and the money stock.

Carrying out the monetary policy actions that I recommend could be greatly facilitated by complimentary actions on the part of others. A balanced Government budget would eliminate much of the pressure on interest rates, thereby

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removing one causes of accelerating money growth in the past. Legislation removing impediments to the free functioning of our product, labor, and financial markets would allow these markets to adjust to monetary restraint more rapidly, and without the severe dislocations of the past.

It would also be helpful if all segments of our society would realize that rapid monetary growth, inflation, and high market interest rates go hand-in-hand; that, once initiated, inflation cannot be eliminated without some temporary costs in terms of slower growth of output and employment; and that considerable time will be required to reduce substantially both the rate of inflation and the level of interest rates. Such realizations would tend to mitigate the short-run pressures that in the past have resulted in postponements of efforts to curb inflation.

MARK-UP AS PER SUGGESTIONS OF MR. PARTEE, MANAGING DIRECTOR FOR RESEARCH AND ECONOMIC POLICY, BOARD OF GOVERNORS FEDERAL RESERVE SYSTEM

Mr. Chairman and Members of the committee, I am pleased to have this opportunity to present my views regarding our country's inflation and high interest rates and the role of monetary policy in dealing with these and other economic problems. Let me state at the outset that I am a monetary purist; many observers, both within and without the System, disagree with me, and I readily admit that there is ample room for reasonable men to differ on these complex issues.

My position regarding the cause of inflation and high market interest rates is that they both are exacerbated by the public desire to keep unemployment low. Monetary policy, therefore, can contribute to solving both of these problems, gradually and over a period of a few years by fostering a non-inflationary rate of growth of the money supply.

I believe that the relatively rapid rate of money growth of the past few years has helped to finance an excessive rate of expansion of total spending in the economy. This rapid money growth has made possible a growth in demand for goods and services at rates in excess of our ability to produce, so that inflation has resulted. In addition, special factors have added to inflation, and have resulted in larger cost increases in the economy and an even stronger demand for money creation.

The historical relationship between expansion of the money stock and the rate of inflation is illustrated in Chart 1. The money stock, defined as demand deposits and currency held by the nonbank public, increased slowly from early 1952 to late 1962. Since then, the average rate of money growth has accelerated. As indicated in Chart 1, the general price index, measured by the GNP deflator, has risen, with a few quarters lag, at rates similar to growth of the money stock (except during Phases I and II of the price and wage controls when reported prices were artificially held down). Of course, the causes of both trends may lie in common factors, such as the tendency of the economy to generate excessive wage increases, which then must be validated by faster monetary expansion if higher unemployment is not to result.

High and rising market rates of interest go hand-in-hand with a high and accelerating rate of inflation. This is because lenders and borrowers of funds take into consideration their expectations with reference to the future rate of inflation. Lenders desire a market rate of interest which provides them a real rate of return plus a premium based on their expectations regarding the future rate of inflation. Also, during inflation borrowers are willing to pay a higher market rate of interest because they expect the prices of their products to rise, and they wish to avoid the higher construction and other costs associated with delaying new projects. Thus, the interaction of demand and supply in the market for funds during a period of inflation results in market interest rates which embody an inflation premium.

This response of interest rates to inflation is illustrated in Chart 1. During the period of a slowly rising general price level in the 1950's, and early 1960's, the seasoned corporate Aaa bond rate rose slowly until 1959 and subsequently remained little changed through 1965. Then, with accelerating inflation, this average of highest quality long-term market interest rates rose steadily for five years. It was relatively stable in 1971 and 1972, probably reflecting expectations of less rapid inflation as a result of Phases I and II of the price and wage control program. During that period the reported rate of inflation decreased to less than 3 percent. However, the renewed acceleration of inflation since early 1973 has been accompanied by a gradual, but marked, increase in the corporate Aaa bond rate.

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According to my monetarist view, the relationships run from an increase in the trend growth of money, to a higher rate of inflation, to higher market rates of interest, present high interest rates are not indicative of a restrictive monetary posture. On the contrary, they are the result of excessively expansionary monetary actions since the early 1960's.

A natural question to be asked at this point is, "What has caused the observed trend growth of money?" My view is that growth of the monetary base is the prime determinant of growth of the money stock. The major sources of growth in the base are increases in the volume of Federal Reserve credit—mainly purchases in the open market of Federal Government securities, and occasional changes in the quantity or price of gold held by the Treasury. A change in the monetary base changes the amount of reserves in the banking system, which changes the amount of deposits created by commercial banks.

Movements in the narrowly defined money stock over extended periods of time are closely associated with movements in the monetary base, Tiers 4 and 5 of Chart 2 illustrate this very close relationship, while the top three tiers show the relation between growth of the outstanding Federal Government debt and that portion held by the Federal Reserve System.

Many people believe that the Federal Reserve System has a high degree of control over market interest rates. They argue that System open market purchases and sales of Government securities should be so conducted as to assure that unduly high market interest rates do not choke-off growth of output and employment. Once accelerating inflation started in the mid-1960's, and market interest rates began to rise reflecting an inflation premium, the System purchased Government securities in increasing quantities in an attempt to limit the increase in interest rates to acceptable levels. But such purchases resulted in more rapid growth in both the monetary base and the money stock. In spite of the efforts to maintain a prevailing level, market interest rates continued to rise.

I can accept neither the proposition that the Federal Reserve can control market interest rates nor that high market interest rates necessarily act to choke-off economic expansion. Past experience, in my opinion, indicates that the Federal Reserve has little ability to control the level of market interest rates for any extended period of time. Experience also indicates, for both this and other countries, that growth of total spending has been retarded very little by high interest rates. On the other hand, attempts to resist upward movements in market interest rates have resulted in faster growth of money.

Another concern which has been expressed about market interest rates is that they should be controlled in order to prevent dislocations in the flows of funds to savings institutions, the housing industry, and state and local governments. In addition, there is a commonly-held view that the burden of high interest rates on small businesses, farmers, and the average consumer may become excessive. At times, especially following the credit crunches of 1966 and 1969–1970, the published policy record indicates that the Federal Reserve has responded to such concerns.

Good though the intentions may have been, I am convinced that monetary actions based on concerns for the financing burden on borrowers have been self-defeating. As explained earlier, attempts to hold nominal interest rates below their free market level in a period of inflationary upward pressure has resulted in accelerating money growth, which has contributed to an acceleration in inflation, and still higher interest rates. Thus, those presumed to be protected by such a course of monetary actions actually turn out to be worse off—they end up with both more inflation and higher interest rates.

Another concern regarding market interest rates relates to the Federal Reserve's role in the orderly marketing of U.S. Government debt. This refers to the so-called "even-keel" operations, which have had a long tradition in central banking. When new Government securities are issued, there is additional demand for credit and temporary upward pressure on market interest rates normally occurs. Since sharp changes in interest rates during the financing are viewed as interfering with the orderly process of marketing new issues, such fluctuations may need to be limited by open market operations. But such purchases, if not subsequently offset by sales, will add to the monetary base.

The desire to assure successful Treasury financing through "even keel" operations has caused problems for monetary policy over the years, particularly when the needed financings have been large and frequent. Recently, however, this problem has diminished, partly because more financings are of the auction type and partly because interest rates have been permitted to vary more widely than before, if this was necessary in order to stay on the monetary course that the System had adopted.

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More generally, however, the large Government deficits we have had since the mid-1960s have generated great pressure to finance these deficits through the creation of money rather than borrowing from the private sector. In many other countries the same result has occurred by the simple and direct expedient of the Government printing the money which is then spent on goods and services.

Since the direct method of printing money to finance Government expenditures is prohibited in the U.S., the pressures are to monetize government deficits indirectly. Our deficit spending is always financed, at least initially, through the sale of new Government securities to the public. But if the Federal Reserve System buys outstanding securities from the public in a larger volume than it otherwise would, a part of the Government debt will be financed by the creation of new money. This is because the Federal Reserve System pays for the securities purchased on the open market by creating a credit to member bank reserve accounts, which increases the monetary base and money held by the public.

Charts 2 and 3 illustrate the results of the process described above. The increases in Government debt and the amounts of debt that have been purchased by the public and the Federal Reserve System are shown in the first column of Chart 3. The proportion of debt bought by the Federal Reserve has been increasing except for the 1971–72 period when substantial amounts were acquired by foreigners. The second column for each time period indicates that changes in the monetary base have closely paralleled Federal Reserve purchases of Government securities. The resulting increases in the monetary base, of course, lead to the expansion of the money stock, which is illustrated in the third column.

The Federal Reserve is, and always must be, on guard to avoid a monetization of the debt. This is an easy trap to fall into, because of the relative visibility of the three methods of financing Government expenditures—taxes, borrowing from the public, and indirect debt monetization. Elements of our society have been continually demanding additional services from the Government, such as more defense, more social security, more medical security, and so forth. Since these services absorb resources which are limited, someone has to give up resources from other productive uses.

When these additional services are paid for with increased taxes, the real resource cost is clearly visible to all taxpayers since they find their disposable income reduced. When they are financed by borrowing from the public, the effect is immediately felt by those competing for funds in capital markets and is visible in the form of higher interest rates. *But in the case of debt monetization*, the immediate and even the short-run impact is neither an increase in taxes, nor an increase in interest rates. And yet, real resources still are being transferred from private to Government use. The ultimate effect of monetization of deficit spending will be reflected in an increase in the price level—inflation—and this occurs only after a substantial lag.

I can find no significant lasting benefits accruing to society from debt monetization, but the risks are very serious and can be expressed in one word—inflation. There has been considerable pressure since the mid-1960's to help finance the large deficits of Government indirectly by Federal Reserve purchases of securities on the open market. To the extent this has occurred, it has produced an unwanted increase in money, and therefore has been inflationary.

Turning to another issue, it is my belief that shifting emphasis of monetary actions because of a presumed trade-off between inflation and unemployment is likely to contribute to the rapidity of expansion. The idea of a trade-off between unemployment and inflation typically assumes that high rates of unemployment are associated with low inflation, and low rates of unemployment are associated with high rates of inflation. This view has led some analysts to argue that policy actions can assist the economy in achieving an acceptable combination of unemployment and inflation.

However, experience indicates that the unemployment-inflation trade-off, if it exists at all, is not an ending one. Chart 4 suggests that there exists no long-run relationship between the unemployment rate and the level of inflation. The only striking features I find are that since 1952 the yearly average unemployment rate has clustered around its average (4.9 percent) for the whole period, and the rate of inflation, regardless of the level of the unemployment rate, has moved progressively higher since the mid-1960's.

In the past, emphasis of monetary policy actions has, at various times, shifted between reducing inflation and reducing the unemployment rate. For example, according to the published record, since the early 1960's (except 1966 and 1969) one of the principle goals of policy was to encourage a lower unemployment rate and monetary policies were adopted accordingly. In 1966 and 1969 emphasis was

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on achieving lower rates of inflation, and restrictive monetary policies were pursued. However, on balance the actions taken in the past decade resulted in periods of rapid monetary growth which were longer than those of slower growth, and the result was a rising average growth rate of the money stock. More recently the emphasis of policy has again shifted to the containment of inflation, but the actions taken thus far have not resulted in a significant reduction in the average growth rate of the money supply.

It is my view that there will always be some normal rate of unemployment as new workers enter the labor market, as relative demands and supplies for labor services change, and as workers simply leave present jobs to find more rewarding ones elsewhere. Such a level is not necessarily desirable, but rather it is a level determined by the normal functioning of our product and labor markets, given existing institutional and social conditions.

Monetary actions are not likely to reduce unemployment below this normal level of unemployment for long. Other policies are necessary to attack that problem instead, because monetary actions taken in an effort to reduce unemployment are likely to contribute to increased inflationary pressures. The danger then is that subsequent attempts to arrest inflation will temporarily foster increased unemployment in addition to the normal amount consistent with existing labor market conditions, so that a cycle of alternating periods of high and low unemployment will be set in motion.

My analysis of the unemployment-inflation trade-off leads me to conclude that it is non-existent, except possibly for very short intervals of time. Therefore, with relatively stable monetary growth over a long period, I believe it would be possible to have an essentially stable average level of prices, and this could be accomplished without accepting a permanently higher unemployment rate. The desire to reduce the average level of unemployment should be approached through programs which reduce or eliminate institutional rigidities and barriers to entry in labor markets, which provide job training, and which improve information regardng job availability.

In recent months a new proposal has been advanced which, if adopted, would most likely lead to further acceleration in the rate of monetary expansion, thereby adding to inflationary pressures. It has been suggested that it is appropriate for monetary and fiscal authorities to stimulate aggregate demand during periods when domestic production is curtailed by some special event, such as the oil boycott, or when foreign demand for a specific product, like wheat, increases suddenly. The argument is that the resulting price pressure from such non-recurring events is inevitable and that an expansionary aggregate demand program is required to protect employment in the case of a decrease in domestic production, and to protect consumer buying power in the case of an increase in foreign demand. Unfortunately, the probability of achieving either of these goals with stimulative monetary actions is small and the potential costs in terms of accelerated inflation are large.

The main point to keep in mind is that the forces that cause prices to rise in a specific market are very different from those which cause inflation—a persistent rise in the average price of all items traded in the economy. The prices of individual items rise and fall continuously, and an increase in a particular price, even if it is the price of an important budget item like food, is not necessarily an indication of general inflationary pressures. In the absence of additional monetary stimulus to aggregate demand, price increases in specific markets are a signal that either the demand or supply conditions, or both, have changed; not that total demand for all goods and services has increased. Such price increases serve a very useful function of allocating scarce resources according to consumer preferences.

An increase in foreign demand for American products is not inflationary per se. It represents a shift in the *composition* of demand for our output, but not an inflationary increase in aggregate demand. Inflation would occur if monetary actions were taken in order to accommodate the price pressure in individual commodity markets. In the case of some unforeseen event, such as a domestic crop failure or an embargo on imports of raw materials, the productive capacity of the economy is reduced. There is little that an increase in aggregate demand can do to stimulate more production in such a situation.

In my opinion, a monetary policy which results in an increased growth of the money stock has no role to play in accommodating the relative price effects of autonomous changes in demand or supply in specific markets. Such monetary actions would only raise the overall rate of inflation. Temporary gains in output and employment might be achieved, but the ultimate effect would be only on the rate of change of prices in general.

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I now turn to my final topic—the contribution that monetary policy can make to reducing the rate of inflation and lowering market interest rates. My views on this topic should by now be very obvious; monetary actions can, and must, make a positive contribution. The interests of the whole economy would be best served if the trend growth rate of the money stock were to be reduced, over a period of time, from the high rates experienced in the recent past. I believe that, once we achieved and maintained significantly lower rate of money growth, both the rate of inflation and the level of interest rates would ultimately decline to their levels of the early 1960's.

I believe such a policy of gradual, rather than abrupt, reduction in the rate of monetary expansion from the high average rate so far in the 1970's, would not have severely adverse effects on the growth of output and employment. Such a gradual policy would probably mean, however, that the period of combatting inflation and high interest rates would extend through the balance of the 1970's.

Some analysts believe that *if* the Federal Reserve sought to control the rate of growth of the money supply within a fairly narrow range, unacceptable short-run fluctuations in short-term interest rates would be generated. I do not believe that it is necessary for the Federal Reserve to intervene systematically in financial markets in order to maintain orderly conditions.

It seems to me that there are three basic parts to this argument regarding the desirability of actions to smooth short-run interest rate fluctuations. First, the argument assumes that Federal Reserve actions in the past have in fact reduced short-run fluctuations in short-term interest rates compared to what they otherwise would have been. As far as I am aware, there is no substantial body of empirical evidence supporting this claim. There is, however, a large and growing body of evidence suggesting that highly organized financial markets by themselves do not generate excessive and unwarranted short-run interest rate fluctuations.

Second, this argument assumes that by stabilizing short-term rates the System can, in the short-run, stabilize intermediate and long-term interest rates. Again, I am not aware of any empirical evidence in support of this proposition.

Third, this position assumes that short-run fluctuations in interest rates have a significant impact on the ultimate goals of stabilization policy—namely, price stability, a high level of employment, and economic growth. I know of no reason to believe that moderating short-run fluctuations in short-term interest rates has any significant stabilizing influence on prices, output, or employment. Even within the context of the well-known econometric forecasting models, stabilization of short-term interest rates has almost no stabilizing influence on prices, output, or employment.

It may be argued that my recommended course of monetary policy would not allow the Federal Reserve to perform its responsibility of a lender of last resort. I want to make my views clear on this point. I believe it is possible that the failure of a major bank or other corporation can, at times, disrupt the functioning of our financial markets. In my opinion, the Federal Reserve has an obligation to prevent the temporary problems of a major institution from affecting financial markets and perhaps even affecting the economy.

At the same time, however, I do not think that the central bank should subsidize or perpetuate inefficient management, or be concerned about the losses that stockholders of a basically unsound institution might suffer. In the long-run, such actions can only weaken, rather than strengthen, the financial system, as well as the business community at large.

Any temporary assistance to a basically sound institution should be unwound as quickly as possible under the circumstances of the case. At the same time, the provision of funds through the Federal Reserve discount window should be matched by a sale of securities from the System's portfolio in order to prevent an expansion in the monetary base and the money stock.

Carrying out the monetary policy actions that I recommend could be greatly facilitated by complimentary actions on the part of others. A balanced Government budget would eliminate much of the pressure on interest rates, thereby removing a major source of the pressure to accelerate money growth in the past. Legislation removing impediments to the free functioning of our product, labor, and financial markets would also be helpful in encouraging these markets to adjust to monetary restraint more rapidly, and without the severe dislocations of the past.

It would also be helpful if all segments of our society would come to share with me the views that rapid monetary growth, inflation, and high market in-

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terest rates go hand-in-hand; that, once initiated, inflation cannot be eliminated without some temporary costs in terms of slower growth of output and employment; and that considerable time will be required to reduce substantially both the rate of inflation and the level of interest rates. Such realizations would tend to mitigate the short-run pressures that in the past have resulted in postponements of efforts to curb inflation.

Response of President Mayo

Answer to question 1. No effort was made by the Board of Governors or by the Board staff to discourage my participation or influence my discussions with Dr. Robert Weintraub.

Answer to question 2. No effort was made to influence or coordinate my testimony. What I said was completely consistent with my public statements. The variety of the testimony from the Presidents in terms of content, approach, and emphasis should clearly indicate that there was no coordination.

Answer to question 3. Within any organization it is frequently helpful to have others who have not worked as closely with you as your own staff read materials to make you feel that you are communicating clearly to others.

Answer to question 4. I have never sent a speech to a Governor for review prior to giving it. Out of more than 25 public presentations I have made in the past year, only two speeches have been sent to the Board staff and then only because they held, I felt, some specialized expertise or knowledge that would be helpful to me.

Answer to question 5. A meeting was held in Federal Reserve Board offices on July 15.

(a) It was attended by the Reserve Bank Presidents who were to testify on July 17 and 18, several of the senior staff economists at the Reserve banks represented, several members of the Board staff and briefly by two Governors.

(b) I briefly reviewed for the benefit of my colleagues the thrust of the comments I intended to make.

(c) There was no explanation of the position of the Board, its Chairman or the staff on the substantive issues that might be raised.

Answer to question 6. Yes, I sent one of the drafts of my testimony to the Board staff.

(a) This had been suggested by a member of the Board staff.

(b) If a draft was completed, there was an indication that the Board staff would like to see it July 9.

(c) I have no idea which members of the Board staff read my draft. As I indicated in my testimony, to my knowledge, no Governor ever saw my statement.

(d) As I told the Committee, there were suggested changes in words—semantics—and nothing substantive was changed. It was suggested that from a stylistic standpoint, the early portions of my formal statement may have made the statement a little too long. These were removed in my oral presentation to the Committee but were retained in the statement submitted for the record. In addition, there were several suggestions on word to improve communication.

(e) The changes made are noted above. Since the suggestions were made in a draft stage and were not significant in the preparation of subsequent drafts and the final statement, the draft was not retained.

Answer to question 7. In no way did anything of this type take place.

Answer to question 8. There was no contact with any member of my Board of Directors concerning my testimony.

Reply Received From Mr. Morris

Answer to question 1. No effort was made by the Board of Governors or its staff to discourage my participation or to control the content of my responses to anticipated questions.

Answer to question 2. Each of the Federal Reserve Bank Presidents participating in these hearings, by prior agreement, sent a copy of his prepared testimony to the Board for staff comment. In my case, the staff comment was received in the form of an informal phone conversation with Mr. Partee of the Board's staff on July 10.

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With the exception of several strictly editorial suggestions, Mr. Partee's comments concerned one paragraph containing economic analysis that implied that there is a strict, mechanical linkage between money growth and GNP growth. I have reviewed the wording of this paragraph with one of my staff economists, and we both agreed that a slight rewording was in order to avoid the unintended implication spotted by Mr. Partee. The only other matter of substance was a request by Mr. Partee, with which I concurred, that a reference to Federal Reserve lending to Franklin National Bank be omitted because the reserves supplied to the Franklin through the discount window were fully offset in open market operations.

Answer to question 3. I had substantial assistance from my staff in the preparation of my prepared statement and in preparing answers to likely questions. My staff, however, is small and it seemed desirable to have the benefit of comment from the Board's much larger staff. I have always felt it desirable to obtain a range of opinion in order to sharpen my own thinking, but at the same time, as I believe my formal dissents at FOMC meetings demonstrate, I have never shrunk from saying what I believe.

Answer to question 4. Most of my speeches are given from notes rather than a prepared text. On those occasions when I have a text prepared sufficiently in advance, I send it in for Board staff comment, but those occasions have been extremely rare.

Answer to question 5. To my knowledge there was no special meeting of the Federal Reserve Board held on Monday, July 15. There was, however, a dinner meeting of the members of the FOMC that evening. Dinner meetings are held occasionally to provide more time for discussion of the issues before us. I believe that all of the Governors and Presidents attended the dinner meeting. I cannot recall whether any staff members were present, but I believe that there were a few.

The content of my testimony was not discussed at this meeting. There was a brief and general discussion of the three proposals of Dr. Weintraub which we had just received. However, there was no attempt to state a Board position on these proposals, since the Board had not yet adopted a position.

On the morning of July 15, there was a meeting of the six Presidents chosen to testify, together with Chairman Burns, Governor Wallich, and four members of the Board staff—Messrs. Partee, Coyne, Rippey and McWhirter. Chairman Burns attended the meeting for only a few minutes. The meeting was primarily oriented toward the housekeeping details of getting the statements of the Presidents reproduced. Each of the Presidents gave a two- to three-minute summary of his testimony for the information of his colleagues. No attempt was made by the Governors or the staff to influence the substance of my testimony.

Answer to question 6. In an early July conference call with Mr. Partee of the Board's staff and the Reserve Bank Presidents (or their representatives) who were to testify at these hearings, it was agreed that drafts of prepared statements would be sent to the Board staff for comment by July 9. As far as I know, no members of the Board reviewed my statement; as noted above, I did discuss it with Mr. Partee.

The changes made in my statement in response to the Board staff comments were discussed in item (2) above. I believe that it would be unwise to establish a precedent of publishing working papers of official statements. The purpose of working drafts is to provide the input required to produce a final draft that a public official can stand behind. Nevertheless, to dispel the suspicions that apparently lay behind Congressman Rousselot's questions, I enclose the original draft which was wired to the Board of Governors on July 9. This is the first draft which anyone in Washington saw. You will find that there are no changes of substance from the final draft presented to the House Banking and Currency Committee on July 18, 1974.

Answer to question 7. There was no pressure of any kind brought to bear on me in connection with the interview with Dr. Weintraub or the other matters listed in question II–7.

Answer to question 8. No.

The changes made on the basis of Mr. Partee's suggestions, as identified by President Morris, are as follows. (Italicized words were added and bracketed words deleted.)

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1. In evaluating Federal Reserve performance the central question must always be whether the trend rate of monetary growth, *over which the Federal Reserve has reasonably effective control,* [which the Federal Reserve does control . . .]

2. In fact, over this period GNP grew at an 11 percent rate, and unfortunately much of the extra growth *reflected a higher rate of inflation than was anticipated* [showed up in the form of higher than anticipated inflation.]

3. But the recent behavior of velocity—*a 4 percent rate of increase over the last two years*—is a surprise given the marked slowing of the trend rate of change in velocity between 1966 and 1971. If we had known that the *GNP would grow by 11 percent per year* [velocity would grow by 4 percent per year] we obviously would have planned for less rapid monetary expansion; [under these circumstances, perhaps 4 percent money growth would have been appropriate.] *A growth rate for the GNP in the neighborhood of 8 percent would have been better and, as a matter of arithmetic, if velocity were completely independent of the rate of growth of money, then a 4 percent money growth rate would have been appropriate. However,* [but] looking at the problem from a 1971 vantage point, suppose we had held money growth at 4 percent *but suppose* [and] velocity had continued to grow at the 1 percent trend characteristic of the late 1960s. Then GNP would have grown at an annual rate of only 5 percent and unemployment would almost certainly have risen above the already elevated levels of 1971.

4. *World-wide food shortage* [poor harvest]

5. *In late 1968 through 1969*—[1969]

6. If fiscal policy is not to carry its fair share of stabilization burden, monetary policy will have to be applied more severely than would otherwise be necessary. [By "more severely", I mean that higher levels of short-term money rates would accompany any given growth rate of the money supply than would otherwise be necessary.] The social and economic problems occasioned by a severely restrictive monetary policy stem in large part from the fact that its impact is not evenly distributed throughout the economy.

7. There is no question in my mind that it is absolutely essential for the Federal Reserve to intervene to stabilize financial markets following events such as the Penn-Central bankruptcy and the *subsequent disturbance in the commercial paper market* [difficulties at Franklin National.] Events of this kind are characterized by irrational market reactions affecting institutions other than those directly involved.

8. I am inclined to believe that one of the lessons of recent years is that we have been too ready to cushion interest rate movements with the result that we have experienced more variable money growth in the short-run than is necessary or desirable. *While very short-run variations in the rate of growth of the money supply have little economic significance in themselves, smaller variations will help us to keep closer to the desired long-run path.* It may well be that in the absence of identifiable money markets disturbances we should intervene less often to smooth interest rate fluctuations.

Again on August 8, 1974, Congressman John H. Rousselot explored the possibility that the Federal Reserve Board tried to influence or coordinate the testimony of the Reserve bank presidents. This time with Chairman Burns. The pertinent dialogue follows:

Mr. ROUSSELOT. Chairman Burns, on July 17th and 18th, as you are well aware, this Committee heard the views of six of the twelve Federal Reserve regional bank presidents concerning the relationship between inflation, high interest rates and monetary policies. I have three questions I would like to briefly discuss with you. I will read all three of them, because I studied their testimony very carefully, and then we will ask for a general response, the best you can summarize it:

One, did the Federal Reserve Board of Governors or its staff make any effort to influence, change or coordinate the testimony of the presidents before this Committee?

Two, were any of the presidents required to submit the text of their testimony to the Board or its staff in advance for review?

Three, was a special meeting of the Board held on Monday, July 15th, 1974, and if so, which governors and presidents participated, and was the content of the presidents' testimony before this Committee discussed?

That is a general area of discussion.

Do you want to make any comments on that series of questions, and you would certainly have full rein to respond in detail by letter if you wish.

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Dr. BURNS. Let me make a general comment, and then I will address myself, if time permits—it probably will not, unfortunately, the way things are going—to your questions. I will not be able to answer your question concerning July 15 until I refresh my memory concerning precisely what happened on July 15. July 15.

Mr. ROUSSELOT. In view of recent events, I think that would probably be a good idea to refresh your memory. I am speaking of testimony taken in the Senate.

Dr. BURNS. I think every one of us at all times ought to know what he is talking about.

I have a certain policy. I will tell you what it is. When I have to make a speech, to make a statement before a Congressional Committee not involving the Board—and I do have to testify as an individual before some Congressional Committees—what I do almost invariably is to present my paper to members of my staff, to my fellow governors, and I invite their criticisms. I want their suggestions and I want them to pick up any factual errors that I might be making.

Mr. ROUSSELOT. If I can interject, that is very understandable. All of us on this Committee, many of us do the same thing with our own staffs.

My question relates to the presidents of the regional banks.

Dr. BURNS. I am well aware of your question. Not only do I follow this practice, but I encourage all of my colleagues to do likewise. We have no rigid requirements along these lines. I am not a censor and I have been brought up in a university and I respect individuals and their thoughts.

You want to know, did the Federal Reserve make any effort to change or coordinate testimony. Let me tell you that I, even as of today, have not read the statements prepared by the Federal Reserve bank presidents who testified.

Mr. ROUSSELOT. Do you think any of your staff members might have?

Dr. BURNS. Oh, yes. The Director of Research did do that.

Mr. ROUSSELOT. What is his name?

Dr. BURNS. His name is Mr. Partee. He did that with a view to calling factual errors to the attention of the bank presidents and with a view to avoiding unnecessary or dubious arguments. Now, what he did——

Mr. ROUSSELOT. At this point, Mr. Chairman, if I could interject. I would like to provide for the record the statement of Mr. Francis and the suggestions that Mr. Partee made relating to that statement when he appeared before this committee.

The CHAIRMAN. Do you want that included in the record?

Mr. ROUSSELOT. Absolutely.

The CHAIRMAN. Without objection, so ordered.

[The statement and mark-up referred to may be found on pages 380 and 389.]

Mr. ROUSSELOT. I clearly want to be fair to the Chairman and make sure that he has adequate and full time to respond to this question, because I know it is highly detailed and I fully appreciate that the staff of the Federal Reserve Board clearly helps the regional bank presidents. I understand that. I do not think that is highly unusual.

The question really relates to the degree of influence, coordination, et cetera.

Dr. BURNS. Well, the governors had nothing to do with that. Mr. Partee looked after that in his own fashion. He is a thoroughly responsible man. He gave suggestions. Now, you had some other questions.

There follows now written questions on this matter by Congressman John H. Rousselot and the reply of Chairman Burns.

1. Information has come to my attention which strongly indicates that an effort may have been made to influence, change, or coordinate testimony which was presented before the Committee on Banking and Currency by presidents of Federal Reserve regional banks on July 17 and 18, 1974. This is a most serious matter because Congress can hardly utilize the "candor, knowledge, and courage of individual Federal Reserve policymakers" if their testimony is coordinated from Washington. I therefore believe it is essential that Congress obtain all of the details concerning this matter, and to that end would ask you to provide for the record the following information:

(*a*) copies of any draft statements which were submitted by regional bank presidents to the Federal Reserve Board or to its staff in preparation for their testimony;

(*b*) copies of any telegrams or other communications requesting or directing that changes be made in the draft statements of regional bank presidents;

(*c*) minutes of any special meeting of the Board of Governors which were held for the purpose of discussing anticipated testimony of regional bank presidents.

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Response of Chairman Burns

As I indicated in my response to your question at the hearing on August 8, the Federal Reserve Board made no effort whatsoever to censor or in any way alter the testimony of the presidents of the Federal Reserve Banks who appeared before the committee. The Board did not consider the testimony of the presidents at any of its regular meetings, nor were there any special meetings called for that purpose. The simple fact is that the Board did not concern itself in any way with this matter.

Each of the Reserve bank presidents sent a copy of his draft statement to Mr. J. Charles Partee, Managing Director of the Office for Research and Economic Policy, for his comments. This is not an unusual practice. We in the Federal Reserve commonly exchange views, and we have come to have respect for one another's judgment. We therefore welcome the criticism of our colleagues.

If you are interested in copies of the draft statements sent to Mr. Partee by the Reserve bank presidents, I would suggest that you send that request directly to them.

The bulk of Mr. Partee's comments and suggestions were conveyed to the Reserve Board presidents by telephone, and they were free to accept or reject his suggestions. His comments on the testimony of President Francis were somewhat more extensive, and were therefore sent by wire. A copy of that communication is attached. President Francis did not choose to change a word of his testimony in light of those comments, which was entirely his prerogative.

[The copy of the wire is retained in the committee's files. President Francis' prepared testimony and the mark-up of his statement as per Mr. Partee's suggestions may be found beginning on page 380. Changes suggested and adopted by Presidents Hayes, Balles, Eastburn, and Morris may be found beginning on pages 376, 377, 378, and 395.]

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ADDITIONAL QUESTIONS

IV

THE FRANKLIN NATIONAL BANK

The following are written questions submitted by Congressman John H. Rousselot to the six Federal Reserve bank presidents who testified at the hearing July 17–18, 1974. The questions concern the effect of the action taken by the Federal Reserve to supply the financially-troubled Franklin National Bank with $1.2 billion in emergency reserves. The replies of the Federal Reserve bank presidents follow the questions.

During the questioning of Presidents Mayo, Morris, and Francis by the committee on July 18, 1974, some confusion developed concerning the effect of the action taken by the Federal Reserve to supply the financially-troubled Franklin National Bank with $1.2 billion in emergency reserves. It was unclear whether this infusion of reserves was inflationary or whether it was offset in whole or in part by open market operations. In order to clarify the nature of the impact of transactions related to assistance provided to Franklin National, please answer the following questions:

Question 1. What were the dates, volumes, and rates at which Federal Reserve loans were advanced to—

(*a*) the Franklin National Bank?

(*b*) other New York clearinghouse banks?

Question 2. What were the dates, volumes, and rates at which Treasury bills were sold in order to offset the assistance provided to the Franklin National Bank?

Question 3. What is your assessment of the net monetary impact of all of the transactions related to the undertaking by the Federal Reserve to provide $1.2 billion to the Franklin National Bank?

Response of President Hayes

Answer to question 1. We would very much prefer not to state for the record at this time the specific details of the recent advances by the New York Reserve Bank to Franklin National Bank. It has been the consistent policy of the Federal Reserve Banks not to release information concerning the exact amounts of extensions of credit to a member bank and we are fully in accord with that view. Generally, the release of such information could be prejudicial to the depositors of the member banks involved, and we believe that this reasoning is also true in Franklin's case.

In 1963 Chairman Patman requested a complete set of minutes of meetings of directors of the New York Reserve Bank for certain years, together with copies of any written reports or other documents referred to in those minutes. Among the deletions made in the copies of the minutes, reports, and other documents sent to the Committee were the names of member banks making use of the discount window. Chairman Patman, in a letter dated May 1, 1963, stated, "There is no objection to your omitting data as to . . . the names and other information that would identify member banks applying for Federal Reserve Bank loans or discounts."

We believe that our current position of refraining from supplying specific figures in regard to this Bank's discount window operations is consistent with the position we took in 1963 which was acceptable to the Committee. We recognize, however, that the Committee does have oversight responsibilities with respect to the operations of the Federal Reserve System; and, although we would strongly recommend to the contrary, we would be prepared to make available on a confidential basis for inspection by you, or a member of your staff that you may designate, information concerning the amounts and dates of extensions of credit to Franklin.

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Certain information concerning extensions of credit to member banks is regularly published. Among the information published are the aggregate amounts of extensions of credit, as of the close of business each Wednesday, by the New York Reserve Bank to all member banks in the Second Federal Reserve District and to a group of 12 weekly reporting banks in the District, not including Franklin. The 12 weekly reporting banks includes ten members of The New York Clearing House Association, excluding its two newest members (one of which is Franklin), and two relatively small banks headquartered in New York City. The following table contains these amounts, as of the close of business Wednesday of each week, since the start of the second quarter of 1974:

BORROWING FROM FEDERAL RESERVE BANK OF NEW YORK

[In millions of dollars]

Date	Total 2d District borrowings	12 weekly reporting bank borrowings	Difference
Apr. 3	369	240	129
Apr. 10	270	145	125
Apr. 17	220	150	70
Apr. 24	591	385	206
May 1	182	0	182
May 8	814	645	169
May 15	1,744	870	874
May 22	1,245	0	1,245
May 29	2,798	1,425	1,373
June 5	1,453	0	1,453
June 12	1,578	300	1,278
June 19	1,162	0	1,162
June 26	1,535	220	1,315
July 3	1,507	100	1,407
July 10	1,405	0	1,405
July 17	2,381	890	1,491
July 24	2,544	861	1,683
July 31	1,607	150	1,457
Aug. 7	1,533	0	1,533
Aug. 14	1,625	130	1,495
Aug. 21	1,607	0	1,607
Aug. 28	1,628	0	1,628
Sept. 4	2,207	440	1,587
Sept. 11	1,561	0	1,561

Since April 25, 1974, all extensions of credit by the New York Reserve Bank to member banks in this District, including advances to Franklin, have been at the rate of 8 percent for loans under Section 13 of the Federal Reserve Act and at the rate of 8½ percent for loans under Section 10(b). The Federal Reserve Act requires that Section 13 advances be secured by Government or Federal agency securities. Advances at the higher rate under Section 10(b) may be secured by other collateral acceptable to the lending Reserve Bank.

Answer to question 2. The borrowing undertaken by Franklin National Bank from the Federal Reserve Bank of New York during the period since mid-May was fully taken into account by the Federal Reserve in its day-to-day open market operations. The Federal Reserve's Trading Desk carries out open market operations to achieve conditions of bank reserve availability consistent with the policy objectives of the Federal Open Market Committee. The fact that Franklin's borrowings were providing a large volume of reserves essentially meant that less reserves were provided through Federal Reserve open market operations than would have been the case otherwise. The Franklin borrowings, in other words, were a technical factor affecting reserves to be taken into account along with such technical factors as Federal Reserve float, the volume of currency in circulation, and the level of Treasury deposits at the Federal Reserve Banks.

In direct response to question 2, there is no meaningful way to relate particular sales of Treasury bills to changes in the level of Franklin borrowings. In fact, at the time of steepest increase in Franklin borrowings, in mid-May, System security holdings remained about unchanged as various other technical factors were absorbing a substantial volume of reserves at that time. Taking the period from mid-May to mid-July, System open market operations added approximately $1.2 billion to reserves and coincidentally Franklin's borrowings from the Federal Reserve Bank increased in about the same order of magnitude. In the

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absence of the enlarged Franklin borrowing, System open market operations would have had to supply an additional $1.2 billion or so of reserves ($2.4 billion in all) in order to meet the expansion of approximately $1.4 billion in required reserves and offset the absorption of about $1 billion through technical market factors.

Answer to question 3. As regards question 3, the net monetary impact of all transactions related to the step-up in Franklin's borrowings was negligible, since as explained above, the Franklin borrowing was regarded as a technical reserve factor to be offset in the course of the System's day-to-day operations. If it had not been possible to offset the reserve impact of Franklin's borrowing, there might have ensued a significant easing in conditions of reserve availability and a speed-up in monetary growth. This did not occur. Money market conditions remained generally firm during the late spring and summer months, and monetary growth slowed during the summer.

Response of President Balles

Answer to question 1(a). I have no specific knowledge of, or participation in the decisions regarding loans to Franklin National Bank. Information on this subject should be requested from the Federal Reserve Bank of New York.

Answer to question 1(b). Again I have no specific knowledge of, or participation in decisions regarding loans to member banks in the Second Reserve District.

Answer to question 2. This question concerns details of the operations of the Trading Desk at the Federal Reserve Bank of New York. I have no such specific information, and suggest requesting these data from the Federal Reserve Bank of New York.

Answer to question 3. It is my impression that neither the reserve target nor the amount of reserves supplied to the market were changed by the Franklin National situation. Hence, by definition there must have been a smaller net purchase of securities by the Federal Reserve System because of the loans to Franklin National Bank.

Response of President Eastburn

Answer to question 1. This information would best be obtained from the New York Federal Reserve Bank.

Answer to question 2. The manager of the Open Market Desk is in the Government securities market on a daily basis in an effort to carry out the FOMC's monetary policy as well as to offset a wide variety of technical factors. I think it would be impossible to isolate precisely which transactions were made to offset advances to Franklin National, although offsetting loans to Franklin National was part of overall Desk strategy.

Answer to question 3. If not offset, provision of $1.2 billion in loans to Franklin National by the New York Federal Reserve Bank would have the impact of increasing bank reserves (and eventually the money stock) more rapidly than otherwise. One can only conjecture what reserve growth would have been in the absence of the Fed's advances to Franklin National, so I can guess at the net monetary impact of the transactions. My reading of the FOMC's intent, however, is that the Committee placed high weight on offsetting the impact of these advances on reserves in the banking system. Moreover, as I review the data, I see no obvious evidence that the loans to the Franklin National led to accelerated reserve growth. Reserves available for private deposits (i.e., bank reserves less those committed for Government and interbank deposits) rose by about $600 million in May, about the same increase experienced in other recent months and only about half the increase in Franklin's borrowing.

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Response of President Francis

Answer to question 1. I do not know, actions were taken by Federal Reserve Bank of New York.

Answer to question 2. I do not know, actions would have been taken by the Federal Reserve Bank of New York.

Answer to question 3. We measure the monetary impact of any Treasury and Federal Reserve transactions by changes in the monetary base, the uses of which are bank reserves and currency supplied to the private sector of the economy. From the week ending May 15 to the week ending May 22, member bank borrowings increased by $1.113 billion, and the monetary base rose by $.662 billion. In the two months since the first special borrowing by Franklin National Bank (week ending May 15 to week ending July 17) member bank borrowing rose $1.2 billion on balance. Also during this period Federal Reserve System holdings of U.S. government securities rose about $1.2 billion. These developments, in combination with other factors, resulted in an increase of the monetary base of $2.85 billion (on a nonseasonally adjusted basis) which is equal to a 7.2 percent rate of increase of the base from the average of the four weeks ending May 15 to the average of the four weeks ending July 17. For the year ending July 17, 1974, the base grew at a 7.6 percent annual rate.

Therefore the evidence indicates that monetary actions following the Franklin episode were not more inflationary than before. It is difficult to be sure from these figures the degree to which the access of Franklin to the discount window was offset.

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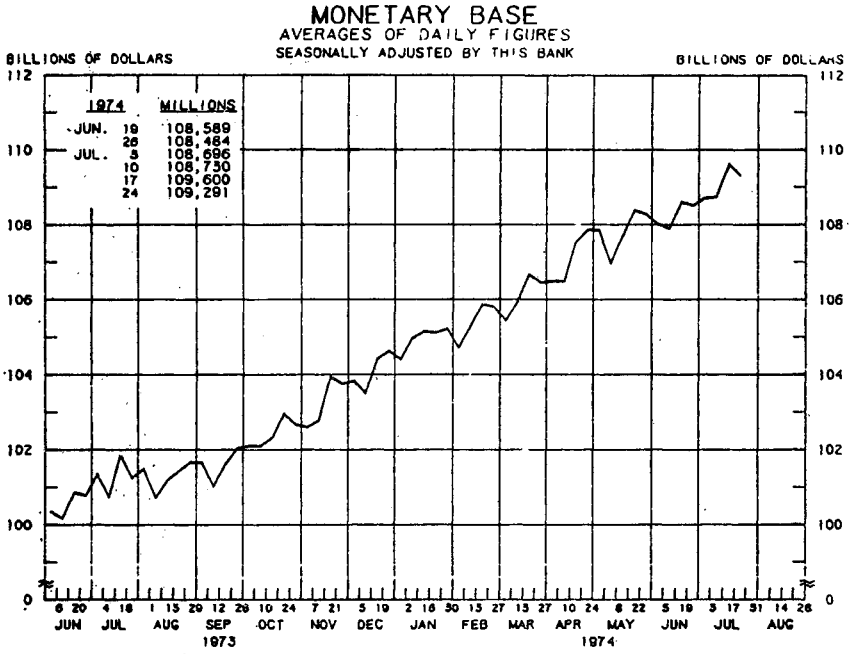

LATEST DATA PLOTTED WEEK ENDING: JULY 24, 1974

USES OF MONETARY BASE ARE MEMBER BANK RESERVES AND CURRENCY HELD BY THE PUBLIC AND NONMEMBER BANKS, ADJUSTED FOR RESERVE REQUIREMENT CHANGES AND SHIFTS IN DEPOSITS. FOR A DESCRIPTION OF THE BASE SEE THE AUGUST 1968 "REVIEW" OF THIS BANK.

COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:

TO THE AVERAGE OF FOUR WEEKS ENDING:	7/25/73	10/24/73	12/26/73	1/23/74	2/27/74	3/27/74	4/24/74	5/22/74
12/26/73	6.6							
1/23/74	7.2	10.5						
2/27/74	6.9	8.8	7.6					
3/27/74	7.2	8.9	8.1	7.0				
4/24/74	7.7	9.4	9.1	8.6	10.8			
5/22/74	7.7	9.2	8.9	8.5	9.9	10.2		
6/26/74	7.5	8.6	8.2	7.7	8.5	8.2	6.4	
7/24/74	7.7	8.9	8.5	8.2	8.9	8.8	7.7	7.5

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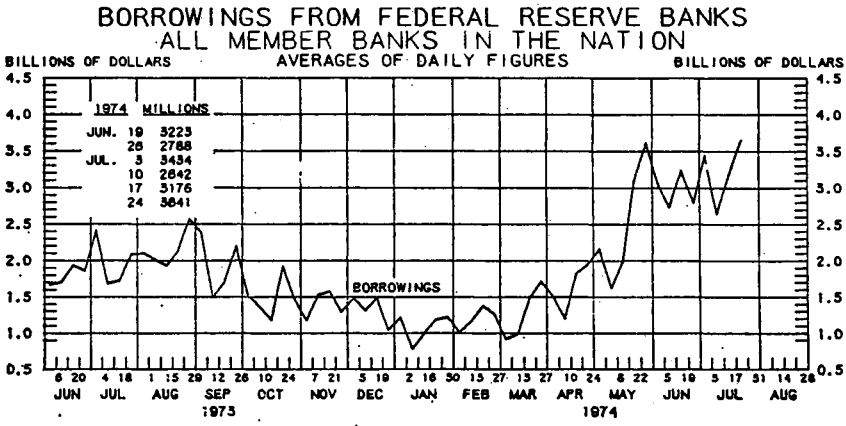
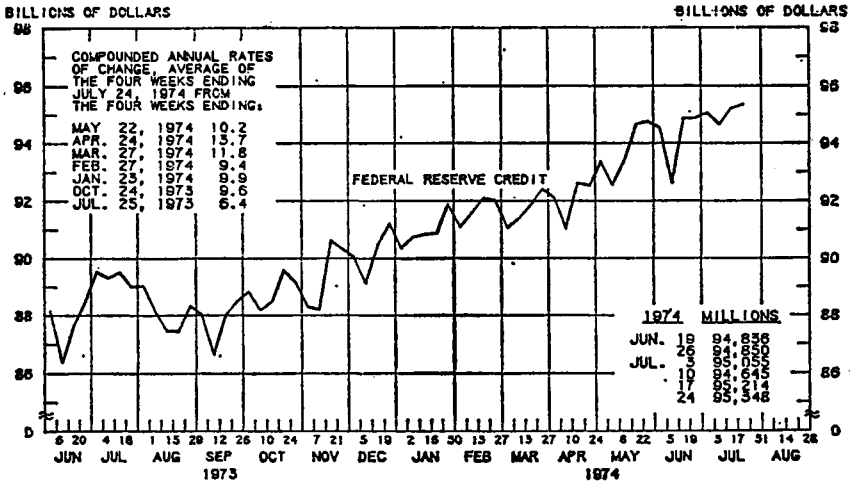


LATEST DATA PLOTTED WEEK ENDING: JULY 24, 1974



LATEST DATA PLOTTED WEEK ENDING: JULY 24, 1974

1/ RATIO OF MONEY STOCK (M1) / MONETARY BASE.

2/ DEFINED TO INCLUDE HOLDINGS OF SECURITIES, LOANS, FLOAT AND "OTHER" ASSETS, ADJUSTED FOR RESERVE REQUIREMENT CHANGES AND CHANGES IN REQUIREMENTS DUE TO SHIFTS IN DEPOSITS AMONG CLASSES OF BANKS. DATA ARE SEASONALLY ADJUSTED BY THIS BANK.

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WEEKLY AVERAGES OF SELECTED ITEMS

	Member bank borrowings	Treasury deposits at the Federal Reserve	Federal Reserve holdings of securities	Monetary base
Mar. 6	912	1,927	80,272	104,022
Mar. 13	983	1,794	80,251	104,426
Mar. 20	1,483	1,324	80,929	105,647
Mar. 27	1,713	2,317	81,064	105,021
Apr. 3	1,503	1,889	81,559	105,566
Apr. 10	1,194	1,354	80,774	105,652
Apr. 17	1,816	1,299	81,736	107,525
Apr. 24	1,939	1,666	81,893	107,542
May 1	2,157	2,460	82,997	107,230
May 8	1,616	2,959	83,479	106,857
May 15 [1]	1,977	2,723	83,932	107,594
May 22	3,090	3,028	84,020	108,256
May 29	3,606	3,224	83,326	107,631
June 5	3,054	2,804	83,302	107,684
June 12	2,729	931	81,412	107,563
June 19	3,223	1,511	83,240	108,589
June 26	2,788	2,659	84,065	108,276
July 3	3,434	2,781	84,262	109,181
July 10	2,642	2,957	84,307	109,354
July 17	3,176	2,366	85,118	110,441
July 24	3,641	2,721	84,656	109,919

[1] During this statement week it was announced that Franklin National Bank was experiencing financial difficulties.

Note: All data are not seasonally adjusted. The monetary base series may be obtained from the Federal Reserve Bank of St. Louis.

Source: Federal Reserve "Bulletin," table entitled "Member Bank Reserves, Federal Reserve Bank Credit and Related Items."

Response of President Mayo

Since I was not directly involved in the advances to Franklin National, Mr. Hayes is in a better position to comment on the transactions with Franklin National and the nature of the open market offsets to the advances made.

Response of President Morris

Answer: As Mr. Mayo and I indicated in our testimony, the monetary impact of the loans to Franklin National were fully offset by the Trading Desk operations of the New York Federal Reserve Bank under instructions from the Federal Open Market Committee. The offset took the form, not of selling securities in the open market, but of buying fewer securities in the open market than would otherwise have been required to keep the money supply growing at the moderate pace desired by the FOMC. In other words, the reserves supplied through the discount window to the Franklin National displaced reserves that would otherwise have been supplied through open market purchases.

I asked Alan Holmes, Manager of the Federal Open Market Account, to provide me with a detailed account of the impact of the Franklin National loan. The report from Mr. Holmes follows. Any additional details needed would have to be obtained from the Federal Reserve Bank of New York.

[The report referred to of Alan Holmes, manager, of the Federal Open Market Account follows:]

FEDERAL RESERVE BANK OF NEW YORK

OFFICE CORRESPONDENCE

JULY 31, 1974.

To: Mr. Holmes.
From: R. L. Cooper.
Subject: Effect of Franklin National Bank borrowing on open market operations mid-May–mid-July 1974.

Since mid-May 1974, emergency borrowing at the discount window by the Franklin National Bank has been outstanding daily in amounts ranging between $1 and $1.4 billion. During this period, the Federal Reserve took full account of the reserves being supplied by the Franklin borrowing as well as the reserve effects of Federal Reserve float, currency in circulation, and other uncontrolled factors affecting bank reserves. The fact that this borrowing was

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constantly supplying a large volume of reserves meant that less reserves had to be provided by open market operations during the period than would otherwise have been the case. Over the period, the reserve effects of the Franklin borrowing were offset indirectly, not by System action to absorb reserves, but by reduced action to supply reserves.

The System is generally a supplier of reserves over the long run, even during periods of monetary restraint, although nonborrowed reserves are provided more grudgingly in relation to deposit growth than in periods in which policy fosters monetary stimulation. The volume of reserves is also affected by other factors not directly under Federal Reserve control, such as variations in Treasury balances at Federal Reserve Banks, Federal Reserve float, currency in circulation and foreign central bank accounts. The Federal Reserve has to take expected changes in these factors into consideration in determining its own course of action each day. During periods of restraint, the Desk aims to restrain the growth of nonborrowed reserves relative to required reserves. The banks in need of reserves then must seek them either at the Federal Reserve discount window or in the Federal funds market, exerting an upward pressure on the Federal funds rate. This impacts on the portfolio decisions of banks and investors, exerting a lagged effect on monetary and credit growth.

In its day-to-day operations, the Federal Reserve considers the estimated need to supply or absorb reserves—in view of the probable extent to which they will be provided or absorbed by uncontrolled market factors, and the short-run objectives of the Federal Open Market Committee. The attached table shows the net result of the interaction of reserve needs, market factors affecting reserves, borrowing by the Franklin National Bank and other member banks, and open market operations, over the period from mid-May to mid-July 1974. (The table referred to appears at the end of the report.)

The Federal Reserve's operational problem is exemplified by the developments in the week ended May 22. The reserve requirements that member banks are legally required to meet rose by $25 million on average in that week while excess reserves fell so that total reserves declined by $30 million. Changes in uncontrolled market factors in the same week reduced the level of nonborrowed reserves available to member banks by $1,212 million. Federal Reserve open market operations supplied only $87 million while the borrowing of Franklin National Bank from the Federal Reserve added $626 million to reserves. Thus, in that particular week, the shortfall of nonborrowed reserves below reserve requirements was largely made up by a $467 million increase in borrowing by other member banks at the Federal Reserve.

Over the longer period from mid-May to mid-July, deposit growth led to an increase of $1.4 billion in the reserves required of member banks, excess reserves fell $0.1 billion, and total reserves increased by $1.3 billion. Uncontrolled market factors absorbed $1.0 billion of nonborrowed reserves over the period as one can see in the attached table. The reserve need was met by a $1.2 million increase in Federal Reserve System holdings of marketable securities and a $1.1 billion increase in member bank borrowing from the Federal Reserve. Had it not been for the rise in Franklin National Bank borrowing, which is included in this total, the Federal Reserve would have had to supply a substantial additional amount of reserves through open market operations.

Providing such a volume of reserves would have been difficult, since securities available for outright purchase by the Federal Reserve or to serve as collateral on repurchase agreements were quite scarce. Even with the Franklin borrowing, the money market was generally tighter and the Federal funds rate somewhat higher than the Federal Reserve would have liked. This was partly because member banks bid up the rate in the process of trying to cut back on their borrowing from the Federal Reserve so that they would feel entitled to use this source of reserves more freely should money market conditions become more strained.

Over the two-month period the Federal Reserve was able to maintain the degree of pressure on the banking system that the Federal Open Market Committee deemed consistent with its own objectives of moderate growth in the monetary and credit aggregates. The emergency borrowing of the Franklin National Bank did not produce insurmountable technical difficulties in the management of reserves.

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DEMAND FOR, AND SUPPLY OF BANK RESERVES—STATEMENT WEEKS ENDED MAY 15, 1974, THROUGH JULY 17, 1974

[Millions of dollars]

	May 15	May 22	May 29	June 5	June 12	June 19	June 26	July 3 [1]	July 10 [1]	July 17 [1]	Cumulative change [2]
Bank Demand for Reserves											
1. Required	36,470	36,487	36,170	36,054	35,658	36,461	36,437	36,904	36,613	37,849	+1,379
2. Excess	+176	+129	+179	+225	+131	+247	+99	+298	+242	+92	−84
3. Total	36,646	36,616	36,349	36,279	35,789	36,708	36,536	37,202	36,855	37,941	+1,295
Sources of Reserves											
4. Nonborrowed reserves for previous week	34,802	34,763	33,638	32,857	33,356	33,196	33,627	33,881	33,894	34,350	−452
Changes in Nonborrowed Reserves											
5. Market factors	−494	−1,212	−87	+523	+1,730	−1,397	−571	−184	+411	−244	−1,031
6. System operations	+455	+87	−694	−24	−1,890	+1,828	+825	+197	+45	+811	+1,185
7. Total change	−39	−1,125	−781	+499	−160	+431	+254	+13	+456	+567	-------
8. Nonborrowed reserves for current week	34,763	33,638	32,857	33,356	33,196	33,627	33,881	33,894	34,350	34,917	+154
9. Member bank borrowing from Federal Reserve	1,883	2,978	3,492	2,923	2,593	3,081	2,655	3,308	2,505	3,024	+1,141
Total reserves, (8) + (9)	36,646	36,616	36,349	36,279	35,789	36,708	36,536	37,202	36,855	37,941	+1,295

[1] Data are considered preliminary.
[2] Change in reserve levels from May 15 to July 17.

Congressman John H. Rousselot also submitted written questions on the Franklin National Bank matter to Chairman Burns. The questions and Chairman Burns' reply follows:

During the questioning of Presidents Mayo, Morris and Francis by the Committee on July 18, 1974, some confusion developed concerning the effect of the action taken by the Federal Reserve to supply the financially-troubled Franklin National Bank with $1.2 billion in emergency reserves. It was unclear whether this infusion of reserves was inflationary or whether it was offset in whole or in part by open market operations. In order to clarify the nature of the impact of transactions related to assistance provided to Franklin National, please answer the following questions:

(a) What were the dates, volumes, and rates at which Federal Reserve loans were advanced to—

(1) The Franklin National Bank?

(2) other New York clearinghouse banks?

(b) What were the dates, volumes, and rates at which Treasury bills were sold in order to offset the assistance provided to the Franklin National Bank?

(c) Please provide the statistics, for the period January to July, 1974, on the amounts of large certificates of deposit withdrawn from the Franklin National Bank and the extent to which such deposits were uninsured.

(d) What is your assessment of the net monetary impact of all of the transactions related to the undertaking by the Federal Reserve to provide $1.2 billion to the Franklin National Bank?

Response of Chairman Burns

Additions to reserves resulting from loans made to the Franklin National Bank by the Federal Reserve have been fully offset by open market operations. I would be pleased to answer specific questions on loan transactions with the Franklin National in executive session.

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ADDITIONAL QUESTIONS

V

[The following is a written question submitted by Congressman Fernand J. St Germain to the Reserve bank presidents, along with their replies:]

Question: Can thrift institutions and housing prosper and even survive in a period of inflation and high interest rates, and if not what can we do first to stop inflation and bring down interest rates and second to keep thrift institutions and housing alive and well while we are stopping inflation and bringing down interest rates?

Response of President Hayes

Answer. Inflation and its inevitable concomitant—high interest rates—are at the root of the problems of housing, as of so many of our economic problems. Indeed, the thrift institutions and the housing industry are among the sectors which feel the severest impact of inflation and high interest rates. Ultimately, the only real solution to this problem is to get inflation under control. Given the heavy reliance in this country on monetary policy in stabilizing economic activity, however, efforts to combat inflation tend to have a severe short-run impact on the thrift institutions and on residential construction activity. This poses a real dilemma for which there is no entirely satisfactory solution. There are some measures worthy of consideration, however, which may help to soften the blow of fighting inflation on the thrift and housing industries.

In considering the problems of housing, it is well to bear in mind the large strides that the nation has made toward meeting the goal, established in the Housing and Urban Development Act of 1968, of 26 million new or rehabilitated housing units in the fiscal years 1969 through 1978. The interim goal for the first six years of that decade, which ended June 30, 1974, has been exceeded. During the past six years, conventional housing starts of nearly 11.1 million units and mobile home shipments of almost 2.9 million units have, in combination, surpassed the official goal for that period by some 600 thousand units. Looking at another indicator of the extent to which the nation's housing needs are being met, the rental vacancy rate rose to 6.3 percent in the second quarter of this year. This was the highest vacancy rate since 1967, although still below the average of over 8 percent witnessed in the first half of the 1960's.

Thus the record of recent years suggests that the problem with housing lies not in the industry's overall longer-run performance but rather with the variability of its performance over shorter periods, largely in response to changing financial market conditions. One reason for this vulnerability to changing financial markets is, of course, the relatively large amount of debt (and relatively small amount of equity) used to finance purchases of housing. Fortunately, housing is an extremely durable good. Compared with other types of consumer expenditures, residential construction is relatively postponable. From the standpoint of the economy as a whole, it may be less painful to restrict the production of highly durable goods, such as housing, during periods of excess aggregate demand than it is to restrict some other types of output. Historically, housing cycles have tended to run counter to cycles in overall economic activity, so that fluctuations in housing activity have played a role in helping to stabilize the economy. Nevertheless, there are real economic costs to very wide fluctuations in housing activity, in the form of inefficiencies in the utilization of resources that are specific to the construction industry. Hence, it is certainly desirable to avoid excessive fluctuations.

A number of Government programs have supported housing activity. In addition to programs such as urban renewal and rent subsidies for lower income families, various Federal or federally sponsored agencies have also helped to sustain the supply of mortgage funds. Chief among these, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation supplement the sources of funds available for housing by purchasing mortgages from originating lenders with funds raised in the securities market. In addition, the Government National Mortgage Association, under its so-called Tandem

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Plan, has added support to the housing market by purchasing mortgages at above market prices and reselling them to private buyers at market prices, absorbing any resulting losses. Finally, the Federal Home Loan Banks provide credit advances to their members to help them finance holdings of residential mortgages.

Some indication of the growing support given by the above-mentioned agencies may be seen by reviewing the experience of recent years. During 1969 and 1970, Federal support activities provided almost $16 billion to housing finance, accounting for about two-fifths of the total increase in residential mortgage debt during the period. Attesting to the success of this effort, total residential mortgage flows increased from $18.6 billion in 1968 to an annual rate of $19.8 billion in the 1969–70 period. During 1973 and the first half of 1974, Federal support amounted to an annual rate of $16 billion, or about one third of the total increase in residential mortgage debt, according to preliminary data. Over that period, total residential mortgage flows averaged, at an annual rate, $49 billion which was only slightly less than the $51 billion in 1972. In contrast to the experience of 1969–70 and 1973–74, mortgage flows from 1965 to 1966, a period of credit stringency when Federal support was considerably smaller, dropped from $19 billion to $13.8 billion.

These Government credit programs have made a significant contribution in preventing fluctuations in housing from being even more severe than they have been. Such credit programs in part recapture deposit funds that are attracted to the open market in search of higher yields. To be sure, these credit demands of the federally sponsored mortgage support agencies have added to upward pressures on market interest rates, but other, more fundamental, forces are largely responsible for the high levels of interest rates currently prevailing.

Sizable outflows from thrift deposits have of course occurred recently, and even larger outflows are a distinct possibility, given the levels of market interest rates and recent innovations such as small-denomination floating-rate securities issued by bank holding companies and other corporations. Massive outflows might not only curtail the availability of private mortgage credit but also impair the liquidity of some thrift institutions. Large and sustained outflows could force liquidation of assets at depressed prices, thereby inflicting capital losses on some thrift institutions.

There does not appear to be any wholly satisfactory *short-term* solution to the problem of the savings institutions. Their problem stems fundamentally from the fact that in marketing their liabilities, they must compete in a market where interest rates have been driven up by accelerating inflation while the rates earned on the bulk of their long-term mortgage portfolio reflect an earlier period of relatively stable prices and consequently lower interest rates. This painful situation can ultimately be cured only by ending inflation and thus wringing out the "inflation premium" embedded in interest rates. This is likely to require a protracted period of monetary and fiscal restraint. The prospects for lower interest rates over the near term would be enhanced, however, by shifting more of the burden of restraint from monetary policy to fiscal policy. Restraint on Federal spending, producing a meaningful surplus in the budget for the current fiscal year, would make a significant contribution.

There are a number of other steps which over a longer run period should be considered to relieve the pressure on thrift institutions and to dampen fluctuations in housing activity. The Congressional hearings on the Financial Institutions Act provide an opportunity for such measures to be debated. One helpful reform contained in the Act would be the gradual removal, over a period of several years, of regulatory ceilings applicable to rates payable on savings and time deposits at banks and thrift institutions. In order to provide a more rapid turnover of thrift institution assets so that earnings would be sufficiently flexible to permit survival in a more competitive environment, however, these institutions would also have to be granted broader powers to diversify their assets. Variable interest mortgages and consumer loans by savings and loan associations are worthy of consideration. While broader asset powers would probably result in a reduction in the proportion of thrift institution funds invested in mortgages, the best evidence indicates that the total amount of funds supplied to the mortgage market by these institutions might be little affected. Their strengthened ability to compete for funds could increase their total resources enough to allow them to maintain their present levels of home finance. The Financial Institutions Act contains other measures which would tend to help the financing of residential construction. One of these is the repeal of Section 24 of the Federal Reserve Act, which imposes special restrictions on real estate lending by national banks.

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To prevent the abrupt cutoff of mortgage funds when market interest rates rise above a certain threshold, it would be highly desirable for states with usury ceilings to remove them. Although intended to protect the consumer, these usury laws have in fact resulted in an almost complete dry-up of mortgage funds in some states on various occasions in recent years. The Congress can take the lead by eliminating the rate ceilings on FHA-insured and VA-guaranteed mortgages.

Another measure that would help the thrift institutions and housing that seems at least worthy of consideration is the proposal to exempt from Federal income taxes a portion of interest paid on savings and time accounts. Such a move would encourage savers to keep their savings in banks and thrift institutions even when interest rates on market instruments rise above levels that these institutions are able to pay. The resultant loss of revenue should be recouped through other taxes, however, or offset by lower Federal spending in order to avoid undesirable fiscal stimulus.

In part, the problem of financing residential construction reflects the tendency of some other sectors, notably the business sector, to capture an increasing share of total credit during periods of exuberant economic activity. There are some proposals designed to help housing finance indirectly by influencing the share of credit obtained by the business sector. While these schemes are not without problems, they may also merit consideration. One such device would be a variable investment tax credit which would be lowered when it appeared that the business community was attracting a disproportionate share of total credit and real resources. Another such scheme would be a variable Federal income tax deduction for interest expenses incurred by corporations, to be lowered when business borrowing threatened to squeeze home buyers and other borrowers out of the credit market.

There is one line of approach which I would urge the Congress to resist. That is assigning the Federal Reserve System the responsibility and authority to allocate credit through supplemental reserve requirements and credits on various member bank assets. Such an approach is contained in H.R. 15709, which has been introduced by Representative Reuss. I concur in the position of the Board of Governors of the Federal Reserve System as presented in the letter of July 29, 1974 from Chairman Burns to Representative Reuss. We feel that it would be unwise for the Federal Reserve to become involved in establishing priorities among potential users of credit. Such an involvement could weaken the Federal Reserve's control over the monetary and credit aggregates. Such a development could be extremely unfortunate from the point of view of bringing inflation under control and thus, ultimately from the point of view of its supposed beneficiary, the housing industry. Moreover, there would be no assurance that attempts to allocate credit would even meet with any significant success, for forced shifts in bank credit might well be offset by opposite shifts in credit from other sources. Finally, applied only to banks that are members of the Federal Reserve System, asset reserve requirements would probably spur the exodus of banks from the System and, thereby, further erode Federal Reserve control over money and credit.

Response of President Balles

In the recent period of high interest rates and inflation, thrift institutions have had difficulty supporting the housing industry. Their assets are mortgages with long average terms to maturity (27.4 years in May 1974), while their liabilities have short maturities (they may in fact be redeemed at any time with appropriate penalties). Since thrift institutions cannot change the rate they charge on their existing portfolio of mortgage loans, in periods of high and rising interest rates they tend to generate insufficient income to pay market interest rates for their deposits. The result is rapid loss of deposits, and a precarious financial situation. Extraordinary short-run measures may be needed to assist thrift institutions this year. Congress in fact is considering an interest rate subsidy which would permit a 2 percent to 4 percent interest rate reduction on Federal S & L's borrowing.

In the long run, however, the root cause of the difficulties of thrift institutions must be removed. This will require major reforms in our financial institutions along the lines suggested by the Hunt Commission. The reforms recognize that thrift institutions would be more viable institutions if given additional lending

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flexibility—that is, the ability to respond to increases in the cost of their liabilities by increasing the yield on their assets. Specfically, thrift institutions might be authorized to (1) make variable-rate mortgage loans, with necessary limitations and other protection to borrowers; (2) make consumer loans; (3) make construction loans not tied (as at present) to permanent mortgage financing; (4) make community rehabilitation and development loans; (5) acquire high quality commercial paper and corporate debt securities; (6) invest in the full range of U.S. Government and municipal obligations; and (7) invest in mortgages that provide for participations in rental income and sharing of capital gains on the sale of properties so financed.

If implemented, the recommendations of the Hunt Commission and the Administration would impart to thrift institutions the portfolio flexibility they need to operate more successfully in periods of rising interest rates and tight money. However, efforts to increase the financial stability of thrift institutions should not be at the expense of either a reduction in the overall supply of home mortgage loans, or a reduction in the comparative viability of the commercial banking system.

The priority assigned to healthy housing and mortgages markets in the United States is high. To increase the viability of thrift institutions at the expense of the housing industry would be to confuse ends with means. As thrift institutions implement added flexibility by replacing mortgage loans with loans of other sorts, it will be desirable to mobilize the resources of *all* lending institutions, especially those of commercial banks and insurance companies, to support home lending. As recommended by the Hunt Commission and the Administration, a very promising way of doing this would be to grant a tax credit against the interest income from such loans to *any* lender engaged in making home mortgage loans.

The elimination of inflationary pressures remains the most important single task to solve the problems of both the thrift institutions and the homebuilding industry. Specifically, this will entail (1) at least balancing the Federal budget, or preferably providing a surplus, in order to avoid the heavy deficit financing which has been a major source of disintermediation; (2) support of the Federal Reserve System by the Administration and the Congress in pursuing a noninflationary growth rate for money and credit, even if in the short run this produces a temporary rise in unemployment; and (3) making price stability a co-equal goal with full employment. The doubling of some prices in little more than a decade means that a given volume of mortgage loans will now finance only half as many homes. In the absence of more vigorous efforts to control inflation, diversifying the thrift institutions will not, in itself, guarantee a larger supply of homes.

Response of President Eastburn

Answer. Let me deal with each part of the question separately. *Can thrift institutions and the housing industry prosper and even survive in periods of inflation and high interest rates?* Yes. The "curse" of thrift institutions and the housing industry has been the sudden increases in interest and inflation rates. High but steady rates are no difficulty once the industries and their customers have adjusted.

The crux of the problem facing thrift institutions is that they lend to home buyers on a long-term basis but obtain funds from depositors on a short-term basis. This contributes to a boom-bust cycle. Regardless of whether interest rates are absolutely high or low, when they suddenly rise, thrift institutions find themselves with relatively low-yield mortgages (made earlier when rates were low), while they must pay high rates to depositors to avoid a loss of funds. To exacerbate the problem, thrift institutions frequently cannot pay the higher rates on deposits because of interest rate ceilings. Of course, when rates *fall* (whether from absolutely high or low levels), thrift institutions benefit from high-yield mortgages and low rate deposits.

The home building industry suffers in periods of rapid interest rate increases for other reasons as well. One is state-legislated usury ceilings on mortgages. While rate ceilings are generally adjusted upward eventually, they do inhibit the supply of funds before legislatures respond to rising market rates. Another reason home building sometimes suffers after sudden run-ups in interest rates is that home buyers may anticipate a quick decline back to more "normal" levels and so they postpone housing purchases.

The second part of your question is *how do we stop inflation and reduce in-*

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terest rates? As I said in my prepared statement, inflation is essentially a monetary phenomenon. Lasting success against inflation, therefore, can only be achieved by gradually moderating growth in the money supply. In the short run, this kind of monetary restraint may well push interest rates up, but over the longer haul it will mean lower rates. Once the economy is purged of high inflation, interest rates will require a smaller inflation component and will therefore decline.

The final part of the question asks *what we can do to protect thrift institutions and the housing industry until inflation has ended and interest rates have been reduced?* In fact, thrift institutions would need protection only in the early stages of pursuit of the policy prescription outlined above, that is, when interest rates continue to exceed returns on their mortgage portfolio. Under these circumstances, the plight of thrift institutions should be alleviated through direct financial assistance by agencies such as the Federal Home Loan Banks and the Government National Mortgage Association. Long-term solutions might include variable rate mortgages and longer maturities for thrift institution deposits so they will be less likely to get "locked-in" to low-yield assets and high-yield liabilities in the future.

Attempts to circumvent market forces by imposing further price or interest rate constraints should be avoided. Past experience suggests that sophisticated market participants can avoid these constraints, sometimes to the detriment of those the Congress is trying to help.

Once interest rates begin to fall, thrift institutions will be left as holders of mortgages issued at earlier high rates yet will be able to pay low rates on their deposits. They will enter the boom stage of the cycle. But lest the Congress take too much delight in this scenario, let me remind you that sudden declines in interest and inflation rates can be just as difficult as sudden increases. If an anti-inflationary policy is successful, what will happen, for example, to all those home buyers who signed 9 percent mortgages in anticipation of continued high inflation in housing prices? Only when inflation finally settles down to a steady (high or low) rate, will the dislocations and inequities in the housing market cease.

Response of President Francis

There is no doubt that the impact of inflation and the resulting high market interest rates fall disproportionately on thrift institutions and the housing industry. However, this situation is largely attributable to the market impediments and institutional rigidities under which our financial system operates. Foremost among these impediments are the limits on the interest rates which thrift institutions are allowed to pay for funds. When market interest rates exceed these administered ceiling rates, these institutions are unable to compete effectively for funds.

In the case of institutions which finance primarily the housing industry, their ability to compete in financial markets would still be limited for some time even if the interest rate ceilings were removed immediately. This is because these institutions are encouraged to specialize in long-term loans with fixed rates of interest. In periods of high or rising interest rates, the costs of their funds rise while the returns on their investments do not. Over the longer term, these institutions should be encouraged to diversify into more short-term assets so that their overall rates of return will move more in line with their costs of funds.

With these considerations in mind, I believe that the first steps taken toward reducing the inequitable impact of reducing inflation and high interest rates should be the abolition of interest rate ceilings, the adoption of proposals which would give Savings and Loan Associations and Mutual Savings Banks more latitude in the kind and amount of assets they can hold, and the adoption of proposals which would permit these institutions to issue credit market instruments.

Response of President Mayo

Given our experiences over the past few years, we are now all aware of the difficulties encountered by thrift institutions and by participants in the housing market during periods of inflation and high interest rates. Clearly, the most direct attack on this problem is to manage our fiscal and monetary affairs so as

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to reduce inflationary pressures and thus restore more reasonable interest rate levels. I have indicated in my testimony the nature of both the fiscal and monetary actions that need to be taken.

Starting from our current position, the process will be long and difficult. And during that time the strain of restrictive policy actions will be felt by many sectors in the economy. Nevertheless, I feel that we can accomplish the task without damaging the fabric of our financial institutions if we do not become overly restrictive and move with persistence in a moderate fashion to achieve our goal.

Response of President Morris

Question. Can thrift institutions and housing prosper and even survive in a period of inflation and high interest rates?

Answer. The housing industry can survive the current inflationary-induced, tight money period as it has survived past such periods because of the relative ease of exit and entry into the industry by both builders and brokers. The thrift institutions can survive by a careful monitoring of their liquidity and earnings situation with the help of the financial support provided them by Federal credit agencies, the Federal Home Loan Bank System, or even the Federal Reserve System in a period of emergency.

In the longer run, the solution lies in restructuring both the asset composition and the liability structure of the thrift institutions so that they might be more viable in periods of sharp increases in interest rates. In addition, both the housing industry and the thrift institutions need a better balance between fiscal and monetary policy so that an appropriate rate of monetary growth would be associated with lower interest rates and, hence, less pressure on these sectors of the economy.

Question. What can we do first, to stop inflation and bring down interest rates, and, second, to keep thrift institutions and housing alive and well while we are stopping inflation and bringing down interest rates?

Answer. The ultimate solution to these problems is of course to curb the rate of inflation. This requires systematic, coordinated use of monetary and fiscal policy as I pointed out in my opening statement. Fiscal restraint is a crucial ingredient in holding aggregate demand in balance with the economy's capacity to produce. Policies such as reduced spending, tightened tax loopholes, and contra-cyclical variations in the investment tax credit would ease interest rate pressures in the credit markets, offsetting some of the burden caused by restrictive monetary policy.

Thrift institutions should take advantage of short-term financial aids by adopting measures that would protect them in the future. The most effective step is issuance of variable-rate mortgages. If their portfolios currently consisted mainly of such mortgages, they could afford to pay 7½–8 percent on their savings, a yield which should hold all but a small fraction of their savings. The shortcoming of variable-rate mortgages is that it takes at least 4–5 years of exclusive issuance of such mortgages before they comprise even half of the mortgage portfolio. As past experience has demonstrated, these institutions tend to lose their interest in such mortgages once money conditions ease.

More immediate relief for the housing market could be obtained from measures taken to rescind state usury laws and ceiling rates on FHA–VA loans. Such restrictions on the contract yield lenders can receive on mortgage loans only dissuade lenders from making mortgage loans and exacerbate mortgage availability problems. Along this line, reduced red-tape in the administration of government-insured mortgage loans would increase their usage as mortgage credit instruments.

Congressman John H. Rousselot submitted additional questions to Chairman Burns. The questions and Chairman Burns' reply follows:

Question 1. An article in the July 1974 edition of Fortune magazine described the Federal Reserve's concern for the effect of monetary policy on the housing market as, to paraphrase slightly, "an albatross, which the Fed almost seems to enjoy." The article went on to suggest that the Federal Reserve opposes the removal of Regulation Q and the broadening of the powers of thrift institutions in order to make them less vulnerable to changes in the money markets.

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Do you in fact oppose these measures, and, if so, how would you propose to liberate thrift institutions from their dependence upon a stable relationship between short- and long-term interest rates?

Question 2. The same Fortune magazine article contained the following account of an alleged dispute involving the Open Market Committee:

"Burns' arguments were impressive, but not impressive enough to sway the FOMC. Throughout the year, the committee's economic staff steadily forecast very rapid rates of G.N.P. growth. Since money affects G.N.P. with a lag of about six months to a year, the impact of additional monetary stimulus might conceivably show up just as the economy was nearing full employment—i.e., at precisely the wrong time. The committee also knew that the Administration's desire to prevent interest rates from rising rapidly was linked to the coming election.

"In the circumstances, the dispute between Burns and the FOMC majority became fairly tense at times. At one point, frustrated at his inability to convince the committee of the need to hold down interest rates, Burns left a meeting in obvious anger. He returned in about an hour, announcing: 'I have just talked to the White House.'

"The effect of this declaration on the committee must have been quite dramatic. Burns was invoking the aid of the White House in a manner rarely, if ever, employed by a Chairman of the nominally independent Federal Reserve System. It was undoubtedly a difficult moment for Burns, a man accustomed to swaying colleagues by the logic of his arguments. But the committee go the idea the White House was determined to try to keep rates from rising."

Is there any substance to this story, and to what extent was FOMC action in this instance influenced by direct, implied, or imagined threats to Federal Reserve independence on the part of the White House?

Question 3. On page 20 of your statement, you recommended that Congress reestablish the Cost of Living Council and empower it to appoint ad hoc review boards that could delay wage and price increases, hold hearings, make recommendations, monitor results, issue reports, "and thus bring the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power."

Are you advocating that virtually every area of the economy should be regulated except the activities of the Federal Reserve? Do you believe that General Motors and the individual consumer, which unlike the Federal Reserve are not creatures of Congress, enjoy having their economic decisions controlled any more than Federal Reserve policymakers appreciate having their discretion circumscribed?

Question 4. In response to a question from Mr. Wylie you discussed reports in recent issues of the Wall Street Journal and the American Banker that the Federal Reserve staff is preparing proposals for "drastic changes" in the Federal bank regulatory structure. Please furnish whatever details you are able to provide as to the nature of the proposed changes and the time table which you expect to follow in implementing them.

Response of Chairman Burns

Answer to question 1. The Federal Reserve Board has long supported the goal of a gradual phasing out of Regulation Q ceilings, so that the thrift institutions can compete more effectively for the savings of the consumer, and consumers can receive the full benefit of the earnings their savings can command. Its position on this issue was set forth in the Board's report to Congress on housing finance in March 1972. Before such ceilings can be removed, however, regulatory changes must be made to insure the viability of the nonbank thrift institutions in an environment of high and fluctuating interest rates. Some of the necessary regulatory changes are embodied in the Financial Institutions Act of 1973 (S. 2591), which calls for a broadening of the asset and liability powers of the thrift institutions, as well as the gradual removal of Regulation Q ceilings.

The Federal Reserve Board has urged that this legislation be enacted. In testimony before Congress, Governor Robert C. Holland stated that: ". . . the Board would favor a gradual lifting of interest ceilings, contingent on a demonstration that thrift institutions and small commercial banks can perform their functions properly with relaxed interest rate controls during periods of high interest rates."

Enactment of this legislation would permit nonbank depositary institutions to correct the present maturity imbalance between their assets and liabilities, and

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it would contribute to a more efficient allocation of the financial resources of the Nation.

Answer to question 2. The alleged incident referred to in the Fortune magazine article did not occur. The story has utterly no foundation in fact. I have so indicated in a letter to Fortune magazine. Letters attesting to the falsity of these allegations were also sent to the magazine by former Governors Andrew F. Brimmer and J. L. Robertson, Governor Robert C. Holland, and President Willis J. Winn of the Federal Reserve Bank of Cleveland, and Mr. Joseph R. Coyne of the Board's staff. I have also stated this fact in a letter to Senator Sparkman, as has the Counsel to the Chairman, Mr. Thomas J. O'Connell. Copies of all of that correspondence have already become a part of the Congressional Record (the relevant pages are attached).

[Chairman Burns response to questions 3 and 4 may be found on page 422.]

[From the Congressional Record, Aug. 20, 1974]

THE FEDERAL RESERVE

Mr. SPARKMAN. Mr. President, the July issue of Fortune magazine carries an article entitled "The Agony of the Federal Reserve," which contends that partisan politics played a part in the formulation of monetary policy during 1972. I was particularly disturbed by one segment of the article which read as follows:

"In the circumstances, the dispute between Burns and the FOMC majority became fairly tense at times. At one point, frustrated at his inability to convince the Committee of the need to hold down interest rates, Burns left a meeting in obvious anger. He returned in about an hour, announcing: 'I have just talked to the White House.'

"The effect of this declaration on the Committee must have been quite dramatic. Burns was invoking the aid of the White House in a manner rarely, if ever, employed by a Chairman of the nominally independent Federal Reserve System . . ."

In view of my knowledge of Chairman Burns, whom I hold in the highest esteem, I found this allegation incredulous and requested his reaction.

Dr. Burns has assured me that there is not one grain of truth to the assertion published by Fortune, and that the purported incident never took place.

When I learned of this matter, I forwarded a written request for a statement of the Chairman's position and I ask unanimous consent that my letter to Chairman Burns together with his response and letters from other Federal Reserve officials be printed in the RECORD.

There being no objection, the material was ordered to be printed in the RECORD. as follows:

AUGUST 14, 1974.

Hon. ARTHUR F. BURNS,
Chairman, Board of Governors, Federal Reserve System,
Washington, D.C.

DEAR MR. CHAIRMAN: An article in the July edition of Fortune magazine has been called to my attention in which the author reports that during the course of a meeting in 1972 of the Federal Open Market Committee you invoked the name of the White House in an effort to sway members of the Committee toward a particular policy.

Since I know how much you prize the independence of the Federal Reserve—as I do—I wonder if you would care to comment on the assertion made in the article.

With best wishes, I am
Sincerely,

JOHN SPARKMAN.

FEDERAL RESERVE SYSTEM,
Washington, D.C. August 19, 1974.

Hon. JOHN J. SPARKMAN,
U.S. Senate, Washington, D.C.

DEAR SENATOR SPARKMAN: I am responding to your letter of August 15 requesting my comment on the article entitled "The Agony of the Federal Reserve" which appeared in the July issue of Fortune magazine. You asked about an allegation in the article that I conveyed an appeal from the White House to sway the Federal Open Market Committee toward a particular policy.

There is not one grain of truth in that assertion. I have asked Mr. Thomas J. O'Connell, Counsel to my office, to transmit for your study relevant information and supporting documentation. These are enclosed,

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I am most appreciative of the opportunity afforded by your inquiry to set forth accurately the facts of this matter.

Sincerely yours,

ARTHUR F. BURNS.

FEDERAL RESERVE SYSTEM,
Washington, D.C., August 19, 1974.

Hon. JOHN J. SPARKMAN,
U.S. Senate, Washington, D.C.

DEAR SENATOR SPARKMAN: Chairman Burns has asked that I reply to your letter of August 14 in which you have noted the article entitled "The Agony of the Federal Reserve" that appeared in the July issue of Fortune Magazine. You have inquired concerning a statement contained in that article that, during the course of a Federal Open Market Committee meeting in 1972, Chairman Burns, in an effort to sway associate members of the Committee to a position of easier monetary policy, directly invoked the aid of, and specifically asserted a conversation with, the White House.

As reflected in the enclosures to this letter, Chairman Burns and other Committee members and staff officials in a position to express first-hand knowledge as to the asserted occurrence, advised the author of the article and editorial and publication officials of Fortune Magazine that there was not one grain of truth in the alleged White House pressure incident. On the basis of extremely careful inquiry of Committee members and officials in attendance at meetings throughout the year 1972, which efforts are carefully chronicled in the enclosed copies of correspondence, the aforementioned advice as to erroneous reporting was made known to Fortune Magazine. The Chairman's denial of the truth of the proposed report, as well as certain supporting denials, was conveyed to Fortune Magazine prior to publication in an effort to correct apparent misinformation or misreporting.

In the belief that the enclosures, fully read both in relation to the article and the refutations thereto effectively sets straight the record in this matter, Chairman Burns has asked that I transmit the same to you in response to your inquiry.

Sincerely yours,

THOMAS J. O'CONNELL,
Counsel to the Chairman.

FEDERAL RESERVE SYSTEM,
Washington, D.C. July 8, 1974.

Mr. HEDLEY DONOVAN,
Editor-in-Chief, Fortune, Time and Life Building, Rockefeller Center, New York, N.Y.

DEAR MR. DONOVAN: In the July issue of *Fortune*, page 188, Mr. Sanford Rose purports to describe certain events during a meeting of the Federal Open Market Committee. There is not one grain of truth in his report.

Sincerely yours,

ARTHUR F. BURNS.

FEDERAL RESERVE SYSTEM,
Washington, D.C., July 10, 1974.

Mr. HEDLEY DONOVAN,
Editor-in-Chief, Fortune Magazine, Time Life Building, Rockefeller Center, New York, N.Y.

DEAR SIR: I am writing to you with respect to the article entitled "The Agony of the Federal Reserve" by Mr. Sanford Rose in Fortune's July issue.

I want to object strongly to the author's assertion that partisan political considerations have influenced the determination of monetary policy—particularly during the presidential election year of 1972. I find especially objectionable the assertion that on one specific occasion the Chairman of the Federal Open Market Committee, Arthur F. Burns, used an appeal from the White House as a means of pressuring the Committee to permit a greater expansion in money and credit than the Committee itself thought wise.

It may be recalled that, in 1972, an economic recovery was under way, but the economy was still producing well below its potential (as indicated by an unemployment rate that averaged 5.8 per cent during the first half of the year). Prices were rising quite moderately, although this partly reflected the system of

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wage and price controls then in effect. Given the overall objectives of national stabilization policy at that time—which were to check the pace of inflation while reducing the level of unemployment—the Federal Reserve directed monetary policy so as to enhance the prospect of achieving those goals.

The part of the article to which I take specific exception is under the legend "the stimulus of politics." This section not only contains a number of serious errors, but it also impugns the integrity of the System's decision-making process. The author alleges generally that during 1972 the monetary policy of the Federal Reserve System was influenced by politics. He asserts specifically that, during one FOMC meeting, Chairman Burns:

". . . frustrated at his inability to convince the committee of the need to hold down interest rates . . . left . . . in obvious anger (and) returned in about an hour, announcing: 'I have just talked to the White House'."

And the article continues:

". . . the committee got the idea: the White House was determined to try to keep rates from rising."

In the next paragraph, Mr. Rose states that "many" of those present "could" have interpreted Chairman Burns (alleged) statement as an implied threat that unless the Federal Open Market Committee "acquiesced" it "might easily" have resulted in efforts to limit the Federal Reserve's independence. As a consequence, the author states, the FOMC was persuaded to continue providing monetary stimulus to the economy throughout 1972.

These assertions are false—both in general and in particular. When the article was in preparation, the author spoke to me by telephone seeking confirmation of the reported event. I told him at the time that no such episode took place. I stated that during my more than eight years as a member of the FOMC (and I have missed only one meeting in all of those years—namely, in September, 1973), there was never an occasion on which the Chairman urged the Committee to adopt a particular monetary policy because "the White House" preferred a specific course of action.

However, to reassure myself that I was justified in denying the validity of the report of such an event, I consulted the detailed minutes of discussion and actions prepared by the staff for each of the 1972 FOMC meetings, and I asked the staff to make a thorough review of those minutes. I also reviewed my own notes taken at these meetings. Furthermore, I discussed the matter with my colleagues on the Federal Reserve Board and with a number of Federal Reserve Bank Presidents who also attend FOMC meetings. These inquiries produced absolutely no evidence to indicate that there was an episode like the one described. This fact was reported to the author during at least two telephone conversations while the article was in preparation. I also know that several other persons who served on the Committee in 1972 independently told the author that the episode did not occur. Yet, the author persisted in his claim—although he cites no individual to support it who is willing to speak for attribution.

As far as I am concerned, this matter extends beyond the role of the Chairman of the FOMC—who, as I have stressed, never urged the Committee to moderate the rise in interest rates because the White House sought such a goal. The individual members of the Committee would not allow themselves to be "persuaded" to yield to the White House or to anyone else their statutory authority to determine the nature and objectives of open market operations as one instrument of monetary policy. By suggesting otherwise, the author has stained the integrity of the FOMC, and he has done so without presenting any evidence to substantiate his insinuating assertion.

In my recent letter to the President announcing my intention to resign from the Board to resume my academic career at the end of this summer, I said:

"During my years on the Board, there has been almost a complete change in membership, but the spirit of nonpartisan cooperation and commitment to the furtherance of the nation's interest on the part of the Members has not changed at all."

I could have made the same statement with respect to the FOMC. Those words would never have been written had there been any incident such as the article alleged.

In concluding this letter, let me say also that I was not only surprised but also disappointed to see that the author missed an excellent opportunity to help broaden public understanding of the objectives and operating techniques of the Federal Reserve System. Instead, he has presented to Fortune's readers a one-sided picture of monetary policy in the last few years. In essence, in carrying

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out monetary policy, the ultimate objective of the Federal Reserve is to encourage a strong, noninflationary economy. In pursuit of this goal, the complexity of the economy makes it impossible to concentrate on a single financial variable. Thus, despite the persistent urgings of monetarists, the Federal Reserve does not base its policy solely on the control of the money supply or other monetary aggregates. Rather, it also gives considerable weight to elements such as interest rates, liquidity, and credit conditions broadly conceived.

I hope Fortune magazine will publish this letter in its August issue as a corrective to what would otherwise stand as a stain on one of the nation's principal organs responsible for the conduct of monetary and credit policy.

Sincerely yours,

ANDREW F. BRIMMER.

JULY 19, 1974.

Mr. HEDLEY DONOVAN,
Editor-in-Chief Fortune, Time and Life Building, Rockefeller Center, New York, N.Y.

DEAR MR. DONOVAN: As a member of the Federal Open Market Committee, I was more than a bit surprised at the insinuation in the Sanford Rose article (July, 1974) that I acted as a puppet for the White House. I attended all the meetings of the Committee in 1972 and 1973 and, therefore, find the account disturbing because of its inaccuracy. The events described by Mr. Rose simply did not occur!

I grow more humble as I attempt to struggle with cascading economic problems, and criticism of System actions is always welcome in our efforts to find appropriate answers for these questions. I have made mistakes in judgment in the past and undoubtedly will continue to do so in the future. However, to be faced with insinuations of a complete lack of integrity, not only by the author but by your editorial board, shocks me, as I know the event described never occurred, or that the members of the Committee, including the Chairman, would be a party to such behavior. This strikes me as a most un-Fortune-ate article. The article and the related editorial comment does both Fortune and its readers a disservice.

Sincerely,

WILLIS J. WINN.

FEDERAL RESERVE SYSTEM,
Washington, D.C. July 22, 1974.

Mr. HEDLEY DONOVAN,
Editor-In-Chief, Fortune Magazine, Time Life Building, Rockefeller Center, New York, N.Y.

DEAR MR. DONOVAN: In the article on the Federal Reserve in the July issue of *Fortune*, there is described on page 188 a purported incident at a 1972 meeting of the Federal Open Market Committee, involving a contact with the White House and the successful urging of White House views upon the Committee. That incident did not take place, and I deeply regret the fact that *Fortune* editors gave any credibility to such a story.

I was Secretary of the Federal Open Market Committee during the year 1972, and responsible for an accurate rendition of what took place at its meetings. In that capacity, I have personally spoken with every individual who was a member of the Federal Open Market Committee during 1972. Not one of them has any knowledge of such an incident.

I report this to you in the expectation that *Fortune* will wish to set its record straight.

Yours sincerely,

ROBERT C. HOLLAND.

BIERBOWER & ROCKEFELLER,
Washington, D.C., July 29, 1974.

EDITOR IN CHIEF,
Fortune Magazine, Time Life Building, Rockefeller Center, New York, N.Y.

DEAR SIR: In the July 1974 issue of *Fortune* there is a provocative article on the Federal Reserve by Mr. Sanford Rose. It contains what I believe to be a serious falsehood (which he apparently failed to check out carefully before using), which reflects on the integrity of members of the Open Market Committee—a low blow which I resent. I refer to the following comment:

"In the circumstances, the dispute between Burns and the FOMC majority

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became fairly tense at times. At one point, frustrated at his inability to convince the committee of the need to hold down interest rates, Burns left a meeting in obvious anger. He returned in about an hour, announcing: 'I have just talked to the White House.'

"The effect of this declaration on the committee must have been quite dramatic. Burns was invoking the aid of the White House in a manner rarely, if ever, employed by a Chairman of the nominally independent Federal Reserve System. It was undoubtedly a difficult moment for Burns, a man accustomed to swaying colleagues by the logic of his arguments. But the committee got the idea: the White House was determined to try to keep rates from rising.

"Many of those who heard Burns' words could have interpreted them as an implied threat. That is, either the committee acquiesced or it risked the White House's maximum displeasure. And White House displeasure might easily have meant Republican backing for persistent southern Democratic efforts to limit the Federal Reserve independence. In any case, Burns eventually succeeded in persuading the FOMC to continue providing that stimulus throughout 1972. But the effort seems to have hurt him personally, and there are signs that his influence over the committee was weakened for some time." *Fortune*, pp. 186, 188,

Obviously, one should not undermine public confidence in the Federal Reserve by impugning the integrity of the members of the OMC—suggesting that they would vote in accordance with White House wishes rather than their own consciences—unless he had made every possible effort to verify what he believed to be facts by going to the best sources available (in this instance the members of the Open Market Committee).

I am certain that no such incident ever occurred. I attended every meeting of the Open Market Committee in 1972 except for one in May. At the May meeting the committee voted unanimously for a policy directive supporting a slower growth in money supply, and so this obviously could not have been the meeting at which the alleged incident described by Mr. Rose occurred.

Certainly no such incident occurred at any meeting I attended. Since I occupied a seat next to Chairman Burns I could not have missed hearing such a remark. Since I was a strong defender of the independence of the Federal Reserve in the 21 years I served on the Board, I can assure you that had any such pressure been applied I personally would have reacted strongly against it. I think that this would have been true of other members of the Open Market Committee. The use of such pressure at any time, by any chairman, would have produced results quite the reverse of the impact alleged by Mr. Rose. The opposition would not have melted; it would have solidified.

The fact is that I believed that the Federal Reserve policies in the fall of 1972 were not sufficiently restrictive. It is a matter of public record that I and one other member of the Open Market Committee did not support the policy directive approved at the September meeting for that reason. I believe that subsequent events have shown that we were correct.

But Mr. Rose is wrong and grossly unfair in suggesting that the majority of the members of the Open Market Committee were politically motivated in voting for the more relaxed policies that were followed. He bases this false conclusion on someone's fabrication of an incident that never occurred and on the assumption that political motivation is the only possible explanation for anyone failing to support a more restrictive monetary policy in 1972.

What Mr. Rose should have done was to report on the advice others were giving during this period. Was it obvious to everyone except the members of the Open Market Committee that money had to be tightened by slowing down the growth of the money supply?

The answer is no. There were plenty of economists, including those who were supporting the Democratic candidate in 1972, who did not want to see the Federal Reserve tighten the monetary screws in 1972. The unemployment rate had risen from an average of 3.5 per cent in 1969 to 5.9 per cent or over until October. I think it is safe to say that most economists at that time were still thinking in terms of policies that would get the unemployment rate down to what was then considered a more acceptable level. Many thought of this as around 4 per cent. This was the view, for example, of a former chairman of the Council of Economic Advisers in a Democratic administration. This prominent economist thought then that a 4 per cent unemployment target was reasonable and that we should be willing to risk some inflation in order to achieve it. Most economists wanted to see the economy sustain a high rate of growth. In the spring of 1972 one of the best known economists in the nation (not a

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Nixon partisan) advised that the Federal Reserve should pursue a liberal monetary policy even though we might be criticized for permitting what might appear to be an excessively rapid rate of growth of money supply. The main thing in his view was achieving a high rate of growth of GNP. He thought we should not worry about money supply until we attained a satisfactory GNP growth rate.

Even as late as December 1972, this same outstanding economist was saying that a 5.5 per cent rate of unemployment was not acceptable to most people and that we would probably have to live with substantially higher rates of inflation than we had been accustomed to in the past in order to get unemployment down.

It is not my purpose to try to rationalize what hindsight shows was an error in policy. I merely want to make it clear that the members of the Open Market Committee who were reluctant in 1972 to take action that they thought would slow economic growth and keep unemployment levels high were in very good company. That company included supporters of both presidential candidates.

Mr. Rose has oversimplified the problem and falsified the record to make the case that the decisions of the Open Market Committee were motivated by politics.

Fortune owes its readers a correction of the misinformation supplied by Mr. Rose. It also owes the honorable men who serve on the Open Market Committee an apology.

Sincerely yours,

J. L. ROBERTSON.

FEDERAL RESERVE SYSTEM,
Washington, D.C., July 19, 1974.

Mr. HEDLEY DONOVAN,
Editor-in-Chief, Time, Inc., Time & Life Building, Rockefeller Center, New York, N.Y.

DEAR MR. DONOVAN: I am writing with reference to your July 15 letter to Chairman Arthur F. Burns in which you outlined plans by *Fortune* to publish letters from Chairman Burns and Governor Andrew F. Brimmer concerning allegations made in an article—"The Agony of the Federal Reserve"—published in the July issue of the magazine.

Your letter also states that you can add nothing of your own knowledge to the incident except to say "that Mr. Rose is a very experienced and thoughtful journalist and . . . I know he approached this assignment in a thoroughly conscientious way."

Drawing upon my own 14 years experience as a journalist, most of it in Washington, I must say that Mr. Rose's article as printed violates the basic tenets of professional journalism. I refer specifically to his assertion that on one occasion Chairman Burns used an appeal from the White House to pressure the Federal Open Market Committee into expanding money and credit to an extent that the Committee as a whole thought inappropriate.

First of all, I can assure you, as a Federal Reserve official who attends Federal Open Market Committee meetings, that no such incident took place.

Nevertheless—and despite the fact that he had been authoritatively informed to the contrary—Mr. Rose's article asserts that it did take place. *Fortune* magazine permitted this assertion to appear in its columns as a bald assertion, and totally without support from any source, named or unnamed.

It is this fact—that the assertion on page 188 of your July issue was repeatedly and flatly denied by those present, but that these denials were nowhere mentioned—that destroys any claim to professionalism in Mr. Rose's article. This is irresponsible writing.

Let me be specific. I informed Mr. Rose that this assertion was totally false. Governor Brimmer also so informed him. Finally, Chairman Burns did so. All of us spoke—weeks before the article appeared—for attribution. Yet *Fortune* permitted a highly damaging statement, as to which it had multiple on-the-record denials, to be printed without attribution or support. Far from being thoughtful and conscientious, this is thoughtless and irresponsible behavior. During the course of my conversation with Mr. Rose, long before publication, I suggested that he recheck the sources he contended told him of this incident. Mr. Rose refused to do this. He also refused to accept my suggestion that he telephone other members of the Federal Open Market Committee and its staff and put the same question to them. Refusal to check and recheck sources, when there is time and opportunity to do so, suggests to any professional journalist that no source exists or that there is no source that would stand up under such rechecking. The

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allegation made by *Fortune* was certainly serious enough to warrant a complete survey of the Committee members and its staff. Yet Mr. Rose failed to do so.

All this shocks the sensibilities of responsible journalism. I think *Fortune* owes it to its readers, to the Federal Open Market Committee and especially to Chairman Burns to print a public apology of this unsubstantiated and invidious allegation.

Very truly yours,

JOSEPH R. COYNE,
Assistant to the Board.

Answer to question 3. I do not advocate that virtually every area of the economy be regulated. My prepared testimony is abundantly clear on that point. The relevant paragraphs read as follows:

"There are other actions that may be of some help in speeding the return to general price stability. For example, limited intervention in wage and price developments in pace-setting industries may result in considerable improvement of wage and price performance.

"I would urge the Congress to reestablish the Cost of Living Council and to empower it, as the need arises, to appoint *ad hoc* review boards that could delay wage and price increases in key industries, hold hearings, and thus bring the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power."

What I do advocate is a program of intervention in a limited number of key industries and reliance upon voluntary cooperation rather than compulsion. Such a program would I believe be helpful.

Answer to question 4. The Board is concerned over the present state of bank regulation in the United States, and will submit to the Congress proposals designed to make the regulatory process more effective, including proposals for a restructuring of the system of regulation. It is not possible at this time to provide details, because staff work is still underway.

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[The papers submitted for the record by David P. Eastburn, President, Federal Reserve Bank of Philadelphia, from the "Business Review" of the Philadelphia Federal Reserve Bank: "Federal Reserve Policy and Social Priorities", dated November 1970; "Should Housing Be Sheltered from Tight Credit", November 1970; "Can Credit Controls Be Controlled", January 1972; "Interest Ban on Demand Deposits: Victim of the Profit Motive?", August 1972; and "Federal Regulation of Stock Market Credit: A Need for Reconsideration", July–August 1974; and the summary report, "Ways to Moderate Fluctuations in the Construction of Housing", reprinted from the March 1972 Federal Reserve Bulletin, referred to on page 309, follow:]

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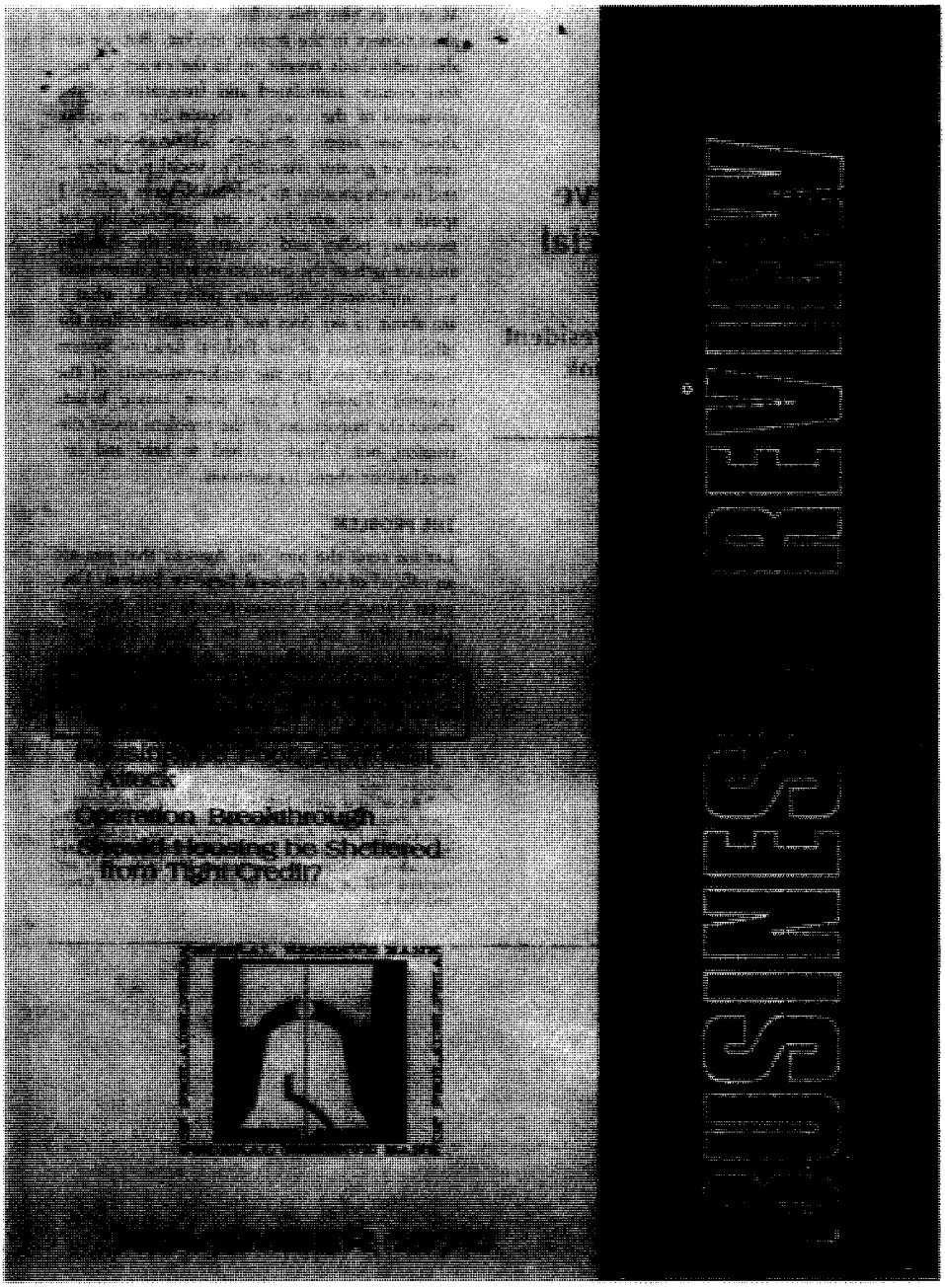

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Federal Reserve Policy and Social Priorities*

by David P. Eastburn, President
Federal Reserve Bank
of Philadelphia

Most of us here this evening are students of or practitioners in the money market. But we are also individuals caught up in the sweep of current events; stimulated and frustrated by the pressures of the times. I should like to speak about one aspect of these pressures—the demand for greater attention to social priorities—and its relationship to Federal Reserve policy. I speak as one who has some responsibility for monetary policy and concern for the viability and strength of the institution which determines and implements monetary policy. But what I am about to say does not necessarily reflect the official position of the Federal Reserve System—and this may be the understatement of the evening. Finally, I have some strong beliefs about the importance of the problem under discussion, but I have reached no hard and fast conclusions about its solution.

THE PROBLEM

Let me state the problem. Assume that you are an official of the Federal Reserve System. Congress (your boss) comes to you with the complaint that what you are doing when you attempt to curb inflation is to hurt certain people whom Congress thinks should not be hurt. How do you react?

I should like to analyze four possibilities:

(1) Hope the problem will go away;

* An address given before The Money Marketeers of New York University, Bankers Club, New York City, October 8, 1970. An earlier version was presented to the 1970 Conference of University Professors at Lake Arrowhead, California, September 11, 1970. This article also will be published in *Journal of Money, Credit and Banking*.

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(2) Reply that it is not your fault;
(3) Recommend direct action by the Federal Government;
(4) Explore possibilities for modifying instruments of Federal Reserve policy.

THE HOPE-IT-WILL-GO-AWAY STRATEGY

I believe it would be irresponsible and short-sighted for a Federal Reserve official to think that the problem will go away. I say this not only because of my view of the responsibilities which such an official has but also because of my appraisal of the future.

A continuing responsibility of any Federal Reserve official is to see to it that the central bank does what it can to meet society's needs. As these needs change, the central bank must change.

I believe it is time for a reappraisal of the relationship between Federal Reserve tradition and the changing desires of society. The traditional posture of the Fed is to be concerned with the overall quantity and flow of money and credit. Society is increasingly concerned with the direction of the flow.

I am not competent to unravel all the forces behind these changing desires on the part of the public, but I think I can detect at least some of the surface manifestations. One is that the public's standards of performance for the economy and for policymakers have been rising, probably at an accelerating rate.

Another is that greater attention is being paid to subparts of the economy. Just as we have changed the focus of policy from catastrophic depressions to mini-recessions—that is, with regard to *magnitude* of economic fluctuations—we have placed under increasingly close scrutiny movements of various sectors of the economy.

A third is that the very success of the economy in generating affluence has afforded us the luxury of paying more attention to distribution. Concerns have turned increasingly to the question of how various groups fare in our economy, and I detect no reason for this trend to change in the foreseeable future.

Indeed, as I look forward to the 70's, I see pressures mounting. Society—particularly as today's youth move into positions of responsibility—will be even more insistent that the economy perform in a way that meets high standards of overall performance and accommodates sectoral and distributional needs.

In short, the problem will not go away.

THE IT-IS-NOT-OUR-FAULT STRATEGY

As we examine this possible response, we should be aware that there is much more involved than economics. Whatever the causes, recent periods of monetary restraint have been characterized by difficulties on the part of housing and state and local governments in obtaining funds. These are precisely the sectors containing highest social priorities and in which political nerve ends are close to the surface.

The general public and many legislators, probably more sensitive to political and social considerations than economic, are inclined to see tight money as the villain in the piece. Since it is tight money that frustrates the achievement of social objectives, the proposed solution is either to have easy money (usually put in terms of low interest rates) or to devise different instruments of policy.

The first proposal is simple for a Federal Reserve official to respond to. Whatever his inclinations, monetarist or fiscalist or something in between, he would not give up the use of monetary policy completely because of sectoral problems. Indeed, he would emphasize that

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greater success in using monetary tools for stabilizing the overall economy would reduce the magnitude and frequency of sectoral problems.

The second is more difficult for him. Rather than rushing off to devise new instruments of policy, he might argue that part of the difficulties experienced by certain sectors during periods of restraint is caused by imperfections of markets. He might urge politicians concerned about the uneven impact of tight money to direct their efforts toward freeing up markets. If markets were more open and competitive, funds might be more likely to flow to their "best" use.

But this kind of response often does not consider what must be done to make freer markets possible. Ceilings on interest rates must be modified so that borrowers and lenders can be more flexible in rates they pay for funds and rates they charge for the use of funds. Entry into markets must be made easier for various kinds of institutions. Restrictions which hamper economies of scale must be eased. Taxes must be adjusted to be more equitable among institutions.

I find it hard to be optimistic. Efforts to free up markets should be persistent, but progress will be slow.

I conclude, therefore, that there is a good deal of truth in the position that the uneven impact of monetary policy is not the Fed's fault. But it requires a good deal of economic sophistication to understand that. Possibilities of removing many of the imperfections in the market seem remote. And even if markets somehow were to be made perfect, the allocation of funds and resources might well not conform to social priorities.

In short, the it-is-not-our-fault strategy has a lot of economic validity behind it, but lacks something as a constructive response to this pressing problem.

THE LET-GOVERNMENT-DO-IT STRATEGY

Because the problem will not go away and because it is not enough simply to say that the uneven impact of monetary policy is not the Fed's fault, some Federal Reserve officials would advocate direct use of powers of the Federal Government.

This approach has a number of advantages claimed for it. It would adhere to the traditional view of the Fed's responsibilities; and as recent experience indicates, the Federal Reserve has its hands full in effectively carrying out these overall duties. Also, by avoiding the appearance of involving the Fed in the matter of social priorities, it would avoid embroiling the central bank in some political hassles and help to maintain its traditional position of "independence." As I shall point out in my conclusion, I am not sure these arguments are as black and white as they may seem, but for the moment let's accept them at face value.

What proponents of this position have not done very thoroughly, however, is to explore the implications of turning the job over to the Federal Government. Considerable thought needs to be given to criteria that should govern this approach.[1] One, obviously, is that it should work. An expenditure for a given purpose, for example, would channel resources more directly than would credit controls. The efficacy of other Governmental approaches would have to be examined. One possible shortcoming of Governmental action is cumbersomeness of decision-

[1] I do not mean to suggest, however, that similar criteria should not be applied to other approaches, including credit controls. As noted in the next section, application of the same criteria examined here raises similar questions about the efficacy of credit controls as for Governmental action.

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making. Consider, for example, the recent difficulties of Congress in redistributing the tax burden.

A second criterion probably should be to minimize Government participation in markets. Some schemes would meet this criterion better than others. For example, those that would offer incentives to the private sector to allocate resources in accordance with social priorities would seem to be preferable to outright Government participation. The danger is that the Federal Government could end up dominating large parts of credit markets and the economy. During the recent period of monetary restraint, for example, a substantial proportion of new mortgage funds was supplied by the Federal Government. If one visualizes Government action as a built-in stabilizer coming into play only during relatively short and rare periods of monetary restraint and then unwinding as money eases, there is no particular cause for concern. But if one foresees a sustained period of pressure on resources, say, for the 70's, considerable care should be exercised in turning the problem of credit and resource allocation over to Government.

Direct Governmental action may, however, turn out to be the best solution. All I mean to say is that even a superficial consideration of pros and cons suggests that the case is not so clear-cut as some apparently assume.

THE NEW-INSTRUMENTS-OF-CREDIT-CONTROL STRATEGY

A fourth response to Congressional pressures would be to explore possible instruments of credit control. Despite its tradition, the Fed has had considerable experience in directing credit flows.[2] The main lesson it has drawn from this experience is that the task is distasteful and results have not been outstandingly successful. Unfortunately, however, the Fed has not tried by means of systematic analysis to formulate a body of theory from this experience.

Careful examination of the past might indicate, for example, the significance of the fact that attempts to deal with sectoral problems almost invariably have occurred in periods of economic and financial stress in which orthodox approaches appear inadequate. Again, if the need for such action were rare and brief, it might not be too serious to meet acute problems in the future by *ad hoc* efforts; but if the demand for sectoral control is to be more or less chronic, an approach based on sound theory is necessary.

This theory would help to tell us whether control of the flow of credit actually would significantly influence the direction of flow of resources. What we do know raises questions. Experience with real bills, for example, has convinced most economists that the central bank can have little effect on the flow of credit and resources by defining the eligibility of discountable paper.

In the realm of open market operations, the Fed recently resisted suggestions that it buy agency issues in order to funnel funds into housing. One of the reasons for its reluctance was that after a complex of adjustments were made, significantly more resources would not, in fact, go into housing.

So far as Regulation Q is concerned, no one can say precisely what would have happened in the absence of the ceilings that have prevailed. The fact that the Fed has issued a series of loophole-plugging regulations suggests, however, that the ceilings have not been very suc-

[2] For example, real bills, "direct action" in the late 1920's, margin requirements, moral suasion, Regulations W and X, "Operation Twist," the September 1, 1966 letter from the Federal Reserve to member banks, and Regulation Q.

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cessful in directing the ultimate flow of funds and resources. This experience suggests an important lesson: restrictive controls like Regulation Q merely place an obstruction in the path of someone's objective without greatly changing his desire to get there. In a market economy, men are ingenious enough to find many new paths around an obstruction. As a consequence, the authorities must pile one obstruction on top of the other to try to close off each new path.

One proposal which has been receiving some attention recently is to impose different reserve requirements on different kinds of assets. Suppose, for example, it were desired to increase investment in housing relative to investment in plant and equipment. The Fed could set a high reserve requirement on business loans and a low requirement on mortgages. At existing interest rates, this would tend to increase the return on mortgages relative to the return on business loans. Then the very market forces which tend to frustrate restrictive kinds of controls, like Regulation Q, would work to induce banks to switch some assets out of business loans and into mortgages.

The difficulty, of course, is trying to figure out what would happen next. If this portfolio shift by banks resulted in a corresponding shift in real resources, the desired objective would be achieved. But, as you know, it is by no means clear that this second shift would occur.

Some economists at our Bank have been doing preliminary work to try to determine what the likely results of differential asset reserve requirements would be. So far they have been working entirely at the theoretical level, developing and manipulating a small-scale general equilibrium model.[3]

[3] D. C. Rao and Ira Kaminow, "Asset Reserves and the Real Investment Mix: A General Equilibrium Approach," Federal Reserve Bank of Philadelphia, unpublished manuscript.

So far the results are inconclusive but not very encouraging. They do show that chances of success would be greater if reserve requirements were placed on all intermediaries and not just banks; if business firms were denied the alternative of raising funds directly in credit markets; and if households were allowed to use mortgages only to finance houses. But even with all these conditions, it is difficult to rule out the possibility that the scheme would not work. Our staff is continuing to work with the model, and later results may suggest a more hopeful outlook for reserve requirements on assets. We expect also to evaluate and test other possibilities for influencing the flow of funds.

CONCLUSIONS

Let me review where we have come so far.

First, my observation of developing trends tells me that society will be demanding that more control be exercised over the allocation of resources. The problem will not go away. This outlook raises important questions for the Federal Reserve, which has traditionally disavowed responsibility for allocating credit and, hence, resources.

Second, although there is much economic validity to the position that the uneven impact of monetary policy is not solely the Federal Reserve's fault, much of the public and many legislators probably believe otherwise. They feel that these impacts do not conform with social priorities. And although the allocation of funds is considerably influenced by market imperfections, I am pessimistic about the degree of success we can expect in removing them. Even if imperfections were completely removed, allocation might well not accord with social priorities.

Third, one possible way of directing funds and resources in accordance with social priorities is through Governmental action rather than by

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credit control. This approach has several advantages, especially that of determining priorities by elected representatives rather than by the central bank. But more careful examination may raise questions about how effectively and efficiently the Government can direct resources. Moreover, depending on how it is done, there is a possible disadvantage over time of Federal domination of considerable parts of credit markets and the real economy.

Fourth, the Federal Reserve's past experience in directing flows has not been analyzed systematically, and there is no adequate theory on which to base policy. Results are generally believed to have been less than completely successful, however, and the present state of the art is rudimentary.

Given this train of thought, what do I conclude about whether the Federal Reserve should change its traditional focus of policy to include more attention to the direction of credit flows?

I should like to think that such a step might not be *necessary*. More success than we had in recent years in our overall stabilization functions could minimize severe distortions in resource allocation caused by inflation and recession.

On the other hand, I should like to think that if the need were to become great enough, such a step would be *possible*. This is, first, a matter of philosophy. Few people, myself included, relish the idea of Federal Reserve involvement in the allocation of resources. The task would be difficult and thankless. It would get uncomfortably close to issues where political interests are strong. And it would raise questions about the propriety of the involvement of an organization traditionally aloof from partisan politics and "independent."

These are all formidable objections. As you may gather, however, I am less ready to dismiss a philosophy of involvement than are some others. The Federal Reserve is already influencing the allocation of resources in carrying out its overall functions. Moreover, it does not need to *set* priorities in order to help *achieve* them. Congress exercises considerable surveillance over the Federal Reserve in its attempts to meet its overall objectives. The Fed could function in a similar way with respect to Congressionally determined objectives for the allocation of resources.

As for Federal Reserve "independence," I believe the Federal Reserve can continue as a viable institution in the long run only if it is responsive to changing public demands. If the Fed is insensitive to the allocation of resources, I wonder whether it can continue as an effective, "independent" central bank with sufficient political and popular support to be able to carry out its traditional stabilization functions.

In short, I believe a good case might be made —philosophically—for involvement. My main difficulty, however, comes with the practical question of our ability to do the job. Much work needs to be done in analyzing past experience and applying sophisticated techniques of analysis to the problem. Existing controls should be analyzed; specifically, immediate attention should be devoted to revamping or dismantling Regulation Q. Alternative methods of allocating resources should be compared.

So the position I would recommend the Federal Reserve take on the question of allocating funds would go something like this: Our main job has to do with growth and stability of the overall economy, and greater success in doing this job will help to reduce problems in particular sectors of the economy. Nevertheless, we can not ignore the effects of our actions on sectors of the economy. Although the fact that certain groups are hurt when money is tight is

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not entirely our fault (and, of course, *someone* must be restricted if a restrictive monetary policy is to be effective), we recognize that this may not be a very constructive position. Everything possible should be done to make markets more competitive, but we realize that this is difficult and that even in perfectly competitive markets, funds and resources might well not be allocated in accordance with social priorities. We do not know as much as we would like about how effective credit controls may be in directing resources, but past experience does not seem outstandingly successful. Direct Governmental action to allocate resources seems preferable in a number of ways to credit controls, but there are also disadvantages in this approach which should be weighed. Although we are not anxious to get into the permanent business of directing credit flows, and although this would be a departure from our tradition, we recognize that this might be considered a legitimate function of the Federal Reserve so long as priorities are determined by elected representatives rather than by the central bank. Therefore, we hope to explore possibilities sufficiently to be able to evaluate alternatives and to offer positive recommendations. These probably will call for action on several fronts and by several groups—Government, the Fed, and private industry—if the problem is to be solved.

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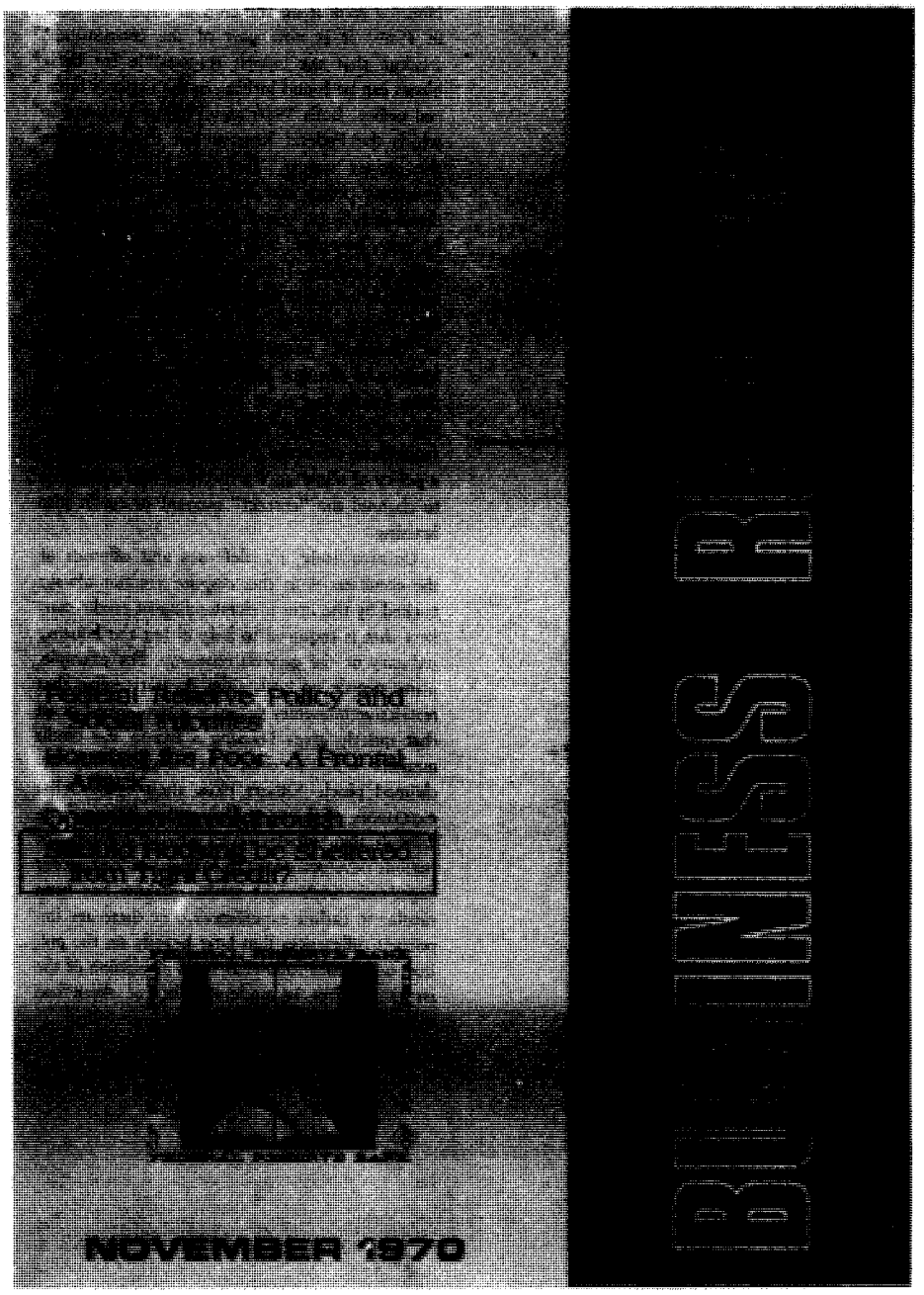

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Should Housing Be Sheltered From Tight Credit?

by Ira Kaminow

Housing took it on the chin in 1966 and again in 1969. It is now part of the conventional wisdom that the culprit responsible for these blows can be found lurking in the nation's financial policy. Both 1966 and 1969 were years in which the Federal Reserve put the screws on the money supply. The view that restrictive monetary policy and tight credit markets bear down heavily on housing is not new. What may be new, however, is a rising national commitment to housing. In many quarters this commitment has led to increased concern over housing's fate during periods of tight credit. The cries to "insulate" housing from the more severe impacts of changes in financial markets seem to grow louder and more frequent. But the noisier the cries get, the more they elicit responses from those who would follow a hands-off policy, a policy of allowing the forces of free enterprise to channel the "correct" amount of credit into housing.

Unfortunately, the defenses and offenses of the combatants in this dispute are not always backed by the firm understanding of credit markets that is required to help either the housing industry or the general economy. For example, many people on both sides do not realize that restrictive monetary policy is a two-armed beast that quietly gives housing a lift in the credit markets some months after each noisily acclaimed pinch. Others close their eyes to the experience of the past. This makes it even more difficult than otherwise to see the meaning of current developments. In many ways our recent experience with tight credit markets has been similar to earlier experiences. But there are important differences that bear heavily on the policies we should follow. A vaild discussion of the issues requires an understanding of these and other relevant points.

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CREDIT MARKETS AND HOUSING: THE LOGICAL LINKS

Who Gets Squeezed When Credit Gets Tight? When credit markets tighten (when the supply of credit falls or demand expands), some sectors will have to tighten their belts more than others.[1] If the firms in an expanding industry want more credit, for example, they will try to bid funds away from current borrowers. If monetary policy causes the supply of credit to shrink, there will be a scramble over the smaller credit pie. Borrowers in some sectors will be more successful than others in holding on to their slice. The question is not whether tight credit markets will affect some sectors more than others, but which ones will suffer the greatest impacts.

Common sense tells us that the least persistent demanders of credit will be the first to fall by the wayside. As demand begins to exceed the supply of credit, the upward movement of interest rates will squeeze the less "serious" credit demanders out, and the limited funds will flow only to groups that "hang on" in the face of rising interest rates.

Of course, demand is only one side of the story. Even very persistent demanders can get cut out of a tight credit market if they rank low on lenders' preferences. Credit suppliers see some borrowers as marginal customers to be accommodated only after more desirable investment opportunities have been exhausted. When credit tightens, these borrowers will be the first ones dropped unless they offer bigger increases in interest rates than other customers. When credit markets tighten up, the demand of these borrowers must be particularly immune to rising interest rates if they are to hold their own.

The Squeeze on Housing. Housing experts have looked into this supply and demand framework to see where housing could be expected to wind up in times of tight credit. Using logic and their knowledge of the credit markets, many have speculated that housing would get a larger share of the nation's credit when financial markets were easy and a smaller share when financial markets tightened. The arguments in support of this speculation often get fairly complicated. Most of them, however, involve two or three basic points. First, there is some evidence that the demand for mortgages is sensitive to changes in interest rates. This is not surprising, since interest costs represent a large percentage of the costs of housing, so that borrowers are very responsive to relatively small changes in interest rates. On a $20,000, 30-year mortgage, a difference of one percentage point means $5,000 more over the life of a mortgage. Second, mortgage borrowers are sometimes restricted from offering rates as high as they would like. Both state usury laws and FHA-VA interest rate limits are occasionally below market rates.

On the supply side, many analysts believe that bankers would rather cut back on loans to households than loans to businesses when the going gets tough. This belief rests on the assumption that bankers would rather maintain the more complete, ongoing banking relation with a corporation than start a new limited one with an individual. In addition to the banks' lending services, corporations maintain check-

[1] We are discussing here why some sectors find that their share of the nation's credit falls when financial markets tighten. The other side of this coin is the equivalent question, why do these sectors find that their share of credit rises when financial markets ease? Our discussion is limited to the tight credit side of the coin because this seems to be the cause of most of the concern from the point of view of the housing issue. The reasons that explain one side of the coin explain the other.
We will return to this point in the conclusion.

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ing accounts, use international credit services, and so on.

To some extent, savings and loan associations were designed to help even out the fluctuations in the supply of mortgages. Savings and loan associations are severely restricted in the kinds of loans they are permitted to make, and most of their loans must be mortgage loans. This means that they will not be shifting in and out of the mortgage market as much as other kinds of lenders. Unfortunately, there is a potential drawback to the plan that grows out of its strength. By limiting the kinds of loans that savings and loan associations can make, their fortunes are tied to these loans. If, as we suggested earlier, mortgage borrowers are easily driven off by rising interest rates, mortgage rates will not rise very much when credit tightens. Therefore, saving and loan associations will not have as much incentive as other lending institutions to try to capture funds during periods of tight credit. If this happens, there will be a general decline in the inflow of savings to these thrift institutions when financial markets tighten. Since these institutions make so many mortgage loans, the supply of mortgages will necessarily suffer. (Another reason for a possible change in the flow of funds into savings and loan associations during periods of tight credit is discussed in the accompanying box.)

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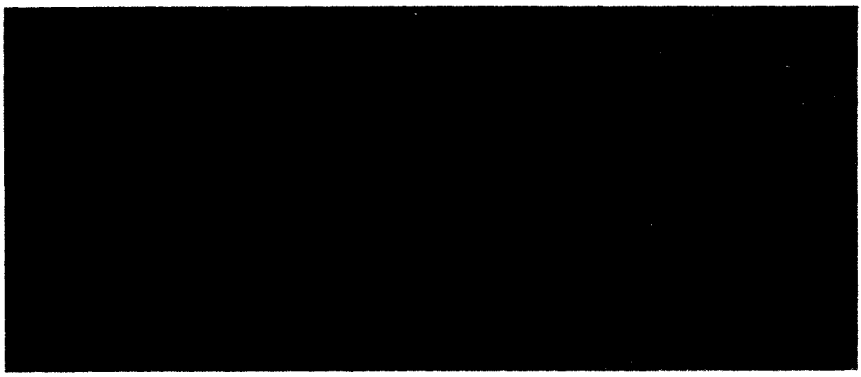

Monetary Policy and Credit Markets. If the condition of credit markets influences housing's fortunes, so does the state of monetary policy. The initial impact of restrictive policy reduces the supply of credit (tightens credit markets) and the initial impact of expansionary policy increases the supply of credit (eases credit markets).

If monetary policy is successful, however, there are delayed impacts on credit markets that tend to reverse the initial influences. Successful expansionary policy means more business activity, a greater demand for credit, and, therefore, tighter credit markets. Successful contractionary policy reduces business activity, which removes demand pressures from credit markets and so eases them.

The delayed impacts of monetary policy on the credit markets make the total impact of monetary policy on housing very difficult to judge. If tight credit drives housing out of the credit markets, an unchecked boom that leads to an overheated economy will not help the cause of housing. A restrictive monetary policy might further tighten credit markets for a while, but it eventually will cool the economy down to a more sustainable pace and draw off some heavy demands from the financial markets. Housing will probably be a big gainer from this kind of restrictive policy. An overly easy monetary policy might give housing a temporary boost in the credit markets. If the policy leads to excessive boom and inflation, however, housing will eventually be forced to pay the piper.

CREDIT MARKETS AND HOUSING: HISTORICAL LINKS

So far we have been using logic and an understanding of financial institutions to speculate on the relation between housing and credit markets. This kind of analysis is essential, but it is not enough. A complete picture of the links connecting the two sectors demand a look at historical experience to provide a check on the logical arguments.

Measures of Credit Market Conditions. It is one thing to talk about changing demand for credit and shifting monetary policy. It is quite another to measure them. This is what we must

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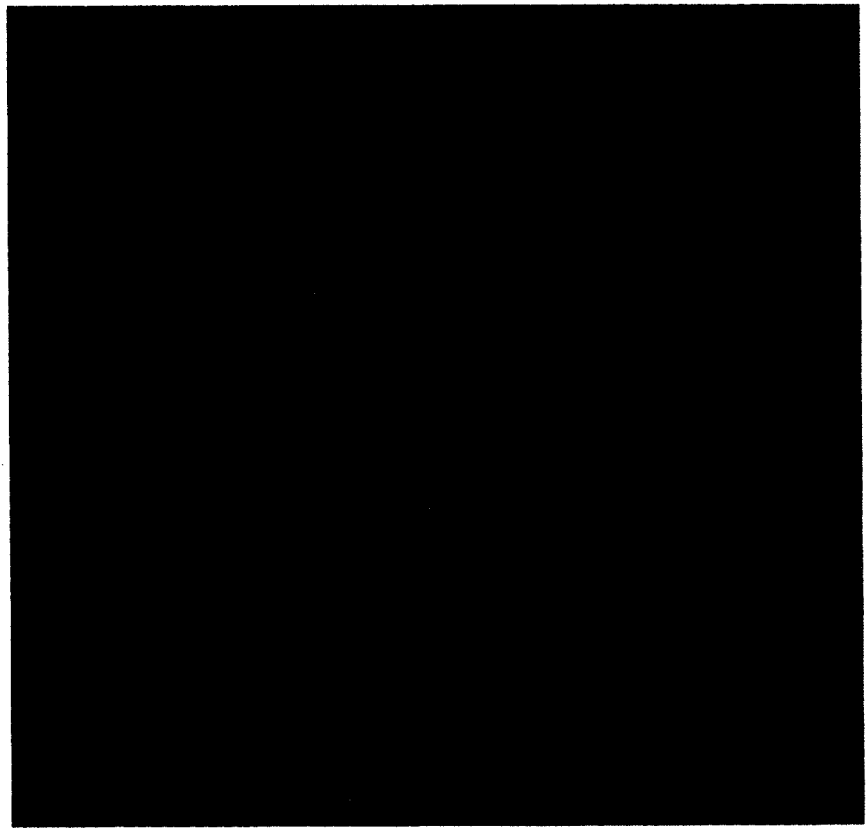
do to examine the historical connection between events in the financial sector and housing's share in the nation's credit. Among all the alternative measures, none stands out as being universally accepted by economists. Rather than get bogged down in the very difficult chore of selecting the best, three were selected more or less arbitrarily. It is probably true that other measures would point to roughly the same conclusions that are suggested by these three. The measures are the following: the rate of growth of the money supply for the state of monetary policy; the unemployment rate for the demands on credit markets; and free reserves for the general state of credit markets. (See box below for further discussion.)



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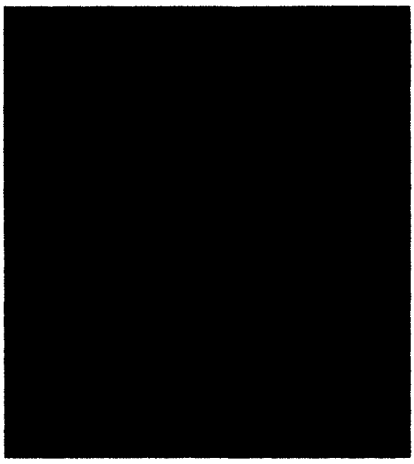
The History of Housing's Share of Credit. One way to find out how housing has fared during periods of tight and easy credit is to examine its share of all debt outstanding.[2] Chart 1 shows the changes in housing's share of the nation's credit from 1948 through 1969. The most recent fluctuations in housing's share of credit are by no means consistent with the "conventional wisdom" that monetary policy works particular hardships on housing. According to Chart 1, the most recent decline in the rate of growth in housing's share of credit began in 1964, two years before the 1966 credit crunch.[3] It continued its nosedive in 1967 and 1968, both years of easy monetary policy. There was a rebound in 1969, but that was a year of tight credit.



[2] See the appendix for a description of the data used in this paper.

[3] All the Charts presented in this paper refer to *changes* in housing's share of credit. A positive value, therefore, means an increase in housing's share of credit. A series of declining but positive values mean, of course, a declining rate of growth.

Chart 2 allows a more comprehensive look at the relation between conditions in the nation's financial markets and changes in housing's share of credit. (In order to concentrate on the shorter run movements, the trend has been removed from the series showing housing's share of credit.) A careful look at the three panels of Chart 2 shows that *some* sharp movements in the changes in housing's share of credit have taken place at about the time of sharp changes in our measures of credit market conditions. The periods 1948-1957 and 1963-1966 provide good examples of these movements. Nevertheless, there were substantial periods (1957-1963, 1966-1969) when there was almost no similarity between credit market conditions and housing's share of credit. We should not be too disappointed at these failings, for the simple analysis that we have used here cannot be expected to answer all the questions. However, the data hide a much closer historical relation between conditions in the financial markets and changes in housing's share of the nation's credit. Fortunately, we do not have to go much further to shake this connection out of the data.

A Further Look at the Evidence. The flow of mortgage funds through financial institutions can be dammed up at two points: (1) the point where funds flow into the financial sector; and (2) the point where funds flow from the financial sector out to home buyers. In the first case, there can be a redistribution of funds away from institutions that traditionally supply a great deal of mortgage loans. In the second, there can be a tendency for lending institutions to move away from mortgages and towards other assets. Changes in housing's share of credit can therefore be divided into two parts: first, the part that is due to changes in funds going to each

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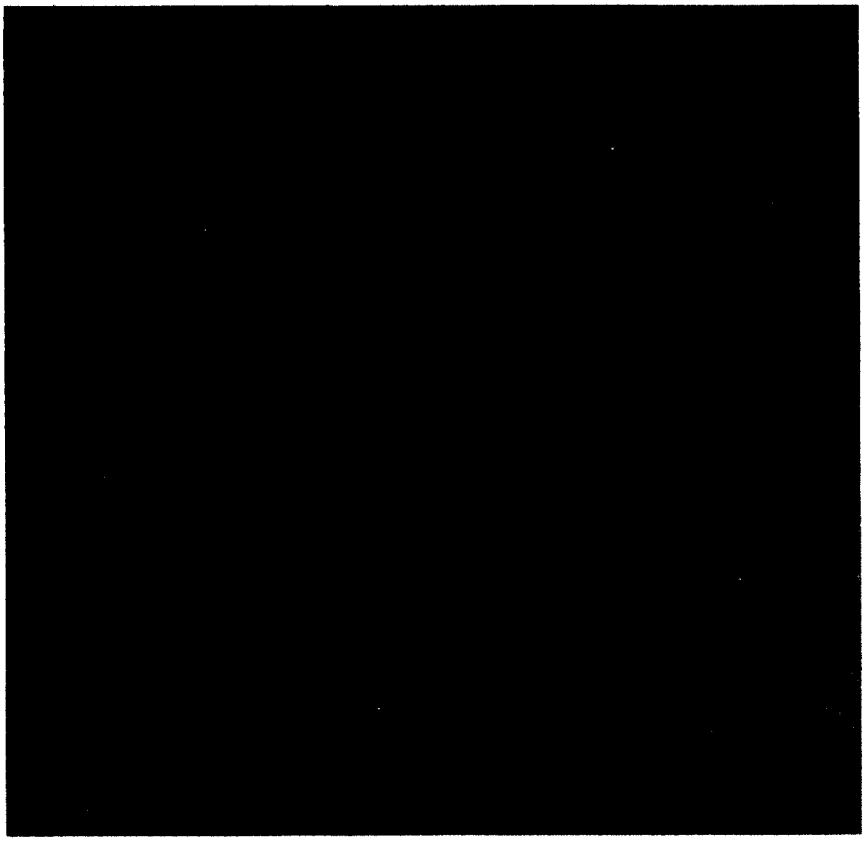
kind of financial institution; and, second, the part that results from financial institutions changing the kinds of credit they extend.[4]

[4] This scheme of partitioning changes in housing's share of credit into two elements is not strictly correct. Some mortgage funds bypass the financial sector completely. Moreover, some financial institutions that account for a small fraction of mortgages have been included in the nonfinancial sector. All data and calculations take account of these imperfections, but they are left out of the discussion.

On the surface, movements in the two components bear little resemblance to each other. However, a comparison of the first component in any year with the second component *in the following year* reveals a fairly strong resemblance. (See Chart 3.)

This could mean that some of the important factors that influence inflows into financial institutions also tend to influence the institutions'



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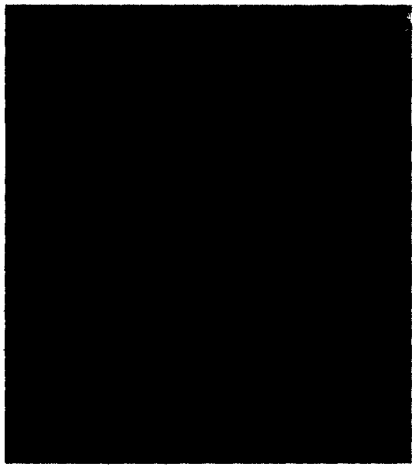

decisions regarding their investment in mortgages, but with a lag of one year. In part this delay may result from mortgage commitments. Builders often ask lenders to commit themselves to mortgages long before construction is completed and the loan is made.

Chart 4 shows changes in housing's share of credit adjusted for the delayed response of the investment policies of financial institutions. It is a crude guess about what would have happened to housing's share of credit if there were no delay on the part of the financial institutions.[5] A comparison of Charts 1 and 4 allows an evaluation of the impact of the delay on housing's place in the credit markets. From 1957 through 1964, for example, the existence of the lag seems to have smoothed out some of the fluctuations. (Chart 1 is more even than Chart 4 over this period.) In more recent years, the delay extended some of the effects of the 1966 credit crunch into 1967.

Chart 5, like Chart 2, compares the detrended change in housing's share of credit with measures of credit market conditions. This time, however, housing's share of credit has been adjusted as in Chart 4. A look at Chart 5 leaves little doubt that housing's share of credit is tied to general credit conditions. During the years from 1951 through 1961, all three measures told roughly the same story about what was happening in the credit markets. In this period, changes in housing's share of credit (adjusted) went up and down as credit eased and tightened. At no time in the postwar period was there a strong, consistent move in credit conditions not matched by a predictable movement in housing's share of credit (adjusted).

Chart 5 clears up many of the problems raised by Chart 2. In terms of our most recent experi-

[5] Unfortunately, the nature of Charts 4 and 5 make it impossible to look at 1969 until the data for 1970 are in. This means that we are forced to leave the year, 1969, as well as 1970 out of our discussion. A number of important developments have taken place during these years that involve a rapid growth of importance in the Federal Home Loan Bank Board loans and Federal National Mortgage Association activity. We must wait for the data to analyze these developments.

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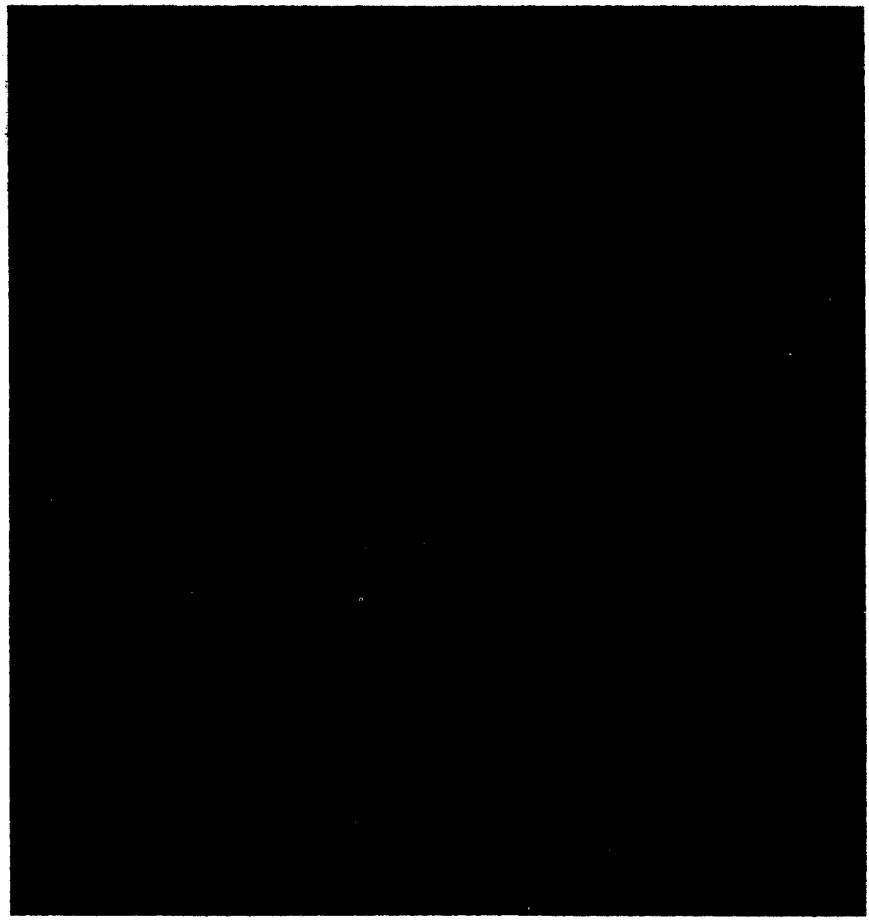
ence, however, it raises one very interesting issue. The 1966 decline in the change in housing's share of credit (adjusted) is perfectly consistent with the troughs in free reserves and the rate of growth in the money supply. But the depth of the trough was far greater than any previous experience would have suggested.

To learn why this is so would require a very comprehensive analysis. However, Chart 3 points to the source of the deep 1966 trough. Up to 1965, the change in mortgage's share of credit resulting from flows into mortgage lenders had fluctuated within a well-defined range. In 1966, for the first time, investment by savers shifted away from the savings and loan associations to such a great extent that the change in housing's share of credit resulting from changes in the flow of funds into financial institutions



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broke out of its normal range, sharply and in a downward direction. On the other hand, the change in housing's share that resulted from the investment policies of financial institutions stayed within its historical range.

The sharp 1966 decline in housing's share of credit is tightly linked to the rather extreme actions of savers in 1966. One way to explain savers' behavior is the imposition of ceilings on the rates that savings and loan associations and mutual savings banks were allowed to pay depositors from 1966 on. This made it difficult for them to compete actively for funds in the nation's credit markets. Because of this, housing's share of credit was greatly depressed in 1966. When short-term interest rates began to ease in 1967, the burden of these interest ceilings was relaxed, and funds began to flow back into thrift institutions much more rapidly than they otherwise would have. Therefore, at least part of the 1966 trough seems to stem from the newly imposed ceilings.

This does not necessarily mean that the ceilings were a bad idea. In the years prior to 1966, interest rates had risen so fast that savings and loan associations found themselves stuck with a large number of old mortgages whose interest rates bore no similarity at all to the rates prevailing in 1966. There was some danger that if savings and loan associations were allowed to compete with each other for funds, they would drive the rates they paid depositors too high relative to their earnings on outstanding mortgages. If this situation went too far, many savings and loan associations might have gone out of business. This would have been catastrophic for the housing industry.

CONCLUSIONS

The discussion over what to do about housing and tight credit is fraught with a great deal of emotion. Many people believe that adequate housing is not an ordinary commodity but a necessity for human decency. The emotional pitch seems to have risen to higher levels in recent years. This is due in part to the recent increase in concern over national goals and in part to the very severe beating housing took in 1966 and 1969. Whatever the merits of the case for a high priority in housing, we should examine the linkage between housing and events in the credit markets dispassionately.

Housing Has Ups as Well as Downs. Like other industries, housing has its ups and downs. Too frequently, however, the spotlight shines on the downs. We are more aware of the relation between tight credit and hard times for housing than the good times that come with easy credit. The real issue is not that housing is hurt when credit tightens—it probably makes most of that up when credit eases. The real issue is that housing production is so variable, an endless cycle of feast followed by famine.

Is this good or bad? If we take a narrow but not necessarily incorrect view, it is obviously cheaper to produce houses at a steady pace than in the boom-bust fashion we have experienced. Firms are not required to pay a lot of overtime one month and then lay people off a few months later. On the workers side, there is more job security with steady production than with the fits and starts of the current situation. What is true for housing construction firms is true for resource suppliers like lumber firms as well. If the building materials industries have more even production, they face fewer start-up and close-down costs.

Taking a somewhat broader view, there is a counterbalance to this argument. When strains on the supply of any resource develop, the market will allocate the supply according to the

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urgency of demand. If credit markets tighten, credit will be allocated so that those whose need is most urgent—those that are most willing to pay the rising interest rates—get credit. Many argue that housing is hurt so much when credit tightens because society finds it very expendable. Each of us balances his wants against his income to decide which products will be purchased. As a market society, we are very sensitive to rising interest rates on mortgages because, *as individuals,* we would rather cut back on housing than on other products when credit gets tight. In this broader view, if anything has to go because of tight credit we, as individuals, have decided that it should be housing. Not everyone agrees with this point of view. Many people believe that housing should not be allocated strictly by market forces. In part, this view reflects a dissatisfaction with the way income is distributed; in part, it reflects a suspicion that the markets in twentieth century America are too imperfect; and, in part, it reflects a general mistrust of the market system.

Monetary Policy and Housing. An important conclusion we reached suggests that the impact of restrictive monetary policy is not so clear-cut as some believe. Great weight is frequently given to the fact that a restrictive monetary policy cuts back on the supply of credit and so hurts housing. We often ignore the fact that successful restrictive monetary policy cools down an overheated economy and draws off some of the demands on credit markets.

Chart 5 shows that changes in housing's share of credit (adjusted) have followed general business conditions (as measured by the unemployment rate) much more closely than they have followed monetary policy (as measured by the growth in the money supply). This suggests that general business conditions might be more important in determining housing's success in credit markets than is monetary policy. Consequently, a restrictive monetary policy that eventually cools off the economy may do housing more good than harm.

Many economists agree with the idea that restrictive monetary policy will eventually help housing in credit markets. Some of them argue, however, that we can reduce part of the initial harmful effects without sacrificing beneficial longer run impacts of restrictive monetary policy on housing. The method is to use fiscal policy more frequently to stabilize the economy. Fiscal policy, which operates through Government expenditures and taxes, need not exert the same initial impacts on credit markets that monetary policy exerts. More fiscal policy, they argue, would allow us to control the economy and eliminate some of the gyrations in the housing industry.

Of course, fiscal policy will also hurt some sectors more than others. It is not even clear that housing would come out very much better under fiscal policy than under monetary policy. If we find housing so expendable that it is among the first to go during tight credit conditions, perhaps it will also be among the first to go when fiscal policies are restrictive. In any event, it might be a good idea to learn which sectors will suffer at the hands of restrictive fiscal policy. Perhaps fiscal policy suffers as much from strong sectoral impacts as does monetary policy.

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TECHNICAL APPENDIX

1. Computation of components of changes in housing share of credit:

Let M be total mortgages outstanding and A be total debt owed by the nonfinancial sector. M_1, M_2, M_3, M_4, and M_5 are mortgages held by commercial banks, savings and loan associations, mutual savings banks, life insurance companies, and "others" respectively. A_1, A_2, A_3, A_4, and A_5 are total financial assets of each of the five categories of mortgage holders. A is total credit market debt owed by nonfinancial sectors.

$$\frac{M}{A} = \frac{M_1 A_1}{A_1 A} + \frac{M_2 A_2}{A_2 A} + \frac{M_3 A_3}{A_3 A} + \frac{M_4 A_4}{A_4 A} + \frac{M_5}{A}$$

The change in housing's share due to inflows to financial institution is approximated by:

$$I = \Sigma \frac{M_i}{A_i} \Delta \frac{A_i}{A} \qquad i = 1, \ldots, 4.$$

The change in housing's share due to investment policies of financial institutions is approximated by:

$$P = \Sigma \frac{A_i}{A} \Delta \frac{M_i}{A_i} \qquad i = 1, \ldots, 4.$$

2. Computation of changes in housing's share of credit (adjusted):

Let I(t) and P(t) be the values of I and P (defined above) in period t and B(t) be the change in housing's share of credit due to flows that bypass financial institutions.

The change in housing's share of credit (adjusted) in period t is:

$$S(t) = I(t) + P(t\text{-}1) + B(t).$$

3. Data sources:

M_1, M_1, M_2, M_3, M_4: *Flow of Funds,** pp. 66-67.

$M_5 = M - M_1 - M_2 - M_3 - M_4$

C_1, C_2, C_3, C_4: Total financial assets of commercial banks, savings and loan associations mutual savings banks and life insurance companies respectively. *Flow of Funds,** pp. 58-63.

A: Credit Market debt owed by nonfinancial sectors. *Flow of Funds,** pp. 66-67.

* *Flow of Funds Accounts 1945-1968,* published by the Board of Governors of the Federal Reserve System. Where data in this volume has been revised, the revisions were used.

Free reserves, money supply, and unemployment rate data were obtained from official sources.

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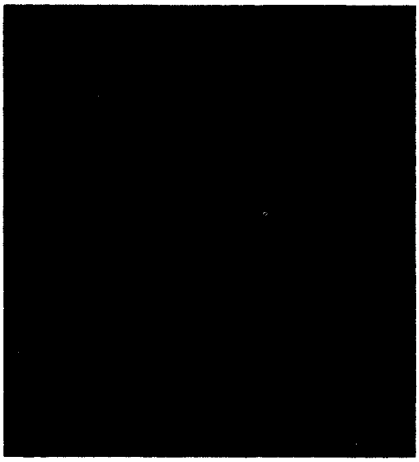
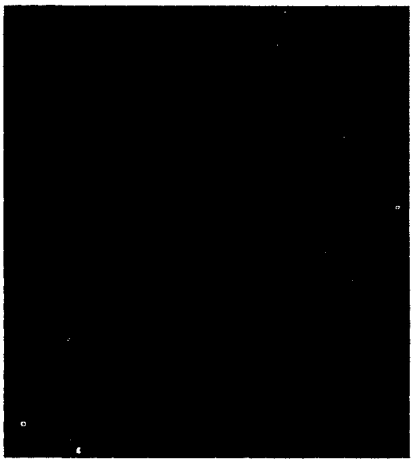
FOR THE RECORD...





SUMMARY	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Sept. 1970 from		9 mos. 1970 from	Sept. 1970 from		9 mos. 1970 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	+ 1	− 7	− 3
Electric power consumed	+ 1	0	+ 2	....	....	....
Man-hours, total*	0	− 5	− 4	....	....	....
Employment, total	0	− 3	+ 2	....	....	....
Wage income*	+ 1	0	+ 2	....	....	....
CONSTRUCTION**	−14	+31	+26	−13	+ 6	+ 1
COAL PRODUCTION	+10	+17	+ 1	+ 1	+13	+ 7
BANKING						
(All member banks)						
Deposits	+ 4	+10	+ 1	+ 5	+10	+ 1
Loans	+ 2	+10	+ 7	+ 1	+ 5	+ 5
Investments	+ 3	+ 4	− 6	+ 2	+ 9	− 2
U.S. Govt. securities	+ 1	0	−10	+ 1	+ 6	− 7
Other	+ 5	+ 7	− 2	+ 3	+11	+ 2
Check payments***	+ 5†	+18†	+14†	0	+ 8	+11
PRICES						
Wholesale	....	....	....	+ 1	+ 4	+ 4
Consumer	+ 1‡	+ 7‡	+ 7‡	0	+ 6	+ 6

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Per cent change Sept. 1970 from		Per cent change Sept. 1970 from		Per cent change Sept. 1970 from		Per cent change Sept. 1970 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	+ 4	− 4	+15	+ 3	− 6	+ 1	+14	+11
Atlantic City	....	....	....	....	+ 4	+19	+ 1	+20
Trenton	0	− 4	− 2	− 1	− 4	+21	+ 3	+30
Altoona	− 1	− 5	− 3	− 6	+ 6	+ 8	+ 2	+ 9
Harrisburg	+ 1	0	− 1	+ 1	+ 4	+ 9	+ 2	+44
Johnstown	− 2	− 6	+ 7	0	+13	+11	+ 1	+11
Lancaster	− 1	0	− 4	0	+ 4	+11	+ 1	− 4
Lehigh Valley	− 1	− 2	+ 1	+ 2	+ 3	+ 3	+ 5	+13
Philadelphia	0	− 6	0	− 3	+ 9	+24	+ 5	+14
Reading	0	− 3	+ 4	+ 2	+ 3	+11	+ 3	+11
Scranton	0	− 9	0	−10	+ 2	+ 1	+ 1	+11
Wilkes-Barre	+ 4	− 2	+ 4	+ 2	+ 5	+ 8	+ 2	+ 4
York	+ 1	− 1	− 1	0	+14	+11	+ 1	− 5

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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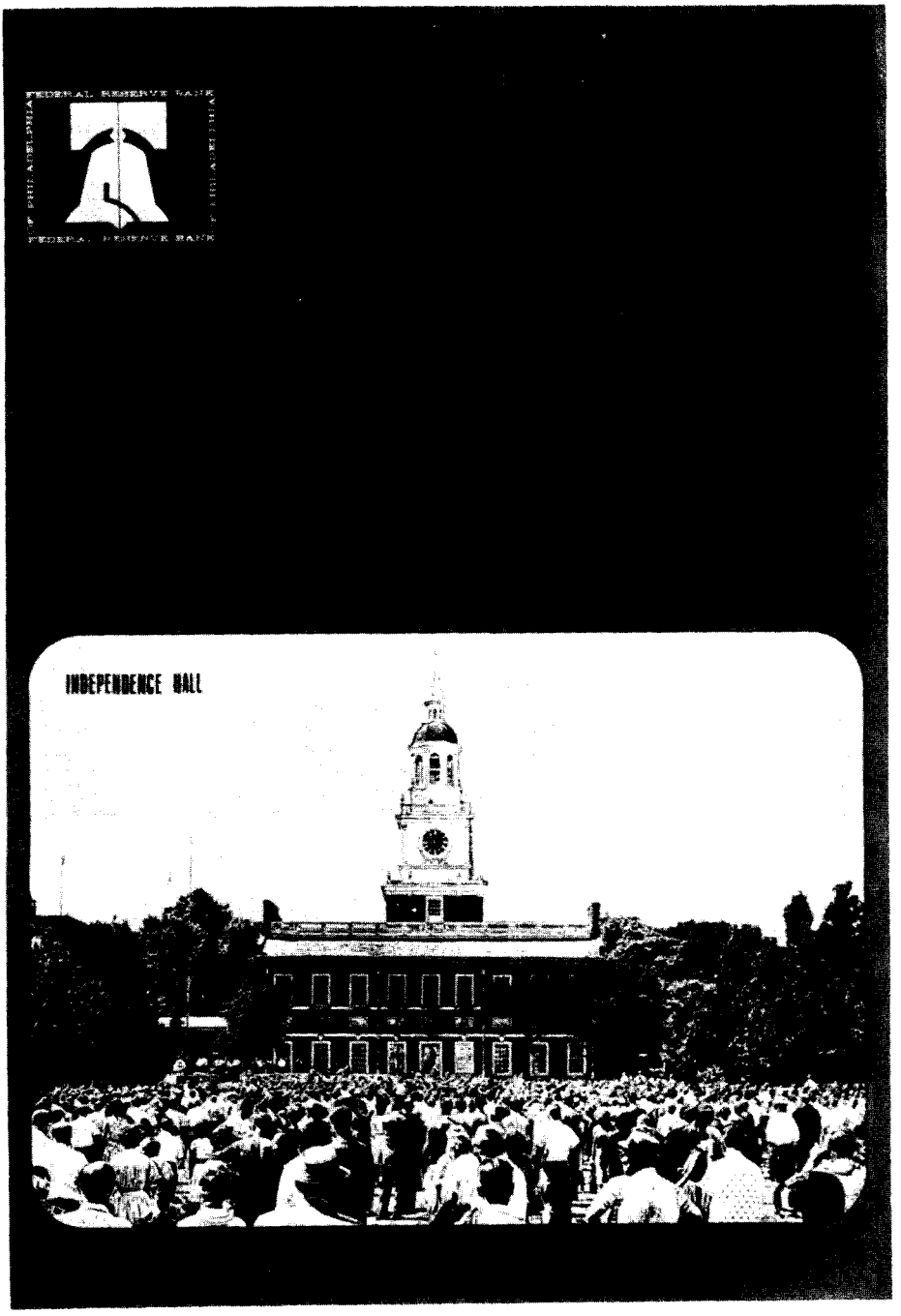

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Can Credit Controls Be Controlled?

by James M. O'Brien

The Federal Reserve Bank of Philadelphia is sponsoring a study of selective credit controls. The study includes investigations of their equity, efficiency, and workability. The conclusion of this article bears on only one aspect of these controls — their tendency to expand. An examination of other aspects of the selective credit issue is necessary before general policy conclusions can be reached.

Last year Buildmore Industries added a giant new skyscraper to its arsenal of capital, a full two stories higher, management said, than the "Tower of Babel" built the year before by its closest competitor. This year Gofast Motor Corporation has begun construction of three new plants strategically located, according to its "Letter to the Stockholder," to keep more Americans on the move even more. These and other corporate expansions no doubt are designed to increase profits, but what do they do to society's welfare? It is now part of the conventional wisdom that the products turned out by free enterprise are not necessarily those that fill our bag of national priorities.

Many public-spirited citizens, though inhabitants of skyscrapers and drivers of autos, are prodding their elected officials to help keep capitalism on the right track. Instead of another auto plant in Detroit or a new skyscraper in Cleveland, why not an additional schoolhouse in Poughkeepsie or a zoo in Sheboygan? Suggestions for giving the country's economic engine more direction have been advanced for some time. One that is gaining in favor is something called selective credit controls.

AIMING CREDIT

Since credit finances a hefty chunk of our production costs, the argument goes, selective alteration of the flows of credit can be a cheap but effective means to rechannel the flow of resources. This policy would make it more (or less) expensive to finance projects according to their social priority. For example, housing construction might get a shot in the arm if the government subsidized mortgage payments, and business investment might be turned off a little by a special tax on interest from

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corporate bonds. If government could induce Buildmore's banker not to lend to Buildmore, there might be one less skyscraper and, possibly, one more schoolhouse.[1]

Selective credit controls are usually seen as an alternative to direct government spending on social goods. Credit controls supposedly entail fewer administrative costs for the government and substantially less interference in the economic affairs of its citizens. So proponents argue that by giving credit a push here and a pull there, we can maintain some control over our economy without giving up the best features of free enterprise.

LIKELY GROWING PAINS

Few solutions to economic problems are perfect. A cloud that comes with the silver lining of selective credit controls is replete with loopholes. The ingenuity of economic man and the malleability of markets seem limitless, and no legislation yet has been able to plug all possible loopholes. Consequently, if selective credit controls are to be effective, more and more government regulation is likely to be required to block escape hatches as they develop.

Suppose, for example, the powers-that-be decide we are building too many skyscrapers and that the best medicine is selective credit control. Soon, a tax or some form of restriction is imposed on the income earned by banks on skyscraper loans. The tax is limited to banks because these are the main suppliers of credit to builders of skyscrapers, and the regulatory agency wishes to limit the regulation and policing. Before long, banks might well be out of the skyscraper loan business as untaxed lenders, such as mortgage and finance companies, find themselves with a competitive advantage. They now make skyscraper loans instead of the banks. Soon regulation will have to be extended to these lenders as well. And, on and on will go the confrontation between loopholes and regulation.

In the end, limiting selective credit controls to a specific type of lender will likely prove difficult, causing regulators to redefine their control in terms of uses and types of credit. Yet, expectations may still outstrip realities. If the government regulated automobile credit, for example, it might reduce the volume of auto credit without much reducing the amount of credit for auto-financing. Suppose controls were imposed on auto credit. Rather than financing, say, 50 per cent of the car on credit, you might finance only 30 per cent, and spend what you had saved for a new TV to make up the difference. Then you could *borrow* to buy the TV. And although *you* might not resort to such deviousness, your neighbor might claim that his loan is for home improvements when it's really for a new automobile.

How might authorities determine the ultimate purpose of credit? There are two approaches, each leading to more interference. One is an examination and policing of the uses of credit not being intentionally regulated. For example, the regulators might have lenders submit for review all consumer loans so as to reduce the substitution of auto credit for other forms of consumer credit. This way would be expensive both to regulators and lenders. Increased costs of processing loans for supposedly nonregulated uses would tend to discourage these loans as well as the intentionally regulated ones. The other alternative is expanding the regulations to other uses of credit that would be difficult to distinguish from the intentionally regulated use. For example, credit for purchasing consumer durables might be brought under the auto credit controls. While regulators may lean toward the latter approach, because the direct cost to them is likely to be less, both ways lead

[1] A limited use of selective credit controls already exists. Various types of credit subsidies are used to aid the financing of housing, a tax exemption is given on income earned from municipal bonds, and credit for purchasing or carrying securities is subject to margin requirements (the last will be analyzed below).

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to extending the selective credit controls to uses of credit not intended for regulation.[2]

And as controls expand to new lenders and to new uses of credit, so does the role of the Government in the economy. The result is increased cost to both regulator and regulated, reduced efficiency of economic markets, and more governmental interference in private decisions. This, of course, does not mean that selective credit controls must be counted out; it merely means that we must approach them with the same careful evaluation of costs and benefits demanded by any proposed economic policy.

A LESSON FROM HISTORY: WIDENING THE NET

When stock prices plunged in the fall of 1929, Americans saw their hard-earned savings evaporate. Everyone has his own theory of what went wrong, but for many the culprit was "excessive" use of credit. Before the Great Crash, this theory goes, credit provided optimistic investors the wherewithal to bid up stock prices to supposedly unsustainable levels that led to the sharp and deep price contraction of October 1929. Spurred by its responsibility to the public welfare, Congress enacted legislation in 1934 aimed at reducing "excessive" use of credit for equity purchases. The Board of Governors of the Federal Reserve System was given the responsibility of administering the law. The Board was empowered to set a lower limit on the down payment that a borrower makes when he borrows for the purpose of buying or carrying equity. For example, the current limit is 55 per cent which means a borrower must put down at least 55 per cent of the price of the security at the time of purchase. This limit or margin requirement has ranged between 40 and 100 per cent in past years but has always been substantially above what security credit lenders usually required before 1934.

Margin requirements on security credit provide us with a good example of this country's experience with clear-cut selective credit controls. On the books since 1934, margin requirements aim to limit credit flowing to a specific type of use — equity purchases. In later years, security credit regulation has tended to loosen its selectivity regarding who and what type of credit fall under its net.

Bringing in Previously Unregulated Lenders. Initially the Federal Reserve Board imposed margin requirements only on credit extended by brokers and dealers (Regulation T).[3] In 1934 only brokers and dealers were extending much security credit; consequently, there was no immediate need to regulate other lenders. However, as the stock market rebounded in the spring and summer of 1936, John Q. Investor found his banker a convenient source of security credit and a convenient alternative to his regulated broker. Nineteen months after the regulation of brokers' and dealers' credit,

[2] Selective credit controls can take the form of a subsidy rather than a tax. When a subsidy is used to reduce the costs of acquiring or extending a particular type of credit for a particular use, the problem confronting the regulatory authorities is how to keep everyone from jumping on the bandwagon. If home building is the favored type of investment, a "house" may be a home with a decreasing frequency. Borrowers, for any purpose, can be expected to seek the cheapest source of credit. In addition, there will be some incentive for privileged individuals or groups to borrow "low" (borrow from the subsidized source) and lend "high" (lend these funds for nonsubsidized uses). As with restrictive credit controls, the regulatory agency must have the means to determine the ultimate uses of credit. It will have to have some control over the portfolio activities of lenders that exceeds the specific types of credit and investment purposely being subsidized. As lenders and borrowers become more familiar with the workings of the regulations, greater controls may become necessary.

[3] The margin regulation applied to brokers and dealers belonging to national security exchanges and those doing business with such members. A primary source of reference for the factual history of security credit regulation is Frederic Solomon and Janet Hart, "Recent Developments in the Regulation of Security Credit," *Journal of Public Law*, XX (1971), 167-213.

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therefore, the Board applied margin requirements to security credit extended by banks (Regulation U). The Board argued that control of banker's security credit was necessary for fair and effective regulation. The net of security credit regulation had begun to widen.

With the extension of margin regulations to bankers' credit, many borrowers during the 1950's and 1960's switched to lenders traditionally not given to extending security credit.[4] Ironically, these unregulated lenders would often obtain their credit from banks with little or no margin. After several limited attempts at reducing the circumventions, the Board, in 1968, applied margin requirements to credit from any domestic lender not currently subject to them who made security credit an important part of its business. This extension brought under regulation security credit being extended by tax-exempt foundations, partnerships, corporations, factors, credit unions, and savings institutions among others. Thus the Board brought all domestic lenders under its control; but regulation of lending sources had still not come the full route.

Foreign lending in the 1960's revealed another flaw in the security credit regulations. Some investors borrowed from foreign banks to buy securities at a margin lower than that required on domestic security credit. Since foreign banks can and do borrow from U.S. sources, they became an intermediary process in the circumvention of margin requirements. In compliance with the Foreign Bank Secrecy Act of 1970, the Board of Governors for the first time required borrowers to comply directly with margin regulations whenever they borrowed to buy or carry securities (Regulation X). The practical effect of this regulation is to bring security credit obtained from foreign sources under regulation.

Bringing Unregulated Credit Uses Under Security Credit Regulation. The purpose of margin requirements was, and is, to restrict the "excessive" use of credit for purchasing and carrying equity. Credit extended for other purposes is not intended to be regulated. However, faced with the dilemma of determining the true purpose of credit, the regulators have felt the need to extend their authority, at least marginally, into other uses of credit.[5]

Although regulating credit for purchasing or carrying bonds is not an objective of margin requirements, the Board, in 1967, felt that it had to subject convertible bonds (bonds which can be exchanged into stock at the option of the holder) to margin requirements. When John Q. Investor buys a convertible bond, it is often with the intention of switching it for stock. Before 1967 this option provided the investor with a way of purchasing equity without being subject to margin requirements. To close this loophole the Board announced that it would impose margin requirements on convertible bonds. However, the requirements were lower than those on true equity, apparently to compromise with the borrower who does not intend to make the switch to equity.

During the 1960's an extension into life insurance came about because of the increased popularity of equity funding plans offered by mutual funds, by which the investor received a package of mutual fund shares and life insurance. The plan is especially attractive to the investor interested in buying both insurance and stocks. He can pay cash for the stock or equity and then

[4] In 1963 the Securities Exchange Commission, in its Special Study of the Securities Markets, contended that unregulated lenders were more important than ever before. The Study identified 58 lenders of security credit and noted that there was evidence of numerous others that operate quietly with a small amount of customers. The study recommended that unregulated lenders be controlled.

[5] It is possible that there currently exist loopholes or circumventions more serious than those which have been closed or stopped because the cost of closing these was judged to be too great.

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borrow on it to pay the insurance premium. The Board ruled in 1969 that it would regard credit for purchasing life insurance in this plan as subject to margin requirements when the equity is used as collateral. Here again another difficulty arises concerning the true nature of security and nonsecurity credit, and the applicability of selective controls.

Because of the difficulties and costs involved in detailed regulation of lenders other than banks and brokers, the Board has put some limits on their nonsecurity credit. An example is that these lenders may not have both security and nonsecurity credit outstanding to the same borrower.

Security credit regulation has been plainly predisposed to expansion. Its growth indicates the difficulty of limiting a credit control to a specific type of lender. Originally covering only brokers' and dealers' credit, security credit regulation now embraces the gamut of lenders. Difficulties of limiting the control to a specific use of credit are also illustrated. Determining the ultimate purpose of a loan is a difficult and expensive task[6] so that, when faced with uncertainty as to the use of a type of credit, regulators have often widened the uses of credit being regulated.

CONTROLLING CREDIT COULD BE COSTLY

If society desires a reorientation of productive resources toward more "socially" oriented goals, it will have to pay the price. The price tag will include not only the "private" products lost by shifting resources from their production to the production of social goods, but also the cost of transferring the resources. Resources will be used in maintaining a government agency to carry out the policy and in requiring private individuals or businesses to meet legal requirements (such as keeping records). There will also be a political cost in the sense that government will play a larger role and the individual a smaller one in choosing what he does with his own resources or income. In short, there will be no free lunches.

While there may be no free lunches, some lunches may be cheaper than others. Selective credit control proponents feel that their policy would be an inexpensive way to rechannel resources to achieve social goals. And they may well be right. However, both reason and at least some experience with this approach suggest that controls, if they are to be effective, will expand to plug existing and developing loopholes. Expansion makes selectivity more difficult and raises the cost to society. These added costs must be recognized when evaluating the merits of selective credit controls.

Selective controls, then, may be compared to an artificial organ, and the U. S. economic system to the human body. A doctor of medicine would be negligent if, in implanting the artifact, he did not consider the full effects that such an operation would

[6] The costs associated with margin regulation of security credit are difficult to assess although they have probably not "gone through the roof." Part of the burden has fallen on existing regulatory bureaus or organizations so that these costs become submerged with that of its other activities. Part of the burden has also probably fallen on those regulated as they have had to determine whether they should impose margin requirements on credit they extend. If these lenders take this responsibility seriously, then they too (and their customers), incur part of this policing cost. Security credit lenders also bear the costs of the increased paper work required to meet the Board of Governors registration and reporting requirements. Perhaps even more difficult to assess is the effectiveness of security credit regulation in reducing the excessive use of security credit. Partly the problem is in defining what is "excessive use of security credit" and partly there is a problem of isolating the effects of margin requirements on the "excessive" indicators. See Bogen, J. L., and Kroos, H. E., *Security Credit* (Englewood Cliffs, N.J.: Prentice-Hall, 1960), pp. 114-127; Cohen, J., "Federal Reserve Margin Requirements and the Stock Market," *Journal of Financial and Quantitiative Analysis*, I (September, 1966), 30-54; Moor, T. G., "Stock Market Margin Requirements," *Journal of Political Economy*, LXXIV (April, 1966), 158-67.

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have on the patient. A "doctor" of political economy would likewise be negligent if, in advocating selective credit controls, he failed to consider the problems and complications that can be expected to follow the attempt to selectively control credit. ■

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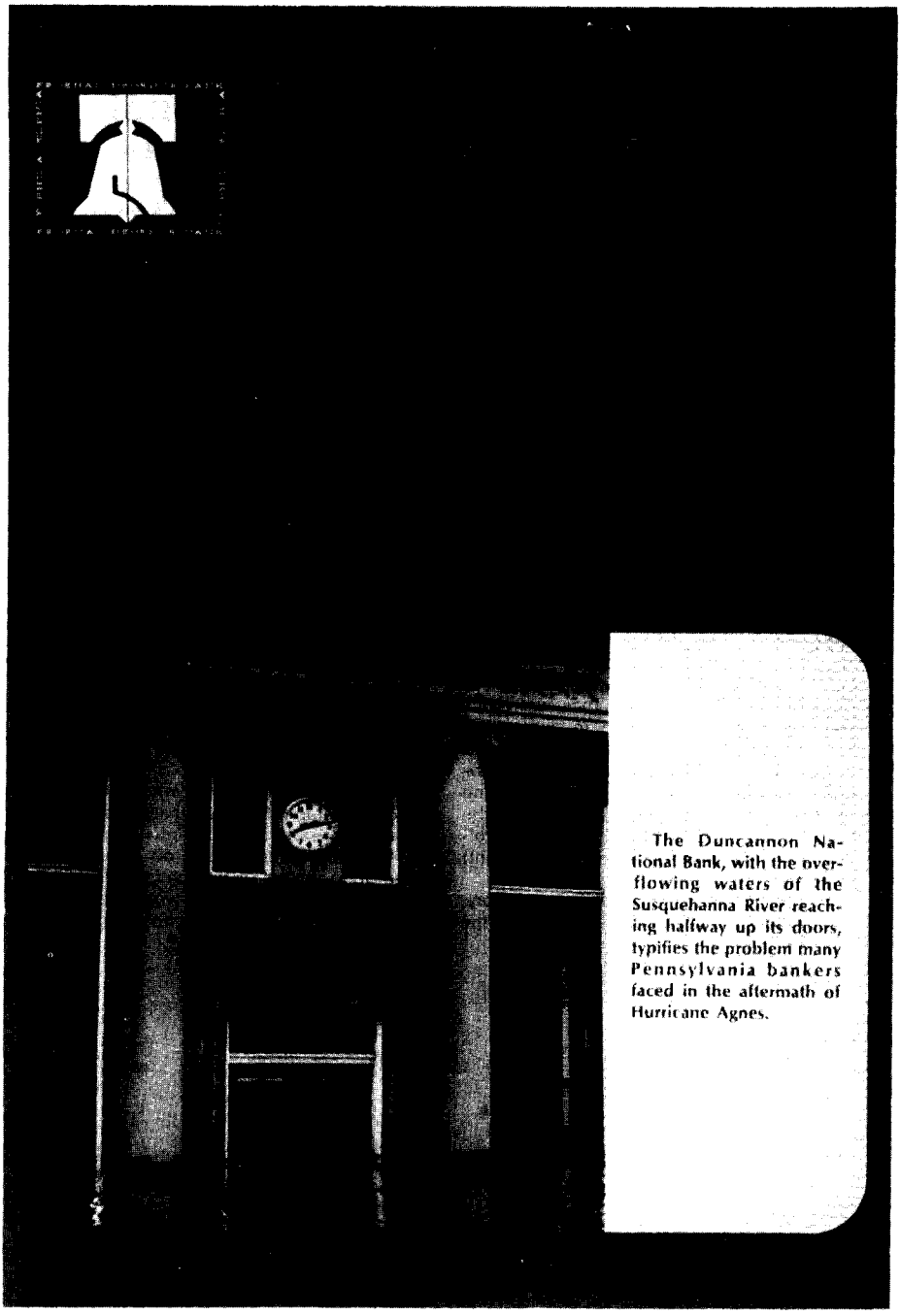

The Duncannon National Bank, with the overflowing waters of the Susquehanna River reaching halfway up its doors, typifies the problem many Pennsylvania bankers faced in the aftermath of Hurricane Agnes.

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Interest Ban on Demand Deposits: Victim of the Profit Motive?

by James M. O'Brien

No bank shall, directly or indirectly, by any device whatsoever, pay an interest on any deposit which is payable on demand . . .

Section 11, Banking Act of 1933

The period was the early 1930s—a time of financial as well as general economic disaster. The stock market had plummeted to its lowest depths in history. Banks fell like swatted flies. Urgency was the order of the day as Congress sped toward revamping and revitalizing the country's economy in the hope of heading off another great depression. Some changes have provided valuable aid toward achieving economic and financial stability. Take, for example, Federal deposit insurance which is credited with a major role in eliminating bank failures. However, action also spurred the passage of other legislation whose economic contribution is more doubtful. One of these appears to be Section 11 of the Banking Act of 1933—the interest prohibition on demand deposit (checking account) balances.

In sifting through the legislative oratory, two reasons for the prohibition rise to the fore. One was to protect banks from *overcompetition*. If forced to pay competitive deposit rates, banks would have to seek higher-yielding but riskier loans to cover the higher costs of attracting deposits. Eliminating the interest payment on demand deposits supposedly would allow banks to pursue sounder lending practices thereby creating a more viable banking system, the lawmakers argued.

A second reason advanced was that without interest prohibition, larger, more profitable city banks would outbid small country banks for deposits, or alternatively small country banks would send "excess funds" (reserves) to large city ones in return for interest payments. Either way, small local borrowers depending on the credit sources of small banks would be frozen out as funds flowed to the large borrowers through large city banks.

By forbidding interest payments, checking account competition and bank costs supposedly would be substantially reduced. Banks could extend credit on the basis of need and safeness of the loan without worrying whether revenues would be high enough to cover payments to deposit cus-

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tomers. During the 1960s, however, a slip *'twixt cup and lip* became obvious as non*interest* competition characterized the market for demand deposits.

THE ACHILLES HEEL: PROFIT AND COMPETITION

Revenue earned on loans is the banker's bread and butter. In order to make a loan, however, sufficient funds or reserves must be on hand. These are acquired primarily by persuading the saver to keep a checking or savings balance with the bank. Like any other businessman, the banker performs his task to make a profit. If, for example, he should find himself besieged with loan customers offering to pay a high rate, he will quite naturally seek more deposits. If, in less fortuitous circumstances, the banker finds his depositors fleeing his ranks for those of competitors, he will likewise have to react by increasing the attractiveness of his deposit facilities.

Interest payments are an effective way to attract or hold depositors. They are also easy to alter. Without a legal taboo, the interest payment doubtless would be a more important weapon in the banker's arsenal for pulling in checking balances. The ban on interest prevents the banker from making a money payment on a checking account but it does not curtail his need or desire to attract these accounts. If the depositor can't be enticed with a dollar payment on his checking surplus, he will likely find himself more heavily showered with other forms of incentives such as reduced service charges or more convenient branches.

Individually, each bank sees such increases in its incentives to checking depositors as enabling it to get more funds and make more loans and, hence, profit. Their collective action, however, makes the greater profit a mirage for the typical banker because competition will simply make deposits more expensive to buy. The interest ban will not prevent these competitive results from emerging. For the banker's cost accountant, dollars spent on noninterest, implicit payments will appear just as real as if charged to interest costs.

The decade of the '60s was testament to this fact. Over the decade, loan rates climbed and the income-earning ability of the typical banker's demand deposits increased. This spurred keener competition for deposits and resulted in numerous forms of implicit payments on checking balances (see Box). Consequently, the typical banker found himself paying a higher (implicit) price to lure, or hold, checking balances (see Graph for the story on New England banks). Competition's sharp edge seemed to have cut through the cost deterrent posed by the interest ban. The prohibition did not stop the banker from making a payment on checking balances in response to competitive conditions. Rather its major impact appeared to be on the form of the payment.[1]

FAILURE TO PROTECT SMALL BORROWERS

Besides reducing bank costs, the interest ban was supposed to make it easier for small borrowers to obtain financing from small local banks. Without the ban, the supposedly more profitable, large city banks would offer higher rates on deposits, thereby attracting funds from the countryside. With the ban, the small local bank could maintain adequate reserves to meet the needs of local borrowers. The numerous ways banks found to make payments on checking balances in the 1960s, however,

[1] Smaller banks often keep demand deposits with larger banks (correspondent balances). The interest prohibition also forbids interest payment on these interbank deposits. But, as with nonbank customers' demand deposits, an implicit payment is made in the form of services (for example, check clearing services) to the bank depositor.

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The rising interest rates of the 1960s persuaded the average banker to offer a variety of incentives to the holder of a checking account balance.

1. **Premiums and Ancillary Services.** Dishware, stationery accessories, and clothing became common items offered by many banks to their depositors. Bank branches increased at a historic rate during the 1960s, offering the depositor greater convenience. In the latter part of the decade, the large demand deposit holder found that he could now obtain portfolio management and investment advice from his banker at reduced charges. Banks also made it easier to transfer savings deposits to demand deposit accounts, thus tending to blur the distinction between the interest paying savings account and the demand deposit account.

2. **Reduced Service Charges.** The 1960s also saw the rise of the "free checking account" for the small depositor. The banker offering this incentive waives the service charge for the use of the checking account providing some minimum balance is held in the account. A study of the New England area found that banks offering some sort of "free checking account" increased from almost no banks in the early 1960s to over half by 1969.*

3. **Reduced Loan Rates to Depositors.** Corporations maintaining large balances in their checking accounts are frequently offered a reduced loan rate for maintaining such balances. At least one recent study found that other things equal, the loan rate charged by various banks on business loans was significantly lower the higher the borrower's balance in its checking account.**

* Steven J. Weiss, "Commercial Bank Price Competition: The Case of Free Checking Accounts," New England Economic Review, September/October 1969, pp. 3-8.

** Donald P. Jacobs, Business Loan Costs and Bank Market Structure: A Cross-Section Analysis from 1970, pp. 1-48.

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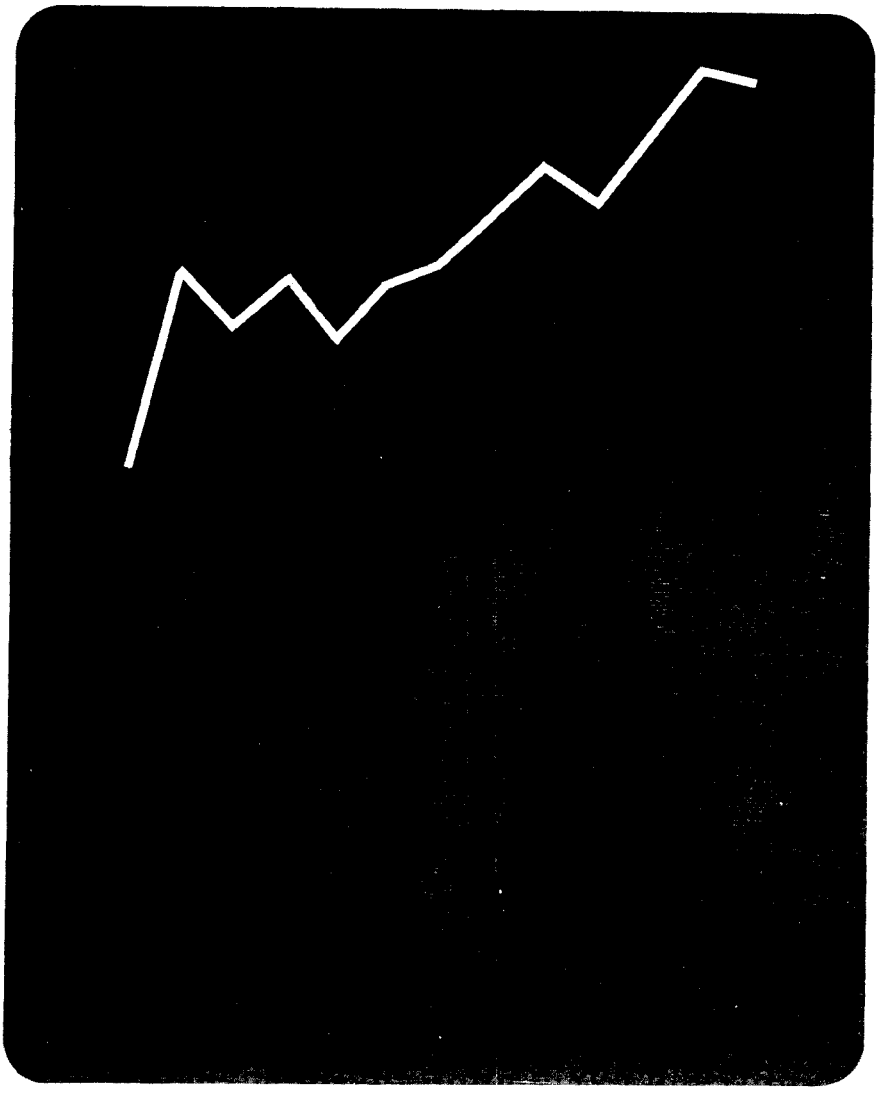

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points up the prohibition's limited ability to keep deposits from flowing to their most profitable use. The bank with a high return on its loans is still able to up its implicit payments as a way of attracting checking balances.

Even if the banker does find that the interest ban on checking balances puts a crimp in his ability to pull in reserves, he can lean more heavily on other sources of funds. One important nondeposit source is the Federal funds market. This is a well developed loan market where banks extend credit to other banks at a competitive interest rate. How much a bank commits of its own funds to this market will depend on the profitability of loans to its (nonbank) customers and the interest rate paid on Federal funds. If large borrowers can offer a high loan rate to large banks, then the latter can acquire additional funds to make the loans by offering a higher Federal funds rate. During the mid- and late 1960s the large city bank increasingly relied on the Federal funds market[2] to finance its strong business loan demand while the small country bank became an important (net) supplier of funds to its larger city cousin.

[2] See George Budzeika, "Lending to Business by New York City Banks," *The Bulletin* of the Institute of Finance, Graduate School of Business Administration, New York University, Nos. 76-77 (September 1971).

COSTS OF INTEREST PROHIBITION

Governmental regulations usually create economic burdens which must be balanced against their benefits. The interest ban is no exception. Although its limited effectiveness is likely to lighten the burdens, some costs will remain.

Being forced to accept payments in kind rather than in money interest is one form of cost the depositor bears. The amount of this burden is how much he would value the interest payment over the value he places on premiums and services he now receives. Without the prohibition, bankers would replace at least part of the services and premium payments with interest, making the average depositor better off.[3]

Economists have focused more on a second set of costs peculiar to the money-

[3] The interest prohibition causes an overproduction in the premiums and services offered. One type of overused service is the payments mechanism itself. The existence of free checking accounts allows depositors to use their account to a greater extent than if they had to pay for the use of the account. Part of what would otherwise be an explicit interest payment is now used to cover the resource cost of the heavier *use* of the checking account. The better procedure would be to charge for the use of the account and pay interest on the balance which the depositor may do with what he wants rather than "force" the depositor to buy more checking account services as now results from the "free" checking account incentive.

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supplying capacity of commercial banks. The contrivance of money contributes greatly to the economic well-being of a nation by oiling the wheels of trade. People would find it much more difficult to produce, buy, and sell goods and services if barter were the form of exchange. Not only does the individual use money to make his purchases, but he also keeps money balances on hand because it is uneconomical to withdraw from savings accounts or sell securities each time a purchase is made. These balances substitute for commodity inventories which the individual would otherwise keep on hand to reduce the frequency of barter. This increases the economic contribution of money by saving on the amount of resources tied up in the form of idle inventories.

With an interest ban, economists argue, people and businesses will generally expend too much effort trying to conserve on the amount of wealth they keep in money form.[4] While an implicit payment takes the place of an interest payment, it is not likely to be as desirable to the checking account holder. For example, in recent years when interest rates and inflation have been high, corporations have gone to great lengths to pare their cash holdings. Computers have been used to let corporate managers know their firm's cash position more quickly; forecasters have been hired to predict cash needs; and, more generally, portfolio costs have increased as it has become worthwhile to move in and out of investment assets for short periods of time. If interest on checking balances had been permitted and allowed to move more freely with other interest rates, corporate treasurers might have allowed money to serve a greater role as a buffer between receipts and expenditures. This could have increased the overall usefulness of this asset in making scarce resources more productive.

[4] For a rigorous analysis using a transactions demand–inventory theoretical approach, see Edgar L. Feige and Michael Parkin, "The Optimal Quantity of Money, Bonds, Commodity Inventories, and Capital," *American Economic Review* 61 (June 1971): 335-349.

INTEREST PROHIBITION: A LESSON FROM EXPERIENCE

Neither the economy nor the banking system appears to profit much from the interest prohibition on demand deposits. The major impact of the regulation appears to have been on the form more than on the degree of competition and bank costs. During the past decade the prohibition did not deter banks from paying higher rewards to demand deposit holders as market conditions dictated.

The interest prohibition produces economic costs but the greater loss may lie in the disrespect for the law that it tends to create. The prohibition is like a detour sign on a road running through a large, open field. As long as the sign warns of no real danger, drivers will simply drive around it, creating new paths to their destination. By analogy, the banker who is prohibited from paying ten cents on a demand deposit balance will reduce the service charge on the account or use some other incentive to attract checking deposits. Because it is not feasible to enforce a prohibition more generally on demand deposit payments, the situation now works to encourage rather than reduce evasion of the law.

For these reasons, striking this 39-year-old statute from the books would appeal to many. However, the interest ban does not stand alone, but is part of an interacting regulatory maze enveloping our financial institutions. Removing any single component without considering its impact on the labyrinth could worsen a bad situation. For example, removing the interest ban may enhance the competitive position of banks in attracting funds relative to, say, savings and loan associations. In order to keep S&Ls viable competitors for deposits, interest ceil-

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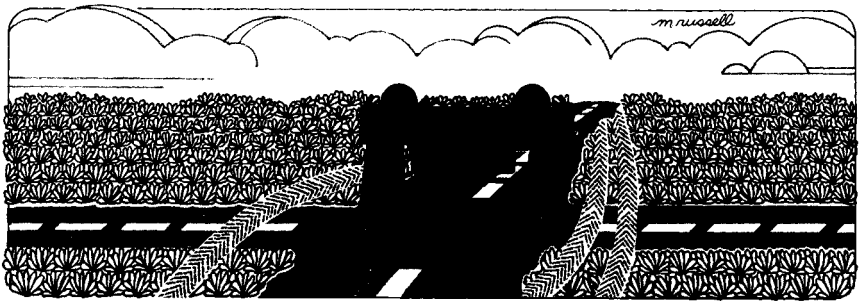

ings on their deposits may also have to be removed. But the removal could be the undoing of these savings institutions since the law restricts how they put their funds to use. A more prudent approach might be to attack the regulatory problem on a broader front. Recently the Hunt Commission (President's Commission on Financial Structure and Regulation) suggested a gradual phasing-out of interest ceilings on time and savings deposits as well as other restrictive financial regulations.[5] If this task were undertaken, it would present a good opportunity to liberalize the checking account interest regulation.[6] Regardless of the future of the interest prohibition, its history is a valuable lesson in the need for realism whenever legislators and regulators consider enacting restrictions on the financial marketplace.

[5] While the Hunt Commission recognized the deficiencies and costs of the interest prohibition on demand deposits, it recommended against removal at the present time. Its recommendation resulted from possibly adverse effects on deposit flows of thrift institutions caused by an *immediate* abolition of the interest ban.

[6] This discussion has abstracted from the effect of interest prohibition on the conduct of monetary policy to stabilize economic activity. This issue has been debated among academic economists. One side argues that interest payments will reduce the potential of monetary movements to accentuate economic fluctuations (see Richard Ward, "Demand Deposit Interest and Monetary Policy," *National Banking Review* 3 [June 1966]: 471-478). Another says that the ability of monetary authorities to stabilize the economy depends on the fixity of the rate of interest on money (see James Tobin, "A General Equilibrium Approach to Monetary Theory," *Journal of Money, Credit and Banking* 1 [February 1969]: Part 1, 15-29). Currently, the implicit payment on money is a variable rate of return but much less flexible than rates on other liquid assets. Even those who argue for a fixed rate on money, for purposes of monetary policy, could agree that a slowly varying explicit interest payment would eliminate or reduce disadvantages of the implicit payment scheme *without* damaging the operation of monetary policy. ■

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FOR THE RECORD...

SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	June 1972 from		6 mos. 1972 from	June 1972 from		6 mos. 1972 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	+ 2	+ 5	+ 5
Electric power consumed	− 1	+ 1	+ 3	....	....	....
Man-hours, total*	+ 2	+ 1	− 2	+ 2	+ 4	NA
Employment, total	+ 1	− 1	− 3	+ 1	+ 2	+ 1
Wage income*	+ 3	+ 8	+ 5	+ 3	+10	NA
CONSTRUCTION**	+ 9	−13	−29	− 7	+ 6	+15
COAL PRODUCTION	−14	−15	− 4	− 3	− 6	− 7
BANKING (All member banks)						
Deposits	− 1	+10	+13	− 1	+ 6	+10
Loans	+ 2	+16	+12	+ 2	+13	+12
Investments	− 1	+ 9	+15	− 1	+ 7	+10
U.S. Govt. securities	− 1	− 4	+ 1	− 3	− 1	+ 1
Other	− 2	+16	+23	0	+12	+15
Check payments***	− 3†	+ 9†	+14†	− 1	+13	+14
PRICES						
Wholesale	....	....	....	+ 1	+ 4	+ 4
Consumer	0‡	+ 2‡	+ 3‡	0	+ 3	+ 3

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change June 1972 from		Percent change June 1972 from		Percent change June 1972 from		Percent change June 1972 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington	0	− 2	+ 3	0	− 8	+ 5	− 1	− 2
Atlantic City	+ 1	0	+ 2	+17	− 1	+14	+ 1	+20
Bridgeton	+ 2	+ 1	NA	NA	N/A	N/A	0	NA
Trenton	+ 1	− 1	+ 2	+11	+24	+ 1	− 2	+11
Altoona	0	− 6	+ 2	+ 4	− 8	−11	− 2	+ 6
Harrisburg	+ 1	− 1	− 1	+ 3	− 6	+17	− 1	+ 9
Johnstown	− 1	− 5	− 4	− 4	− 1	+ 4	− 1	+ 7
Lancaster	+ 3	+ 2	+ 4	+13	+ 8	+35	0	+11
Lehigh Valley	+ 2	+ 2	+ 5	+12	+ 1	+ 5	− 2	+12
Philadelphia	+ 1	+ 1	+ 2	+ 8	− 3	+11	− 2	+10
Reading	+ 1	− 1	+ 1	+ 5	+ 6	0	+ 3	+11
Scranton	0	+ 2	− 1	+ 4	− 3	− 3	0	+10
Wilkes-Barre	+ 2	+ 2	+ 3	+12	− 3	+14	− 3	+21
Williamsport	—	+ 1	NA	NA	−11	−12	0	NA
York	+ 2	+ 3	+ 5	+12	+ 2	− 9	0	+ 8

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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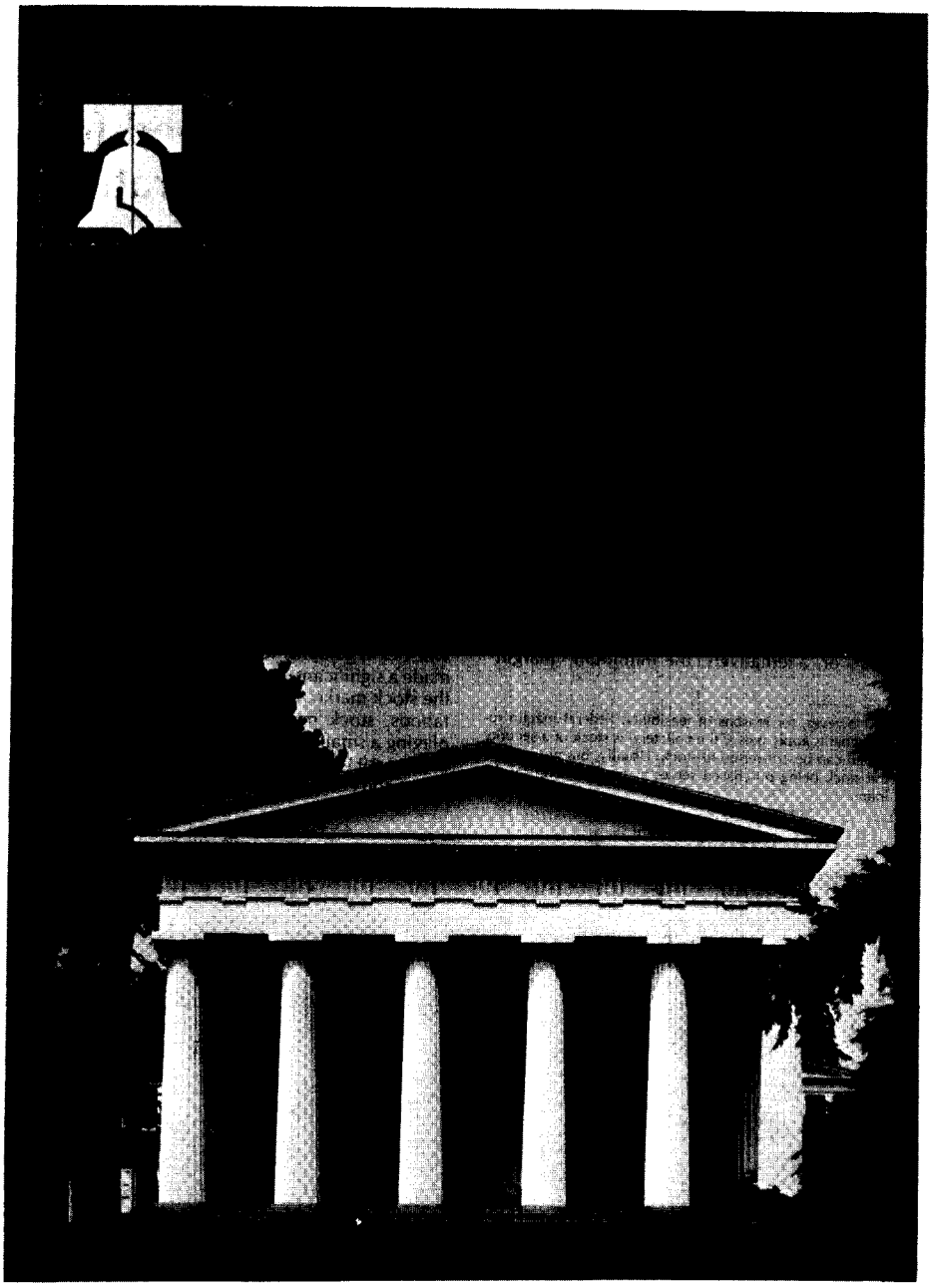

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Federal Regulation Of Stock Market Credit: A Need for Reconsideration

By James M. O'Brien

Financing the purchase of an asset by borrowing is as American as apple pie. Most of the time the size of the loan is worked out by the borrower and lender. However, an exception occurs when the purchase is stock.

Since 1934, Uncle Sam has restricted stock market lending by imposing Federal margin requirements which fix the maximum amount of the loan relative to the value of the collateral.[1] Suppose, for example, the margin requirement were 65 percent and a potential stock purchaser puts up $1,000 worth of stock as collateral. The most he could borrow would be $350 or, alternatively, the minimum "margin" would be $650. The Federal Reserve Board, custodian of this regulation, varies Federal margin requirements according to conditions in the stock market. Currently requirements are 50 percent which, except during the late 1930s and early 1940s, is the lowest they've ever been. Prior to regulation, lenders had generally only required between 10 and 30 percent margin.

Margin requirements are mainly intended to eliminate a destabilizing impact on stock prices that supposedly results when "too much" credit is used to buy stock. However, it seems unclear whether regulating security credit has actually made a significant contribution to the stability of the stock market. Moreover, even without legal taboos, stock market loans would likely be playing a smaller role on Wall Street today than prior to 1934. Despite these considerations, the scope and complexity of margin regulation have

[1]However, for reasons of feasibility, Federal margin requirements apply only if the collateral is stock or a security which can be converted to stock. Usually, but not always, the stock being purchased serves as the collateral for the loan.

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been expanding substantially. And sizable "gaps" in regulation still remain. As security credit control reaches its 40th birthday, a re-evaluation of its need and structure may be in order. One possible alternative to the current regulatory apparatus would be to maintain only standby control over stock market credit. Restrictions on lending to buy stock would be applied only if a special need appeared to arise.

THE UNCERTAIN GAINS OF STOCK MARKET CREDIT CONTROL

Regulating stock market credit originated with the Securities Exchange Act of 1934. Prior to the 1930s, the use of credit had become a popular way to buy stock, particularly where the investor figured to profit on expected near-term price increases. Following the stock market crash of 1929 and the early 1930s, support for security credit regulation became quite strong. Many observers believed that low margin requirements had accentuated both the stock market boom of the '20s and the bust of the '30s. From 1926 to 1929 stockbrokers' loans to customers jumped from $3 billion to $8 billion but by 1932 stock market credit had dropped to only a half billion dollars! This importance of security credit and its volatility gave rise to several arguments for regulation.[2]

Undesirable Effects on the Banking System? One argument rested on the fact that most stock market credit ultimately came from banks that treated the credit extension as a liquid asset—a short-term loan which could be "called" for repayment when the bank needed reserves. The importance of "call" loans supposedly threatened the stability of the banking system. In the event of a serious decline in stock prices, the value of these loans, and hence banks' solvency, might be jeopardized. Whatever the merits of this argument may have been, since the early 1930s other sources of bank liquidity have developed independently of stock market credit regulation. Today banks hold large amounts of U.S. Government securities which can readily be converted into cash. There also exists a highly developed mechanism for interbank lending—the Federal funds market. These and still other sources of bank liquidity have obviated the use of call loans as an important secondary reserve for banks.

Reducing Credit for Productive Trade? A second contention was that margin credit (stock market credit) which financed "speculation" reduced the volume of loans available for "productive" trade. However, many have pointed out that this argument is erroneous. Margin credit merely facilitates the exchange of securities from one party to another. It does not represent a claim on real resources and, hence, does not reduce the *overall* ability of consumers and businessmen to buy food, homes, or machines. Proceeds from the stock loan must end up as a source of finance for either businesses or consumers.

Destabilizing Effects on Stock Prices? But the main argument for curbing the use of security credit is that unregulated lending increases the volatility of stock prices. The evidence is the strong tendency of security credit to rise and fall with stock prices. It is argued that prices would rise less if credit to finance stock purchases were restricted. And with a smaller amount of credit outstanding, less stock would be sold to repay loans when prices start declining. Consequently, stock prices presumably would not

[2]Background references enumerating the arguments for margin regulation are Jules I. Bogen and Herman E. Kroos, *Security Credit: Its Economic Role and Regulation* (Englewood Cliffs, N. J.: Prentice-Hall, 1960); Robert E. Harris, "Federal Margin Requirements: A Selective Instrument of Monetary Policy," University of Pennsylvania, unpublished dissertation, 1958; Carl Parry, "A Short History of Regulation T and U," Board of Governors of the Federal Reserve System, unpublished (1949); Frederic Solomon and Janet Hart, "Recent Developments in the Regulation of Securities Credit," *Journal of Public Law* 20 (1971): 165–69; John Stoffels, "The Use of Margin Credit in the Trading of Securities," Michigan State University, unpublished dissertation (1969); U.S. Congress, Senate, Committee on Banking and Currency, *Factors Affecting the Stock Market*, 84th Cong., 1st sess., 30 April 1955, chap. 3.

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fall so far.[3]

Since the enactment of margin regulation, stock market credit does appear to have been less volatile—particularly when compared to the less dramatic changes in the volatility of stock prices (see Tables 1A and 1D). The tendency of security loans to fluctuate with stock prices has also been less pronounced (see Table 1B). These facts help to corroborate the view that Federal margin requirements have helped to stabilize stock market credit.[4] Still, it may be that

[3]This argument raises the question of whether the price fluctuations supposedly fostered by margin trading might represent, in some sense, proper reevaluations of firms' expected earnings and, hence, be justified on grounds of economic efficiency. The issue of what constitutes "excessive" fluctuations in stock prices is not addressed here and the goal of reducing stock price fluctuations that might be caused by margin trading is accepted without question. However, the issue is not resolved among economists. See Irwin Friend, "The Economic Consequence of the Stock Market," *American Economic Review* 62 (1972): 212–19.

[4]All credit data since 1939 reported in Table 1 is regulated security credit. However, the margin credit measures of volatility and coincidence with stock prices were also computed for January 1971–May 1973, using a definition of margin credit which also included reported data on unregulated security credit as well. The results were very similar to those obtained using only regulated credit over the same period.

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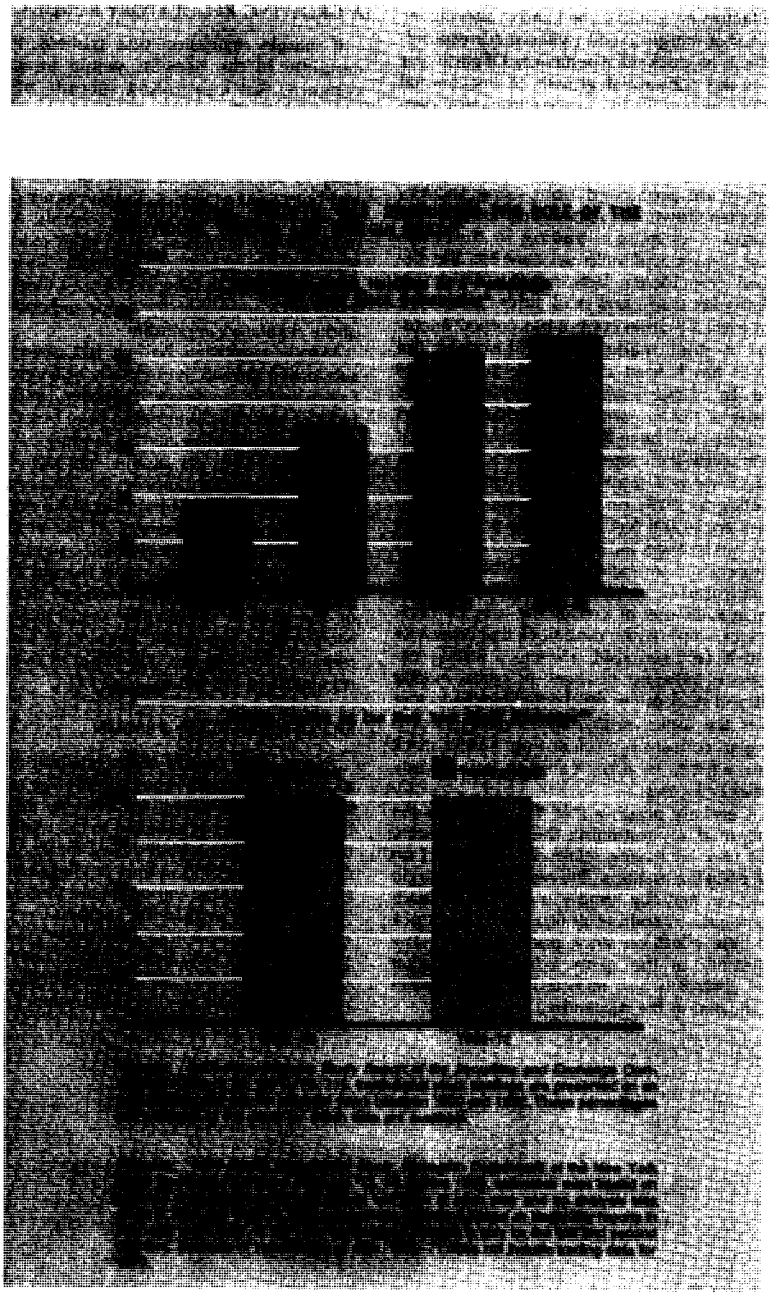

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other factors have had some hand in altering the behavior of margin credit (without corresponding effects on stock price behavior). Of particular note is the substantial growth of institutional investors such as life insurance companies, pension funds, mutual funds, and trusts. These investors now account for a large share of stock market trading (see Chart). Because institutional investors are prohibited from using security credit, their growth has significantly lessened the importance of margin trading in the stock market. This could help account for the decreased coincidence between fluctuations in stock market credit and stock prices.

But even if margin control has curbed fluctuations in stock market credit, this need not mean it has helped make stock prices more stable. To a large degree, stock prices fluctuate because of fluctuations in what market traders think prices will be in the future. For example, if traders revise their forecasts of stock prices upward, they will want to hold more stock, expecting to profit on the difference between current prices and predicted future prices. Stock prices can be expected to bid up *until they match the more optimistic expectations of the "market."* The increased demand for stock will be financed by a heavier use of credit, the sale of other assets, or simply by holding stock that otherwise would have been sold. Hence, a strong coincidence between changes in stock market credit and stock prices need not mean the former causes the latter. *Both may simply reflect a changed consensus concerning future stock prices which, in turn, can result from any number of factors.*

It is entirely possible that this is usually the situation. If so, restricting the use of security credit may be having relatively little effect on stock price fluctuations. The end result of margin regulation may be simply a greater reliance on unregulated sources of finance to buy stock with little effect on stock price stability. (The uncertainty of the gains from stock market credit control is also reflected in other studies as indicated in the Appendix.)

A GROWING REGULATORY BURDEN

If margin regulation was costless, the uncertainty of the benefits would be of little concern. But controlling security credit is not costless. Taxpayers must pay for the administration and enforcement of the rules. The regulated must keep records and report periodically to Uncle Sam on some of their lending and borrowing activities. Resources are spent in developing ways around the controls. And, for enforcement purposes, some rules extend beyond just loans to purchase stock. These costs will be difficult to tally, but at least they can be expected to grow with the scope and complexity of the regulatory repertoire.

Margin regulation has, in fact, experienced substantial growth, particularly in recent years. Extensions in coverage of lenders and in the types of securities purchased have been numerous. Rules governing margin lending have been tightened. And, all of this has significantly compounded the complexitiy of controlling stock market credit. The causes of this regulatory growth have been changes in the structure of the stock market and the development of credit avenues designed to avoid margin requirements (see Box for a more detailed description of the growth in security credit regulation). Moreover, a significant amount of avoidance remains, creating the possibility of even more regulation in the future.

SIGNIFICANT GAPS REMAIN

Some stock market loans are purposely excluded from margin requirements. For example, there are loans whose tendency to destabilize the stock market is believed to be small—credit to buy some stock traded over the counter and the special exemption and privilege categories (see Table 2). Also important are those security loans which would be especially hard to regulate. The most notable of these are loans to purchase stock which do not have equity as the collateral—unrestricted collateral loans. Banks make almost all of the unrestricted collateral

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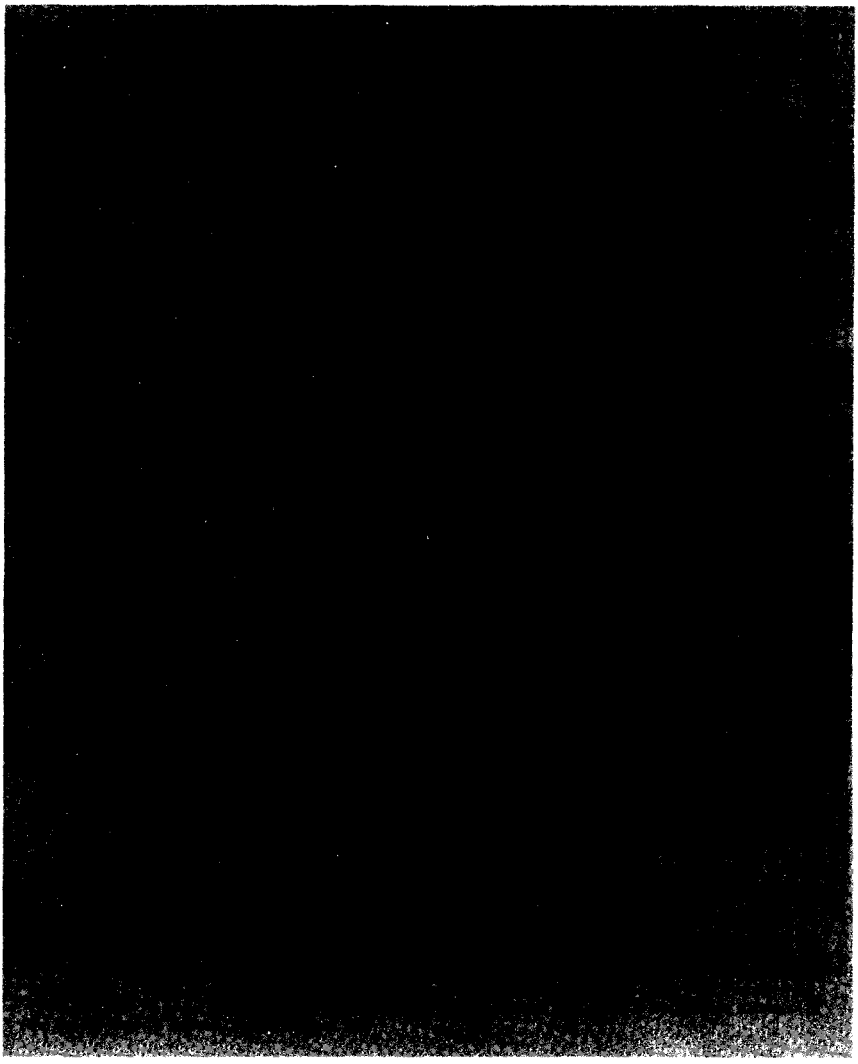

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loans since brokers are generally not allowed to make such loans. The amount of this credit is greater than regulated loans extended by banks and is even significant relative to the total volume of regulated stock market credit (see Table 2).

Finally, there are those security loans (collateraled by stock) that circumvent Federal margin requirements because they are declared by the borrower to be for a purpose other than purchasing stock (or simply not reported by the lender). Few facts on the amount of this lending are available. However, the volume of *bank* loans secured by stock but declared to be for other purposes can give some indication of the potential for this form of evasion. Based on a 1962 survey of commercial banks, the Securities Exchange Commission reported that only 13 percent of all stock-collateraled loans extended by banks were reported to be for the purpose of purchasing stock and, hence, subject to margin requirements. Forty-nine percent were declared to be "single payment personal" loans and 33 percent "business" loans (4 percent were "other").[5]

To what extent a borrower can obtain a "business" or "personal" loan to help buy stock will depend on how similar these loan categories are to regulated stock market credit. When several types of credit are similar, the borrower can more easily move from one source to another. Moreover, the regulator will find it difficult to police the illegal use of highly substitutable sources. Information collected by the SEC's study indicated that, besides having the same collateral, the "business" and "personal" loans were similar to the regulated "purpose" loans in other respects as well—location of lender, size of loan, and maturity of loan.[6] While this need not mean that the actual amount of "business" or "personal" loans used to facilitate stock purchases is significant, it does seem to imply a significant potential for avoidance—a potential which must add to concern for the ability of current margin rules to limit stock market credit effectively.[7]

AN OPTION FOR REDUCING THE REGULATORY BURDEN

Given the uncertainty of the benefits of security credit control, the marked expansion in regulation and the potential importance of remaining regulatory gaps, some alternatives to the current regulatory structure may be worth considering. One alternative would be to rescind the Government's responsibility for controlling stock market lending. However, the spector of 1929 still haunts many as does the possibility that the unprecedented build-up in stock market credit accentuated the Great Crash. A more moderate option might be to eliminate the *permanent* imposition of Federal margin requirements. Normally, lenders and borrowers would decide themselves the appropriate margin level. Yet to prevent a replay of the 1920s credit frenzy, the Federal Reserve Board would maintain authority to reimpose some form of margin control should a similar situation arise again.[8]

In order to monitor security credit activity, the Federal Reserve could continue to collect information on the volume of bank and broker stock lending—although in far less detail than is now being done. Except for infrequent surveys, information on stock market credit extended by

[5]The SEC's 1963 *Special Study of Securities Markets* (Part 4, Chapter 10) is currently the most exhaustive public report on stock market credit. However, in an early 1955 survey of 271 banks, the Senate Banking Committee reported that 64.5 percent of security collateraled credit was declared "nonpurpose" and, hence, not regulated.

[6]*Special Study* . . . , Chapter 10, pp. 51–60.

[7]In fact the Board of Governors has indicated its concern about this potential for avoidance by its attempts to tighten the legal requirements concerning the statement of purpose of a stock collateraled loan and by its limited attempt to control credit used to "carry" stock—that is, credit used to finance another purchase while cash which was originally intended to finance the purchase is instead diverted to the purchase of stock, see Solomon and Hart, op. cit. p. 199.

[8]The stock market credit bubble of the 1920s was far from being something the Federal Reserve was unaware of or unconcerned about. Rather the situation was one where they lacked the statutory authority to influence margin lending directly. See Stoffels, op. cit., pp. 5–8.

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other lenders may not be necessary. These lenders extend only about 5 percent of regulated security credit.[9] Federal margin requirements would be imposed only during a period when stock market credit, or its rate of expansion, reached some "critical" level. The behavior of stock market lending in the late 1920s and possibly preceding earlier market crises might be used in helping to establish the critical conditions.

If this stand-by authority were used only infrequently, the problem of effective regulation could be eased in several ways. First, the regulatory burden would be reduced. Most of the time individual stock market traders would have greater flexibility in their trading activities than currently. The reduced need for information on security credit lending also would mean lower regulatory costs for lenders, borrowers, and Government. Second, if a need for temporary Federal margin requirements arose, the problem of effective control could be simplified. Under such a system, there would likely be fewer channels or methods for extending security credit than now. Many of those forms of stock market lending which developed because of Federal control over the ordinary channels would be eliminated through competition. The relatively short and infrequent times that margin requirements might be applied would make redeveloping at least some of these inefficient channels unprofitable. Another potential advantage is that it may be unnecessary to maintain all the special privileges and exemptions which have added measurably to the scope and complexity of current margin regulation.

Imposing credit controls on a temporary basis is not new. In the past, part-time controls have been applied to consumer and housing credit. The New York Stock Exchange imposes special (100 percent) margin requirements on a temporary basis to loans extended by brokers for purchasing particular issues of stock as a perceived need arises. The Federal Reserve Board itself periodically alters the level of margin requirements under changing stock market conditions. These various experiences might be usefully applied to a more complete study of a stand-by form of control on stock market credit.

A NEED FOR RECONSIDERATION

Federal regulation of stock market credit has been in force for 40 years. For many, the importance of regulation has been a foregone conclusion. However, hard facts to substantiate this belief are not easy to come by. It appears to be an open question whether margin regulation has helped to reduce "excessive" swings in stock prices. In any event, the growth of institutional investing has probably diminished the importance of margin trading on stock prices relative to that before regulation. The uncertain and possibly diminishing gains from margin control notwithstanding, regulation has grown substantially. Still, avoidance of margin requirements appears to be at least significant. Closing remaining avenues of avoidance could mean even more regulation for the future. These considerations suggest that some basic changes in the current structure of security credit regulation might be warranted. Putting margin control on a stand-by basis is one alternative that could reduce the regulatory burden without foregoing complete control over stock market credit.

[9]See *Federal Reserve Bulletin*, December 1970, p. 916.

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Ways to Moderate Fluctuations in the Construction of Housing

Report of the Board of Governors of the Federal Reserve System—March 3, 1972

Recently the staff of the Board of Governors completed an extensive study of short-term cycles in housing production, of their relation to general credit conditions and monetary policy, and of means by which these fluctuations might be moderated. The individual study papers were submitted to the Congress last fall. Since then, the Board has considered what its recommendations in this area should be.

In order to provide the background needed for assessing public policy, this report on ways to moderate fluctuations in the construction of housing begins with a brief review of the salient facts about the problem of short-run variability in housing production.

THE PROBLEM OF SHORT-RUN VARIABILITY IN HOUSING CONSTRUCTION

Wide variations in the rate of homebuilding have occurred throughout the postwar period. These fluctuations have characterized all major classes of permanent dwelling units: multifamily dwellings and single-family homes alike, housing units financed by Federally-backed mortgages, as well as those that are conventionally financed.

Production of mobile homes, on the other hand, has been relatively stable. This category of home construction is less responsive to variations in general credit conditions. The terms of finance and the sources of funds for mobile homes differ considerably from those for traditional dwellings. Also, statutory and regulatory restraints on lending are less stringent for mobile homes.

There is no evidence that short-term fluctuations in traditional types of residential construction are moderating with the passage of time. One of the sharpest postwar declines occurred from the first quarter of 1966 to the first quarter of 1967, when residential construction expenditures fell by about one-fifth. In that period, the Nation's savings and loan associations experienced a marked decline in net deposit inflows. Another sharp reduction in their deposit inflows occurred in 1969. Housing activity during that year did not contract as much as it had in 1966–67, however, because of the greater underlying strength of housing demand, and the large-scale intervention by Federally-sponsored credit agencies to help stabilize the supply of mortgage funds.

Instability in residential construction is not confined to the United States. In Canada and the industrialized countries of Western Europe, downturns in private housing production have occurred repeatedly during periods of credit restraint in recent decades. There is evidence, also, that instability in residential construction afflicts the socialized economies of Eastern Europe—where the allocation of resources is determined through central planning.

Thus, instability of housing construction has been a problem practically everywhere. No quick or easy solution

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is in sight. Wide-ranging, persistent, and well-considered efforts will be needed to limit the swings in housing construction without compromising our national economic stabilization objectives.

Relation to aggregate economic activity. Short-term swings in our Nation's housing production are related closely to fluctuations in the pace of aggregate economic activity. Housing has provided a balance wheel for the rest of the economy—tending to boom during periods of slack in the economy and to turn down when activity in most other lines was rising briskly. These variations in housing production have helped to temper inflationary pressures in periods of excess aggregate demand and to support economic activity during recessions, thus serving to even out fluctuations in total output and employment.

The tendency for housing production to vary inversely with general economic activity is at times identified as a response of residential construction to changes in monetary policy. There is some truth to this. In the very short run, restrictive monetary policies do result in reduced availability of credit and higher interest rates, just as expansive monetary policies produce a temporary easing in general credit conditions. The experience of recent years indicates, however, that these effects of monetary policy on credit markets are transitory. The more lasting effects on the cost and availability of credit come from the demands for loanable funds, particularly as these demands are influenced by the expected rate of inflation.

Funds for housing typically are in short supply when demands for credit from other sectors rise rapidly—as they did in 1966 and again in 1969. Competition faced by the housing industry for a limited volume of loanable funds may stem from a variety of sources, including Federal deficit financing. The strongest competition, however, usually comes from the business sector. When retained earnings of business firms rise less than the planned increase in their investments in fixed capital and inventories, they must depend more on external sources of finance. The share of total available funds absorbed by businesses then tends to rise, while the share available for housing falls.

The housing industry is not the only economic sector that responds sensitively to changes in general credit conditions. Repeatedly in recent years, State and local governments have been subject to financial constraints when interest rates have risen. Numerous small business firms, too, have had difficulty coping with cyclical changes in the cost and availability of credit. It appears, however, that variations in general credit conditions have had a much larger effect on the rate of residential construction than on other major economic activities.

Sources of the problem. One basic reason for this special effect on the housing industry is the dependence of this industry on nonbank thrift institutions for long-term mortgage funds. Over the past 15 years, savings and loan associations and mutual savings banks have supplied nearly two-thirds of the increase in the Nation's outstanding residential mortgage credit. These institutions depend almost exclusively on consumer-type time and savings deposits as a source of funds, and they make the bulk of these funds available for home financing. As a consequence, when deposit inflows to these institutions shrink, the aggregate supply of residential mortgage credit from private lenders also declines.

Deposit inflows to savings and loan

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associations and mutual savings banks have become increasingly volatile over the past two decades. In years when interest rates in the open market have risen, the flow of consumer savings has been diverted away from depositary institutions, which pay interest rates that are relatively inflexible, and has moved instead towards market instruments. Conversely, in years when yields on market securities have fallen relative to those paid on deposits, inflows to the depositary institutions have risen.

These swings in deposit flows have of late been on a massive scale. With market interest rates rising rapidly, the increase in total deposits at savings and loan associations and mutual savings banks fell by more than half between 1967 and 1969. In 1970, short-term market interest rates fell substantially, and the net deposit inflow doubled—regaining its 1967 level —and then more than doubled again in 1971. Such alternations of feast and famine are bound to create instability in mortgage credit supplies and in homebuilding.

The asymmetry of the assets and liabilities of the nonbank financial intermediaries needs to be carefully noted. These intermediaries provide highly liquid assets for individuals to hold—assets that are close substitutes for short-term market securities on which yields are highly variable. But these intermediaries specialize in mortgage lending, and thus pile up assets with a long average life. Since the average yield on their earning assets changes little in response to variations in current market rates of interest, the nonbank depositary institutions are in a poor position to compete for consumers' savings, and to maintain their mortgage lending, when yields on market securities become more attractive.

Thus, by their very nature, these institutions are ill equipped to cope with widely fluctuating market interest rates. Moreover, this problem has been aggravated by the ceilings on rates of interest that depositary institutions may pay to attract consumer savings. The legislative extension of these ceiling rates in 1966 to cover savings and loan associations and mutual savings banks has reduced competition among financial institutions, and it may therefore have spared some individual institutions from a drain of funds to a nearby competitor. But the ceilings have interfered with the ability of all depositary institutions to compete effectively with market securities in periods of rising yields.

There are numerous legal and regulatory obstacles that discourage or prevent lenders from acquiring residential mortgages, thereby contributing to the uneven flow of mortgage credit. Chief among these are the ceilings imposed on the interest rate paid on conventional mortgages by State usury laws and on FHA-insured and VA-guaranteed loans by Federal regulations. At times, these ceiling rates of interest have gotten so far out of touch with market realities that mortgage funds—in certain regions of the country or for certain classes of loans—have literally vanished. Such laws and regulations were originally designed with the purpose of providing borrowers with funds at reasonable rates of interest, but their effect has often been to limit or to prevent the access of borrowers to mortgage credit.

There are other laws and regulations that also prevent funds from moving freely into mortgages. Federally-chartered savings and loan associations, and mutual savings banks in some States, face rather stringent geographical restrictions on lending. The terms on which national banks may make funds available for

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conventional real estate loans are limited by statute, and their total investment in such assets is also restricted. Many State-chartered commercial banks face statutory restrictions similar to those applicable to national banks. And the Federal Reserve Act discriminates against mortgage loans at the discount window: such loans are eligible as collateral for member bank borrowing only at a penalty rate of interest.

These imperfections of financial markets are not the only source of instability in the housing industry. Some categories of spending respond much more than others to changes in interest rates. Variations in the cost of credit tend to lead to particularly large changes in spending when the asset acquired is very durable, when the purchase is postponable, when there is heavy dependence on external financing, and when interest costs bulk large relative to the buyer's total expenditure. For all these reasons, the demand for housing is highly sensitive to changes in interest rates.

THE COURSE FOR PUBLIC POLICY

Given the factors responsible for the sensitivity of housing to changes in general credit conditions, public policy actions on several fronts are needed to moderate fluctuations in residential building. Legal and regulatory obstacles to the flow of mortgage money need to be removed or reduced. Ways need to be devised for reducing the instability of deposit flows to savings and loan associations and to mutual savings banks. And some significant changes will be required in the character of our Nation's economic stabilization policies.

The most important single contribution that could be made to stability of housing production would be to obtain better control over the forces of inflation. Housing activity in the postwar period has declined whenever our Nation has failed to adopt promptly the policies of restraint needed to avert excess aggregate demand. Improvements in the use of all of our instruments of stabilization policy are clearly needed. But avoidance of sharp fluctuations in interest rates and credit conditions will require heavier reliance on fiscal tools, and less reliance upon monetary policy, to achieve our national economic stabilization objectives. Once variations in general credit conditions are lessened, both the supply of mortgage credit and the rate of housing construction will become more stable.

In considering the proper scope and direction of public policy, it is important to recognize that complete elimination of fluctuations in housing production is not a feasible objective. From time to time, excess aggregate demand will reemerge, and then it will become necessary to curb demand in order to reduce, if not prevent, inflationary pressures. At such times, some curtailment in residential construction need not be against the national interest. During brief periods of excess demand, reduced output of highly durable assets, such as houses, would permit the achievement of restraint in the use of real resources without much sacrifice of current standards of consumption and, in the process, would contribute to holding down inflation. Since the stock of houses is very large, a moderate decline in the rate of new production for several months or a year would have negligible effects on the quantity and quality of the total housing available for use by the public.

In the past, however, credit-induced declines in housing construction have often gone beyond the point of tolerance, creating unnecessary hardships for construction workers, contractors, and those

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employed in associated industries. These declines have also interfered with improvements in the efficiency of resource use in residential construction—improvements that could lead to lower housing costs if fluctuations in the rate of housing production were moderated. Economic policy, therefore, should seek to redress the balance of restraint during periods of excess aggregate demand—by imposing more restraint on categories of durable goods output other than housing and, in the process, reducing the burden to be borne by the residential construction industry.

Expanding role of Federal housing agencies. In recent years, a number of significant steps have been taken to reduce the severity of short-term declines in housing construction. Federally-sponsored agencies concerned with housing credit or related fields have focused more insistently on the problem; new agencies and programs for dealing with the problem have been established by the Congress; and the powers of existing Federal agencies have been expanded.

The present network of Federally-sponsored credit agencies has demonstrated its capability of contributing powerfully to bolstering the supply of mortgage credit during periods of general credit stringency. During 1969, these agencies supplied directly, or indirectly through loans by the Federal home loan banks to savings and loan associations, over 40 per cent of the net funds borrowed to finance housing. In the absence of these massive operations, a much more precipitous decline in housing construction would have occurred in 1969.

Undoubtedly, additional improvements could be made in Federal credit programs to assist the housing industry when private mortgage funds are in short supply. But it would be unwise to rely entirely on this approach to solve the housing finance problem. The main thrust of new initiatives should strike directly at the sources of fluctuation in housing construction.

Removal of legal and regulatory obstacles to flows of mortgage credit. The Board recommends that the Congress eliminate all interest rate restrictions on FHA-insured and VA-guaranteed loans. Rates on these loans then would reflect market conditions and permit a larger flow of funds into residential construction than would otherwise occur at a time of credit stringency. Legislation enacted in 1968, putting responsibility for determining ceiling rates in the Department of Housing and Urban Development and in the Veterans Administration, was a step forward. More flexible adjustments in ceiling rates are now possible than was the case when these rates were established by congressional statute.

Under present arrangements, however, decisions to change these ceiling rates can never be free from political constraints. There are likely to be recurring periods, therefore, when mortgage discounts rise again to levels that severely limit or actually deny the access of borrowers to this type of credit.

Such troubles can be avoided by abolishing the ceilings. Alternatively, the Congress might instruct HUD and the VA to adopt a mechanical rule that ties the ceiling rate to a market-determined interest rate.

State governments should also be encouraged to remove their usury ceilings, or to raise them to levels at which they would no longer block the flow of funds into mortgages. There is a growing awareness of the damage that usury ceilings have done, as is evidenced by the fact that numerous States in recent years have raised their usury ceilings—some of them only temporarily, however. Action

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by the Congress in dispensing with ceiling rates on Federally-backed mortgages would encourage State governments to take similar actions.

Several changes in Federal banking laws are needed to remove impediments to investment in residential mortgages by commercial banks. First, the Federal Reserve Act should be modified to permit the Federal Reserve Banks to lend to member banks on the basis of sound mortgage collateral at the regular discount rate. The Board has recommended this action on prior occasions. Second, quantitative limits on acquisitions by national banks of conventional, and some types of FHA-insured, real estate loans should be abolished. These loans presently may not exceed the capital stock and surplus of a bank, or 70 per cent of its time and savings deposits, whichever is greater. Although mortgage acquisitions at present are probably not being limited significantly by this provision, its retention seems unnecessary. Third, the Board recommends rescinding the requirement that conventional real estate loans of national banks may not exceed 90 per cent of the appraised value of the property mortgaged, nor exceed 30 years in maturity. Removal of the maximum maturity provision would be essential to investment by national banks in variable-rate mortgages with variable maturities, as discussed later in this report.

Once these provisions were dropped, investment by national banks in conventional mortgages would be governed principally by considerations of safety and soundness, to be tested by bank examinations, as is the case with most other types of loans. The Board believes, however, that it would be prudent to authorize the Comptroller of the Currency to establish safeguards through such regulations as may prove necessary.

Many State banking laws applying to investment in conventional mortgages by State-chartered banks are similar to national banking laws and regulations. Here, too, action by the Congress in liberalizing the mortgage provisions of the national banking laws would provide guidelines that the States could follow.

Especially stringent geographical restrictions on mortgage lending by depositary institutions are found in regulations applying to conventional mortgage loans of Federal savings and loan associations. Though liberalized about a year ago, these regulations still impose rather narrow limits on the geographical mobility of mortgage funds. It is doubtful whether limits of this kind are needed to protect the soundness of individual associations. In our judgment it would be helpful to drop these restrictions, so that funds of savings and loan associations could be loaned out wherever the need seems greatest.

Such action might prompt States in which mutual savings banks operate to reconsider geographical restrictions on conventional mortgage lending by those institutions.

Elimination of these legal and regulatory constraints on mortgage lending would augment the long-run supply of mortgage funds, as well as lessen short-term fluctuations in mortgage credit supplies.

IMPROVEMENTS IN THE FUNCTIONING OF DEPOSITARY INSTITUTIONS

Let us next consider ways of improving the capability of depositary institutions to compete more effectively for consumer savings during periods of rising market interest rates, and thereby to provide a more even flow of funds to the mortgage market.

The problem that nonbank financial intermediaries face, as noted earlier, stems from their nature as specialized financial institutions that lend chiefly in

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the mortgage market. These institutions would function better in a world of fluctuating market interest rates if the average life of their earning assets were shortened. This objective could be accomplished by diverting a substantial part of their loanable funds to assets other than residential mortgages. Such a solution, however, could well affect adversely the long-run supply of residential mortgage credit and thus raise the average cost of mortgage borrowing.

There is no fully satisfactory solution to this dilemma. The Board believes, nonetheless, that courses of action are available that will improve the ability of nonbank thrift institutions to stabilize their deposit flows and their mortgage lending, while avoiding an undue reduction in the long-run supply of residential mortgage funds.

In the near term, there are good prospects for reducing the asymmetry of the assets and liabilities of nonbank intermediaries by measures to encourage lengthening in the average maturity of deposits and a reduction in deposit turnover rates. Progress in this direction already has been made in recent years, but further steps could be taken. For example, ceiling rates of interest on deposits established by the supervisory authorities could be modified to provide for greater differentiation of accounts by maturity classes, and to permit higher interest rates to be paid on longer-term deposits. The Board intends to pursue these matters with the other regulatory agencies.

Some benefits also can be gained by encouraging the specialized mortgage lending institutions to put a modest proportion of their earning assets into consumer loans—perhaps a maximum of 10 per cent. Over the long run, this may tend to reduce somewhat the flow of funds from these institutions to the mortgage market. However, since the average effective life of consumer loans is much shorter than that of mortgages, the average yield on earning assets would respond better to changing market interest rates over a period of several years. This would enhance the ability of nonbank depositary institutions to increase their interest rates on deposits at times when market yields were rising and thus at least partially reduce the tendency of consumer savings to shift to market instruments.

Another step well worth considering would be enabling all depositary institutions to offer mortgages with variable interest rates and attendant safeguards, side by side with the traditional fixed-rate mortgage, as a means of home financing. Depositary institutions holding variable-rate mortgages would experience more flexible average earnings rates. Since they could then change deposit interest rates in response to variations in yields on market securities, deposit inflows should be more stable. Short-term fluctuations in mortgage credit supplies would thereby be reduced, so that home buyers could reasonably expect to find mortgage funds available even during times of general credit restriction. This greater cyclical stability of mortgage credit availability could be achieved, moreover, without affecting adversely the long-run supply of mortgage funds.

There are, of course, some problems associated with rate provisions that would involve the absorption by borrowers of some of the risks of interest rate fluctuations. This would be a complicating element in the budgeting and financial planning of a homeowner carrying a mortgage. It would be wrong, however, to assume that he has no capacity at all to absorb such risks. Variation in interest rates are to a significant degree attributable to changes in the rate of inflation. Increases in the

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interest rate on a variable-rate mortgage, consequently, would generally be accompanied by a rise in the average borrower's income and his debt service capacity. And, of course, there would be times when borrowers would enjoy a decline in their mortgage interest rate, since a variable-rate mortgage contract would need to provide for reductions in the contract rate when market yields moved down, as well as for increases when market yields rose.

In negotiations over this kind of rate provision, professional lenders would have significant bargaining advantages over relatively unsophisticated homeowner borrowers. If such advantages were exploited, an undue share of the burden of interest rate adjustment could be shifted to homeowners. Accordingly, variable-rate mortgages should have protective features to safeguard the interests of borrowers.

For example, it would be wise for public policy to limit the degree to which any individual borrower is subjected to changes in his mortgage interest rate. This could be done by designing a mortgage instrument on which the possible fluctuation in interest rates is restricted to a moderate range. Furthermore, lenders could be required to provide prospective borrowers with data showing the differences in costs that could result over the life of the contract under alternative assumptions as to interest rate movements. Also, the fixed monthly payment form of the variable-rate mortgage would need to be given particular encouragement. In such a mortgage contract, the variation in interest rates under most circumstances would take the form of a lengthening or shortening of the term to maturity rather than a change in the monthly payment. This would be more suitable for borrowers than the variable monthly payment form, since adjustments in other expenditures would then not be required to accommodate changes in outlays for debt service.

The Federal Government could help prepare the way for use of variable-rate mortgages as an instrument in home financing. Thus, HUD and the VA might authorize variable rates on FHA-insured and VA-guaranteed mortgage loans, and the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation could include such mortgages in their secondary market operations. Also, assistance might be given to the community of mortgage lenders in developing a standard contract for variable-rate mortgages, and to the States in developing model legislation to provide mortgage borrowers with adequate safeguards against possible abuses by lenders.

It should be emphasized that the proper role of variable-rate mortgages is additional and complementary to the traditional fixed-rate mortgage contract. Borrowers should have the option of choosing freely between these instruments. Unless a potential borrower expected interest rates to decline, he would usually prefer to finance his home purchase with a fixed-rate mortgage—thereby avoiding the uncertainty inherent in a variable interest rate. In view of this normal preference of borrowers, lenders would probably need to make the initial interest rate and other contract terms more attractive than those on a fixed-rate mortgage.

If promptly implemented, it would probably still take a decade or longer for variable-rate mortgages to reach a sizable fraction of the portfolios of the Nation's depositary institutions. In time, however, this financial innovation might be of substantial help in moderating swings in the availability of mortgage credit and in residential construction.

Steps discussed in this section to strengthen our depositary institutions, if

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implemented, should speed the day when ceiling rates of interest on consumer time and savings deposits would no longer be needed. Removal of the ceilings would permit savers to be rewarded more fully; it would increase efficiency of financial markets and it would enable each depositary institution to compete with market securities to the maximum extent permitted by its own earnings position.

Although it would be wise to leave standby authority in the hands of the regulatory agencies to impose interest rate ceilings on consumer time and savings deposits in the event of unforeseen contingencies, the Board believes that it is time to begin planning for gradual withdrawal of ceiling rates as an instrument of financial regulation. The Board again recommends, therefore, that the Congress make permanent the authority—which was granted to the regulatory authorities in the fall of 1966 and extended since then on several occasions—to differentiate between kinds of deposits for purposes of deposit rate regulation and to suspend interest rate maxima when it is judged appropriate to do so. It would also be constructive if the Congress saw fit to indicate a desire to have the regulatory authorities formulate, and begin implementation of, a long-range plan for step-by-step removal of effective ceilings.

IMPROVEMENTS IN THE USE OF FISCAL POLICY

Some years will pass before the above recommendations for reform of the depositary institutions and for the removal of legal and regulatory barriers to mortgage fund flows can have their full beneficial effects in stabilizing housing construction. In the short run, the principal hope for lessening the variability of homebuilding lies in gaining a fuller measure of control over inflation—and particularly in improving the use of fiscal policies, so that lesser reliance would need to be placed on changes in credit conditions to stabilize aggregate economic activity. Indeed, as students of the housing problem have long recognized, increased reliance on fiscal policies to stabilize aggregate economic activity has a permanent role to play in any well-conceived program to lessen the instability of housing construction.

Such a course has a number of related advantages. If we succeed in establishing a financial environment conducive to less volatile flows of mortgage credit, other sectors that are sensitive to fluctuations in credit market conditions will also benefit. State and local governments, for example, will not be confronted with such pronounced variations in financing costs, and smaller business firms will experience less difficulty in securing funds when business is booming. Furthermore, greater stability in residential construction will be achieved without sacrificing the broader objectives of stability in aggregate employment, production, and prices. By resorting to a more flexible use of fiscal tools, sectors of the economy in which spending is influenced relatively little by monetary policies could thus be made to bear their share of restraint during periods of excess demand.

A variety of fiscal tools could be used to stimulate or restrict spending in one or more sectors other than housing. However, suggestions for flexibly administered fiscal policies previously set forth by academic economists and others have not been viewed by the Congress with much enthusiasm. The Congress has been understandably reluctant to take steps that might interfere with efforts to rationalize tax policy, or result in manipulating private spending incentives capriciously, or give the Executive Branch excessive con-

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trol over Federal expenditures or tax rates. It may be possible, however, to overcome these objections with a systematic approach that minimizes the threat of undermining either tax policy or budget policy.

A promising approach is to use fiscal policy to control changes in the rate of business investment. Outlays by business firms on machinery and equipment are large and cyclically volatile. Clearly, greater stability in such purchases would foster a more steady growth rate of aggregate production and employment. These expenditures, furthermore, are relatively insensitive to monetary policy, particularly in the short run. During periods of credit restraint, the business sector has repeatedly drawn on financial and real resources that would otherwise have probably gone into the housing industry.

One instrument of tax policy, the investment tax credit, has in recent years been employed to influence business investment decisions. By now the investment tax credit is well understood by the business community, by the Congress, and by the general public. Its effects on the rate of business fixed investment have been demonstrated in actual experience.

The investment tax credit was originally thought of as a device for providing additional stimulus to business capital expenditures over the long run. However, successive congressional measures dealing with this tax credit since 1966 have suggested that the credit might also be used flexibly to even out the behavior of business investment spending over the course of the business cycle. Thus, the magnitude of the tax credit could be lowered when excess aggregate demand threatened to generate inflationary pressures, or it would be raised when the economy was in need of stimulus. If the tax credit were adjusted in this fashion, variations in business external financing demands would tend to be reduced, fluctuations in market interest rates would tend to diminish, and these developments could contribute to stabilizing the flow of mortgage credit and housing construction.

A flexible use of the investment tax credit would require orderly procedures for adjustment of the rate of credit. Experience suggests that, if timely adjustments are to be made, the Congress would need to assign responsibility to another body for determining when a change in the rate of tax credit should be effected. However, this could be accomplished in ways that protected and preserved the ultimate responsibility of the Congress to determine tax policy and that avoided subjecting the business community to capricious changes in taxes.

For example, the Congress might grant to the President authority to vary the investment tax credit within prescribed limits—say, from zero to 10 or 15 per cent. Once a change in the rate of tax credit was announced by the Executive, it would go into effect 60 days hence, retroactive to the date of the announcement, unless the Senate or the House of Representatives disapproved of the rate change in the intervening period. The Congress might, if it so chose, stipulate that the President could act only after a public recommendation had been made by an advisory body, such as the Council of Economic Advisers.

Under such a system, timely adjustments of the investment tax credit could be achieved, but there would also be ample time for careful deliberation by the Congress to determine whether the proposed fiscal action was in the national interest.

CONCLUDING COMMENTS

The Board recommends that priority consideration be given to establishment of the

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machinery for a variable investment tax credit. This is the most important single contribution that could be made to easing the plight of the housing industry in recurring periods of credit restriction. The Board also suggests consideration of actions to enable the use of variable-rate mortgages to finance residential structures.

Other recommendations set forth in this report, though less significant individually, would in the aggregate also serve to reduce materially the instability of credit flows to the housing industry.

At present, the residential construction industry is not suffering from any want of credit. Housing activity has been rising rapidly for over a year and a half, with starts reaching a new peak in January of this year. Even now, mortgage interest rates are falling, while inflows of time and savings deposits at commercial banks and nonbank thrift institutions continue at unusually high levels.

These recent developments do not imply that the cyclical problems of housing and housing finance are behind us. On the contrary, they illustrate that the supply of mortgage credit and the rate of housing production are still highly sensitive to changes in general credit conditions.

This is a good time for the Congress to consider carefully the most appropriate steps to help stabilize supplies of mortgage credit. In the course of its deliberations, the Congress will no doubt wish to obtain the judgments of a number of governmental agencies, of consumer groups, of representatives of industry and finance, and of recognized scholars in the housing field.

The Board would urge the Congress to take the opportunity afforded by present conditions in the mortgage credit and housing fields to move forward and put in place the machinery that will be needed for moderating fluctuations in residential construction in the years ahead. □

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FEDERAL RESERVE POLICY, INFLATION, AND HIGH INTEREST RATES

WEDNESDAY, AUGUST 7, 1974

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10:50 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman [chairman], presiding.

Present: Representatives Patman, Barrett, Sullivan, Stephens, St Germain, Minish, Gettys, Hanley, Boggs, Widnall, Johnson, Blackburn, Rousselot, Roncallo, and Burgener.

The CHAIRMAN. I think we have something that all of our members would be proud of today. I do not know of any man in the United States who has more knowledge and information and is more qualified to speak on the subject that we are investigating and having hearings on than the witness we have today.

Today the committee will hear testimony from John Winthrop Wright on the question of inflation and interest rates. Mr. Wright has prepared what I believe to be a most important study. Mr. Wright is president of the Wright Investors' Service, Bridgeport, Conn., an investment and advisory organization registered with the Securities and Exchange Commission.

He is the author of "QVT, Three Keys to Stock Market Success," published by Prentice-Hall, and numerous articles on investment in economic subjects. I want to give him all of the time he needs to present his most significant study, and the members time to question him.

Now, Mr. Wright, the policy of our committee is, after we hear from you—and we must give you all the time you want because you have a compendium of information here that is unexcelled by anything that I have ever seen in my life, and I think if it is all right with you, we will put the whole thing in the record at this point.

Will that be satisfactory?

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. Without objection, so ordered.

[Testimony resumes on p. 516.]

[Mr. Wright's prepared statement follows:]

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TESTIMONY OF JOHN WINTHROP WRIGHT

Before The Committee on
Banking and Currency
U. S. House of Representatives
Washington, D. C.

August 7, 1974

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OUTLINE OF TESTIMONY

By John Winthrop Wright

A. BACKGROUND AND QUALIFICATIONS OF JOHN WINTHROP WRIGHT

1) Born Bridgeport, Connecticut, June 27, 1912.

2) Education: Phillips Exeter Academy 1929, Amherst College 1933, Teacher of Economics St. John's College 1939-40.

3) Experience: Accountant, Home Owners' Loan Corporation, Washington, D.C. 1933-36; Special Representative, Mortgage and Trust Departments, First National Bank, Bridgeport, Connecticut 1937-38; Fraternity Business Manager, Amherst College 1938-39; Treasurer, St. John's College, Annapolis, Maryland 1939-40; Commander, active duty, U.S. Naval Reserve 1940-47; Executive Vice President, Standard Air Service 1947-48; Founder and President Wright Power Saw and Tool Corporation 1947-54; Sr. Partner, Andres Trubee and Company, Financial Consultants 1955-59; Chairman, Rototiller, Incorporated 1958-59; President Wright Investors' Service, Bridgeport, Connecticut 1960 to date. Wright Investors' Service is an investment management and advisory organization, registered with the United States Securities and Exchange Commission since 1961, presently consisting of 120 officers and employees, managing directly about one quarter of a billion dollars of investments of corporate and union pension and profit sharing funds, eleemosynary institutions and other organizations and individuals, and serving as investment adviser to 17 NYSE member brokerage firms and about 500 banks and institutional investors.

4) Author: "Q.V.T., Three Keys To Stock Market Success", published by Prentice-Hall, Inc., 1970. Also numerous articles on investment and economic subjects in most leading financial journals.

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B. THE PURPOSE OF THIS TESTIMONY

1) As a citizen, to protest the ill-conceived legislation and the misguided governmental policies and management which in six years have drastically damaged and are now destroying the American free enterprise system as we have known it.

2) As an investment counselor and manager, to ask for relief from the unrelenting pressure by which the Federal Reserve Board has caused the greatest shrinkage of American security values since the great depression of the nineteen thirties, virtually destroyed our equity markets, forced the liquidation of individual ownership of publicly held corporate equity securities and of most of the securities industry, caused the transfer of ownership of American industry from individual to institutional investors, and transformed us from a nation of investors into a nation of lenders and borrowers.

3) As both a lifelong student of finance and economics and a practical businessman of thirty years experience, to point out the dogmatic, pedagogical misconceptions and the obvious lack of objective, constructive thought which have caused these ill-conceived governmental policies and brought us to this sorry state, and to present to this committee some remedial and constructive proposals which, I believe, have at least the merit of objective logic and common sense.

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C. THE CURRENT MISCONCEPTIONS OF OUR ECONOMISTS AND NATIONAL ECONOMIC AND MONETARY MANAGERS VS THE TRUE CAUSES OF AND REMEDIES FOR INFLATION

Misconception Number One . . .that the cause of today's inflation is excessive growth of the nation's domestic money supply, and that this has been an unavoidable result of excessive government spending.

I submit that this is a gross over-simplification and distortion of the facts. The inflation of 1968-70 which reached a 5.3% annual rate (GNP deflator) was a result of financing the escallated costs of the Viet Nam War without either raising taxes or imposing controls, but the double digit inflation of 1973-74 is a result of a confluence of factors, none of which may be laid at the door of excessive government spending *per se.* Here is a list of the true causes.

1) The **accumulated Federal deficits** of 1970-73 were a contributing factor to, but by no means the principal cause of today's inflation. These deficits, in fact, resulted primarily from a decline of more than -10% in federal tax receipts per capita (in constant dollars) from 1969 through 1971, and an expansion of nearly +20% in expenditures (in constant dollars) from 1970 through 1972, both of which were a direct result of the until then unprecedented contraction in 1969-70 of our money supply by the Federal Reserve Board and the consequent decline in national product, corporate and personal incomes, and the government's tax revenues thereon. *Neither the decline in tax revenues nor the "economically stimulative" expansion of federal expenditures would have occurred if the Federal Reserve Board had not taken it upon itself to plunge the nation into a recession in 1969-70.*

2) **The Administration's decision in 1971 to suspend the convertibility of the U.S. dollar into gold** although necessary to correct a long term accumulated imbalance of international payments, cast practically all of the world's currencies, as well as the dollar to which they had been tied, afloat upon a confused and angry international sea. The result was a worldwide loss of confidence in the stability of practically all governmental currencies and an unprecedented, excessively stimulative demand for every kind of tangible store of value which caused world commodity prices to more than *double* within one year, and created material shortages which substantially impaired production in the United States and caused severe imbalances between supply and demand for practically all products.

3) **The devaluation of the U.S. dollar,** although necessary to restore the international competitiveness of U.S. dollar priced exports, was also a direct result of the long term mismanagement of our international trade and finance, our subsidy of foreign nations, and the export of American capital to increase production overseas instead of in the United States. The resulting cumulative decline of -17.4% in the U.S. dollar's international purchasing power was in effect a defacto recognition of the U.S. dollar inflation which had already occurred internationally, and which has subsequently been reflected in the increase of domestic prices. Please note that a -17.4% dollar devaluation is equivalent to a +21% price rise, and that this alone is equivalent to two years of double digit inflation at annual rates.

4) **The foreign-controlled increase in the cost of energy,** has, of course, been an inescapable and major factor in our current inflation. Certainly, this was not and is not subject to correction by reducing the domestic money supply, or by any other domestic measures, except for the long term development of alternate sources of energy which, incidentally cannot possibly be successfully financed if today's usurious level of interest rates is permitted to continue. The energy price rise, although more than double for foreign oil, averages out, according to our calculations, to close to a +50% overall average price rise in all U.S. energy costs, foreign and domestic. Although this is still in the process of permeating the price structure of practically all U.S. goods and services, the process is now nearing completion and this major cause of domestic inflation will soon become an historical fact as distinguished from a continuing factor.

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5) **The unregulated increase in the supply of "Eurodollars"** has been equivalent to a +115% increase in the total supply of current U.S. dollars (M1) since 1968, +95% of the total current money supply of $241 billion at the beginning of the period ($200 billion in domestic funds [M1] plus $41 billion in Eurodollars already on deposit in foreign banks). The Eurodollar increase was also equivalent to +57% of all dollar deposits inside the U.S.A. including all time deposits. The FRB regulated domestic U.S. money supply (M1) increased by only +40% during the same period (or 33% of all current dollars including Eurodollars at the beginning of the period). The unregulated massive increase of Eurodollars has been and still is unquestionably a major domestic as well as a worldwide cause of inflation. Believe it or not, the supply of "Eurodollars", which are essentially deposits in foreign banks abroad payable in U.S. dollars, is now almost as great as the entire U.S. domestic money supply of about $279 billion in currency and demand deposits in U.S. banks (M1). These dollars, have in part been simply created by foreign bank dollar loans and are not backed, directly or indirectly, by reserves in U.S. Federal Reserve banks. Here is the major villain of the inflationary piece, for these dollars, "fictitious" or not, do represent actual dollar buying power demand and are therefore a very powerful factor in the demand/supply imbalance which has created today's inflation. This unregulated creation of U.S. dollars by foreign banks is a continuing inflationary factor which can and should be brought under strict U.S. control. Is it not incredible that our government's monetary authorities are now drastically restricting the U.S. domestic money supply and our domestic economic growth, while completely neglecting to take any measures to reduce or even to bring under control this enormous, unregulated foreign-made expansion of U.S. dollars?

6) **The suspension of ceilings on negotiable bank certificates of deposits in June 1970**, while essential at the time to avoid a nationwide financial panic of the first magnitude which then threatened to result from the FRB's excessive and prolonged "credit crunch" of 1969-70, has since turned out to be a financial Frankenstein of previously unimaginable power. Herein is the cause of the apparent paradox of unprecedentedly usurious interest rates and an "adequate" supply of bank lendable funds – that is by big banks to big borrowers. For while the conventional "current money supply" of currency and demand deposits (M1) has been growing at an average +6.3% annual rate during the last 5½ years (+6.8% during the last eighteen months), large certificates of deposit have averaged a +25% compound annual rate since 1968, have skyrocketed to a +54% annual growth rate since 1972, and have caused the total money supply including all demand and time deposits to rise at a +12.7% annual rate during the same period.

The adverse effects upon the American free enterprise capitalistic system of this suspension of regulation of large negotiable bank certificates of deposit can scarcely be exaggerated. This one terrible mistake, which benefits no one except the large banks, has caused:

a) The escallation of interest rates to levels which are unprecedented in our history, were inconceivable a few years ago, are nearly double the rate which centuries of civilization have considered "usurious", and are unsustainable by a productive society. It is interesting, if somewhat disconcerting to note that in the early vigorous days of the Roman Republic 8 1/3% was the maximum legal rate of interest; this was raised to 12% in 87 AD as the empire began to decline.

b) The demoralization, disintegration and forced liquidation of our securities markets for common stocks, bonds, and commercial paper alike.

c) The concentration of financial and economic power in the major banks, interposing big bankers between the owners and the users of capital and causing the transformation of equity capital into debt, investors into lenders and businessmen into borrowers instead of partners.

d) A dangerous shift from long term capital investment into short term lending, which seriously reduces the true liquidity of our banks and the availability of long term investment capital for the expansion of competitive, productive enterprise.

e) A serious impediment to the liquidity, viability and growth of our savings institutions and a very real threat to the American tradition of individual home ownership.

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7) Finally, high interest rates are themselves a primary cause of inflation for two reasons:

First, because the very reason by which they are justified – "to slow down the economy" – actually slows down production before consumption, reduces supply before curtailing demand, and thus accelerates inflation while causing recession.

Second, because interest costs are themselves a major component in the cost of goods and services. Gross debt of the United States Government now amounts to close to $500 billion. Each additional 1% added to the cost of servicing that debt amounts to $5 billion. Thus the increase of $11.2 billion in the annual interest cost of the federal debt, which has already resulted from the increase in interest rates, can be computed to have inflated by about 2% per year that portion of the cost of our Gross National Product which represents interest on the Federal debt alone. When we compute an estimated average 5% increase in current vs 10 year 1959-68 average annual interest costs on private consumer debt of $178 billion, plus the progressive escallation of interest rates from 6% to 9½% on mortgages of $620 billion, we add billions more to inflation. Altogether, U.S. public and private debt now totals more than two and a half trillion dollars ($2, 526 billion at 1973 year end), about double the U.S. Gross National Product, which is now estimated at $1,383 billion. Thus each 1% addition to interest costs adds close to 2% to inflation. A very significant portion of the inflation of 9.3% during the last 12 months can be attributed to the concurrent escallation of interest rates.

Misconception Number Two . . .that the current rate of inflation is unprecedented in our history and threatens the destruction of the American capitalistic system.

This is simply not true. Since World War II, inflation in the United States has twice before reached "double digit" proportions, first in 1947 with the post-war relaxation of wage/price controls and second during 1951 as a result of the Korean War. Both cases, represented essentially one time price adjustments and were followed by a return to "normal" rates of less than 3% within one or two years.

I submit that it is thoroughly irresponsible for any of our economic leaders to threaten our nation with the permanent destruction of our economic way of life unless we accept their program for an extended period of economic regression. The recent excessive rate of inflation is essentially a "one time" adjustment which has already run most of its course, and which was the inevitable result of the domestic governmental mismanagement and the international developments which have already been outlined. These inflationary measures have already taken place, and there is no reason to believe that the excessive inflation which they caused will continue beyond 1974 unless excessively restrictive FRB monetary policies and a prolongation of prohibitively usurious interest rates are allowed to cause another recession to be followed again by stimulative spending and a renewal of federal deficits.

Misconception Number Three . . .that the principal remedy for inflation is unrelenting restriction of the domestic supply of money and credit and a continuation of unprecedentedly high interest rates.

The rationale for this belief assumes that all inflation is caused by an increase in the domestic money supply, and is therefore curable by reducing the supply, or is at least stoppable by ceasing to increase it. This would be demonstrably valid if the United States were an island, entirely insulated from the rest of the world; but it is demonstrably false in the present circumstances because the regulated U.S. domestic money supply has not increased excessively. On the contrary, it is the unregulated foreign supply of dollars, known as "Eurodollars" which have proliferated and are the fundamental cause of a worldwide inflation in which the United States has been caught up because it did not take effective measures either to control this proliferation or to insulate itself against its effects. To hold that this is curable by starving the American domestic supply of money and credit, and denying American business the working capital which is vital to its existence seems to me to represent a new high in irrationality.

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Misconception Number Four . . . that these policies, currently described as "that old time religion" have been successful in the past and must now be employed regardless of their consequences in reduced national productivity, increased unemployment, and a reduced standard of living for our citizens.

Although a balanced federal budget may perhaps be properly described as an "old time religious credo", the history of the application of policies of excessively restrictive monetary growth can be described as "successful" only if one is willing to consider the creation of a series of domestic recessions as a successful accomplishment. The disinflation of 1930 which followed the speculative boom of 1926-29 was unnecessarily turned into the "great depression" of the nineteen thirties as a result of the unrelenting contraction of money and credit by the Federal Reserve Board, and was finally corrected after three years of unnecessary damage to our economy, by the then unprecedented, easy money and low interest rate policies of the New Deal. During the last two decades, the United States has experienced a series of interruptions of the growth of its gross national product and the standard of living of its citizens (1957-58, 1960-61, 1967, 1969-70, and now in 1974), none of which had to happen and all of which were caused by excessive contraction of money and credit by the Federal Reserve Board. Two wrongs do not make a right, and there is simply no logic in a belief that because poor monetary management has caused excessive expansion from time-to-time in the past, it necessarily follows that stable monetary growth is not attainable and that excessive monetary restriction and recession are unavoidably required periodically to offset a prior cyclical period of excessive monetary growth.

When I hear over and over again the statement that high interest rates and a stagnant, no-growth economy are "necessary to fight inflation", I cannot help but be reminded of the post-medieval era when the medical profession believed, practically to a man, and had persuaded the public of the "scientific" doctrine of "phlebotomy", which held that bloodletting was practically the universal cure for diseases of all kinds, ranging from high blood pressure to insanity. This, it seems to me, is now the sorry state of our economic science whose leaders today are so busily engaged in draining the very life blood from our competitive free enterprise economic system.

Misconception Number Five . . .that the management of the nation's credit, interest rates, and money supply had best be left in the hands of the Federal Reserve Board, "because they know best" and "such matters ought to be kept out of the hands of politicians", specifically the President and the Congress.

During World War I, the French Premier Clemenceau once remarked that "War is much too important a matter to be left to the generals". I believe that with different words the essential truth of this statement is applicable today to our economy and its masters, the seven members of the Federal Reserve Board and the five Federal Reserve Bank presidents who serve with them on the all-powerful "Open Market Committee" which absolutely (not partially) controls (not influences) the supply of money and credit and the level of interest rates in the U.S.A.

I am, therefore, including in the proposals for economic reform which I am about to submit respectfully to this committee one which is intended to place the responsibility for economic and monetary policy with the elected representatives of the people, specifically the President and the Congress, a second proposal which broadens and more precisely defines the qualifications for F.R.B. membership and a third proposal which increases the regulatory means and authority of the Board in carrying out these policies.

D. THE IMMINENT DANGER OF DESTRUCTION OF THE TRADITIONAL AMERICAN FREE ENTERPRISE SYSTEM AS A RESULT OF CURRENT FEDERAL BANKING AND MONETARY POLICIES.

When we think of the special genius of America, we think of liberty, opportunity and free enterprise. Today, the constitutional safeguards of our liberty remain intact, but the economic opportunity to develop and expand free, competitive economic enterprise has been drastically curtailed by two major developments:

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1) The great expansion of the power of the major banks as a result of the One Bank Holding Company Act, has given them a grossly unfair and decisive competitive advantage over independent competitive enterprises which have neither the franchised right to use the public's deposited funds for private profit, nor the influence on prospective clients for non-banking services which is inherent in lender-borrower relationships. Consequently, we are today witnessing a progressive "takeover" by the major banks of the investment industry and a parallel penetration of leasing, insurance and related activities. This is obviously damaging to thousands of independent competing organizations, serves absolutely no discernable public purpose, and should be stopped forthwith before it is too late.

2) The unrestricted use of large negotiable certificates of deposit, together with the incredible, escallation of interest rates to unprecedentedly usurious levels has already largely destroyed the American capital markets and is rapidly killing independent competitive business.

The word "usury" has an ancient history, and it is no accident that throughout the evolution of civilization seven percent has been considered as the threshold rate beyond which society suffers and only the rich and the greedy can benefit. Today's "prime rate" plus compensating balances is more than twice that level, is causing our cherished competitive free-enterprise system to expire before our eyes and is replacing it with an oligarchy of bigness – big banks and the big corporate customers who have first call on what it takes to get ahead in a creditor-debtor society.

I have been unable to find any reason why it is in the public interest to permit banks to pay unlimited rates of interest on large deposits to those who presumably have more and need less than the run-of-the-mill saver; and I have therefore included the prohibition of such discriminatory regulation, or lack of it, in these proposals for economic reform.

E. PROPOSALS FOR LEGISLATIVE AND REGULATORY REFORM OF AMERICAN ECONOMIC AND MONETARY MANAGEMENT.

1) Require by Resolution, U.S. International Negotiation to Create an Inflation-proof Standard of Value in the International Monetary System.

The recent international agreement on the "basket of currencies" principle for the valuation of each nation's currency in relation to an international "numeraire" known as "SDRs" was a useful first step in the right direction, but left unsolved the establishment of a constant inflation-proof standard of value to fill the role which, in the past, was acted by gold. For this purpose, I propose an extension of the "basket" principle to arrive at an overall rate of international inflation by applying the same "weights" as in the currency basket to each nation's respective "GNP Deflator" rate, thus adjusting and devaluing (or revaluing) all currencies in relation to the "SDRs", which would thereby always maintain constant purchasing power. By doing this, we would create for the first time a constant standard of monetary value, suitable for inflation-proof international financing and the settlement of international obligations. The result would immensely advance the restoration of confidence in the international monetary system and diminish international inflationary expectations.

2) Require by Resolution, U.S. International Negotiation of An Agreement to Regulate the Creation of "Eurodollar" and Other Foreign Currency Deposits in Non-domiciled Banks.

The unregulated creation of "Euro-dollars" by means of loans made by and deposits in banks domiciled outside of the United States and not subject to U.S. Federal Reserve Board regulation, has been the major cause of worldwide inflation. It is obviously not in the interest of the United States or, for that matter, of any nation to permit a foreign bank to "create" additions to its money supply without restriction, regulation or the requirement of liquid reserve deposits with the central bank of the nation whose money supply has thus been expanded. For this reason, I propose that the United States take the lead in negotiating an international banking agreement under which any bank which accepts or creates deposits in the currency of another nation would be required to keep reserve deposits in the central bank of that nation and to comply with the regulations of that central bank with respect to such deposits. I believe that all central banks would find this to be in their respective self interests.

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3) Enact Legislation to Insulate Domestic U.S. Monetary and Credit Policies from the Influence of Excessive Foreign Capital Requirements and Interest Rates.

The fear of increasing the outflow to foreign borrowers of U.S. capital has frequently been given as a compelling reason for maintaining interest rates in the United States which are excessively high by traditional American standards. I propose that this influence can and should be effectively neutralized by requiring American taxpayers with capital deposits, loans or investments abroad to pay a tax on any net annual increase of such capital, the rate of such tax to be determined from time-to-time by the U.S. Federal Reserve Board as sufficient to offset substantially any competitive attraction to U.S. capital of higher interest rates abroad.

4) Expand by Legislation, the Federal Reserve Board's Regulatory Powers to Include Variable Reserve Requirements Depending on the Proportion of Each Bank's Loan Portfolio Allocated to National Economic Purposes and Priorities.

The current reserve requirements of the Federal Reserve Banks are directed to the safety of deposits and the overall liquidity of lendable funds. As a weapon in "the fight against inflation", this is more like a single bludgeon than the assortment of precision instruments which our modern economy and diverse national interests require. Accordingly, I propose that the powers of the Federal Reserve Board be expanded to permit the reserve deposit requirements of individual banks to be varied in accordance with formulae promulgated from time-to-time by the Board for the purpose of increasing or decreasing reserves in proportion to each bank's distribution of its loan portfolio between loans for

a) Specific National Priorities

b) Productive Purposes

c) Consumer Purposes

d) Purchasing or Carrying Publicly-Owned Equity Securities

e) Purchasing or Carrying Publicly-Owned Debt Securities

f) All Other Purposes

Obviously, the present objective of containing inflation would be much better served by selectively favoring loans for productive purposes which would add to the supply of goods and services, and limiting loans which would add to consumer demand, than by the present policy of indiscriminately beating the economy to death.

The FRB's utilization of these powers would be required to implement national economic policies established as provided in proposal number 5 below.

5) Establish by Legislation, More Precise Requirements and Procedures for National Economic and Financial Policies.

Because it is self-evident that our national economic and financial welfare is of vital concern to all of the people and should by no means be the special province of a group of bankers, regardless of their qualifications, I propose that the President, aided by his Cabinet and Council of Economic Advisers be required to supplement his annual national economic message to Congress with specific policies and priorities, and to supplement such policies and programs by quarterly reviews and modifications, that, subject to a 30-day veto by either house of the Congress, the Federal Reserve Board be required to exercise its powers to implement this program, and that the policies and operations of the Federal Reserve System be subject to audit and review comparable to that required for other federal government organizations.

6) Expand and Revise by Legislation, the Requirements and Terms of Office of Membership of The Federal Reserve Board so as to Provide for Broader Representation of Public and National Interests.

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The Federal Reserve Board is presently made up of seven members appointed by the President with the advice and consent of the Senate, for terms of 14 years so arranged that one term expires every two years. The President is supposed to give due regard to fair representation and balance between financial, agricultural, industrial, and commercial interests in making his selections. Of the present Board, three may be classed as academic economists, two as economists with banking backgrounds, one as a lawyer-banker, and one as a businessman.

I submit that neither the present statutory representation nor its implementation is adequate for the Board's immense responsibilities and suggest reform to enlarge the board to fifteen members with 5 year overlapping terms (3 to expire each year), 10 members representing both big and small banking, investment, industrial, commercial, and agricultural interests, plus five members (two consumers and three professional economists) representing the general public interest. Membership on an Open Market Committee of 9 members would be by selection of the Chairman, approved by the Board and would include 3 Presidents of Federal Reserve Banks.

7) Limit by Legislation, Interest Rates on All Deposits including Negotiable Certificates of Deposit to a Maximum of 1% Less than the Prime Bank Lending Rate or 5% whichever Is Higher.

I believe that the compelling need to control this centralization of big bank control and escallation of interest rates is self-evident for the reasons previously outlined in this testimony.

8) Repeal the One-Bank Holding Company Legislation and Limit Banking Corporations Strictly to Banking Functions With No Involvement in Investment, Insurance or Other Non-banking Activities.

The need to repeal this legislation is self-evident in the light of the damage which it has already done to our competitive free-enterprise system as previously outlined in this testimony.

9) Establish a Citizens' Capital Investment Tax Credit to Encourage Savings and Capital Formation by Individual Citizens and thus Reduce Inflationary Spending Demand while Increasing the Supply of Productive Capital.

Although I recognize that tax proposals are not the special province of this Committee, I venture to bring to your attention a proposal which I recently made supplementing my testimony as Chairman of the Committee on Capital Gains Taxation before the Committee on Ways and Means last year. I do so, because I believe that the preservation of our free enterprise capitalistic system requires not only the remedial measures which I have submitted here, but also every practicable encouragement to the formation of new capital by individual American citizens, as distinguished from banks and major corporations many of which, although domiciled here, are trans-national in character, interests, and loyalties.

For these reasons, I propose that Congress give individual American citizens a break by extending to them a "Citizen's Capital Investment Tax Credit" of 5% on the first $100,000 accumulated, beginning in 1974 and continuing for life. Mechanically, this would take the form of a supplemental optional tax schedule on which any citizen could list the net annual increase (up to a cumulative total of $100,000) of his savings, cash, investments and real estate at cost less indebtedness. 5% of the net annual increase could be deducted each year from his federal income tax due. Thus each citizen who saved $1,000 in a year would get a $50 tax break, and dedicated savers could look forward to saving $5,000 in taxes on the first $100,000 accumulated over the years.

Here at one stroke, the Congress would:

1) offer every citizen a non-inflationary tax break and incentive to become a constructive capitalist

2) provide individual citizens with a savings tax credit comparable to the investment tax credit which is now available to commerce and industry

3) reduce inflationary demand by substituting savings for consumption, and capital formation for its dissipation

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SCHEDULE OF EXHIBITS

I THE BUDGET & THE ECONOMY
- a) Chart of Interest Rates, Inflation, Federal Surplus/Deficit & Gross National Product
- b) Table of Federal Government Receipts, Expenditures & Surplus/Deficit
- c) Table of Inflation Rates
- d) Table of Consumer Price Index

II GROWTH OF UNREGULATED U.S. MONEY SUPPLY
- a) Chart of U.S. Money Supply vs Gross National Product & Inflation

III COMPARATIVE INTERNATIONAL ECONOMIC INDICES
- a) Charts of Money Supply, Inflation & Real Gross National Product for Europe, Japan & U.S.

IV CAUSES OF INFLATION IN THE U.S.
- a) Chart of Components of Inflation in U.S.

V COMPARATIVE GROWTH OF U.S. MONEY SUPPLY
- a) Chart of Gross National Product vs The Components of Money Supply – Current & Constant Dollars

VI COMPARATIVE INTEREST RATES
- a) Chart of 10 Year (1959-68) Average vs Current Rates
- b) Table of Historic Interest Rates

VII COLLAPSE OF THE U.S. STOCK & BOND MARKETS
- a) Chart of Dow-Jones Industrial Average, Dow-Jones Corporate Bond Average & Unweighted Average of 1,550 Publicly-Owned Common Stocks

VIII FEDERAL INTEREST EXPENSE
- a) Chart of Interest Expense & Potential Increase at Current Interest Rates

IX THE MONEY SUPPLY vs THE ECONOMY
- a) Chart of Dow-Jones Industrial Average vs Stock Price/Earnings Ratios, Prime Bank Lending Rates, Gross National Product, Current Money Supply & Broadly Based Money Supply

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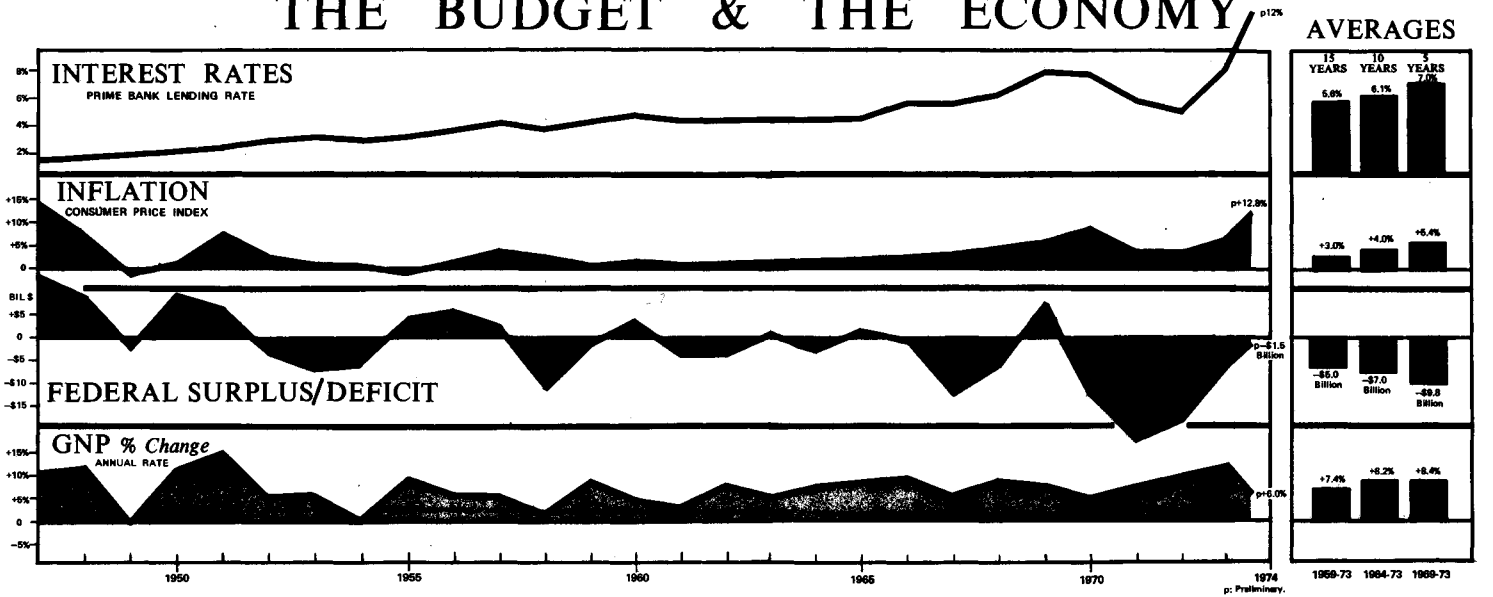
THE BUDGET & THE ECONOMY



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FEDERAL GOVERNMENT
RECEIPTS, EXPENDITURES & SURPLUS / DEFICIT

	FEDERAL GOVERNMENT RECEIPTS				FEDERAL GOVERNMENT EXPENDITURES				SURPLUS/DEFICIT				
	In Billions $	% Change	Per Capita Nominal $	Per Capita Real $	In Billions $	% Change	Per Capita Nominal $	Per Capita Real $	In Billions $	% of Expendi-tures	% of GNP Nominal	Per Capita Nominal	Per Capita Real
1947	$43.2	N.C.	$299	$618	$29.8	N.C.	$206	$426	$+13.4	+45.0	+5.8	$+93	$+192
1948	$43.3	+0.2	$294	$570	$34.9	+17.1	$237	$459	$+8.4	+24.1	+3.3	$+57	$+111
1949	$38.9	-10.2	$260	$507	$41.3	+18.3	$276	$538	$-2.4	-5.8	-0.9	$-16	$-31
1950	$49.9	+28.3	$328	$631	$40.8	-1.2	$268	$516	$+9.1	+22.3	+3.2	$+60	$+115
1951	$64.0	+28.3	$413	$744	$57.8	+41.7	$373	$672	$+6.2	+10.7	+1.9	$+40	$+72
1952	$67.2	+5.0	$426	$751	$71.0	+22.8	$451	$795	$-3.8	-5.4	-1.1	$-24	$-44
1953	$70.0	+4.2	$437	$764	$77.0	+8.5	$480	$839	$-7.0	-9.1	-1.9	$-44	$-76
1954	$63.8	-8.9	$391	$673	$69.7	-9.5	$428	$737	$-5.9	-8.5	-1.6	$-36	$-64
1955	$72.1	+13.0	$435	$738	$68.1	-2.3	$410	$696	$+4.0	+5.9	+1.0	$+24	$+42
1956	$77.6	+7.6	$459	$753	$71.9	+5.6	$426	$699	$+5.7	+7.9	+1.4	$+34	$+54
1957	$81.6	+5.2	$474	$750	$79.6	+10.7	$462	$731	$+2.1	+2.6	+0.5	$+12	$+19
1958	$78.7	-3.6	$450	$694	$88.9	+11.7	$508	$784	$-10.2	-11.5	-2.3	$-58	$-90
1959	$89.7	+14.0	$504	$765	$91.0	+2.4	$512	$778	$-1.2	-1.3	-0.2	$-7	$-13
1960	$96.5	+7.6	$534	$798	$93.0	+2.2	$515	$759	$+3.5	+3.8	+0.7	$+19	$+29
1961	$98.3	+1.9	$535	$789	$102.1	+9.8	$556	$820	$-3.8	-3.7	-0.7	$-21	$-31
1962	$106.4	+8.2	$571	$833	$110.3	+8.0	$591	$862	$-3.8	-3.4	-0.7	$-20	$-29
1963	$114.5	+7.6	$605	$871	$113.9	+3.3	$602	$866	$+0.7	+0.6	+0.1	$+4	$+5
1964	$115.0	+0.4	$600	$851	$118.1	+3.7	$616	$874	$-3.0	-2.5	-0.5	$-16	$-23
1965	$124.7	+8.4	$642	$893	$123.5	+4.6	$636	$885	$+1.2	+1.0	+0.2	$+6	$+8
1966	$142.5	+14.3	$725	$982	$142.8	+15.6	$727	$985	$-0.2	-0.1	-0.02	$-1	$-3
1967	$151.2	+6.1	$761	$998	$163.6	+14.6	$824	$1081	$-12.4	-7.6	-1.6	$-62	$-83
1968	$175.0	+15.7	$872	$1100	$181.5	+10.9	$905	$1142	$-6.5	-3.6	-0.8	$-32	$-42
1969	$197.3	+12.7	$973	$1171	$189.2	+4.2	$933	$1123	$+8.1	+4.3	+0.9	$+40	$+48
1970	$192.0	-2.7	$937	$1069	$203.9	+7.8	$995	$1136	$-11.9	-5.8	-1.2	$-58	$-67
1971	$198.5	+3.4	$959	$1047	$220.3	+8.0	$1064	$1162	$-21.9	-9.9	-2.1	$-106	$-115
1972	$227.2	+14.5	$1088	$1149	$244.7	+11.1	$1171	$1237	$-17.5	-7.2	-1.5	$-84	$-88
1973	$258.5	+13.8	$1227	$1227	$265.2	+8.4	$1259	$1259	$-5.6	-2.1	-0.4	$-32	$-32
AVERAGES													
5 Year 1969-73	$214.7	+8.3	$1037	$1133	$224.7	+7.9	$1084	$1183	$-9.8	-4.1	-0.9	$-48	$-50
10 Year 1964-73	$178.2	+8.7	$878	$1049	$185.3	+8.9	$913	$1088	$-7.0	-3.4	-0.7	$-35	$-39
15 Year 1959-73	$152.5	+8.4	$769	$970	$157.5	+7.6	$794	$999	$-5.0	-2.5	-0.5	$-25	$-29
15 Year 1963-67	$98.8	+5.7	$542	$810	$100.9	+5.9	$553	$858	$-2.0	-1.7	-0.4	$-11	$-48
15 Year 1947-61	$69.0	*+6.6	$416	$703	$67.8	*+9.8	$407	$684	$+1.2	+5.1	+0.6	$+9	$+19

Notes: Per Capita (Real) are in 1973 Dollars; *: 14 year Average.

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INFLATION

	CONSUMER PRICE INDEX			WHOLESALE PRICE INDEX			
	All Items % Change	Food % Change	All Items Excluding Food % Change	All Commodities % Change	Farm Products % Change	Industrial Commodities % Change	GNP Implicit Price Deflator % Change
1947	+14.4	+21.5	–	+22.8	–	+22.1	–
1948	+7.8	+8.5	+7.2	+8.2	+7.4	+8.6	+4.3
1949	-1.0	-4.0	+1.0	-5.0	-13.5	-2.1	+1.7
1950	+1.0	+1.4	+1.1	+3.9	+5.0	+3.6	+4.3
1951	+7.9	+11.1	+6.5	+11.4	+16.4	+10.4	+5.3
1952	+2.2	+1.8	+2.4	-2.7	-5.6	-2.3	+1.8
1953	+0.8	-1.5	+1.9	-1.4	-9.4	+0.8	+1.1
1954	+0.5	-0.2	+0.6	+0.2	-1.4	+0.2	+1.6
1955	-0.4	-1.4	+0.3	+0.2	-6.2	+2.2	+2.0
1956	+1.5	+0.7	+1.8	+3.3	-1.3	+4.5	+4.1
1957	+3.6	+3.3	+3.3	+2.9	+2.7	+2.8	+3.2
1958	+2.7	+4.2	+2.3	+1.4	+4.4	+0.3	+2.1
1959	+0.8	-1.6	+1.9	+0.2	-6.2	+1.8	+1.5
1960	+1.6	+1.0	+1.7	+0.1	-0.3	0	+1.9
1961	+1.0	-1.3	+1.0	-0.4	-0.9	-0.5	+1.1
1962	+1.1	+0.9	+1.2	+0.3	+1.7	0	+1.1
1963	+1.2	+1.4	+1.3	-0.3	-2.0	-0.1	+1.4
1964	+1.3	+1.3	+1.3	+0.2	-1.5	+0.5	+1.7
1965	+1.7	+2.2	+1.4	+2.0	+4.3	+1.3	+1.7
1966	+2.9	+5.0	+2.3	+3.3	+7.3	+2.2	+3.5
1967	+2.9	+0.9	+3.4	+0.2	-5.6	+1.5	+3.5
1968	+4.2	+3.6	+4.4	+2.5	+2.5	+2.5	+4.1
1969	+5.4	+5.1	+5.5	+3.9	+6.4	+3.4	+5.3
1970	+8.5	+5.6	+6.0	+3.7	+1.7	+3.8	+5.3
1971	+3.4	+3.0	+4.6	+3.2	+1.7	+3.5	+4.5
1972	+3.4	+4.3	+3.0	+4.6	+10.8	+4.6	+3.4
1973	+6.2	+14.5	+3.9	+13.8	+41.0	+7.7	+5.6
1974 (6 Mos Annual Rate)	+12.8	+12.3	+13.0	+14.8	-18.9	+25.5	+10.5
AVERAGES							
5 Year 1969-73	+5.4	+6.5	+4.6	+5.8	+12.3	+4.6	+4.8
10 Year 1964-73	+4.0	+4.6	+3.6	+3.7	+6.9	+3.1	+3.9
15 Year 1959-73	+3.0	+3.1	+2.9	+2.5	+4.1	+2.1	+3.0
15 Year 1953-67	+1.5	+1.0	+1.7	+0.8	-1.0	+1.2	+2.1
15 Year 1947-61	+3.0	+2.9	+2.4	+3.0	-0.6	+3.5	+2.6

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CONSUMER PRICE INDEX

	INDEX END OF PERIOD	% INCREASE ANNUAL AVERAGE DURING PERIOD	% INCREASE CUMULATIVE FROM DECEMBER 1950	PURCHASING POWER OF $1.00 END OF PERIOD
				1950 = $1.00
5 YEAR AVERAGES				
1951-1955	80.4	+1.4%		
1956-1960	89.3	+2.1%		
1961-1965	95.4	+1.3%		
1966-1970	119.1	+4.5%		
1969-1973	138.5	+5.4%		
ANNUALLY				
1966	98.6	+3.4%	+31.6%	.760
1967	101.6	+3.0%	+35.6%	.737
1968	106.4	+4.7%	+42.1%	.704
1969	112.9	+6.1%	+50.7%	.664
1970	119.1	+5.5%	+59.0%	.629
1971	123.1	+3.4%	+64.4%	.608
1972	127.3	+3.4%	+70.0%	.588
1973	138.5	+8.8%	+84.9%	.541
1974 (June 30)	147.1	+12.8%	+96.4%	.509

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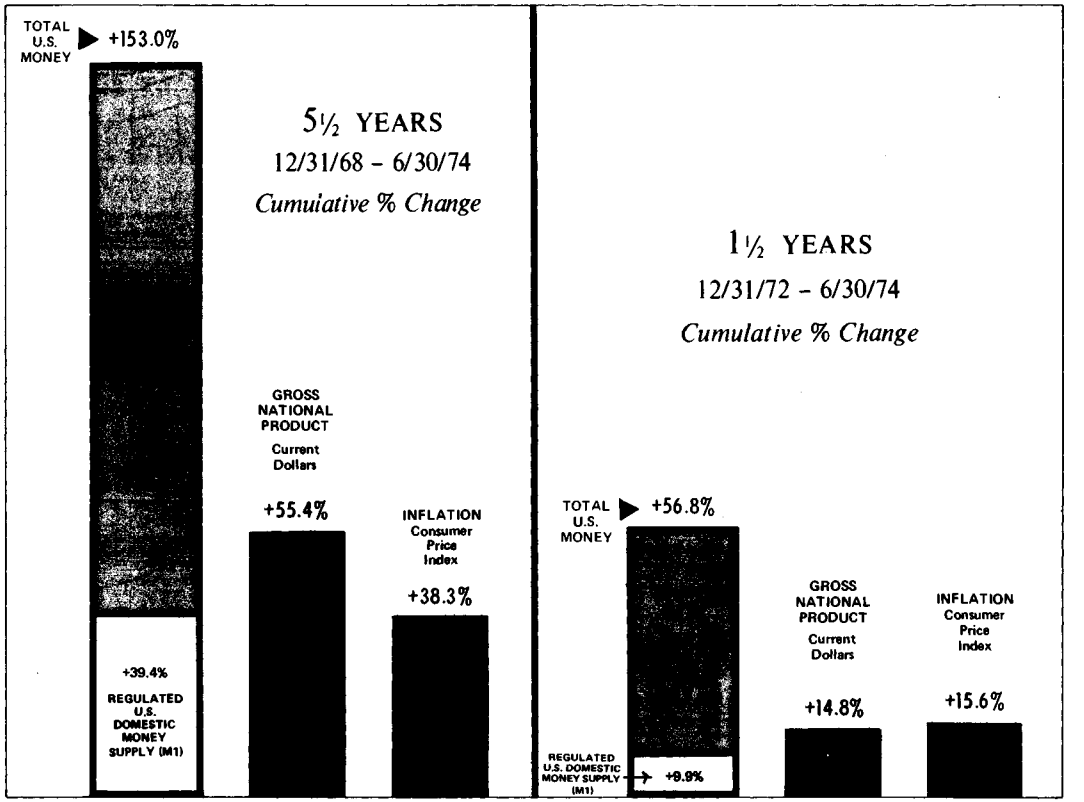
GROWTH OF UNREGULATED U.S. MONEY SUPPLY



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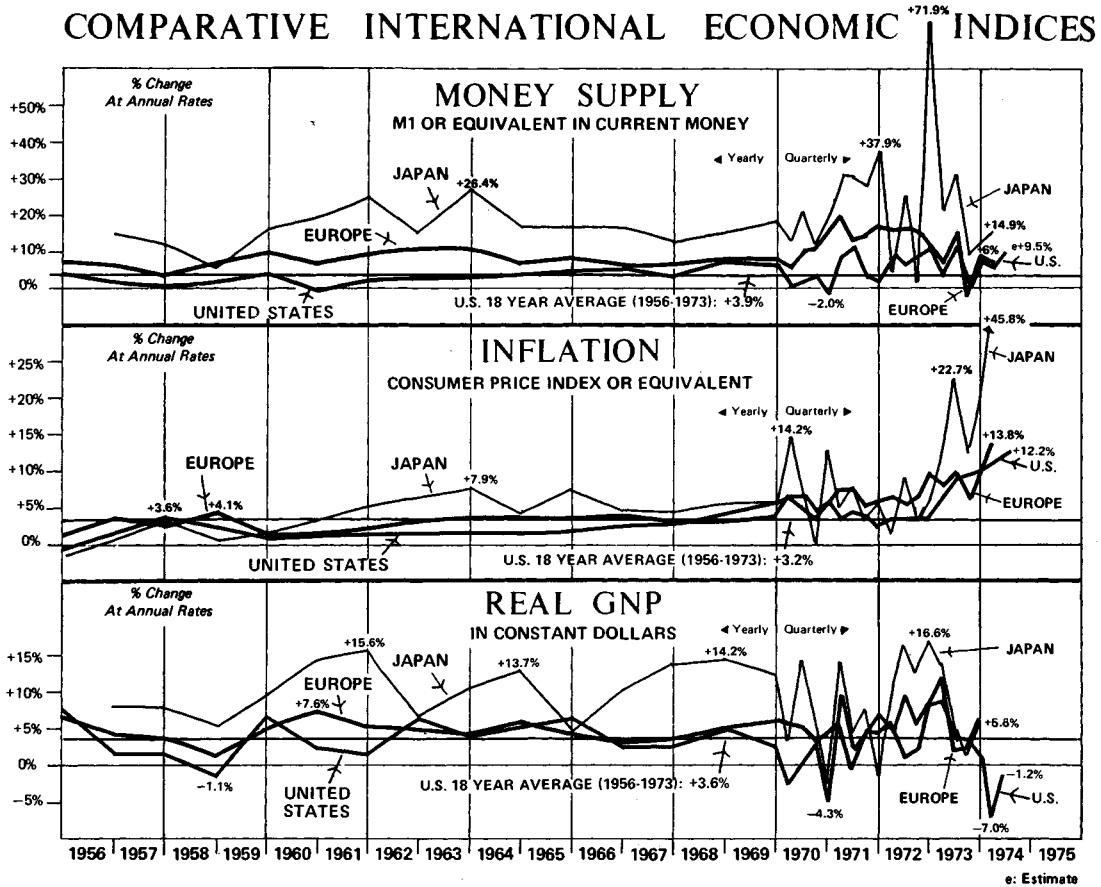
COMPARATIVE INTERNATIONAL ECONOMIC INDICES



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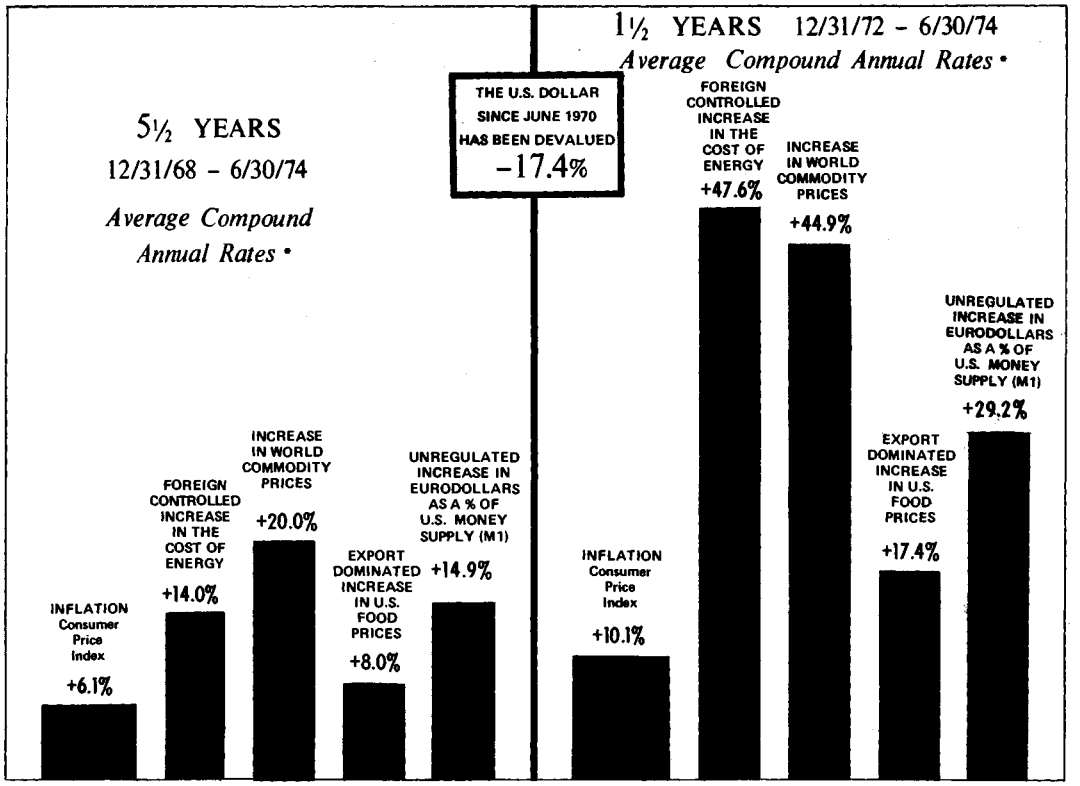
CAUSES OF INFLATION IN THE U.S.



* Based on 3 month averages at beginning and end of period for money supply, and on index prices at end of periods for all other items.

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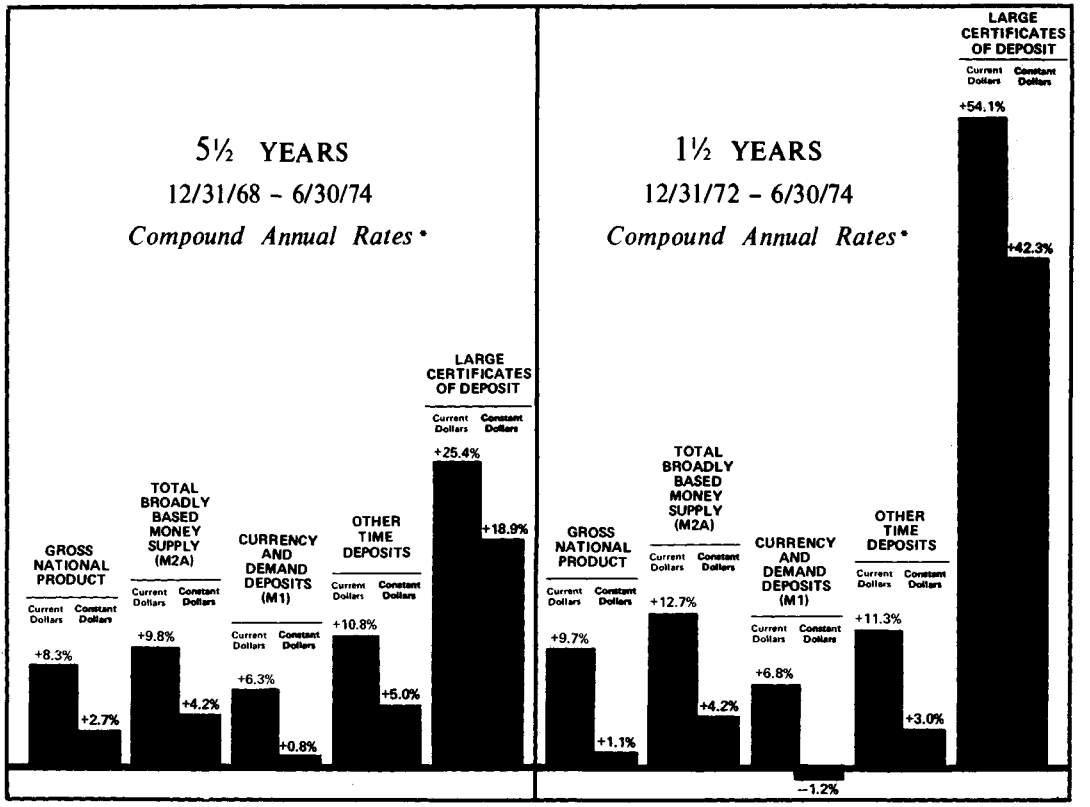
COMPARATIVE GROWTH OF U.S. MONEY SUPPLY



*: Based on 3 month averages at beginning and end of periods.

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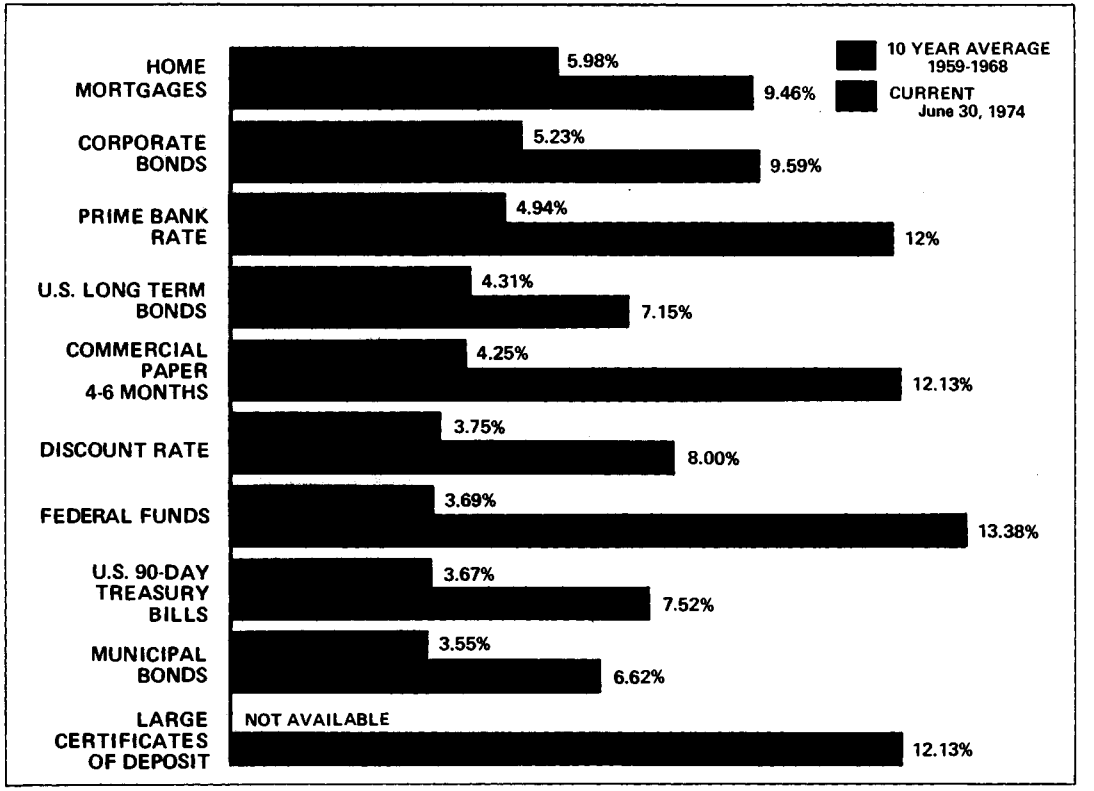
COMPARATIVE INTEREST RATES



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INTEREST RATES

	U.S. Treasury Bills (3 mo.)	U.S. Long Term Bonds	Prime Bank Lending Rate	Municipal Bonds	Corporate Bonds	Mortgage Residential	Composite*
1947	0.60	2.25	1.50	N.A.	2.62	N.A.	1.74
1948	1.04	2.44	1.85	2.36	2.92	N.A.	2.12
1949	1.10	2.31	2.00	2.15	2.64	4.21	2.42
1950	1.22	2.32	2.08	1.92	2.60	4.14	2.38
1951	1.55	2.58	2.57	1.95	3.04	4.23	2.65
1952	1.77	2.68	3.00	2.19	3.10	4.30	2.84
1953	1.94	2.94	3.19	2.73	3.42	4.66	3.15
1954	0.95	2.55	3.04	2.39	2.80	4.10	2.78
1955	1.75	2.84	3.15	2.48	3.17	4.65	3.01
1956	2.66	3.08	3.77	2.76	3.68	4.82	3.46
1957	3.26	3.47	4.20	3.28	4.45	5.43	4.02
1958	1.84	3.43	3.84	3.16	4.02	5.49	3.63
1959	3.41	4.08	4.47	3.56	4.93	5.81	4.37
1960	2.95	4.02	4.82	3.52	4.92	6.16	4.40
1961	2.38	3.90	4.50	3.46	4.63	5.76	4.10
1962	2.78	3.95	4.50	3.16	4.36	5.60	4.06
1963	3.16	4.00	4.50	3.17	4.34	5.46	4.11
1954	3.55	4.15	4.50	3.21	4.47	5.45	4.22
1965	3.95	4.21	4.53	3.26	4.61	5.47	4.34
1966	4.88	4.65	5.62	3.81	5.67	6.40	5.16
1967	4.33	4.85	5.62	3.94	6.08	6.56	5.23
1968	5.34	5.26	6.30	4.45	6.84	7.19	5.90
1969	6.69	6.12	7.95	5.72	8.06	8.26	7.13
1970	6.44	6.58	7.91	6.35	9.05	9.03	7.56
1971	4.34	5.74	5.72	5.48	7.85	7.70	6.14
1972	4.07	5.64	5.25	5.26	7.59	7.53	5.89
1973	7.03	6.31	8.00	5.19	7.89	8.19	7.11
Current (6/30/74)	7.51	7.09	12.00	6.35	9.32	p9.46	8.62
AVERAGES							
5 Year 1969-73	5.71	6.08	6.97	5.60	8.09	8.14	6.77
10 Year 1964-73	5.06	5.35	6.14	4.67	6.82	7.18	5.87
15 Year 1959-73	4.35	4.90	5.61	4.24	6.09	6.70	5.31
15 Year 1953-67	2.92	3.74	4.28	3.19	4.37	5.45	4.00
15 Year 1947-61	1.89	2.99	3.20	2.71	3.53	4.90	3.14

p: Preliminary; *: Arithmetic Average.

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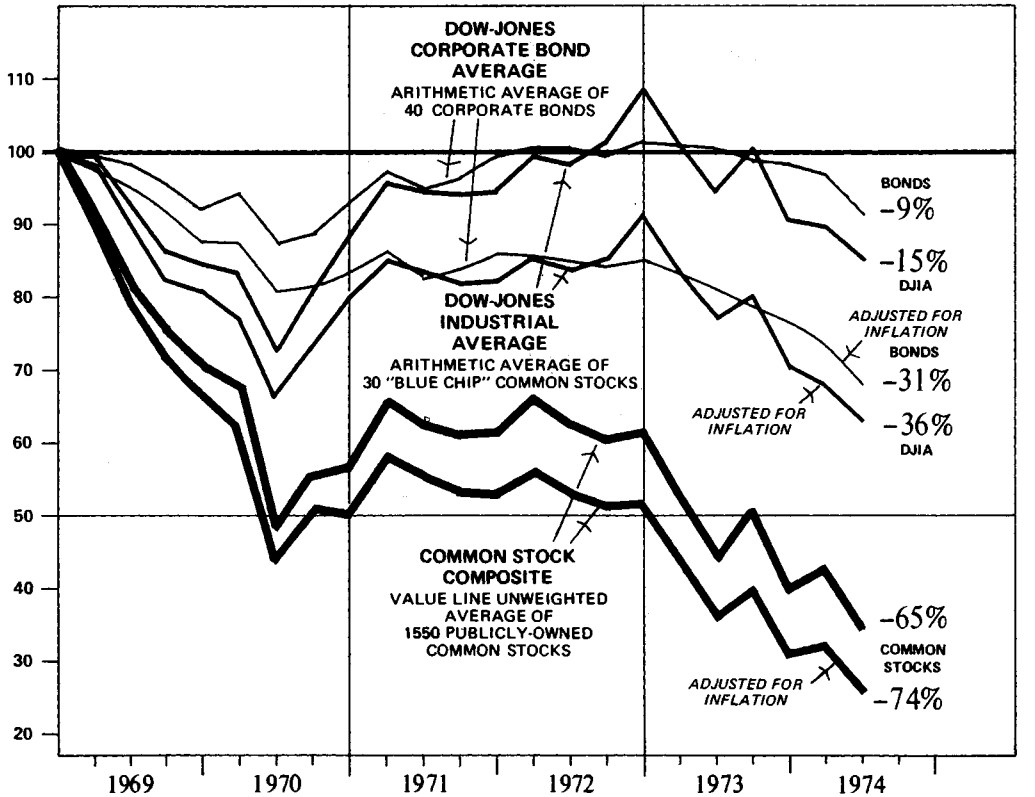
COLLAPSE OF THE U.S. STOCK & BOND MARKETS



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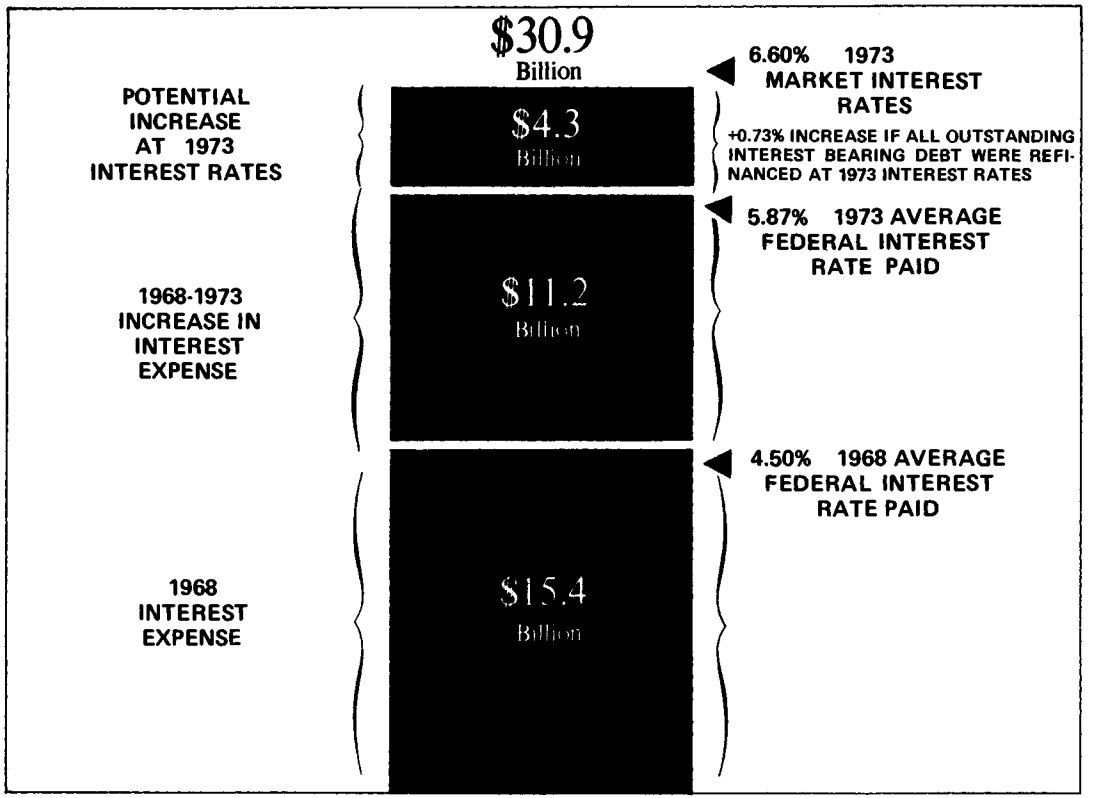
FEDERAL INTEREST EXPENSE



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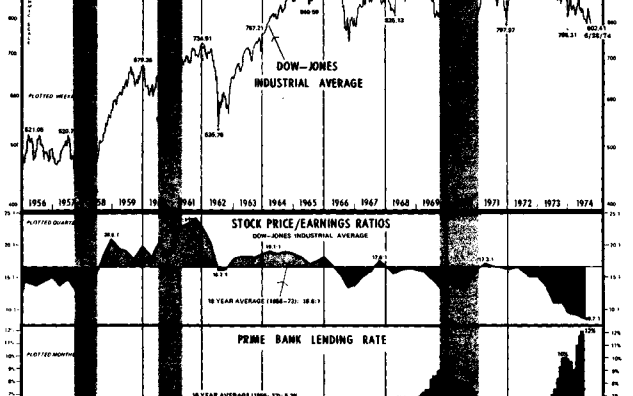
THE MONEY SUPPLY vs THE ECONOMY



COMPARATIVE STATISTICS

Quarter Ending		Dow-Jones Industrial Average Stock Prices Qrtly % Chg	Dow-Jones Industrial Average Price-Earnings Ratio	Dow-Jones Bond Average Bond Prices Qrtly % Chg	Dow-Jones Bond Average Bond Yields	Prime Bank Lending Rate	Gross National Product Constant Dollars Qrtly % Chg*	MONEY SUPPLY "M1" Current Money Dollars Qrtly % Chg*	"M1" Current Money Dollars Qrtly % Chg*	"M2A" Broadly Based Money Supply Constant Dollars Qrtly % Chg*	"M2A" Broadly Based Money Supply Current Dollars Qrtly % Chg*	"M2A" Broadly Based Money Supply Constant Dollars Qrtly % Chg*	Inflation GNP Deflator Qrtly % Chg*
1954	Mar	+4.78	14.3	+0.23	3.54	3.50	-2.4	+1.48	-2.41	+1.09	-2.94		+4.3
	Jun	-3.71	13.4	-2.46	3.72	3.72	+1.8	+0.89	-2.43	+1.25	-1.97		+0.7
	Sep	-3.06	14.1	-4.27	4.07	3.86	-1.0	+0.29	-4.98	+1.73	-2.77		+5.4
	Dec	+6.10	15.0	2.85	4.29	4.00	+5.4	+1.76	1.83	+2.50	1.40		+3.2
1957	Mar	-4.84	13.8	+1.19	4.19	4.00	+2.7	+0.88	-3.03	+3.44	-0.40		+4.2
	Jun	+6.00	14.4	-4.40	4.76	4.00	-0.1	0	-3.05	+2.98	-0.40		+2.9
	Sep	-8.34	12.4	-2.13	4.87	4.31	+1.8	+0.29	-3.28	-2.74	-0.81		+4.7
	Dec	-4.52	12.1	+3.30	4.77	4.50	-6.0	-2.32	-4.76	+1.04	-1.41		+1.9
1958	Mar	+2.84	13.7	+0.96	4.82	4.11	-6.2	-0.29	-3.14	+8.21	+1.33		+3.4
	Jun	+7.03	16.2	+2.88	4.24	3.61	+1.8	+4.46	+2.38	+10.20	+7.72		+1.6
	Sep	+11.27	19.0	-4.47	4.08	3.61	+10.8	+4.13	+2.34	+7.19	+9.48		+1.7
	Dec	+6.09	20.9	-0.48	4.74	4.00	+10.0	+4.96	+3.20	+4.80	+2.88		+1.9
1959	Mar	+3.08	19.4	-0.44	4.77	4.00	+6.3	+5.51	+3.47	+5.75	+3.56		+2.1
	Jun	-6.96	18.0	-3.38	5.12	4.34	+10.0	+3.41	+1.71	+3.30	+1.75		+1.9
	Sep	-1.85	17.7	-1.64	5.21	4.87	-4.0	+1.96	+0.28	-2.11	+0.68		+1.8
	Dec	+7.55	19.8	-1.00	5.07	5.00	+4.6	-2.47	-3.34	-1.13	-3.29		+0.8
1960	Mar	-10.12	18.2	+2.65	5.32	5.00	+6.4	1.66	-3.27	1.70	-3.25		+2.0
	Jun	+6.92	20.5	-0.14	5.40	5.00	-0.4	-0.56	-2.96	+0.38	-1.95		+1.7
	Sep	-6.44	18.2	+1.86	5.13	4.78	1.9	+3.12	+1.46	+6.03	+4.38		+1.5
	Dec	+6.16	19.1	+0.45	5.04	4.50	-2.9	+0.84	-0.96	+6.74	+3.73		+2.5
1961	Mar	+9.86	22.9	+1.72	4.98	4.50	-0.9	+1.67	+0.29	+5.66	+4.29		+1.1
	Jun	+1.08	23.4	-2.23	5.14	4.50	+8.7	+3.38	+2.32	+7.11	+6.02		+0.6
	Sep	+2.52	24.2	-0.98	5.26	4.50	+7.2	+2.49	+2.02	+6.42	+6.32		+0.1
	Dec	+4.27	22.9	+0.42	5.25	4.50	+6.4	+3.87	+2.89	+6.88	+5.07		+2.1
1962	Mar	-3.31	20.7	+1.86	5.07	4.50	+2.6	+3.57	+2.93	+9.23			+1.4
	Jun	20.61	18.2	-0.06	4.91	4.50	+6.5	+1.62	+0.86	+8.06			+0.5
	Sep	-3.15	18.3	+1.15	4.80	4.50	+4.3	-0.80	1.40	+4.41			+1.8
	Dec	+12.83	17.9	+1.84	4.67	4.50	+3.7	+2.43	+0.86	+7.82			+1.8
1963	Mar	+4.88	18.2	+1.39	4.64	4.50	+2.2	+2.78	+2.28	+8.87			+1.5
	Jun	+3.54	18.3	+0.99	4.49	4.50	+3.6	+4.01	+2.56	+8.17			+1.2
	Sep	+3.60	18.2	-0.83	4.56	4.50	+5.6	+3.51	+2.10	+7.68			+0.8
	Dec	+4.13	18.5	-0.45	4.52	4.50	+5.4	+4.20	+2.61	+6.67			+2.1
1964	Mar	+6.80	19.1	+0.01	4.64	4.50	+6.6	+2.33	+0.55	+6.80			+1.5
	Jun	+2.34	18.7	+0.96	4.61	4.50	+6.3	+3.87	+2.50	+8.63			+1.4
	Sep	+5.28	19.1	+0.17	4.61	4.50	+5.1	+5.71	+4.72	+8.62			+2.0
	Dec	-0.14	18.8	-0.27	4.80	4.50	+1.9	+5.05	+3.00	+9.08			+2.0
1965	Mar	+1.71	18.3	+0.29	4.58	4.50	+6.2	+2.72	+0.54	+9.62			+2.0
	Jun	-2.36	17.1	-0.60	4.64	4.50	+5.9	+3.20	+1.34	+7.81			+2.0
	Sep	+7.31	17.6	-0.92	4.73	4.50	+6.2	+4.66	+3.24	+9.07			+1.1
	Dec	+4.16	18.1	-1.00	4.92	4.54	+9.4	+5.85	+5.12	+11.25			+1.8
1966	Mar	-4.99	15.6	-2.96	5.20	5.12	+8.1	+5.49	+3.71	+8.26			+2.1
	Jun	9.91	16.6	1.48	5.42	5.51	+3.7	+4.94	+3.38	+8.46			+4.0
	Sep	-11.02	13.5	-3.45	5.79	5.88	-3.2	-0.68	-1.30	+3.82			+3.6
	Dec	+1.48	13.6	+0.63	5.76	6.00	+4.9	+0.46	-2.84	+0.97			+3.0
1967	Mar	+10.22	15.3	+2.93	5.47	5.81	-0.9	+3.94	+1.06	+10.48			+2.8
	Jun	-0.86	15.8	-3.57	5.81	5.90	-3.0	+6.01	+3.46	+11.37			+2.3
	Sep	+7.72	17.6	-2.07	6.06	5.90	+1.4	+9.72	+8.34	+13.92			+4.0
	Dec	-2.33	16.8	-5.13	6.61	5.73	+2.8	+8.02	+1.28	+8.98			+3.70	+4.7
1968	Mar	-7.12	15.6	+6.58	6.60	6.00	+5.4	+5.26	+1.03	+7.14			+2.47	+3.6
	Jun	+6.80	16.1	+0.46	6.61	6.40	+7.5	+7.86	+4.14	+6.68			+3.12	+3.9
	Sep	+4.23	16.4	+1.87	6.50	6.47	+4.0	+8.59	+4.10	+10.48			+5.85	+4.3
	Dec	+0.85	16.3	-3.62	6.83	6.27	-2.4	+8.19	+3.54	+12.34			+7.62	+4.6
1969	Mar	-0.88	15.8	-1.32	7.12	7.06	-3.4	+7.80	+3.00	+4.88			+0.49	+4.2
	Jun	-8.66	14.7	-0.96	7.34	7.74	+1.9	+4.79	0	+1.38			-3.39	+5.6
	Sep	+4.07	13.8	2.40	7.58	8.50	+1.9	+2.35	3.40	4.34			9.87	+6.1
	Dec	-12.35	14.0	-3.89	8.75	8.50	-2.3	+2.14	-3.42	-0.79			-8.22	+6.5
1970	Mar	-1.85	14.5	+2.16	7.98	8.46	-2.1	+4.29	-1.74	+1.80			-4.33	+6.4
	Jun	+12.99	12.8	-6.58	8.78	8.00	+0.5	+6.81	+1.77	+10.37			+5.06	+4.6
	Sep	+11.29	14.7	+3.06	8.90	7.94	+2.9	+6.11	+1.76	+16.47			+11.44	+4.1
	Dec	+10.28	16.4	+4.59	8.51	7.23	-4.3	+5.83	0	+14.78			+8.88	+6.4
1971	Mar	+7.80	17.3	+4.36	7.73	5.68	+10.2	+6.50	+1.25	+17.26			+11.65	+4.6
	Jun	-1.46	16.7	2.84	8.11	5.39	+2.8	+11.36	+8.36	+16.97			+10.58	+4.8
	Sep	-0.54	16.6	+1.48	8.01	5.34	+2.8	+8.60	+3.31	+9.10			+5.73	+2.6
	Dec	+0.34	16.2	+3.08	7.76	5.54	+6.5	+2.07	-0.24	+8.96			+9.25	+1.9
1972	Mar	+9.67	16.4	+1.08	7.59	4.89	+6.4	+5.38	+0.97	+11.80			+7.23	+5.5
	Jun	1.24	15.5	+0.13	7.60	5.01	+8.4	+8.90	+5.43	+11.62			+8.26	+1.9
	Sep	+2.61	15.3	-0.43	7.83	5.34	+6.0	+9.40	+6.28	+12.38			+8.39	+3.3
	Dec	+7.50	15.2	+1.64	7.74	5.76	+8.3	+8.85	+4.80	+12.33			+8.19	+4.0
1973	Mar	-4.77	13.2	-0.77	7.87	6.11	+9.5	+7.13	+1.88	+14.29			+8.77	+5.5
	Jun	-8.24	11.6	-0.38	7.98	7.03	+2.2	+7.86	+1.16	+10.88			+6.69	+7.1
	Sep	+6.31	11.8	-1.70	8.38	8.13	+1.6	+6.76	-2.08	+10.98			+2.34	+8.3
	Dec	10.18	9.9	-6.25	9.35	9.81	-1.4	+4.39	-3.87	+8.40			1.88	+8.6
1974	Mar	-0.49	9.5	-1.81	9.59	9.25	7.0	+6.86	-3.93	+11.70			+0.60	+12.3
	Jun	-8.23	8.7	-5.07	9.32	11.00	-1.2	+8.75	-0.94	+16.84			+6.35	+8.8
AVERAGES														
1954-65	5 yr.	+4.36	16.4	-3.63	5.00	4.32	+5.0	+6.05	+2.17	+8.52			+5.52	+2.9
1966-72	5 yr.	3.08	14.0	-0.34	7.90	6.97	+3.8	+5.13	+1.12	+9.09			+4.42	+5.1
1966-69	10 yr.	-4.82	15.1	-1.83	5.36	4.86	+4.8	+3.62	+1.47	+6.97			+4.76	+2.1
1966-73	10 yr.	+2.13	15.0	-1.09	6.58	5.33	+2.7	+2.94	+0.84	+7.14			+3.94	+3.1

Data included all FRB revisions. (a): Estimate. (*): Quarterly % changes at annual rates.

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The CHAIRMAN. Mr. Wright, you may present your testimony as you desire. It is entirely up to you.

When you get through, then we will have the 5-minute rule. I will take 5 minutes and then I will yield to people on my right and left, alternating from the minority side to the majority side, and, of course, we will bring up the questions that we think are most important and get your views on it.

If you would just let down your hair and just give us the benefit of your best advice, based upon your achievements in the past and your knowledge, it will please us very much.

We are grateful to give you the opportunity, sir, to have someone who has prepared such wonderful testimony. I have looked it over and it is fine. I know that the committee members will be pleased with it, and you have many things to tell us that we have not had testimony on before.

So you may proceed, sir, in your own way.

STATEMENT OF JOHN WINTHROP WRIGHT, PRESIDENT, WRIGHT INVESTORS' SERVICE, BRIDGEPORT, CONN.

Mr. WRIGHT. Thank you, Mr. Chairman.

From time to time I would like to refer to the charts. Would it be all right if I stand up to do that, for that purpose?

The CHAIRMAN. Certainly.

Mr. WRIGHT. Thank you.

The CHAIRMAN. You can have them moved around as you desire.

Mr. WRIGHT. All right, sir.

I might like to say first that there is no need to go into the details of my own history. I put that history in so you could see the limitations of my qualifications, and I prepared at the beginning of the testimony which you have a summary of proposals. But I would like to begin with the background first, leading up to the summary, because there are nine proposals for action by the committee.

So perhaps it would be well to begin with the reasons, the purpose of this testimony, and why I am here, and have asked for your consideration. I have come here, really, in three different capacities. One is as a citizen and just as an American citizen I want to protest what I believe is very ill-conceived governmental policies and some legislation, and the management of our economy, because in 6 years, it is self-evident, if you just open your eyes and look around, that it is drastically damaged and is now in danger of actually destroying the American free enterprise system as we have known it.

That is an awfully large statement, but I do not believe that statement is exaggerated. I have been in business for 30 years. I have been a student of the economy and of financial matters ever since I was in college, back in the 1930's, early 1930's, and it is self-evident, just from looking around, that what we are witnessing is a destruction, actual destruction of the competitive American free enterprise system as we have known it, and I will go into the details of that.

So, as a citizen I am here to protest this and to ask your concentrated thought to stop it.

My profession is as an investment counselor and manager. We are beholden to no one. We do manage about a quarter of a billion dollars,

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mostly corporate and union pension and profit-sharing funds, the endowment funds of universities and other monetary institutions and other individuals. We also have 500 banks as our clients, mostly the smaller banks throughout the United States, and we have some 17 member firms of the New York Stock Exchange. I want to make it clear that my testimony here today is not on behalf of any special interest group. I am familiar with their needs. I am familiar with our economy because of our business, but there is no special interest involved.

As an investment counselor and manager, I want to ask for relief from the unrelenting pressure by which the U.S. Federal Reserve Board—and it is the Federal Reserve Board and nobody else—has caused the greatest shrinkage of American security value since the Great Depression of the 1930's. I will document this as I go into the testimony. It has virtually destroyed the American equity markets which for decades were the pride of the United States. It has forced the liquidation of individual ownership, not in theory but in practice, of the majority of the owners of American business individually, and of most of the securities industry. There is just a fraction of the number of people in the securities industry that there used to be. It has caused the transfer of ownership of American industry from individual ownership where the citizens could look at a company and say I am a shareholder of that company. It has killed that and transferred that to institutional investors.

Finally, it has largely transformed our Nation from a nation of investors into a nation of lenders and borrowers. We always were a nation of owners, of businessmen, of equity owners and partners, and today we are becoming a nation of lenders and borrowers, and equity is being squeezed right out.

I come before you as a lifelong student of finance and economics, and a practical businessman for 30 years, because I used to be in industry. I was a manufacturer, and I want to point out—the language may be strong, but I do not believe it is an exaggeration—that dogmatic and pedagogical misconceptions and the obvious lack of objective, constructive thought which has caused these ill-conceived governmental policies and has brought us to this sorry state—and I am going to present to this committee some remedial and constructive proposals which I believe have at least the merit of logic and commonsense.

If I may, I would like to begin with what I call the current misconceptions of our economists and our national and economic monetary managers, and compare that with what I believe, once considered, you will agree are the true causes of, and the remedies for, inflation.

The first misconception is that the cause of today's inflation has been excessive growth of the domestic money supply, as currently defined in terms of currency and demand deposits and that this has been an unavoidable result of excessive Government spending.

The climate is such that to say anything else may sound like heresy, but sometimes the truth sounds like heresy, and I believe you will agree that you will be hearing the truth. I submit that this misconception is a gross oversimplification and distortion of the facts. The inflation of 1968 through 1970, which reached a 5.3 percent annual rate, that is, measured by our broadest measure, the GNP deflator, was a result of financing the escalated costs of the Vietnam war without either rais-

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ing taxes or imposing controls. That is true. That was Government spending without sufficient revenues. But the double digit inflation of 1973 and 1974 is the result of a confluence of factors, none of which may be laid at the door of excessive Government spending per se.

Here is a list of what I believe are the true causes of the inflation which is rampaging in this country.

First, the accumulated Federal deficits of 1970–73 were a contributing factor to, but by no means the principal cause of today's inflation. These deficits, in fact, resulted primarily from a decline of 10 percent in Federal tax receipts per capita in constant dollars from 1969 through 1971, and an expansion of nearly 20 percent in expenditures.

Why did this take place? Both were a direct result of the contraction by the Federal Reserve Board, the unprecedented contraction in 1969 and 1970, of our money supply, and the consequent decline in gross national product, corporate and personal incomes, and the Government's tax revenues thereon. Neither the decline in tax revenues nor the so-called economically stimulative expansion of Federal expenditures which took place in 1970–71 would have occurred if the Federal Reserve Board had not taken it upon itself to plunge this Nation into an economic recession in 1969 and 1970. In other words, they grossly overdid it, the contraction of the money supply, and they overprolonged it in 1969–70, and because of that, that threw us into a recession. The Government's tax revenues declined substantially, and then we spent a lot of money in so-called stimulation. The result of this was a 10-percent decline in revenues, a 20-percent increase in expenditures, and that is the cause of the Federal deficits that we had in 1970 and 1973, not constructive overspending.

Second, the administration's decision in 1971 to suspend the convertibility of the dollar into gold, although this was necessary to correct a long-term accumulated imbalance of international payments, it cast all of the world's currencies, as well as the values to which they had been tied, afloat upon an international sea. The result was a worldwide loss of confidence in the stability of practically all governmental currencies, and consequently, throughout the world, everybody with money put that money as much as possible into tangible materials, tangible goods, tangible inventories, driving up the price of world commodities. This within 1 year literally doubled the price of world commodities, world commodity indexes doubled within 1 year as a result of this.

Third cause, so with this tremendous increase in world commodity prices, you can see here, this is the average compound rate, 20 percent a year for 5½ years, is the average increase in world commodity prices, and during the last year and a half, an average rate at a 45-percent rate. That does not have anything to do with the domestic money supply. That is world conditions, and that was caused in part as a result of the devaluation of the dollar.

The devaluation of the dollar, which has been 17 percent since it took place in 1971, the beginning of it, although necessary to restore the international competitiveness of U.S. dollar priced exports, was also a direct result of the long term mismanagement of our international trade and finance, a result of our subsidy, unnecessary subsidy of foreign nations, a result of the export of American capital to increase production overseas instead of in the United States. The resulting cumulative decline of 17 percent in the dollar's international pur-

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chasing power was in effect a de facto recognition of dollar inflation which had already occurred internationally, and which has subsequently been reflected in the increase of domestic prices. It is important to note that a 17 percent devaluation of the dollar is equivalent to a 21 percent rise in prices, and if you think about that for a minute, a 21 percent rise in prices as a result of devaluation of the dollar is itself equivalent to 2 years of inflation at a rate of 10 percent. Just that one simple thing alone accounts for 2 years of inflation at a 10 percent rate.

The fourth true cause of inflation is the foreign-controlled increase in the cost of energy. I do not think I need to read all the text here to make it clear that when the Arabs double the price of oil, you certainly could not rescind that by reducing the supply of money and the working capital of American business—no way. Yet that is what they have been trying to do. So that in itself, when that increase in the cost of energy, which doubled abroad, when that is spread out to include the price rise of American produced energy, it is averaged at 14 percent annual compound rate for 5 years, or a 48 percent increase in the last year and a half. That is the average rise in the cost of energy.

If anything is inflationary, that is, and certainly that had nothing to do with the domestic money supply, demand deposits inside the United States. No way are you going to cure that by raising interest rates at home, yet that is the stated cause.

Finally, the unregulated increase in the supply of Eurodollars—you know what a Eurodollar is. A Eurodollar is simply a deposit in a bank outside the United States that you can write a check on it in dollars, just the same as you can write a check in the United States. That can be created by a deposit that you make by depositing a check in an American bank, in a foreign bank, and then you have got a dollar deposit there in London or Paris or any other place, but it also can be created without any reference to dollars at all, simply by going to a foreign bank and saying I want to borrow a million dollars in dollars, and they will do it, and they will create a deposit of a million dollars without any sanction by the United States monetary authorities at all, no control, no reserves, nothing.

How great that has been, how enormous that has been. It has been equivalent to 115 percent increase, more than double the total supply of U.S. demand deposits since 1968. You want to know where the expansion of the money supply came from, what caused that. It was not in the United States where it could be used by American businessmen and American citizens. It was created in Europe, and it has become so great that it is as large as the entire money supply in the United States. In other words, it is just as if we had given the Europeans a printing press and said, you can print American dollars without any limit at all, and we do not care, and those same dollars can be used to buy and sell commodities just as much as they can in an American bank. That is exactly what happened—incredible. Incredible that there has been no effort by the Federal Reserve Board or the administration to place that under American control.

The unregulated massive increase of Eurodollars has been and still is unquestionably a major domestic as well as a worldwide cause of inflation. Believe it or not, the supply of Eurodollars is now almost as great as the entire U.S. domestic money supply of about $279 billion in currency and demand deposits in U.S. banks.

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Here is the major villain of the inflationary piece, for these dollars, fictitious or not, do represent actual dollar buying power demand and are, therefore, a very powerful factor in the demand-supply imbalance which has created today's inflation. This unregulated creation of U.S. dollars by foreign banks is a continuing inflationary factor which can and should be brought under strict U.S. control. Is it not incredible that our Government's monetary authorities are now drastically restricting the U.S. domestic money supply and our domestic economic growth, while completely neglecting to take any measures to reduce or even to bring under control this enormous, unregulated foreign-made expansion of U.S. dollars?

A little later on when I come to the proposals I will make a proposal which I believe can be negotiated to control this.

The sixth cause of inflation—mind you, not one of these has been a prolonged, excessive increase in the domestic money supply as commonly defined—the sixth cause was the suspension of ceilings on negotiable large certificates of deposits by large banks of over $100,000. We always used to have a regulation Q which limited that, but remember in 1970 when the Federal Reserve Board overdid and overprolonged the tremendous restrictive money supply, and it was clear that we were facing financial panic in the United States, and they had to open the window in order to keep the Penn Central collapse from spreading throughout the country. At that time they came to you and they got their regulation Q suspended, and they said, let us pay whatever interest rates we want so we can get the money in the banks so we will not go broke, and you let them do it.

This has since turned out to be a financial Frankenstein of previously unimaginable power. I am certain that you had no idea at the time that this could develop as it has. Herein is the cause of the apparent paradox of unprecedentedly usurious interest rates versus an adequate, so-called adequate supply of bank lendable funds. That adequate supply of bank lendable funds, by the way, is adequate by big banks for big borrowers and to nobody else. It is not adequate for the big businessman, for the average competitive individual, and it is inadequate in the average bank. So while the conventional current supply of money of currency and demand deposits, called M–1, has been growing at an average of 6.3-percent annual rate during the last 5½ years, 6.8 percent during the last 18 months, large certificates of deposit have averaged a 25-percent compound annual rate since 1968, and have skyrocketed to a 54-percent annual compound rate of growth since 1972, and this has caused the total domestic money supply, including the demand and time deposits, to rise at a 13-percent rate, 12.7 percent.

Here is the domestic villain, the two great villains in the money supply, unregulated, first, is Eurodollars by foreign banks, and second is no ceiling on the interest rates paid by our domestic banks, only on large certificates of deposit of over $100,000. You have got ceilings on what they will pay the average man, but not the rest.

The adverse effects upon the American free enterprise system of the suspension of regulation of large negotiable certificates of deposit can scarcely be exaggerated. This one terrible mistake, which benefits no one except the large banks has caused, first, the escalation of interest rates to levels which are unprecedented in our history, levels which

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were inconceivable a few years ago, and are nearly double the rate which centuries of civilization have considered usurious, and which are, in fact, absolutely unsustainable in a productive society. No way can any society sustain rates at 12, 15, 20 percent, which is what we have got.

We did a little research on the word "usury" and we found that in the early days of the Roman Republic, when it was vigorous and expanding and dynamic, and when capital was in short supply, they had a law which limited interest rates to 8⅓ percent, but later on, after it became the empire and passed its peak, it was dominated by fat cats. They raised it to 12 percent. That is a rather chilling thought.

I might say to you this. I do not think you would hurt anything, and you would save a great deal if you were to sponsor legislation which made it an absolute law to limit maximum interest rate in the United States to 10-percent simple interest.

Mr. JOHNSON. Would you repeat that? I did not get that. Pass a law what?

Mr. WRIGHT. Which would limit the maximum interest rate in the United States, simple interest rate, to 10 percent. I do not think you would lose a thing. I do not think it would hurt a thing, and I think it would immensely improve things. You cannot sustain a business, you cannot sustain homeownership, you cannot sustain anything, at the rates that we have got today. It is killing the whole thing which built the United States. I am pretty vigorous here. You may think I am supervigorous. But I tell you, gentlemen, it is the truth. It is what is happening right before your eyes. It has caused demoralization, it is causing the demoralization, the disintegration, and the forced liquidation of our securities markets for common stocks, bonds, and commercial paper—all of them.

Look here. This is not a small decline in stock prices. It is the death of the American equity markets as we have known them. Look at that. You look at the Dow Jones average, which is 30 big companies which are held mostly by large institutions, and you see that since 1968, well, they have declined by 36 percent adjusted for inflation, or 31 percent—oh, that is the bonds. Yes, these stocks have declined by 36 percent, and the bonds have declined 31 percent when adjusted for inflation and true values. In nominal values they have declined 9 percent and 15 percent.

But the average stock owned by the average American, an unweighted average of 1,500 and some leading common stocks in the United States are worth 26 cents on the dollar. They are down 74 percent in value in 5 years. You have destroyed it. You have destroyed three-quarters of it.

You will forgive me. I did not mean that you have destroyed it. But I did mean that our Government has permitted this destruction to take place. It is not an exaggeration. You are looking at the truth.

The concentration of financial and economic power in the major big banks has interposed big bankers between the owners and the users of capital. Letting the ceiling go on large certificates of deposits has caused all of the flow into the big banks, and thus has put the big banker into the position of controlling where the money will be used, rather than the owner of the capital.

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It used to be that there was competition in the commercial paper markets and other free markets. Today it is all flowing through the major banks. This has caused the transformation of equity capital into debt, the investors into lenders and businessmen into borrowers instead of partners. It is an entirely different kind of society. It has caused a dangerous shift, and I notice that Senator Bentsen is holding hearings on what he calls the imminent financial crisis that we are facing, and it is not an exaggeration.

It has caused a dangerous shift from long-term capital investment into short-term lending which seriously reduces the true liquidity of our banks and the availability of long-term investment capital for the expansion of competitive, productive enterprise. It is a serious impediment to the liquidity, the viability and the growth of our savings institutions, and it is a great real threat to the American tradition of homeownership.

These are all the things which we are proud of in the United States. We are proud of savings; we are proud of homeownership; we are proud of owning a share of American business; we are proud of having lots of free enterprise and competition. All of these things are being destroyed before your eyes.

Finally, high interest rates are themselves a primary cause of inflation. Here are the interest rates. Here is the 10-year average in black, and red is what we have got today, on the whole shebang, home mortgages right down to the large CD's, which are paying over 12 percent. These very high interest rates are themselves a primary cause of inflation for two reasons.

First, because the very reason by which they are justified, which is to slow down the economy, actually slows down production before it slows down consumption. It reduces the supply of goods and services before it curtails the demand, and it thus accelerates inflation at the same time that it is causing the recession. It is only after you have the recession and people are out of work that you then have less demand, and then you do not have production and you have got to spend money to start it up again. It is ridiculous.

The second reason that high interest rates are themselves the primary cause is because they, the interest cost, the cost of money, is itself a major complement in the cost of goods and services. You will see over here what it costs our Government alone. This is what it used to cost the Government. In 1968, this was the interest expense, $15 billion. What is it actually costing today? Another $11.2 billion, almost double. If you allow the interest rates to continue at the interest rates which were in effect at the beginning of this year as the Federal issues get rolled over and refunded at the present rates, that will be another $4 billion, bringing it up to $31 billion.

That was the interest rates at the beginning of this year, and if you add the interest rates that are actually in effect today that would be up here around $35 billion. This has to be paid for. The taxpayers have to pay this. It is inflationary. The gross debt of the United States now amounts to close to $500 billion. Each additional 1 percent added to the cost of servicing that debt amounts to $5 billion a year.

Thus that interest of $11.2 billion and the annual cost which has already resulted with the increase in interest rates can be computed to have inflated U.S. gross national product costs by about 2 percent a

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year. That portion of our gross national product which represents interest on the Federal debt alone, just the Federal debt. When we compute an estimated average, 5 percent increase in current versus average interest rates in the average 10 years, prior to 1969, on private consumer debt of $178 billion plus the progressive escalation of interest rates from 6 percent to 9.5 percent on mortgages of $620 billion, you have added billions and billions more to inflationary costs of goods and services. Altogether, the U.S. public and private debt now totals more than $2.5 trillion, about twice as much as our gross national product, which is about $1.4 trillion. Thus each 1 percent which is added to the cost of interest rates—and mind you, they have more than doubled—every 1 percent adds 2 percent to inflation.

Thus a very significant portion of the 9.3 percent inflation which we have had during the last 12 months is accounted for alone by the escalation of interest rates. In other words, what the Federal Reserve Board and the administration and the economists are telling you needs to be done is itself a major cause of inflation.

I have never seen anything even remotely approaching the illogic which is apparent. Gentlemen, if you study this yourself and think about it, you will inescapably come to the same conclusion. It is self-evident.

What is the second misconception? The first misconception, which I dwelt on at such length, is the misconception that the cause of inflation was the increase, excessive increase, in the demand deposits of business.

Mr. BARRETT. What page are you on?

Mr. WRIGHT. I am on page 5, now.

The second is that the current rate of inflation is unprecedented in the history of the United States. We have heard this from the Chairman of the Federal Reserve Board. You have heard it from many other people, and it is not true. I do not know why they do not do their homework, but it is not true.

Since World War II, inflation in the United States has twice before reached double-digit proportions. First in 1947 with the postwar relaxation of controls, and so for a year or so we had inflation a little bit higher than the maximum rate which we saw this year, and second in 1951, as the Korean war got started, we had also little bit higher than what we have had in the last year.

Both cases represented essentially one-time price adjustments and they were followed by return to normal rates of less than 3 percent within 1 or 2 years. I submit that it is thoroughly irresponsible for any of our economic leaders to threaten our Nation with the permanent destruction of the foundation of our economic way of life unless we accept their program for an extended period of economic regression—absolutely irresponsible for them to do that.

The recent excessive rate of inflation is essentially a one-time adjustment which has already run most of its course, and which was the inevitable result of the domestic governmental mismanagement and the international developments which have already been outlined. These inflationary measures have already taken place, and there is no reason to believe that the excessive inflation rate which they caused will continue beyond 1974 unless excessively restrictive monetary policies and a prolongation of prohibitively usurious interest rates are allowed to cause another recession, to be followed again by stimulative

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spending and a renewal of Federal deficits. I should add that unless we fail to do something to control this enormous escalation of Eurodollars, the expansion of the monetary supply of dollars on deposit with foreign banks which are not subject to regulation by the United States, that needs to be done. But otherwise, there is no reason at all to believe that we are in the grip of an inflation which is unprecedented in our history and which will undermine it.

What will undermine our society is these usurious interest rates and the concentration of power in the major banks. That is undermining it, killing our competitive enterprise.

Number three misconception—these are the misconceptions which seem to be uniform. I am a voice crying in the wilderness, and I hope you will forgive me if I cry loud. The principal misconception is that the principal remedy for inflation is unrelenting restriction of the domestic money supply and credit, and a continuation of these unprecedentedly high interest rates.

The rationale for this belief assumes that all inflation is caused by an increase in the domestic money supply, and is therefore curable by reducing that money supply, or at least stoppable by ceasing to increase it. This would be valid if the United States were an island, entirely insulated from the rest of the world.

But it is demonstrably false in the present circumstances because the regulated U.S. domestic money supply has not increased excessively—not M-1, not the demand deposits in banks that the citizens and the American corporations have in the American banks. That is not excessively large. On the contrary, it is the unregulated foreign supply of dollars known as Eurodollars which have proliferated which are the fundamental cause of worldwide inflation in which the United States has been caught up because it did not take effective measures either to control this proliferation or to insulate itself against its effects.

Not one darned thing was done, and yet it is the most obvious cause of huge increases, as much as the whole domestic money supply.

To hold that this is curable by starving the American domestic supply of money and credit, and denying American business the working capital which is vital to its existence seems to me to represent a new high in irrationality, and I carefully chose the word against the alternatives.

The fourth misconception that seems to prevail is that these policies—high interest rates, holding the money supply down—described now as "that oldtime religion" have been successful in the past and must now be employed regardless of their consequences in reduced national productivity, in increased unemployment, and in a reduced standard of living for our citizens.

We are asked to hold to it regardless because these policies have been successful in the past. That is nonsense.

Although a balanced Federal budget may perhaps be properly described as an "oldtime religious credo," and that would be true, the history of the application of policies of excessively restrictive monetary growth can be described as successful only if one is willing to consider the creation of a series of domestic recessions as a successful accomplishment. We have got some history over here. You know, back after the 1929 crash, the disinflation of 1930 which

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followed that speculative boom of 1928 and 1929 was unnecessarily turned into the great depression of the 1930's—it did not have to be—because the Federal Reserve Board then clamped down on money and credit. It shut it off, just like they are trying to do now, shut it off. That unrelenting contraction of money and credit by the Federal Reserve Board was not corrected until 3 years later after the damage had been done, when the New Deal came in, and then we had an enormous change in the policy at that time of unprecedented, easy money and low-interest rates, and we also had the lowest inflation rates that we had in this country in years. When we had low-interest rates, we never had any high-inflation rates.

During the last two decades, the United States has experienced a series of interruptions of the growth of its gross national product and its standard of living of its citizens. In 1957–58, as is shown here, this gross national product, the red is where we went below average. Again in 1960–61; again in 1967; again in 1969–70. Now in 1974, gross national product going below zero in real dollars or below average. None of these had to happen, not one of them. Every single one of them were caused by excessive contraction of money and credit by the Federal Reserve. You can see here the irregularity of the growth of money and credit.

I submit that the performance of the Federal Reserve Board in the control of money and credit is a record not to be repeated at any cost. It is an irregular record. It is not a competent record, and we had no need at all for these recessions, one, two, three, four, five. They did not have to happen. Now you are headed for another one if you do not stop it.

Two wrongs do not make a right. An excessive increase in the money supply followed by an excessive decrease does not correct the wrongs. It is two wrongs. They do not balance each other out, and there is simply no logic in the belief that because poor monetary management has caused excessive expansion from time to time in the past that it necessarily follows that stable monetary growth is not attainable and that excessive monetary restriction and recession are unavoidably required periodically to offset a prior cyclical period of excessive monetary growth. There is no reason to accept that and say we cannot do anything about it, given corrective, decent management.

If you ran American businesses that way, you would not have any business. When I hear over and over again the statement that high interest rates and a stagnant, no-growth economy are "necessary to fight inflation", I cannot help but be reminded of the post-medieval era when—maybe you will not, perhaps, remember, but I recall it—when the medical profession believed, practically to a man, and had persuaded the inhabitants of society at that time, of the scientific doctrine known as phlebotomy, otherwise known as bloodletting, which held at that time, that bloodletting was a universal cure of all kinds of diseases ranging from high blood pressure to and including insanity. In my judgment that is exactly what we are experiencing today. They have got everybody flimflammed into this idea that we have got to have a recession in order to prevent inflation. It is a bunch of nonsense. There is no justification.

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I have given you five basic reasons for inflation, none of which requires the contraction of the working capital of American business to correct it, none of it. But they have got everybody believing it. It is just the same kind of mass psychology that is believed. The so-called scientific economists—with apologies to anyone present in that category—are not scientific at all. They uphold that belief just the way the phlebotomists held their beliefs that bloodletting was a cure for everything.

What they are engaged in is draining the lifeblood out of our American free enterprise system. That is exactly what is going on before your eyes.

The fifth misconception—and I think that is enough of them—is that the management of the Nation's credit, interest rates, and money supply had best be left in the hands of the Federal Reserve Board, because "they know best," and "such matters ought to be kept out of the hands of politicians," especially the President and the Congress of the United States.

I remember in World War I the French Premier Clemenceau who said, "War is much too important a matter to be left to the generals," and I think the moral is pretty clear. With different words, the essential truth of that statement is as applicable today to our economy and its masters—and I mean masters, the seven members of the Federal Reserve Board and the five Federal Reserve bank presidents who serve with them on the all-powerful Open Market Committee.

The CHAIRMAN. If you will excuse me just a minute, please?

Mr. WRIGHT. Yes.

The CHAIRMAN. Mr. Barrett?

Mr. BARRETT. Would it be appropriate to interpose and ask you to repeat your statement you just made? Leave war to whom?

Mr. WRIGHT. The generals. Clemenceau said:

> War is much too important a matter to be left to the generals.

The important decisions regarding war, national decisions, was what he meant, and I say that this same thing applies.

Mr. BARRETT. You do not mean that war is not to be avoided?

Mr. WRIGHT. Oh, no, nothing to do with that. He said you cannot trust the generals to make important decisions regarding a war, and I say that that applies to today, to our economists and particularly the Federal Reserve Board. It is too important. Our economy is a national matter and it should not be entrusted to them. They have done a poor job with it, and it is self-evident, I believe.

The CHAIRMAN. Mr. Wright?

Mr. WRIGHT. Yes, sir?

The CHAIRMAN. I have in mind that we will have to recess here directly for lunch, and I would kind of like to have the members just briefly state what they are interested in this afternoon, if that will meet with your satisfaction. We will leave it up to them as to timing. We hope they will be brief, because Mr. Wright has the knowledge and information to answer your questions, I know, and I consider him one of the best authorities in the United States. If you will indicate in a brief comment as to what you are interested in him replying to, it would be appreciated very much. Will that be satisfactory?

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Mr. ROUSSELOT. Are we going to 5 minutes?

The CHAIRMAN. Well, we could not give everyone 5 minutes before lunch I do not think. But we want to do some questioning now and then have a recess for lunch, and then come back here at 2 o'clock, say.

Will that be all right, and let us just be brief on it? All right, just take your seat, please, and I believe we can hear you better anyway, Mr. Wright.

What I am interested in is—you are a great authority on interest rates from the Roman Empire on up to today, and you are advocating that there be a uniform rate in the United States not exceeding 10 percent. I thoroughly agree with you. I think anything above 10 percent is immoral, and I think people just feel they cannot cut it, and I agree with you on that. Now then, on our debts, we have $2.5 trillion in debts—now, on the interest rate that you mentioned awhile ago, 1 percent would run into billions of dollars extra, and, of course, that is something that is worthy of great consideration. The manufacture of money—you do not say manufacture of money, created money—but you do recognize that the Federal Reserve and the commercial banks are the only ones, the only entities that can create money.

Mr. WRIGHT. Of course.

The CHAIRMAN. Commercial banks can do that on 3 percent reserve on time deposits. Of course, it is more than that on demand deposits. You said that the Federal Reserve Board and the Federal Reserve was the major cause of inflation. I think you are exactly right. They misuse their money-creating powers. They raise interest rates to stop inflation. It is just like putting gasoline on a fire to try to put out the fire, the way I see it, and whenever you raise interest rates you raise prices. Whenever you raise prices you cause inflation.

Do you not agree with that?

Mr. WRIGHT. Yes.

The CHAIRMAN. So therefore they are doing exactly the wrong thing.

Mr. WRIGHT. Exactly.

The CHAIRMAN. I just want to make this one statement, and then I will yield to others. I will yield to Mr. Widnall next. This inflation is what is getting us. It is ruining our country. We must stop it. For 25 years I made critical comments about how our Government did not have an economist at the head of the Federal Reserve Board, and if we ever have a good economist, why, we will have quite a different situation insofar as money and inflation are concerned, and until we had Dr. Burns in 1969 we had never had an economist. We just had people in different vocations of life, avocations, like economists and others, but no experts like a person should be. When we got Dr. Burns I thought we had the very man. He had an international reputation and I thought he was the very man, and that he would really bring us out of the situation that we were in at the time. But when he took office interest rates commenced going up and they have been going up ever since.

Now then, the small businessman is paying 16 and 18 percent, and all the others are paying in a proportion. People cannot live and support their families and enjoy any kind of a satisfactory environment unless we change that, and I thought Dr. Burns would do it. But it has been worse under Dr. Burns than anyone that I have ever

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known, and I have been here for 46 years. So I know something about the Federal Reserve and I have questioned every one of its Chairmen.

So I will not take up any more time. But if you can see anything in that to comment on this afternoon, I would appreciate it.

Mr. Widnall?

Mr. WIDNALL. Mr. Wright, I believe you just agreed with Mr. Patman that 10 percent was the top interest rate that there should be.

Do you feel that about credit in general where we have sanctions through this committee by a credit bill, 18 percent interest on all kinds of accounts?

The CHAIRMAN. Mr. Widnall, will you please yield briefly?

Mr. WIDNALL. Yes, I will yield.

The CHAIRMAN. Did we say that? We did not pass on interest rates, I do not think.

Did we, Mrs. Sullivan?

Mrs. SULLIVAN. Not that I have ever heard of.

Mr. WIDNALL. I thought there was a consumer bill sponsored by Mrs. Sullivan that I voted for and that others on this committee voted for in an effort to get at the loan sharks, and all it has done is get a lot of people who never charged interest on accounts—for instance, gas companies and others—to charge 1.5 percent a month, 18 percent a year.

Mrs. SULLIVAN. Mr. Widnall, would you yield?

Mr. WIDNALL. Yes.

Mrs. SULLIVAN. The truth in lending bill did not require any rate of interest to be charged. The truth in lending bill only required those who extended credit to say what percent they were charging on an annual basis for their interest. That is all it called for, and it had never ever set any limit for interest charged or interest rates. It was a disclosure bill.

Mr. WIDNALL. I understand that. But in effect, in operation it has legalized what I would call an 18 percent lending rate for general credit, credit cards and other things in connection with that.

What do you think about the contribution that credit cards have made to the economy and the inflation that is taking place all over?

Unlimited credit advertised on the big signboards—you do not need any money, just come in and we will give it to you, up to $3,500 on the radio, I hear these days. It practically does not cost you anything.

Is not the overextension of credit one of the major factors in the inflation that has been taking place?

Mr. WRIGHT. I do not think it has been the major factor. I would not say it has not been a factor, but I would say that we would not have excessive inflation because of the growth of the credit card alone. I am not taking a position for or against the credit cards as such.

In answer to your question about the 10-percent rate, I would say this: If you had proper management of our money supply and the proper international control so that we did not allow the Europeans to print American dollars, as many as we print in the United States, that is the effect of it. If we had a proper control over this, you would find you would not need the 10-percent rate, because our whole history of the United States is that even consumer credit, which is much higher than other credit, used to have a 5-percent prime rate, and a 10 percent or 9 percent would be the limit on installment loans, except for personal loan companies that are limited by State statute.

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But I think that it has got to be stopped. I think if you introduce a bill for 10 percent absolute limit, although there will be some risk cases where a higher rate than 10 percent, because of the risk of capital, would be justified, the net result of it would be so much more beneficial than what we would lose that you would have it, and it would greatly encourage equity participation then for the risk situations, which is what equity is for.

Mr. WIDNALL. Mr. Wright, how do you view the present conditions in the credit markets, both domestic and international? Are we on the verge of a severe liquidity crisis?

To your knowledge, are there a number of other large banks, domestic and international, in the type of difficulties experienced recently by Franklin National or the Herstatt Bank in Germany?

Mr. WRIGHT. Well, Mr. Widnall, I cannot say to my knowledge, because I cannot look at the validity of the loan portfolios that they have. Take, for example, all of these large bank holding companies have, among other interests, what is called REIT's, which are real estate investment trusts. No way can I tell whether the value of that real estate is actually there or present.

But I will answer the first part of your question by saying yes, we have a very serious danger, and that serious danger stems from the fact that the bank deposits are all short term. We have the large certificates of deposit that are 30 to 90 days, and they are enormous in size. This enormous expansion of that is short-term money. We have long-term commitments by the banks, and so whenever you have the short-term money being used for long-term commitments, you have a very serious risk. But yes, I think we do have that.

Mr. WIDNALL. Mr. Wright, my time is up.

The CHAIRMAN. Mr. Barrett.

Let us all be as brief as we can.

Mr. BARRETT. I have just 2 minutes allotted to me. You and Chairman Patman agreed that first comes high prices, then high interest rates, and then inflation.

We have been told it is a diseased economy that causes inflation, and then comes high interest rates, and then comes high prices. You seem to put it in the reverse here. Which is the right way to put it?

Mr. WRIGHT. Well, sir, I will try to answer you in 1 minute as briefly as I can.

The causes of the inflation that we have in the United States are international in origin. I gave six causes; those are the causes.

Mr. BARRETT. Let us agree, so that I do not lose my time, that a great increase in the flow of money into the money market causes inflation.

Mr. WRIGHT. Yes, but it has not been domestic; it has been foreign.

Mr. BARRETT. Let me take it, then, on the basis of what the Federal Reserve presidents indicated here. They said inflation is a disease; it is a malady, and we can look back for 2 or 3 decades to see that.

If those people were looking back over 2 or 3 decades, should not this show some symptoms that ultimately this disease would come to a point where not only they would observe it, but everybody in the country would observe the disease. Yet the money market, the banker, the conglomerates, have done nothing about these symptoms until they reached the epidemic proportions causing high interest rates, and the high interest rates caused high prices.

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Who are the avaricious people now that are permitting this inflationary disease to continue and destroy the monetary system of this Government?

I know you are going to point to the Eurodollars now and say the outflow of dollars is causing this condition we have here in America. But it is my understanding back in 1969 or 1970 when William McChesney Martin said here, after we questioned him about the outflow of the Eurodollars that it should have been stopped long ago. Only now we are putting this restriction on it, 10 percent of the assets of any bank could be sent out of the country.

My time has expired, and I am sorry I cannot get your answer to it.

The CHAIRMAN. All right.

Mr. BLACKBURN. Mr. Wright, I find your testimony most interesting. I think your observation about the impact of Eurodollars on our domestic money supply is well taken. Frankly, you are the first witness we have had who has made that observation.

What do you anticipate will happen to the stock prices by the end of the year domestically? I am talking about common stocks. Are you bearish or bullish as far as the next few months on our domestic stock market?

Mr. WRIGHT. Mr. Blackburn, that depends partly on what your committee does.

Mr. BLACKBURN. You are really leaving it up to the fate of the Gods if you are going to leave it up to this committee, so I am just asking you, in the absence of any committee action, what do you anticipate will be the state of the stock market at the end of this year?

Mr. WRIGHT. If Dr. Burns and company are allowed to follow the procedures which they now are following and are not caused by natural forces other forces, to change that, we will have a dreadful collapse. My investment judgment is not predicated upon that collapse taking place. The reason for that is that I believe that the forces which are gathering will force that change.

I do not, cannot conceive that we will be able to go through 5 more months of this kind of thing before there will be such a cry, such a force taken with many other people, other than me, putting every kind of pressure to cause a change of policy.

Mr. BLACKBURN. Are you talking about a reversal of the Fed's monetary policy?

Mr. WRIGHT. That is right.

Mr. BLACKBURN. Yet we have to recognize that the Fed's monetary policies for the last year have not been really restrictive; in the last few months, perhaps. But I think, if anything, the Fed's monetary policies have been overly expansive for the past year. Do you agree with that?

Mr. WRIGHT. No, Mr. Blackburn, and I will tell you why. I may find myself in a minority in this, but I have studied it with great care, and it is at least my considered opinion that when the rise in the costs, the price of commodities, general price level has risen as much as it has for reasons which were independent of the domestic money supply, which I have given, that means that every business has got a greater amount of receivables and a greater amount of inventories and must have a corresponding increase in its working capital or it cannot sustain itself. It cannot; it has to borrow money. It is a simple fact.

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So it is necessary to adjust the domestic money supply to the amount of gross national product that we have to keep the working capital in proportion to the amount of investment that each company has to have money tied up. That is an obvious fact.

Mr. BLACKBURN. Let me make sure I am understanding you. You move pretty fast for those of us who are not economists. You are saying that the Fed necessarily must increase money supply as a reflection of the inflationary impact on inventory, perhaps, and receivables?

Mr. WRIGHT. Irreversible increases in cost which are not a result of excessive domestic money supply. For example, the price of energy, which is spread throughout the economy, no way can you drop that by starving American business for working capital. You have got to provide it.

Mr. BLACKBURN. Well, I understand what you are saying, and I think I am inclined to agree with you to some extent. But let me ask you about this.

You referred to the double-digit inflation in 1947, and yet that was a time when interest rates were controlled to a maximum of 2½ percent.

Mr. WRIGHT. Yes, sir.

Mr. BLACKBURN. Is that—was that occurrence, that is, the double-digit inflation in 1947, consistent with your view that high interest rates are themselves the cause of inflation, when inflation in that year was running double-digit and interest rates were held to 2½ percent?

Mr. WRIGHT. Yes, sir. What I said is that the interest rates, high interest rates, we have now are a cause of inflation, not the primary cause, but a very great increase. The primary causes I have given——

Mr. BLACKBURN. In effect, you are saying they are an aggravation of inflation?

Mr. WRIGHT. That is right, sir.

Mr. BLACKBURN. I notice that a great deal of your testimony was aimed at criticism of the Fed. And, understand, I have made some criticism of the Fed myself. Then on page 8 of your testimony, you want to expand by legislation the regulatory powers of the Fed.

What sort of metamorphosis is going to occur on the Fed Board to give them greater judgment to exercise greater regulatory powers?

Mr. WRIGHT. Mr. Blackburn, I very carefully set out the order of those things, because that is a perfectly correct observation. The answer is this: It is what I hope you will permit me to do this afternoon. I am going to make nine proposals.

One of the proposals is to give the Fed better tools. Along with that is the proposal to tell them what they must accomplish, not allow them to make up their decisions.

Mr. ROUSSELOT. If the gentleman will yield at that point. That is not the only place that you recommend increased powers. You have several other places, too.

Mr. WRIGHT. Yes, sir.

Mr. ROUSSELOT. Yet you are critical of that.

Mr. WRIGHT. I have not come to that section.

Mrs. SULLIVAN. Regular order.

The CHAIRMAN. Now, Mrs. Sullivan.

Mrs. SULLIVAN. I want to say that I am dreadfully sorry that a caucus prevented me from being here to hear you, because you are just the kind of person that we needed to have come before us.

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This afternoon, Mr. Chairman, I have to be in the conference with the Senate on another committee, so I cannot be here.

What you have been saying I am taking to mean that the supply of money must dovetail with inventories and so forth—I am no economist and cannot explain it—but could not we have controlled some of this if we did not allow some big businesses to be able to borrow all the money needed at whatever rate was charged?

Mr. WRIGHT. Mrs. Sullivan, the Eurodollar market in Europe, which we do not control at all and which has grown to be as large as all the dollars on deposit in the United States, the transnational corporations have access to that, can borrow all they want. You see, they have no shortage of money. But the domestic people do not have enough money.

Mrs. SULLIVAN. I can understand this. But back in 1969 we enacted the Credit Control Act to be used as it was used in World War II to control credit rise. We could have stopped all of this excessive consumer credit by simply saying, if you want a car, you have got to pay 30 percent down, and then you borrow the rest.

I know what it would do to business, but nevertheless automobile companies are not selling cars anyway. There ought to be some way to control this. Small business cannot obtain a loan because there is not enough money because all of it is given to the big companies and big business. This is the one thing that I would like to hear you talk about but I will not be able to be here to hear it.

But could this help? If you would touch on that this afternoon, I will read the transcript at a later time.

Mr. WRIGHT. Yes, Mrs. Sullivan, I will do that. It dovetails into the controls that I suggest. We have got a bludgeon now, and we need instruments.

Mrs. SULLIVAN. Another thing I want to clear up, because it was mentioned by Mr. Widnall, is that before we ever had a Truth-in-Lending Act companies who were extending credit were charging 1½ percent a month and fooling the people into thinking they had a low rate of interest of 1½ percent. All we insisted in the Truth-in-Lending Act was that they tell the truth to the people when they wanted to buy on credit—let the public know the cost of credit expressed in terms of an annual financing rate. That is all; that is all it was supposed to do, and all it ever did do.

If creditors are charging interest now when they did not do so before, it is not being done because of any law. Our legislation did not bring that on. High interest rates brought it on.

Mr. WRIGHT. No, I would not see why. Personally, I think that was an excellent piece of legislation, the Truth-in-Lending. I think it was a very much needed and a very good and healthy thing.

Mrs. SULLIVAN. People do know that interest they are paying on charge accounts, because they get that reminder every month that they do not pay their bill. If they are foolish enough to pay 18 percent, well, that is up to their own choice.

But we were talking about the legislation we had enacted to give the administration the power to establish credit controls so that it could discourage excessive credit. We did not set rates; we just said, when you control credit, you simply say if you want a new car you must pay a third or fourth down and the balance on credit, as one example.

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I do not know if this is the best way to help stop inflation. We have to find an answer, and we did not find it with the Federal Reserve bank witnesses and we did not find it with the other economists who testified.

Mr. WRIGHT. I do not know that I have the answer, but I have nine proposals.

Mrs. SULLIVAN. Thank you.

The CHAIRMAN. Mr. Rousselot.

Mr. ROUSSELOT. Thank you.

Mr. Wright, I, too, find your testimony fascinating and interesting. I am interested in your basic thesis, one of your basic theses, and you have several here.

In fact, you make the statement that misguided Government policies have caused inflation, contributed to it, and that one of them is, in fact, the Federal Reserve's policy of regulating the money supply, but that you do not feel that the deficit-spending tendencies of this Congress, together with the President, have quite as much weight or impact.

If you are correct—and I am not sure I would agree with that thesis—I would think that is an equal problem—is it not a fact that the Treasury, because of the deficit spending caused by Congress and the President, in the money market, creates a drying up of the supply of money to a substantial degree and an unwarranted competitive entrance into the marketplace?

Mr. WRIGHT. Yes, sir, that would be the case, if the Federal Reserve Board did not go into the open market and buy those securities, which it does.

If I may, I would just like to clarify what I do think about the points that you made. I believe in a balanced budget.

Mr. ROUSSELOT. Good. You think that is an important governmental policy?

Mr. WRIGHT. Certainly. However, what I am saying is that because of what we have got now, it has not been because of hog-wild Government spending. What we had was the spending for the Vietnam war, and we did not raise the taxes for it. That created the inflation we had.

Mr. ROUSSELOT. I agree with you.

Mr. WRIGHT. Then, what we had that caused the Federal Reserve Board to shut off credit, and the great recession that we had in 1969 and 1970, that cut down our revenues by 10 percent. Then the administration spent a 20-percent increase to get the economy going again.

Mr. ROUSSELOT. I cannot argue with you on that point; and Congress participated in that wild spending spree.

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. Yes. Mr. Wright, because of the quorum call, I am going to have to be brief. I asked this question of Chairman Burns when he appeared before us last week, I believe.

With respect to the Citicorp notes and similar issues that are now coming out—and we can anticipate there will be quite a few others—my question was to him, What will be the effect on the stock market? With the market depressed already, the average investor who has $5,000 or more to invest is going to look at this type of a rate and say to himself, "With the performance of the market over the past 18 months to 2 years, why should I invest in the market?"

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That being the case, is this not a terrible cancer on our American business picture?

Mr. WRIGHT. Mr. St Germain, I think it is a dreadful thing. I think it is a very great evil. What you have said is true. That is money which, instead of going into the free markets, is going to go into the banks. The whole thing, along with the unregulated large CD's—that is an extension of that—interposes the banker between the American citizen who owns capital and the man who uses it.

That is a bad thing. That is a tremendous concentration of power, and it is wrong, and it ought to be stopped. The banks ought to be the depository for the savings of people; that is all. They should not be the czars of our system. There is no reason for them to be, and that is what this—this is another thing to increase the big bankers' position between the owners of capital and the users of it, and let them be the deciders; it is wrong.

Mr. ST GERMAIN. I noted in your testimony that you have already given, or perhaps will give a little later on, your concept of one-bank holding companies.

Mr. WRIGHT. Yes.

Mr. ST GERMAIN. I think that I am becoming convinced that one of the big problems is we no longer have bankers, but we have bankers trying to be businessmen.

Mr. WRIGHT. That is right.

Mr. ST GERMAIN. This is perhaps one of the reasons for some of our large and small bank holding companies who definitely should not have become holding companies, being in precarious positions today.

Mr. WRIGHT. Absolutely correct. I want to discuss that this afternoon, if I may.

Mr. ST GERMAIN. Thank you, Mr. Chairman. I am going to run over for the quorum call.

The CHAIRMAN. Mr. Wright, we will recess until 2 o'clock. We all have some things to do, as you know, but we will meet you back here at 2 o'clock.

We are delighted to have you. Your testimony is wonderful. We look forward to hearing you this afternoon, sir. The committee will stand in recess until 2 o'clock this afternoon.

[Whereupon, at 12:20 p.m., the committee was recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order.

Mr. Wright, first I would like to yield to a couple of gentlemen who did not ask questions this morning to ask their questions this afternoon, and then you can get back to your dissertation if you want to.

All right, first is Mr. Burgener.

STATEMENT OF JOHN WINTHROP WRIGHT—Resumed

Mr. BURGENER. Thank you, Mr. Chairman.

The CHAIRMAN. Go right ahead, sir.

Mr. BURGENER. Two questions very briefly, one on Eurodollars and one on mortgage loan money, which is near and dear to my heart and my community. The Eurodollar, I take it, is a dollar deposited in a European bank?

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Mr. WRIGHT. Yes, sir, in any nondomiciled bank, that is, any bank not domiciled in the United States.

Mr. BURGENER. That is all it is, from whatever source, is a dollar?

Mr. WRIGHT. Yes, sir. It may even be created, not transferred from anywhere. In other words, if you went to a bank in London and you said you wanted to open an account in dollars, they say, well, let us have your check on a New York bank. That is one way of doing it.

Mr. BURGENER. All right.

Mr. WRIGHT. But you say, no, I am not going to do that. I have got some collateral here. I want you to loan me $100,000.

Mr. BURGENER. All right.

Mr. WRIGHT. They will do it. All they do is open an account, create $100,000 in deposit. It has not been approved by anybody.

Mr. BURGENER. So they are in the money creation business?

Mr. WRIGHT. Exactly the same as an American bank. Then you can draw a check on that bank and you can buy anything you want with it.

Mr. BURGENER. All right. They are not regulated by anybody?

Mr. WRIGHT. No regulation whatsoever. It is incredible, but it is the truth, incredible. One of my proposals, I propose a method of bringing that under control.

Mr. BURGENER. I want to hear about that.

Mr. WRIGHT. Yes, sir.

Mr. BURGENER. Now second, I guess——

Mr. WRIGHT. Just to reiterate, the amount of money which has been created that way in the last 6 years is as great now as all of the deposits in the United States. In other words, they doubled the money supply.

Mr. BURGENER. Was that estimate $279 billion or something like that?

Mr. WRIGHT. About $270 billion.

Mr. BURGENER. $270 billion is the amount?

Mr. WRIGHT. Yes; that is it, after you take out the interbank deposits which wash each other out.

Mr. BURGENER. Is there such a thing as an inventory of the number of dollars in this country?

Mr. WRIGHT. Yes; what is called M–1.

Mr. BURGENER. Except for the dollars that people have got in their safety deposit box, I suppose.

Mr. WRIGHT. The money supply called M–1 is currency plus all demand deposits in American-domiciled banks, and that is about the same. It is about $279 billion. There is an addition to that, all of the savings deposits, time deposits in dollars.

Mr. BURGENER. Obviously 10, 20, years ago, that was a much smaller figure.

Mr. WRIGHT. Yes; and then on top of that, which I am going to address myself to as soon as we finish this, is the so-called certificate of deposit, which is the new wrinkle. It is all new. It did not start until the sixties. Then you took the ceiling off the interest rates, and that is the only part of the American money supply that has been growing too fast. There are two villains in money supply. The biggest and the worst is the Eurodollar expansion, which is just like doubling the dollar expansion, and the second is the expansion of the certificates of deposit, which is principally big banks and no ceiling on it.

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Mr. BURGENER. All right. Very briefly, in your dissertation do you address yourself to the long-term mortgage loan money?

Mr. WRIGHT. Yes, sir.

Mr. BURGENER. You do?

Mr. WRIGHT. Yes, sir. I am going to speak about that.

Mr. BURGENER. You have a suggestion of what to do about it?

Mr. WRIGHT. We will have to get the rates down, and to get the rates down I have got a proposal to do that.

Mr. BURGENER. All right, so it solves itself if interest rates come down and money is available.

Mr. WRIGHT. Yes, sir, yes, sir, that is right.

Mr. BURGENER. That is all at this time, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Mr. Hanley?

Mr. HANLEY. Thank you, Mr. Chairman.

Mr. Wright, I too want to express my appreciation for your interest and effort in this all-important issue. I regret that I did not have the opportunity to hear your testimony. I certainly will make a point to read through it.

May I ask your opinion with regard to the policy of Dr. Arthur Burns? Are you in agreement with it?

Mr. WRIGHT. No, sir. I am in absolute disagreement with it. I would describe it——

Mr. HANLEY. Would you expand upon that line?

Mr. WRIGHT. I would have to describe it as dogmatic and pedagogical in the greatest degree and without constructive logical thought and analysis, and I regard it as creating a terrible, terrible destruction of the American free enterprise system. He has the best of intentions and the worst of policies, in my opinion.

Mr. BURGENER. Would the gentleman yield?

Mr. HANLEY. I yield to the gentleman from California.

Mr. BURGENER. Of course, he dwelt at length on that this morning and it was most interesting. But I just want, without getting into personalities—what do you think of the philosophy and economic policies of Mr. Greenspan?

Mr. WRIGHT. I do not know what they are. I know that in general he has stated that he is taking the hard line and believes that the old-time religion must be followed which I described this morning, and I disagree with that. That is, I believe in the balanced budget, but I do not believe that it is necessary to have a depression at all in this country or a recession, and that is exactly what they are heading for. That is not the way to correct inflation. It is entirely unnecessary for the reasons I have given, and I am going to propose this afternoon nine measures which I think, all of which I think will be of some help and in the aggregate they are more than are needed.

They are doing the wrong, wrong thing. The escalation of interest rates does not reduce inflation; it enhances it. Everything proves that over the years. We have an average interest rate in the United States for the last 20 or 30 years of about 2½ percent, and we had very low interest rates. We have never had high inflation until we had, after we had the high interest rates. That has always been the case.

I am not saying that the high interest rates are the fundamental cause of the inflation. I am saying that they have enhanced it.

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Mr. BURGENER. If I may, if I went into this London bank, London account for x amount of dollars, and I had collateral, could I open it in any other currency?

Mr. WRIGHT. Oh, any currency you wanted to, and that is called Eurocurrency.

Mr. BURGENER. Francs, pounds, lira, anything?

Mr. WRIGHT. Yes, sir. There is about $40 billion in other nondomiciled currencies like francs, sterling, et cetera. But there is $270 billion in American dollars that are created.

Mr. BURGENER. Thank you, sir.

Mr. HANLEY. Mr. Wright, with regard to the recent overture on the part of Citicorp and Chase Manhattan Corp. related to certificates of investment, do you have an opinion on this overture?

Mr. WRIGHT. Yes; sir, I do and it is related to what I am going to say about large bank holding companies and these large certificates of deposit. But to answer you briefly, I think it is a very serious and wrong extension of the growth of major banks to a point where they are dominating our economy unnecessarily.

That money, of course, comes right out of the free markets like the commercial paper markets, the stock markets, the bond market, and so on. It is an extension of that. What has happened with this enormous growth through the large certificates of deposits, which I am going to come to in a moment, that plus the bank holding company plus the issuance of subordinated notes which they began a few years ago, and now this latest wrinkle, is that the bankers have interposed themselves between the men who created capital, the American public, and the people who use it, and they have become the sole arbiters of our fate. They decide whether you can open a new business, whether you can borrow the money to expand your business. It is no longer a free competitive society. That is exactly what has happened. On those grounds alone, outside of the immediate effect on the securities markets, I would oppose this.

Mr. HANLEY. Would you say that in recognition of the imposition of regulation Q on banks that this overture on the part of Citicorp would be quite unfair and in fact an effort to circumvent the provisions of regulation Q?

Mr. WRIGHT. Regulation Q has been circumvented already when you abolished the ceiling in large certificates of deposit. That just killed that. That is the reason. That is the reason for the high interest rates, and that has aggravated inflation. But that sole thing, that is a Frankenstein. When you allowed them to do it in 1970 because the restriction of the money supply in 1969 and 1970 by the Federal Reserve Board went so far that we were on the verge of absolute financial crisis.

They had to open the window to keep things going in May and June. You remember that. Then the Penn Central crisis came in and it scared the hell out of them. At that time they came to you and they said, let us take the interest rate ceiling off large certificates of deposit so that the banks could get the money to stay in business and not go broke. Remember that, that is what happened. That turned out to be a Frankenstein because, while it helped to prevent the crisis which they had created themselves through their excessively restrictive policies, since then it has allowed the banks to outbid everybody else to bring money

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into them, and it has killed the commercial paper market, killed the stock market, killed the bond market, and put them in a position of control.

Mr. HANLEY. With regard to inflation, if you were to point out the single most important factor or ingredient in the inflationary problem, what would it be?

Mr. WRIGHT. The creation of Eurodollars has doubled the supply of dollars in the world, and that doubled the price of world commodities, and that made possible the rise in the price of oil, and that rubbed right off here and caused the increase. Unquestionably, that is the major factor.

Mr. HANLEY. And second?

Mr. WRIGHT. The high interest rate. Second, the monetary policy of the Federal Reserve Board which restricted the growth of domestic money, restricted the growth of production in the United States, restricted the growth of the ability to produce competitive products, and raised the interest rates which in themselves are an inflationary factor.

Mr. HANLEY. All right. Now, if I could carry it to just one——

Mr. WRIGHT. That is a good way to put it.

Mr. HANLEY [continuing]. Just a degree further, what would be the third most important factor?

Mr. WRIGHT. The third would be a series—I have a chart here which shows it—a series of factors such as——

Mr. HANLEY. For instance, would you——

Mr. WRIGHT. For instance, the exportation of American products abroad—enormous, including food and so on.

Mr. HANLEY. So for instance, would it be accurate to say food prices?

Mr. WRIGHT. That would be—yes, sir.

Mr. HANLEY. Energy prices?

Mr. WRIGHT. Yes, sir. Food prices as a result of the exportation of the basic products abroad, I would say.

Mr. HANLEY. I see.

Mr. BURGENER. Would the gentleman yield?

Mr. HANLEY. I yield to the gentleman from California.

Mr. BURGENER. Mr. Wright, we have had a number of economists before us in the past year, many of whom did not agree with each other. There is nothing unusual in that. We do not agree with each other either. But one, only one, seemed to take strong disagreement with the Federal Reserve's monetary policies, and he described it this way, and I would like your comment. He said that they have choked off the money supply and prevented capital expansion in industry.

Mr. WRIGHT. Absolutely.

Mr. BURGENER. He says the proof of that is that we were not running plants to maximum capacity and because we were not that was a self-defeating kind of thing. I said, how much should they open up the money supply? He said, something like, if I recall, enough to get every plant operating at maximum capacity with proper expansion. Is that generally your thought?

Mr. WRIGHT. You could say that. I would say that it is true, it is absolutely right what he says, that choking off the supply of working capital and capital to business has killed the productive enterprise, expansion of competitive enterprise. Competition is what holds prices down and a sufficient supply, and it killed that. That is the basic thing.

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So, what is enough money supply? Enough to make sure that we have the expansion that we need of basic industry. That is what is needed. I can supplement that.

Mr. HANLEY. I thank you, Mr. Chairman. I thank you, Mr. Wright.

The CHAIRMAN. Mr. Wright, I wanted to ask you some questions, but I know—our friend from South Carolina, do you want to ask any questions?

Mr. GETTYS. No, thank you, Mr. Chairman. I just got in. I have no questions.

The CHAIRMAN. All right; I would like to ask some now, and then these gentlemen after that, before you return to your dissertation, if it is all right.

Mr. WRIGHT. All right.

The CHAIRMAN. Mine would be more of a comment. Just sit down, please, sir.

The first question I would ask you is this. If you were asked which is better for the country, the whole Nation and individual citizens thereof, the poor, the rich, all kinds, just like there are, would you say that they would be helped or harmed by low interest or high interest?

Mr. WRIGHT. There is no question about that, Mr. Chairman. The high interest rates harm the citizens, the businessmen as a whole, and high interest rates harm it seriously. Low interest rates help. No ifs, ands, or buts about that.

The CHAIRMAN. In fact, you cannot build the country unless you have low interest rates, can you?

Mr. WRIGHT. You cannot. I do not think any nation in the history of the world can.

The CHAIRMAN. There is one thing that I am very proud of the Democrats on, and that is when war clouds were over this country preceding World War II, Mr. Eccles, who was Chairman of the Federal Reserve Board, and President Franklin D. Roosevelt and the other leaders of our country had a meeting and they decided that if they did not control interest rates in the war that was coming up that they would have to pay for the cost of the war many times over after we had won the war. They decided to fix interest rates below 2½ percent.

That commenced before Pearl Harbor. They stayed with that all during the time before the war commenced, all during the time of World War II, and then after the war until 1951. They decided that they wanted to get rid of that ceiling of 2½ percent on bonds that were issued even though Mr. Truman paid $29 billion on the national debt through that low interest rate. It kept interest rates down and the people did not complain because they could invest their money with the Government at 2½ percent. If they found an investment that was more attractive to them, they could go get their money without loss of capital or any other penalty, with interest up to that time, and then they could take that money and invest in anything they wanted to if they found a more attractive investment. Of course some got their money and invested.

The reason the people never did object to it was because they had a place to put their money that was safe, and if they could find a better investment—and many of them did—they could take that money and invest it. Therefore, they had nothing to complain about and that worked out fine.

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For 14 years that interest rate never exceeded 2½ percent. In 1951 when John Snyder, Secretary of the Treasury, was in the hospital, out at the naval hospital, he was temporarily confined and he had to forgo the duties of the office for a while and went out there, and Mr. Martin took his place, an Assistant Secretary of the Treasury. I do not think they communicated much. One of these days we will get that story, but we do not know it now.

But anyway, Mr. Martin, he got into this accord business. They were going to have an accord. They were going to take that ceiling off of interest rates and let the interest rates just go on up. Mr. Truman heard about that order and he called them all in, the whole Open Market Committee and the Board of Governors and every one of them entered the White House, and the first thing after they got in there and had quite a discussion, the newspapermen surrounding it, they could hear kind of a loud noise going on, loud talking. Finally, one of them came out, one of the people who was in there, and they all got around him and said, now what is going on here? He said, well, I cannot tell you, but Mr. Truman is in a bad humor. The fact of the matter, he started off calling us names. He said, if you think you can get by with that you have another thought coming. He said, you will make the people pay the cost of this war—the Korean war—two or three times yet. Furthermore, I am going to denounce you as traitors to your country, and I am going on the television and do it, and I am going to call your names in the denunciations because you cannot get by with that, and I just want to warn you. They went out and within 30 minutes they changed that order and put it back.

Then Mr. Truman still had 2 years to go as President. Government bond rates had never been raised above 2½ percent during the 12 years up until then, and the next 2 years they were not raised at all either. So it shows you can fix the rates if you want to.

Mr. WRIGHT. You most certainly can.

The CHAIRMAN. And keep them there.

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. You know, Mr. Eccles testified that the Federal Reserve Board can fix the rate 1.99 percent or 2.01 percent and keep it exactly there if they want to.

Mr. WRIGHT. And have absolute control.

The CHAIRMAN. This 14 years of experience, it occurs to me, is a convincing example that no one can dispute. Do you not agree?

Mr. WRIGHT. Yes, sir; that is right. That is absolutely right.

The CHAIRMAN. Now, then, I want to ask you about something that I think would solve more problems in this country than any other thing. We have in the Federal Reserve Bank of New York—of course, the No. 1 bank in the Federal Reserve System out of the 12—we have $80 billion in Government securities. I did not say millions, I did not say thousands. I said billions. Eighty billion dollars in U.S. Government bonds that have been purchased by the Open Market Committee of the Federal Reserve System, under, of course, the domination of the Federal Reserve Board's seven members, and they have purchased every one of those bonds, not with money out of the Federal Reserve. The Federal Reserve has no money. The only money they have is what they create. As we suggested this morning, there are only two entities of Government or two entities of any kind that can create money. One of them is the commercial banks under the fractional reserve system, and the other the Federal Reserve.

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So they created the money and bought those bonds. If they had canceled the bonds because trading one obligation, Government obligation, for another, it would not have been so bad. But they did not cancel a one of them. They still required the people, the taxpayers, to pay interest on these bonds just the same as if they had never been paid. But they had been paid. Mr. Martin testified to that in answer to a question I asked him.

I said, is it not a fact that these bonds have been paid for once? He said, yes, they have been paid for.

Dr. Burns was sitting in the place you are sitting in one day less than a year ago, and I said:

Dr. Burns, in view of the fact that you testified that these bonds were bought with Government credit and money—you have got to sell them or buy them through a dealer, as you know—and whenever you buy a million dollars worth of bonds through a dealer and you give him a million dollars worth of credit on the books of the Federal Reserve banks, if he wants some currency he can get every bit right then or he can draw it when he needs it. But the fact is, Government money has been used to pay for those bonds. I have always heard that there is not a single academic professor of economics in this Nation that does not sometime or another use an illustration like this on promissory notes and securities and the issuance of securities and the payment of them.

He says that when the obligor and the obligee become the same person, the debt is paid. Have you not heard that?

Mr. WRIGHT. Yes, I believe so.

The CHAIRMAN. It is almost the exact language, is it not?

Mr. WRIGHT. Yes, it would have to be. Yes, I would say so.

The CHAIRMAN. Yes, sir.

So it is paid for when the obligor and the obligee become the same person. Well, they become the same person, the same entity there, so they are paid. But notwithstanding that, every year right now the taxpayers are paying interest on that money as though they had not been paid. They are paying about $5 billion a year and that money goes straight to New York, to the New York Federal Reserve Bank that holds those harbored bonds, those hidden bonds. They are back there out of circulation.

The only service they perform is, the Federal Reserve Bank of New York, the father of the Federal Reserve System, gets interest on those bonds, $5 billion. Well now, that is clearly wrong, to make the taxpayers pay interest on something that has already been paid, and it should not be permitted. At least I do not think so. You know churches in this country, you see oftentimes about a big celebration that the churches have. They have owed a lot of bonds on this church for many years and they are paying for it the painful way, the hard way, year by year every year. Then when they get the bonds paid for they have the greatest event of the church life. They have a bond burning out in front of the church. They burn those bonds and they are all so happy.

Do you not think if we had a bond burning out here in front of the Capitol of the United States of those $80 billion bonds it would be the greatest event in the U.S. Government as far as monetary matters are concerned—$80 billion, and that $80 billion would be taken off our national debt?

Right now they are carried as part of our national debt and they have been paid for. Do you not think that that question should be gone into first by a complete audit of the Federal Reserve?

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We had a bill up here, Mr. Wright, and we voted on it, but we discovered that Dr. Burns was over in New York lobbying against us. Of course, you take a man with all of the resources of the Federal Reserve, $80 billion, and had all the advantages he had. We did not have much chance of winning that fight.

But we are not quitting. We are going to win it one of these days, and I just believe it, that we will. When we do and we have an audit of the Federal Reserve System, the first thing they are going to find is that $80 billion, as they collect $4 or $5 billion interest on it now and use it for the Federal Reserve System, what they want of it. If there is any left over it goes into the Treasury and goes back to pay on the debts of the United States.

Why should not all of it be paid on the debt of the United States? Number one is, why should it be collected when it is not owed?

It is wrong. It is treating the people wrong that are paying these taxes when they are not due. So we are going to keep on until we get that thing done, and we could put this country in pretty good shape.

Mr. WRIGHT. Yes, you could.

The CHAIRMAN. But you know, you cannot get a lot of people to see that. They just will not see it. They just refuse to see it. So I hope you help us enlighten the people on that, and I believe you realize that something should be done. Do you not, Mr. Wright?

Mr. WRIGHT. Mr. Chairman, the one thing I can say clearly is that I can see absolutely no reason why the American people should have to support the Federal Reserve banks that ought to be supported by a banking business.

The CHAIRMAN. Yes.

Mr. WRIGHT. This is supporting the Federal Reserve banks with the taxpayers' money. That is all it is. It is just a subsidy. It is not voted on. It is just a plain thing that they have been able to accumulate for themselves through the use of their powers.

They take what they want and turn back what is left over, and that is not a decision that is made by the Congress or by the administration. I think that is wrong.

I said this morning, you know, I referred to the French Premier when he said war was too important a matter to be left to the generals, remember?

Now certainly, you would not allow the generals to collect their own revenues and have whatever they wanted. The Government is going to control them. I would say the same thing applies to the Federal Reserve Board.

The CHAIRMAN. May I suggest, when I asked Dr. Burns these questions, I said:

> Dr. Burns, now you admitted that these bonds had been purchased by the credit of the United States, and when they want their money they get U.S. currency for the credit. You have admitted all that, and you have admitted that the Federal Reserve did not pay out any member banks' money for these bonds at all.

"Now, in view of that, who owns these bonds?" He said, "These are all the Federal Reserve banks', the Federal Reserve System's." I said:

> Well, Dr. Burns, I have been interrogating officials of the Federal Reserve for longer than 40 years and you are the first one that has ever said that, that the Federal Reserve owned those bonds when they did not contribute one penny, not

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one copper penny or anything else for them. They were bought by the Federal Reserve with Government money and the officers who bought them were employed by the Federal Reserve System, an instrumentality of the Government, and therefore they would belong to the Government still, an instrumentality of the Government.

Mr. WRIGHT. Oh, sure.

The CHAIRMAN. He said, oh, no, he did not agree with that. I said, "Well, we are going to have to have an argument a long time on that." We are going to continue until we get that wrong righted, and I still believe we will be able to right that wrong.

It is the most terrible thing in the world, the way I see it. A lot of people say, if we just could reduce the national budget that is coming up, $5 billion, it would be wonderful, wonderful.

Well, if they just canceled those bonds, they would get $5 billion right there, just on the saving of interest of 1 year. But one of these days the right is going to win, the right side, and we are going to cancel those bonds, just like they ought to be canceled because they should not be paid for twice. That is a big thing, and so I am glad you are interested in it.

Mr. WRIGHT. This sounds like "Alice in Wonderland."

The CHAIRMAN. Yes, sir. If you want to comment on it in your remarks, you are privileged to do so. You may extend your remarks and insert anything that you think is material.

Mr. WRIGHT. I have some proposals with respect to the oversight of the Federal Reserve Board.

The CHAIRMAN. All right, sir; fine. Now, if you would like to, you can go ahead with your dissertation and then when you get through, why, the members here will be allowed to ask questions if they want to.

Mr. WRIGHT. All right, sir.

What I would like to go through this afternoon is I want first to talk about the one-bank holding company which I think is a great evil, and why, but in leading into that I would like to pick up the very end of what I said, and then come up with nine specific proposals for legislative action, things that are within your power at least to present to the Congress if you decide to do it, specific things. I mean, it is one thing to criticize and one thing to dissertate, but then if you are going to try and do an honest job, you should come up with at least some logically or reasonably well thought-out proposals for action, and that is what I have tried to do so I could finish doing my job.

But first I want to come back a moment again to this increase in the money supply so you can see when it happened.

Mr. BARRETT. What page are you starting on, Mr. Wright?

Mr. WRIGHT. I am referring now to a chart. I am really interposing between the pages, but I will be beginning on page 6, the imminent danger, but in leading to that, I have already referred to these large certificates of deposit as a terrible Frankenstein when you let the ceiling go on interest rates that banks could pay on negotiable certificates. You know, you do have ceilings on all other savings deposits, and individual certificates of deposit. Only the very large certificate of deposit of $100,000 or more, which is for large corporations and very large individuals, that is the only one on which there is no ceiling. They are allowed to pay very much higher rates on that than they are allowed to pay to other people that really need the money more.

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What I wanted to point out here is this: Here is the growth rate for the last 5½ years in blue of the gross national product in nominal dollars, and here it is after inflation, 2.7 percent. That has been the true rate of growth in real dollars for the last 5½ years of our gross national product.

This is one of the lowest growth rates in the world. The United States used to have growth rates of 5, 6, 7 percent, but we are way behind everybody else now.

It has been said reduce the money supply, and part of the reason for inflation was the big rise in money supply, and I say that is not true, not with respect to the money supply that we have from most people, that is, demand deposits and savings. It has been too small.

Here is the currency and demand deposits, currency and checking accounts, corporate and individuals. Nominal rate of increase, 6.3 percent, less than one-tenth of 1 percent in real dollars, compared with 8.3 and 2.7. So that has increased at a rate which is less than the rate of growth of the gross national product, which means less and less money on deposits, and then if you add other time deposits, savings and small certificates of deposit on which their ceiling rate, ceilings on the interest rates, that was at 10.8 percent, and is 5 percent in constant dollars.

If you put these two, just these two together, without the large certificates of deposit, it is about the same as gross national product. In other words, there has been no additional amount for any faster growth, and nothing that would account for our inflation.

But there has been an exception, and that has been these larger certificates of deposit on which the sky was the limit on interest rates that they could use to attract it, and that is mostly large funds that has been draining that away from the stock market and the bond market, and the commercial paper market, and that has increased at a 25-percent average compound annual rate, an enormous rate. That is the Frankenstein that must be stopped.

In order to stop it, you must put a ceiling on those interest rates, require a ceiling as you used to, and I say it should be not more than 1 percent less than the prime lending rate. If the prime lending rate is 6 percent, it should not be over 5 percent. If the prime lending rate were over 8 percent, it should not be over 7.

Mr. BARRETT. Mr. Chairman, why can we not ask Mr. Wright a question here and now?

The CHAIRMAN. Sure you can be recognized on your 5 minutes right here.

Mr. BARRETT. How are we going to stop that growth? Why do you not tell us how to stop it now?

Mr. WRIGHT. I am making that specific proposal. That specific proposal to stop that growth is to limit the rate of interest which may be paid on any deposit in a bank, including the large negotiable certificates of deposit, and limit that to a maximum of 5 percent, or 1 percent less than the prime bank lending rate, whichever is higher. That would today reduce that right away to 11 percent from 12, and—or 10 percent, and they would no longer be able to attract that money.

Mr. BARRETT. Mr. Wright, you are talking about that limitation now through legislation.

Mr. WRIGHT. Yes, sir.

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Mr. BARRETT. Not through the cooperation of the Federal Reserve.

Mr. WRIGHT. Well, you used to require a ceiling, and I think by legislation you changed it. In other words, you took the ceiling off by legislation and I think you have got to put it back on by legislation. I am not sure about that.

I know they talked to you about it and you gave them permission to do it, but I do not know whether it was by law or not.

Mr. BARRETT. Well we have, just the other day, on Citicorp—and this is coming out of my time—we have at least got legislation out of here to give the Federal Reserve, the home loan bank, and the FDIC authority to control the Citicorp's note issue because we felt this was taking all the money out of the thrift institutions.

Mr. WRIGHT. It is, yes, sir.

Mr. BARRETT. We learned during that course that it was not the legislative body that took the restrictions off Federal Reserve. The Federal Reserve removed those restrictions themselves.

Mr. WRIGHT. Well——

Mr. BARRETT. Now you are telling us to come back and inaugurate new legislation to restrict them to a certain interest rate level.

Mr. WRIGHT. Yes, sir, yes, sir. Now, I——

Mr. BARRETT. But will the patient not die before we can——

Mr. WRIGHT. If you can do it by any means, including getting him down here and telling them that they are going to be severely penalized by this committee if they do not do it, anything that will make them do it is what is required. I have had now an interview with Dr. Burns some time ago, and I have never been so discouraged in my life as when I was finished. I could not make a dent in him. I do not think anybody else has been able to. Maybe collectively you can. I hope you can. It has got to be done. It is killing us, and now, if I may, this leads right to the one-bank holding company.

You see what that large certificate of deposit has done. It has made big banks huger and huger and huger and getting the capital which otherwise would go into the commercial paper market, and the securities markets, and be freely lent by one or invested by one individual in another. It has put them in a controlling position, but along with that came the one-bank holding company, and this is the second great evil that has taken place.

I have called it the imminent danger of destruction of the traditional American free enterprise system as the result of current banking and monetary policies. When we think—shall I proceed with this?

The CHAIRMAN. Yes, sir; go right ahead, sir.

Mr. WRIGHT. When we think of the special genius of America, we think of liberty, we think of opportunity, and we think of free enterprise, and they are indistinguishable to us. All of us think that way.

Today the constitutional safeguards of our liberty remain intact, but economic opportunity to develop and expand free, competitive economic enterprise has been drastically curtailed, drastically, and there are three major developments which have done that.

The first is the great expansion of the power of the major banks as a result of the One-Bank Holding Company Act. This has given them a grossly unfair and decisive competitive advantage over independent competitive enterprises which have neither the franchised right to use the public's deposited funds for private profit, nor the influence on

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prospective clients for these other services, which is inherent in a lender-borrower relationship. No way can you get over that fact. If you owe a man money, you are mighty careful about how you talk to him in case he might call the loan. So they have got two tremendous advantages over other businesses.

Consequently, we are today witnessing a progressive takeover by the major banks of the investment industry, and a parallel penetration of leasing, insurance, and related activities. This is obviously damaging to thousands, hundreds of thousands of independent, competing organizations, and it serves absolutely no discernible public purpose. No way can I see any public purpose which is served by this. It should be stopped before it is too late, if it is not already. That is the first thing, the first thing that is killing private enterprise.

The second, and I have already been through, which is the unrestricted use of this which further aggregates the power and the money which is under the control of these very large institutions, and here I spoke about the word "usury" and how no nation has ever been able to sustain rates as high as this.

I have been unable to find any reason why it is in the public interest to permit banks to pay unlimited rates of interest on large deposits to those who presumably have more and need less than the run-of-the-mill saver; and I have therefore included the prohibition of such discriminatory regulation, or lack of it, in these proposals for economic reform.

There is another thing I would like to bring out at this point. Here we have these huge banks with more and more of the country's capital coming into their control, and billions and billions of it, wiping out the free enterprise, freely competitive system that we have always had. What happens about our taxes?

We all know, any of us that pay interest, we can take our interest off our income tax, and if we run a corporation and we borrow it, we can take it off, and it saves us 44 cents on the dollar because that is the average rate of corporate income tax which is being paid now.

But what about paying the taxes on the other end of it by the big banks? Do they pay 44 cents on the dollar?

Certainly not. Their tax rates have been going down, down, down. We just ran an average of the 25 big banks and we find they are only paying about 29 percent, and have gone right on down. The figure is actually 35 percent and it declined—oh, from 35 percent in 1968—they always did have a tax break. Now they are down to 29 percent. So they pay less money.

So on the one hand, it is being deducted from the taxes of the borrowers, but the Government is not getting it back at the other side. It is going into the owners of the major banks.

That is hurting us. It is causing us all to pay more taxes. It is increasing our Federal deficits. That is an inflationary factor. I cannot see any possible justification. Why should a bank pay less taxes than any other enterprise? Why? Can you think of a single good reason? I cannot think of any, but they are loaded with tax breaks.

You passed a good law awhile ago called the investment tax credit. We wanted to get more industry. We wanted to produce more so we would have less inflation. We said, all right, anybody that will put in more machinery and build more plants and employ more people can take 7 percent of the money they invested to pay off their taxes.

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So who is getting the 7 percent? The banks. How? Because they formed a leasing company subsidiary in the one-bank holding companies, and they buy the stuff and then rent it to the people, you see, and they take off. They take off the 7-percent tax credit.

That certainly is not what the Congress intended, and you cannot tell me that any of you gentlemen believe that a bank should pay less taxes than any other corporation.

Why are they going into the insurance business? Because the insurance businesses have had tax breaks over the years. So they go into the insurance business, and that gives them another way to save taxes.

The One-Bank Holding Company Act is one of the most serious errors that I think has ever been made in the United States, and it is rapidly killing competitive free enterprise.

All right, now, if I may, I will present the proposals that I have, things that I think could possibly——

Mr. GETTYS. Mr. Chairman, would the gentleman yield at that point?

Do you think that has been the result of the experience under the one-bank holding company?

Mr. WRIGHT. Yes, sir.

Mr. GETTYS. You will recall, and I am sure the chairman and Mr. Barrett and Mr. Burgener will recall when we worked on that legislation here, that it was the intention of this committee and the intention of the Congress to prevent the channeling of all of the money in this country into 200, I believe it was, Mr. Chairman, 200 top corporations and to control the money. It was to diffuse.

So you think the purpose of the legislation has been defeated by experience?

Mr. WRIGHT. Absolutely subverted. Subverted is the word for it.

Mr. GETTYS. But the intent of the Congress was entirely different from what you say is the result.

Mr. WRIGHT. You know the Congress represents the people. You know the people do not want that. Congress does not want that. I do not know how——

The CHAIRMAN. Will the gentleman yield to me?

Mr. GETTYS. I yield to the chairman.

The CHAIRMAN. You know, what we were dealing with, a few banks are gaining more and more, they now have over half the assets of all 13,500 banks. Fifty banks have 46 percent of all of the assets of those 13,500 banks. Now, then, they have over half of the assets of those 13,500 banks. Therefore, whenever they get into the holding company business, they go out, they pick up anything, whether it is related to banking or not. We had a definite understanding. I was in that conference with the Senate, our conferees with me. We dealt with the Senate. We met halfway between the House and the Senate to iron out the differences, and when we got down to where we thought we could agree to it, we wanted to talk to the members of the Federal Reserve, and many of us did, to make sure that they were going to find what we found, that the people would have to be treated right and a few banks could not take over this country.

They assured us that we had nothing to fear, that we were going to be all right. With that understanding, we went ahead and agreed to that bill. But they turned around immediately, right quick, and just came at us the other way.

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Mr. GETTYS. Mr. Chairman, was it not true that the Federal Reserve Board has misinterpreted the language by a loose construction of the functionally related language and has defeated the purpose of the Congress?

The CHAIRMAN. That is right. You put your finger right on it. It had to be closely related to banking, and they disregarded that, and the fact of the business, if you are talking about impeachment charges, if impeachment charges were filed against them, they would have a hard time defending themselves.

Mr. GETTYS. I asked the question, Mr. Chairman, was it the law or the interpretation of the law at fault that produced bad results or good results?

The CHAIRMAN. That is right, bad results instead of good. They promised us good results and we got bad results.

Mr. GETTYS. Thank you.

Mr. BURGENER. A brief question, Mr. Chairman.

The CHAIRMAN. Yes, Mr. Burgener.

Mr. BURGENER. Mr. Wright, you are about to go through nine proposals.

Mr. WRIGHT. Yes, sir.

Mr. BURGENER. Do they work independently of each other?

Mr. WRIGHT. Any one of them would help.

Mr. BURGENER. So it is not a package.

Mr. WRIGHT. No, sir. I think each one has its place. They would complement each other I believe but there is no magic about it.

Mr. BURGENER. Thank you.

Mr. WRIGHT. Thank you, sir.

The first one here, I made a distinction here between what you might do by legislation and what you could only do by requiring the administration to try to accomplish, and that is why in each case I have tried to start off—for instance, I say, No. 1, require by resolution, what I suggest, whether it is resolution of the Congress or resolution of your committee, is to ask the administration to do this, and that is, in this case, to U.S. international negotiation to create an inflation-proof standard of value for the international monetary system. What this is, this would be a great help. This is not an essential, but in the end it will be essential, but it would be a great help.

You see, in 1971 when Nixon cut loose the dollar from gold and from convertibility, that automatically floated the currencies of all nations because they had been tied to the dollar, the dollar had been tied to gold, and it was a standard of value.

I do not say that was the wrong thing to do at the time. I think it had to be done at the time. But the effect of it was that no longer was there any tie between the nations, practically any nation, its currency and a standard of value, and so they all floated, you see, and they all floated upward. This was one contributing factor to international inflation. It reduced the confidence of people all over the world in any currency, not just the dollar. Then they put their money in whatever they could put it in, ores, any kind of tangible store values, and international materials doubled in price.

They have been trying to get a new system, international monetary system going. They have had meetings, meetings and meetings, and they got one thing accomplished. They have agreed on a basis for the

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comparative valuation of one currency versus another by what they call the basket of currency principles and they take it and they give them all weights according to gross national product, and add them up and divide them and it comes out, and it says that in terms of the SDR, which is the special drawing right by the International Monetary Fund, a new international currency for settlement of obligations between nations. Each other nation, each nation's currency is valued in terms of that, according to this formula. That is a good step in the right direction, but it does not take care of the float of the SDR's along with everything else.

So I propose that we require the administration to negotiate one more step, that they take the basket principle and they apply that to the inflation rates of all of the nations in terms, they have all got what we have got, the GNP deflator, measure of inflation in terms of their national product, give it the same weights that we give to the currency, and thus—and take that weighted average of inflation and raise them all up in relation to the SDR's. So the effect, if this is done, the effect of this would be that the SDR's, the new international currency, would always buy the same amount of goods worldwide, and we would have a standard of value, international, for the first time.

Mr. BURGENER. Question, Mr. Chairman.

The CHAIRMAN. Yes, Mr. Burgener.

Mr. BURGENER. Thank you, Mr. Chairman.

Would a country with a 20-percent inflation whose currency was in the basket, how would it fare as opposed to a country with 10-percent inflation?

Mr. WRIGHT. You would not change. The relationship between that currency and another currency would not be affected. Only the overall relationship, and that would make it possible to get them to agree to it. You see, and what we would have accomplished or what we want to accomplish is that there would be an international standard of value which could work for the settlement of international obligations, and at very low interest rates because it would not change in value. This would work and you could get them to agree to it because the individual nations, the particular inflation rates would not affect its valuations, only in terms of the basket of currencies principle, which they have already agreed on.

That is quite a lot to get over in a few minutes, but I can assure you that this would keep the SDR's as a constant standard of value for the first time, and that is what we have got to have in a world that is getting so small.

Mr. GETTYS. Is your idea—Mr. Chairman?

The CHAIRMAN. Go ahead.

Mr. GETTYS. Is your idea set forth in this testimony?

Mr. WRIGHT. Yes, sir.

Mr. GETTYS. Because I very frankly do not understand the equalization.

Mr. WRIGHT. It takes a little thinking about it, but it is set forth.

The CHAIRMAN. It will be in the printed record.

Mr. WRIGHT. Yes, sir, it is in the printed record. But the establishment of that international, unchanging standard of value is essential if we are going to work toward a noninflationary world. I would say it is the least imminent thing we need to do to stop our domestic problem today, but it is of basic long term importance.

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The second is also international, and that is also to require by resolution that the administration negotiate an agreement to regulate the creation of the Eurodollars. That is essential and that is imminent, and other foreign currency deposits in nondomiciled banks.

This can be done quite simply, and I believe it can be done successfully. You simply require that any bank which accepts or creates a deposit in the currency of another nation be obliged to carry out or to maintain the reserves required by that nation in its own central bank, and any other regulations which that nation puts out. No one could tell American banks what to do with respect to American deposits except our own Federal Reserve Board, but the French could tell them an American bank cannot create francs without their permission, and to the amount that they agree, and must maintain a reserve with the French bank. The same thing with the British, and we could tell the British and the French, you cannot create American dollar deposits and create dollars in your bank except by following the same rules that we require for our own banks. It is our currency.

Every nation, I believe every central bank would agree to this. Why? Because every central bank wants to control its own currency, so they will regard it in their own self-interest.

I think it should be easy to negotiate. I have been trying to see what the holes are, and I cannot see why they would object. If it is done, we would immediately put this great beast under control.

Realize, those Eurodollar markets, that is double the amount of the money supply. There is the great inflationary force. Think of it, double the supply of dollars in the world.

Mr. BURGENER. If I may, Mr. Chairman?

The CHAIRMAN. Yes; go ahead, Mr. Burgener.

Mr. BURGENER. I go into the bank in London, and I want to open an account with $100,000 and I do not give them cash. I give them collateral. Right now they create $100,000 out of nothing, they create it.

Mr. WRIGHT. That is all, no reserves with the Bank of England, no reserve with the American Federal Reserve.

Mr. BURGENER. So it is a paper transaction.

Mr. WRIGHT. Right.

Mr. BURGENER. Under your plan they would have to have reserves.

Mr. WRIGHT. With the Federal Reserve Bank of New York, just the same as the Chase Manhattan Bank would have to do for the same thing.

Mr. BURGENER. I think I understand.

Mr. WRIGHT. Sure, and it is not hard to accomplish.

The CHAIRMAN. On that point, now, it is not a fact that those multinational banks that operate from New York operate all over the world——

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. That when they go into another country and they are in all the developed countries of the world, we lose supervision of them, the people in the United States, I mean, the regulatory powers in Washington and the United States lose supervision of these agencies. That is the reason all of these dollars were just dished out by Chase Manhattan and the First National City and all the rest of them, and sent to Europe, Eurodollars. That is where the Eurodollar market started, was it not, Mr. Wright?

Mr. WRIGHT. That is right.

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The CHAIRMAN. That started the Eurodollar market and caused all of that trouble, and then when their banks come over here, they are not supervised by us.

Mr. WRIGHT. That is right.

The CHAIRMAN. If that is fair, I just cannot understand it. It does not seem fair to me.

Mr. WRIGHT. It is not fair.

Mr. BARRETT. Mr. Chairman?

The CHAIRMAN. Yes, Mr. Barrett.

Mr. BARRETT. One thing. Suppose we bring your interest rate down to a much lower rate than the European interest rate. Then how are we going to control——

Mr. WRIGHT. That is the next proposal.

Mr. BARRETT. OK.

Mr. WRIGHT. No. 3, enact legislation to insulate domestic U.S. monetary and credit policies from the influence of excessive foreign capital requirements and interest rates. It is quite easy to do. The fear of increasing the outflow to foreign borrowers of U.S. capital has frequently been given as a compelling reason for maintaining interest rates in the United States which are excessively high by American standards. They say we have to keep them up there, otherwise the capital will flow to Europe.

I propose that this influence can and should be effectively neutralized by requiring American taxpayers with capital deposits, loans, or investments abroad, any American who has got capital abroad, to pay a tax on any net increase of such capital, the rate of such tax to be determined from time to time by the U.S. Federal Reserve Board as sufficient to offset substantially any competitive attraction to U.S. capital of higher interest rates abroad.

Put them right on the spot. I am coming to how you are going to check on whether they do what you want them to do, but in other words, give them the responsibility, make them responsible, and then they cannot say, well, we had to have the high interest rates because interest rates are higher in France, and it will work. It will work absolutely because no longer will there be an incentive to send that capital over there, whatever their rates are. That is No. 3. You can do this. If you can get the votes, you can do it.

No. 4, expand by legislation the Federal Reserve Board's regulatory power to include variable reserve requirements depending on the proportion of each bank's loan portfolio which is allocated to national economic purposes and priorities.

Do not worry about giving them these extra powers. As I said, I am coming to how you are going to make sure they exercise them properly a little later. But you have got to have a way of doing this.

What they have got now, the current reserve requirements of the Federal Reserve banks are directed to the safety of deposits and the overall liquidity of lendable funds. As a weapon in the fight against inflation, this is more like a bludgeon than the assortment of precision instruments which our modern economy and our diverse national interests require. It is as if the only weapon we had was a great big club and you beat them to death with it. Instead of that we have got to have particular instruments.

Accordingly, I propose that the powers of the Federal Reserve Board be expanded to permit the reserve deposit requirements of in-

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dividual banks to be varied in accordance with formulas promulgated from time to time by the Board for the purpose of increasing or decreasing reserves in proportion to each bank's distribution of its loan portfolio between loans—and I have put five classes of loans. The first one is a new class, and this I might say Congressman Reuss has introduced a bill similar to the first class only, in other words, the same general idea he is getting at. What I have is a little bit more developed than what is in his present bill, but he has provided for a class, as I have, of specific national priorities.

For example, if we want to encourage the development of other sources of energy, one of the classes, a priority class of loans which would require fewer reserves and therefore be more profitable to a bank would be loans for the purpose of developing new sources of energy, and whatever other causes are determined in the national interest by methods which I come to later.

The second is any loans for productive purposes as distinguished from the third, loans for consumer purchases, and fourth, any loans for the purpose of purchasing or carrying publicly owned equity securities, common stocks, and fifth, purchases of loans for the purchasing or carrying debt securities, and finally, all other purposes.

Mr. BURGENER. Question, Mr. Chairman.

The CHAIRMAN. All right, go ahead.

Mr. BURGENER. You kind of lost me there for a minute. Back on the energy loan, you could have a different reserve requirement?

Mr. WRIGHT. Yes, sir.

Mr. BURGENER. Why is that more profitable to the bank? The bank makes its money only by interest, right?

Mr. WRIGHT. Whatever portion of its deposits the bank has to keep in reserves in the Federal Reserve bank, it does not earn on them any money.

Mr. BURGENER. Oh, yes.

Mr. WRIGHT. You see, so the higher the reserve requirements, the less profitable the loan.

Mr. BURGENER. So the answer is more money to loan.

Mr. WRIGHT. That is right, it is more profitable for them.

Mr. BURGENER. Out of the same total number of dollars that you have.

Mr. WRIGHT. Yes, sir, that is right.

The CHAIRMAN. May I suggest something on that?

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. That is known as a fractional reserve system.

Mr. WRIGHT. Yes.

The CHAIRMAN. Under the system, demand deposits, they can lend about 8 or 9 or 10 to 1 on demand deposits, but on time deposits and savings accounts, they can lend 33⅓ to 1 because the reserves required are only 3 percent.

Mr. WRIGHT. That is right. The large certificates of deposit, they can earn more.

The CHAIRMAN. That is manufacture or creation of money.

Mr. WRIGHT. Yes, sir, that is right.

Mr. BURGENER. If I may, the reason for that, or the rationale is liquidity, is that right?

Mr. WRIGHT. Yes; that is the reason for the present reserve requirements.

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Mr. BURGENER. For the present.

Mr. WRIGHT. I am suggesting that that be expanded so that you can add without touching the liquidity requirements by analyzing the mix of the loan portfolio. You can control the purposes of loans for the national interest.

Mr. BURGENER. Which is a form of credit allocation.

Mr. WRIGHT. Yes; that is exactly right. It is a simple way of doing it, and it is very easy to enforce, very easy to administer. It does not cost anything, and it will accomplish it.

Obviously the present objective of containing inflation would be much better served by selectively favoring loans for productive purposes which would then add to the supply of goods and services, and limiting loans which would add to consumer demand, than by the present policy of indiscriminately beating the economy to death. That is what you have got.

Their utilization of these powers would be required in accordance with national priorities and policies which they do not determine, but which they are required to implement, which brings us to No. 5, establish by legislation—this should require congressional legislation, but somewhat like what you have been going through on the budget. You have got much better requirements now for the establishment of the budget and control of appropriations, and this would systematize the national economic priorities, I think, a good deal better, and what I propose is that because it is self-evident that our national economic and financial welfare is of vital concern to all of the people, all of us, not just the Federal Reserve Board, I propose that the President, aided by his Cabinet and the Council of Economic Advisers, be required to supplement his annual national economic message to Congress with specific policies and priorities, and to supplement such policies and programs by quarterly reviews and modifications which, subject to a 30-day veto by either House of the Congress, the Federal Reserve Board would be required to exercise its powers to implement this program, and that the policies—and now we come to an important thing—that the policies and operations of the Federal Reserve Board and System be subject to audit and review comparable to that which is required for other Federal Government organizations.

There is no reason why there should be any exception. They should not be the determiners of national policy. That is why we have got the President and the Congress. They should be required, as an instrumentality of the U.S. Government, to exercise their powers, to carry out those policies. I think we have got it backward.

That is proposal No. 5. Now, 6, we should expand and revise by legislation, the requirements and terms of office of membership of the Federal Reserve Board so as to provide for broader representation of public and national interests. I think it is very much needed. I think what we have got is archaic and obsolete and does not accomplish the purpose at all.

The Federal Reserve Board, as you know, is presently made up of seven members appointed by the President with the advice and consent of the Senate, for terms of 14 years each, so arranged that one term expires every 2 years. The President is supposed to give due regard to fair representation and balance between financial, agricultural, industrial, and commercial interests in making his selections. Of the

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present Board, however, three may be classed as academic economists. That does not sound to me like agricultural, industrial, or commercial interests at all.

The CHAIRMAN. Are you talking about the class C directors?

Mr. WRIGHT. I am talking about the seven members of the Federal Reserve Board, and of them, of the present, three are academic economists today. They do not represent what is in the statute. Two are economists with banking backgrounds, and one is a lawyer-banker, and one is a businessman. The statute says that there must be fair representation of financial, agricultural, industrial, and commercial. According to the information I have on the background of these people, the statute has not been obeyed. It has not been carried out.

That is the present statute. What I propose is that neither the present statutory representation nor its implementation is adequate for the Board's immense responsibilities, and I suggest reform to enlarge the Board to 15 members with 5-year overlapping terms, 3 to expire each year. With 15 members, 10 members would represent both big and small, not just big, both big and small banking, investment, industrial, commercial, and agricultural interests. That would give you two to each, one representing a big organization, another representing the run of the mill American free enterprise organization. They would both be in there, and that would give you the whole scope of the economy in those five. That would make 10 members altogether. That would leave you five more. Those five members would represent the general public interest at large.

I suggest that they be made up of two consumers, and three professional economists, not bank economists, and not teachers, necessarily, although they could be, but professional economists. So it would not be dominated by the economists. It would not be dominated by the bankers, but it would have a fair representation of all of the enterprises of the United States, and the consumers, and what we do know about economic science. That would give you 15 members.

The Open Market Committee at present consists of all of the Board plus I believe it is the presidents of five Federal Reserve banks.

The CHAIRMAN. Plus the other seven. They walk in later, you see. That is a violation of the law, and they do it.

Mr. WRIGHT. I think it is a violation of the law. I think that is an anacronism, what we have got now, and I suggest that like any other board, you should have a board now of 15 members, and it would be fair representation. I suggest that the chairman appoint a committee of nine members—this is the Open Market Committee—but that his appointment be subject to the approval of the whole Board.

Now, you would have a fair representation. Let that be the case. Then you could have three members, presidents of Federal Reserve banks, serve along with that committee so that their banking expertise would not dominate but would supplement it.

The CHAIRMAN. But remember this, Mr. Wright. The law says that committee will be composed of 12 members, the Open Market Committee.

Mr. WRIGHT. That is the seven and the five.

The CHAIRMAN. But here is what actually happens. They, of course, have the seven Board Governors. Then they select the 5 from the 12 Federal Reserve banks that can come in there. They have a very secretive room down there in this Federal Reserve.

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Mr. WRIGHT. They sure do.

The CHAIRMAN. They march in on a certain Tuesday to do their business, Open Market, and the Board comes in. Then the five members from the Reserve banks that represented, and then the seven other members come in, too. That makes—how many does that make? That makes 19, does it not?

Mr. WRIGHT. Yes.

The CHAIRMAN. Of course, they try to justify that by saying, well, they do not have any power except just——

Mr. WRIGHT. I did not know that.

The CHAIRMAN. Except just, of course, power to jawbone and the power of moral suasion, but they can discuss every argument that comes up, and it is so closely divided, those extra seven can almost control it. I suspect they do control it a lot of times.

So they are violating the law there and they ought to be stopped from that.

Mr. WRIGHT. I think they are. I do not think the law has been implemented, but I do not think the law is adequate either. It would be better if they implemented what they got than what they are doing, but the law is inadequate. It is an anacronism. It is not sufficient. They have more power over our economy than the President and the Congress put together.

The CHAIRMAN. Your proposal is very interesting, all right, but look at how Reserve bank directors are chosen.

The directors run every institution, do they not, every corporate institution? The directors run it. Well, then, who appoints these directors? The member banks themselves. They vote for them just like you are going in an election of Democrats to Republicans. You vote for them. But in this case, the first six out of the nine directors are selected by the banks themselves. Nobody else can vote.

Mr. WRIGHT. There is no reason for that at all.

The CHAIRMAN. They have two-thirds of them right off, and then the other three are selected by the Federal Reserve Board, and the Chairman must be of tested banking experience.

Mr. WRIGHT. The people of the United States own the Federal Reserve Board and its banks. It belongs to the people, not the banks. They forget that. They think they own it. But they do not, the people own it, and this is one person that thinks they are doing a bad job and messing up our country. I am asking you to change it.

The CHAIRMAN. Let us evaluate that a moment. We think that they belong to the people, and that these people who are the Governors, they claim that they are trustees. All right.

Whoever heard of a trustee taking the estate of the principal and putting it in his own name and saying, it is mine? That is what they are doing here to us, and they have done it to the extent of $80 billion.

Mr. WRIGHT. Now, No. 7, the limit that I have already proposed to limit by legislation the maximum interest rate on any deposit in any bank. It ought to be limited to 5 percent basically, but in any event it should not get higher than within 1 percent of the prime rate, 1 percent less than the prime rate.

Mr. BARRETT. Mr. Chairman, a question.

The CHAIRMAN. Mr. Barrett?

Mr. BURGENER. Mr. Chairman?

Mr. BARRETT. Would you like to ask your question first?

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Mr. BURGENER. If I may. You are not advocating wage and price controls?

Mr. WRIGHT. No, sir. It will do no good. I am opposed to it.

Mr. BURGENER. So interest rate regulation is a specialized kind of thing that you allege is not a piece of wage and price controls?

Mr. WRIGHT. Yes, sir. No problem about enforcing interest rate regulation because any contract with a higher interest rate could not be collected.

Mr. BURGENER. Is it not true that one of the main problems on wage and price control was that it was obviously maybe unenforceable, or not across the board, or not uniform?

Mr. WRIGHT. Yes.

Mr. BURGENER. All right.

Mr. WRIGHT. I see no problem at all with the limits, and there is a historic thing. For centuries nations, beginning, as I say, before the Romans——

The CHAIRMAN. Mr. Wright, we have enjoyed your testimony very much. You have helped us a lot. We have an unusual situation coming up here.

Mr. Barrett, do you want to be recognized?

Mr. BARRETT. Yes; I was going to say the very same thing, Mr. Chairman. I hate to see Mr. Wright go.

The CHAIRMAN. We will have him back, with your permission, here Mr. Wright, we will try to negotiate a time which will be satisfactory.

Mr. BARRETT. Not giving him a full opportunity here today to give us the full impact of his statement. But the President is coming on at 4 o'clock to make a statement, and I thought it would be necessary and beneficial to all members to have an opportunity to hear him.

The CHAIRMAN. And besides, we will be going under the 5-minute rule at about that time. So we must be—we could not be in session anyway.

Mr. WRIGHT. May I make one concluding statement?

The CHAIRMAN. Yes, sir.

Mr. WRIGHT. I am pretty well finished here. I have got the repeal of the One Bank Holding Company Act. The last thing is the tax proposal. I suggest you give that very careful thought. It is called a citizen's proposal.

Mr. BARRETT. Mr. Chairman, I wonder if we could not ask Mr. Wright to put his full testimony——

The CHAIRMAN. It has already been put in.

Mr. BARRETT. Oh, has it?

The CHAIRMAN. Is that satisfactory with you, Mr. Wright? Would we be all right if we want to ask you questions in writing and you will answer them when you look over the transcript?

Mr. WRIGHT. Yes; and my object is to serve. You know, it is our country. Thank you.

The CHAIRMAN. That will be fine. We will try to agree on a time that will be mutually satisfactory and have you here another time because you have really provoked us into doing a lot of thinking that we had not been doing.

Mr. WRIGHT. Thank you, gentleman. It has been a pleasure.

The CHAIRMAN. Thank you very much, sir.

The committee will stand in recess subject to the call of the Chair.

[Whereupon, at 3:50 p.m., the committee was recessed, subject to the call of the Chair.]

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TESTIMONY OF JOHN WINTHROP WRIGHT

Before The Committee on
Banking and Currency
U. S. House of Representatives
Washington, D. C.

August 7, 1974

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TABLE OF CONTENTS

I SUMMARY OF PROPOSALS ..... Page 1

II BACKGROUND AND QUALIFICATIONS OF JOHN WINTHROP WRIGHT ..... Page 2

III PURPOSE OF TESTIMONY ..... Page 2

IV CURRENT MISCONCEPTIONS OF OUR NATIONAL ECONOMIC AND MONEY MANAGERS ..... Pages 3-6

V THE IMMINENT DANGER OF DESTRUCTION OF THE TRADITIONAL AMERICAN FREE ENTERPRISE SYSTEM AS A RESULT OF CURRENT FEDERAL BANKING AND MONETARY POLICIES ..... Pages 6-7

VI PROPOSALS FOR LEGISLATIVE AND REGULATORY REFORM OF AMERICAN ECONOMIC AND MONETARY MANAGEMENT ..... Pages 7-9

VII SCHEDULE OF EXHIBITS ..... Page 10

VIII EXHIBITS

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SUMMARY OF PROPOSALS FOR LEGISLATIVE AND REGULATORY REFORM OF AMERICAN ECONOMIC AND MONETARY MANAGEMENT

I Require by Resolution, U.S. International Negotiation to Create an Inflation-proof Standard of Value in the International Monetary System

II Require by Resolution, U.S. International Negotiation of An Agreement to Regulate the Creation of "Eurodollar" and Other Foreign Currency Deposits in Non-domiciled Banks

III Enact Legislation to Insulate Domestic U.S. Monetary and Credit Policies from the Influence of Excessive Foreign Capital Requirements and Interest Rates

IV Expand by Legislation, the Federal Reserve Board's Regulatory Powers to Include Variable Reserve Requirements Depending on the Proportion of Each Bank's Loan Portfolio Allocated to National Economic Purposes and Priorities

V Establish by Legislation, More Precise Requirements and Procedures for National Economic and Financial Policies

VI Expand and Revise by Legislation, the Requirements for and Terms of Office of Membership of the Federal Reserve Board so as to Provide for Broader Representation of Public and National Interests

VII Limit by Legislation, Interest Rates on all Deposits including Negotiable Certificates of Deposit to a Maximum of 1% Less than the Prime Bank Lending Rate or 5%, whichever is Higher

VIII Repeal the One-Bank Holding Company Legislation and Limit Banks and Banking Corporations Strictly to Banking Functions with No Involvement in Investments, Insurance or Other Non-banking Activities

IX Establish by Legislation, a "Citizen's Capital Investment Tax Credit" to Encourage Savings and Capital Formation by Individual Citizens and thus Reduce Inflationary Spending Demand while Increasing the Supply of Productive Capital

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OUTLINE OF TESTIMONY

By John Winthrop Wright

A. BACKGROUND AND QUALIFICATIONS OF JOHN WINTHROP WRIGHT

1) Born Bridgeport, Connecticut, June 27, 1912.

2) Education: Phillips Exeter Academy 1929, Amherst College 1933, Teacher of Economics St. John's College 1939-40.

3) Experience: Accountant, Home Owners' Loan Corporation, Washington, D.C. 1933-36; Special Representative, Mortgage and Trust Departments, First National Bank, Bridgeport, Connecticut 1937-38; Fraternity Business Manager, Amherst College 1938-39; Treasurer, St. John's College, Annapolis, Maryland 1939-40; Commander, active duty, U.S. Naval Reserve 1940-47; Executive Vice President, Standard Air Service 1947-48; Founder and President Wright Power Saw and Tool Corporation 1947-54; Sr. Partner, Andres Trubee and Company, Financial Consultants 1955-59; Chairman, Rototiller, Incorporated 1958-59; President Wright Investors' Service, Bridgeport, Connecticut 1960 to date. Wright Investors' Service is an investment management and advisory organization, registered with the United States Securities and Exchange Commission since 1961, presently consisting of 120 officers and employees, managing directly about one quarter of a billion dollars of investments of corporate and union pension and profit sharing funds, eleemosynary institutions and other organizations and individuals, and serving as investment adviser to 17 NYSE member brokerage firms and about 500 banks and institutional investors.

4) Author: "Q.V.T., Three Keys To Stock Market Success", published by Prentice-Hall, Inc., 1970. Also numerous articles on investment and economic subjects in most leading financial journals.

5) Address: John Winthrop Wright, Wright Building, 500 State Street, Bridgeport, Connecticut 06603 Telephone: 203-377-9444.

B. THE PURPOSE OF THIS TESTIMONY

1) As a citizen, to protest the ill-conceived legislation and the misguided governmental policies and management which in six years have drastically damaged and are now destroying the American free enterprise system as we have known it.

2) As an investment counselor and manager, to ask for relief from the unrelenting pressure by which the Federal Reserve Board has caused the greatest shrinkage of American security values since the great depression of the nineteen thirties, virtually destroyed our equity markets, forced the liquidation of individual ownership of publicly held corporate equity securities and of most of the securities industry, caused the transfer of ownership of American industry from individual to institutional investors, and transformed us from a nation of investors into a nation of lenders and borrowers.

3) As both a lifelong student of finance and economics and a practical businessman of thirty years experience, to point out the dogmatic, pedagogical misconceptions and the obvious lack of objective, constructive thought which have caused these ill-conceived governmental policies and brought us to this sorry state, and to present to this committee some remedial and constructive proposals which, I believe, have at least the merit of objective logic and common sense.

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C. THE CURRENT MISCONCEPTIONS OF OUR ECONOMISTS AND NATIONAL ECONOMIC AND MONETARY MANAGERS VS THE TRUE CAUSES OF AND REMEDIES FOR INFLATION

Misconception Number One . . .that the cause of today's inflation is excessive growth of the nation's domestic money supply, and that this has been an unavoidable result of excessive government spending.

I submit that this is a gross over-simplification and distortion of the facts. The inflation of 1968-70 which reached a 5.3% annual rate (GNP deflator) was a result of financing the escallated costs of the Viet Nam War without either raising taxes or imposing controls, but the double digit inflation of 1973-74 is a result of a confluence of factors, none of which may be laid at the door of excessive government spending *per se.* Here is a list of the true causes.

1) **The accumulated Federal deficits** of 1970-73 were a contributing factor to, but by no means the principal cause of today's inflation. These deficits, in fact, resulted primarily from a decline of more than -10% in federal tax receipts per capita (in constant dollars) from 1969 through 1971, and an expansion of nearly +20% in expenditures (in constant dollars) from 1970 through 1972, both of which were a direct result of the until then unprecedented contraction in 1969-70 of our money supply by the Federal Reserve Board and the consequent decline in national product, corporate and personal incomes, and the government's tax revenues thereon. *Neither the decline in tax revenues nor the "economically stimulative" expansion of federal expenditures would have occurred if the Federal Reserve Board had not taken it upon itself to plunge the nation into a recession in 1969-70.*

2) **The Administration's decision in 1971 to suspend the convertibility of the U.S. dollar into gold** although necessary to correct a long term accumulated imbalance of international payments, cast practically all of the world's currencies, as well as the dollar to which they had been tied, afloat upon a confused and angry international sea. The result was a worldwide loss of confidence in the stability of practically all governmental currencies and an unprecedented, excessively stimulative demand for every kind of tangible store of value which caused world commodity prices to more than *double* within one year, and created material shortages which substantially impaired production in the United States and caused severe imbalances between supply and demand for practically all products.

3) **The devaluation of the U.S. dollar,** although necessary to restore the international competitiveness of U.S. dollar priced exports, was also a direct result of the long term mismanagement of our international trade and finance, our subsidy of foreign nations, and the export of American capital to increase production overseas instead of in the United States. The resulting cumulative decline of -17.4% in the U.S. dollar's international purchasing power was in effect a defacto recognition of the U.S. dollar inflation which had already occurred internationally, and which has subsequently been reflected in the increase of domestic prices. Please note that a -17.4% dollar devaluation is equivalent to a +21% price rise, and that this alone is equivalent to two years of double digit inflation at annual rates.

4) **The foreign-controlled increase in the cost of energy,** has, of course, been an inescapable and major factor in our current inflation. Certainly, this was not and is not subject to correction by reducing the domestic money supply, or by any other domestic measures, except for the long term development of alternate sources of energy which, incidentally cannot possibly be successfully financed if today's usurious level of interest rates is permitted to continue. The energy price rise, although more than double for foreign oil, averages out, according to our calculations, to close to a +50% overall average price rise in all U.S. energy costs, foreign and domestic. Although this is still in the process of permeating the price structure of practically all U.S. goods and services, the process is now nearing completion and this major cause of domestic inflation will soon become an historical fact as distinguished from a continuing factor.

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5) **The unregulated increase in the supply of "Eurodollars"** has been equivalent to a +115% increase in the total supply of current U.S. dollars (M1) since 1968, +95% of the total current money supply of $241 billion at the beginning of the period ($200 billion in domestic funds [M1] plus $41 billion in Eurodollars already on deposit in foreign banks). The Eurodollar increase was also equivalent to +57% of all dollar deposits inside the U.S.A. including all time deposits. The FRB regulated domestic U.S. money supply (M1) increased by only +40% during the same period (or 33% of all current dollars including Eurodollars at the beginning of the period). The unregulated massive increase of Eurodollars has been and still is unquestionably a major domestic as well as a worldwide cause of inflation. Believe it or not, the supply of "Eurodollars", which are essentially deposits in foreign banks abroad payable in U.S. dollars, is now almost as great as the entire U.S. domestic money supply of about $279 billion in currency and demand deposits in U.S. banks (M1). These dollars, have in part been simply created by foreign bank dollar loans and are not backed, directly or indirectly, by reserves in U.S. Federal Reserve banks. Here is the major villain of the inflationary piece, for these dollars, "fictitious" or not, do represent actual dollar buying power demand and are therefore a very powerful factor in the demand/supply imbalance which has created today's inflation. This unregulated creation of U.S. dollars by foreign banks is a continuing inflationary factor which can and should be brought under strict U.S. control. Is it not incredible that our government's monetary authorities are now drastically restricting the U.S. domestic money supply and our domestic economic growth, while completely neglecting to take any measures to reduce or even to bring under control this enormous, unregulated foreign-made expansion of U.S. dollars?

6) **The suspension of ceilings on negotiable bank certificates of deposits in June 1970**, while essential at the time to avoid a nationwide financial panic of the first magnitude which then threatened to result from the FRB's excessive and prolonged "credit crunch" of 1969-70, has since turned out to be a financial Frankenstein of previously unimaginable power. Herein is the cause of the apparent paradox of unprecedentedly usurious interest rates and an "adequate" supply of bank lendable funds – that is by big banks to big borrowers. For while the conventional "current money supply" of currency and demand deposits (M1) has been growing at an average +6.3% annual rate during the last 5½ years (+6.8% during the last eighteen months), large certificates of deposit have averaged a +25% compound annual rate since 1968, have skyrocketed to a +54% annual growth rate since 1972, and have caused the total money supply including all demand and time deposits to rise at a +12.7% annual rate during the same period.

The adverse effects upon the American free enterprise capitalistic system of this suspension of regulation of large negotiable bank certificates of deposit can scarcely be exaggerated. This one terrible mistake, which benefits no one except the large banks, has caused:

a) The escallation of interest rates to levels which are unprecedented in our history, were inconceivable a few years ago, are nearly double the rate which centuries of civilization have considered "usurious", and are unsustainable by a productive society. It is interesting, if somewhat disconcerting to note that in the early vigorous days of the Roman Republic 8 1/3% was the maximum legal rate of interest; this was raised to 12% in 87 AD as the empire began to decline.

b) The demoralization, disintegration and forced liquidation of our securities markets for common stocks, bonds, and commercial paper alike.

c) The concentration of financial and economic power in the major banks, interposing big bankers between the owners and the users of capital and causing the transformation of equity capital into debt, investors into lenders and businessmen into borrowers instead of partners.

d) A dangerous shift from long term capital investment into short term lending, which seriously reduces the true liquidity of our banks and the availability of long term investment capital for the expansion of competitive, productive enterprise.

e) A serious impediment to the liquidity, viability and growth of our savings institutions and a very real threat to the American tradition of individual home ownership.

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