

CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced Growth
Act of 1978, P.L. 95-523)

HEARINGS
BEFORE THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
NINETY-SIXTH CONGRESS
FIRST SESSION

—
FEBRUARY 21 AND 22, 1979
—

Serial 96-3
—

Printed for the use of the
Committee on Banking, Finance and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1979

42-656 O

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY S. REUSS, Wisconsin, *Chairman*

THOMAS L. ASHLEY, Ohio	J. WILLIAM STANTON, Ohio
WILLIAM S. MOORHEAD, Pennsylvania	CHALMERS P. WYLIE, Ohio
FERNAND J. ST GERMAIN, Rhode Island	STEWART B. MCKINNEY, Connecticut
HENRY B. GONZALEZ, Texas	GEORGE HANSEN, Idaho
JOSEPH G. MINISH, New Jersey	HENRY J. HYDE, Illinois
FRANK ANNUNZIO, Illinois	RICHARD KELLY, Florida
JAMES M. HANLEY, New York	JIM LEACH, Iowa
PARREN J. MITCHELL, Maryland	THOMAS B. EVANS, Jr., Delaware
WALTER E. FAUNTROY, District of Columbia	S. WILLIAM GREEN, New York
STEPHEN L. NEAL, North Carolina	RON PAUL, Texas
JERRY M. PATTERSON, California	ED BETHUNE, Jr., Arkansas
JAMES J. BLANCHARD, Michigan	NORMAN D. SHUMWAY, California
CARROLL HUBBARD, Jr., Kentucky	CARROLL A. CAMPBELL, Jr., South Carolina
JOHN L. LAFALCE, New York	DON RITTER, Pennsylvania
GLADYS NOON SPELLMAN, Maryland	JON HINSON, Mississippi
LES AUCCOIN, Oregon	
DAVID W. EVANS, Indiana	
NORMAN E. D'AMOURS, New Hampshire	
STANLEY N. LUNDINE, New York	
JOHN J. CAVANAUGH, Nebraska	
MARY ROSE OAKAR, Ohio	
JIM MATTOX, Texas	
BRUCE F. VENTO, Minnesota	
DOUG BARNARD, Georgia	
WES WATKINS, Oklahoma	
ROBERT GARCIA, New York	
MICHAEL LOWRY, Washington	

PAUL NELSON, *Clerk and Staff Director*
MICHAEL P. FLAHERTY, *General Counsel*
MERCER L. JACKSON, *Minority Staff Director*

(II)

CONTENTS

Hearings held on—	Page
February 21, 1979-----	1
February 22, 1979-----	115

STATEMENTS

Brunner, Dr. Karl, professor, University of Rochester, Rochester, N.Y.-----	116
Miller, Hon. G. William, Chairman, Board of Governors of the Federal Reserve System-----	2
Thurow, Dr. Lester, professor of economics and management, Massachusetts Institute of Technology, Cambridge, Mass-----	131

ADDITIONAL INFORMATION SUBMITTED

Brunner, Dr. Karl:	
Prepared statement-----	121
Response to questions of Congressman Chalmers P. Wylie-----	141
Feldstein, Prof. Martin, statement-----	153
Lekachman, Prof. Robert, statement-----	152
Miller, Hon. G. William:	
Letter, dated March 9, 1979, responding to Congressman Ron Paul's February 22, 1979, letter re potential consequences for monetary policy of shifts into the United States of deposits now held in the Euro-dollar market-----	91
"Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978," report of the Board of Governors of the Federal Reserve System, February 20, 1979-----	11
"Percent Change in Real Gross National Product and Related Items," table submitted in response to question of Chairman Henry S. Reuss-----	109
Paul, Congressman Ron, letter dated February 22, 1979, to Chairman G. William Miller, re potential consequences for monetary policy of shifts into the United States of deposits now held in the Euro-dollar market-----	90

APPENDIXES

Appendix I.—Briefing material submitted by staffs of—	
Committee on Banking, Finance and Urban Affairs-----	157
Congressional Research Service of the Library of Congress-----	166
Subcommittee on Domestic Monetary Policy-----	161
Appendix II.—Statements of Associations:	
American Association of Retired Persons-----	171
National Retired Teachers Association-----	171
Appendix III.—House Report No. 96-32-----	183

CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced Growth Act of 1978, P.L. 95-523)

WEDNESDAY, FEBRUARY 21, 1979

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

The committee met at 10:15 a.m., in room 2128 of the Rayburn House Office Building; Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, St Germain, Cavanaugh, Vento, Stanton, Wylie, Leach, Evans of Delaware, Green, and Paul.

The CHAIRMAN. I wish to congratulate you, Chairman Miller, on your appearance before the Senate yesterday in the midst of a record snow storm. I congratulate you and your associates in the Federal Reserve on the way you met this initial responsibility.

These hearings open a new chapter in the relationship between the Federal Reserve, the administration, and the Congress. For the first time, we now have a formal procedure that relates the conduct of monetary policy to a set of explicit economic goals and objectives, and that requires both sides in these hearings to focus on and evaluate those goals. The Federal Reserve has done so in the Monetary Policy Report that was submitted to the Congress yesterday. This committee will shortly do so in a report to Congress, as required by law.

While I have a number of questions about the report, and a few thoughts on how it might be made even more responsive to the new law in the future, I want to commend you and the Federal Reserve staff for a conscientious effort to prepare and present a truly informative and useful document. The review of recent economic developments is especially thorough and well presented.

I note that your new target for M_1 , the narrowly defined money stock, accomplishes something I have long recommended: It makes the M_1 target, which has been a perennial understatement of actual M_1 growth in the past, consistent once again with the announced ranges for the higher M 's. This is because you incorporate an estimate that automatic transfers, NOW accounts and so on, will substitute for 3 percentage points in the normal growth of M_1 , so that your seemingly strangulatory M_1 growth path of 1.5 to 4.5 percent is in effect an eminently reasonable 4.5 to 7.5 percent, if the figures are made comparable to the M_1 of less complicated times.

Chairman Miller, your report is received in full and will be inserted in the record.

Would you now proceed?

(1)

**STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN,
FEDERAL RESERVE BOARD**

Mr. MILLER. Thank you very much, Mr. Chairman.

Can everyone hear me satisfactorily?

I would find it much preferable, if you don't mind, to stand at this little podium. It is a high technology device, with wastepaper baskets supporting it; I note that they are turned upside down because we don't have any wastepaper to throw away today. At least, I hope this report will be looked upon as something other than wastepaper.

I appreciate your comments, Mr. Chairman, about this report. It is to us a historic event to report to you for the first time under the new requirements of the Humphrey-Hawkins Act. And I must assure you that the credit for this report should be given to the staff of the Federal Reserve, which has worked very hard and diligently to try to be responsive to the mandates of Humphrey-Hawkins.

We have divided the report into three chapters to follow and track precisely the language of the monetary policy section of Humphrey-Hawkins, which instructs us as to the report to be filed with Congress.

With your permission, as you have suggested, the report will be filed for the record. I would like to walk through the report, just to make some comments as a preface to questions and comments from this committee.

The CHAIRMAN. Do members have any objections?

Fine.

Mr. MILLER. Does everybody have a copy, I hope?

Chapter 1 of the report is "a review and analysis of recent developments affecting economic trends in the nation."

The important thing to note about recent economic trends is that we are in the process of completing 4 years of expansion from the trough of the great recession of 1974-75; we are about to enter the fifth year. This economic expansion is one of considerable longevity and one which has had a considerable magnitude of gains.

We are moving closer to the point of a relatively high utilization of our productive and labor capacities, and so we must operate from here on with considerable caution, in view of the efforts that further high rates of expansion could have in exacerbating inflationary tendencies.

If you will follow with me in looking at some of the charts, that might be the easiest way to hit the highlights.

The upper panel of the chart on page 5, shows the performance of this economic cycle as compared with the average of previous economic cycles. You will see that there has been a fairly even, somewhat slower growth in the earlier part of this cycle, and, more recently, evidence of more vitality and continuity than had been shown in previous expansion periods.

The bottom panel indicates that over the period of the current expansion—one quarter short of 4 years, since we don't yet have the data for this quarter—the gross national product in real terms has grown at an average annual rate of about 5 percent. Housing expenditures have grown a little more than 14 percent, and shows the highest rate of growth for any component in this cycle. That results, however, from the abnormally low rate of activity in housing at the trough; in absolute terms, growth is not as great as it is in relative terms.

Business fixed investment has grown at a 5.4 percent average annual rate; personal consumption expenditures at 5 percent; and Government purchases at just over 2 percent.

On the chart on page 7, you will see that during this period, growth in real personal income has fluctuated with economic conditions. During the early part of this "up" trend, personal consumption expenditures were running ahead of disposable income. Except for the year 1977, this has continued. So, as you will see in the middle panel, there has been a general down trend in the rate of savings, as savings as well as disposable income have been used to maintain consumer spending during this period.

The bottom panel indicates the growth of consumer credit, which has also supported consumer spending.

Turning to the chart on page 10, you can see illustrated the point that I was making a moment ago about housing. With the downturn that started in housing in 1973, there was a dramatic dropoff in housing starts from a 2½-million annual rate to about 900,000 within 2 years. That wasn't a recession in housing; it was a depression. So it is that the recovery has been somewhat stronger in housing than in other components, but still not back to the previous levels.

The demand for housing, of course, is influenced by demographics. We do have more family formations, more younger families who are in need of shelter. And we do have a demand for housing based upon its perceived value as a store of wealth for families, who are purchasing in anticipation of further price increases from inflation. So housing has been a relatively stable part of the expansion.

The chart on page 13 takes a look at Government expenditures during this cycle. The upper panel shows the nominal and real rates of Federal expenditure for goods and services. The pattern has been erratic, but generally we have seen a positive contribution from this component during this period, although more recently, in real terms, Federal purchases have dropped off.

The bottom panel shows the growth of State and local government purchases of goods and services in constant dollars.

Turning to page 15, we can look briefly at the labor market. The civilian labor force has grown rather rapidly during this period, but there has also been a record rate of growth in job creation. In the last 2 years, 7½ million additional jobs have been created in our economy, which is certainly gratifying. While we still have pockets of unemployment for young, urban and minority Americans, the general rate of absorption of the labor force has been encouraging. The unemployment rate has trended lower. And, more importantly, the civilian employment population ratio has trended up to new record highs. As shown in the bottom panel, civilian employment in relation to the adult population is now at about 60 percent, an alltime record.

The chart on page 18 gives a breakdown of the unemployment rates. Generally, at the end of 1978, we were back to roughly the same level of unemployment overall that existed in 1972. For adults, this is also generally true. The rate is slightly higher, but in the range that existed in 1972, as is true for skilled workers. However, we continue to show a high rate of unemployment for teenagers, for nonwhites, and for unskilled workers. So, as we have expanded and begun to see some strain in the market that exists for skilled and adult workers, we have found we still need to concentrate on targeted programs to help provide

skilled training for those who have not yet been able to take full part in this economic progress.

As to productivity, let me call your attention to the chart on page 21. One of the concerns that we have is the general attenuation in the growth in output per hour. The trend line shows a general rate of growth of about $2\frac{2}{3}$ percent over the postwar period; you can see that we have been falling woefully short of this increase in productivity in the nonfarm business sector in the last few years. The trend at $2\frac{2}{3}$ percent in the period 1947-67 is followed by only 1.2 percent growth since 1973; last year, even less than that. This is of considerable concern.

On the chart on page 23, you can see one of the reasons we have had this poor performance. The ratio of capital stock to the labor force has been dropping off. If we fail to create the investment to support the growth of the labor force and growth in jobs, we indeed run into difficult problems.

The bottom panel shows that the average annual rate of growth of capital stock from 1962-67 was over 5 percent; from 1972-77, it was only 2.9 percent. This is one of our serious concerns, looking at long-term trends in the economy.

The chart on page 26 makes this point in terms of international comparisons. Not only has the United States been falling behind its own prior rates of investment, but it is continuing to fall behind other countries. In the period 1966-76, in real terms, the United States expended about 13.5 percent of GNP on capital investment. Other industrial countries have invested much more: Japan, 26-plus percent; Germany, over 17 percent; Canada, over 17 percent.

I must point out that it is not proper to make direct comparisons because of the different structural characteristics of the various economies, but there is no way that such differences account for this significantly lower rate of investment. It is clear, as a general proposition, that the United States is falling behind in its investment.

The international situation in terms of trade and current account balances is shown on page 28, in the upper panel. The chart shows us in a favorable position in our trade balance until the oil boycott and in its immediate aftermath. With the recession of 1974-75, we came back to a balanced trade position. But now, because of the rapid growth of our economy and the slower growth in other countries of the world coupled with our high demand for imported oil, we have moved into a record deficit position.

I point out, however, that the trade deficiency in annualized terms—we reached the largest trade deficit in the first quarter of 1978—it has been improving since that time.

The current account balance follows somewhat the same pattern. In any case, the current trends are toward improvement in our trade balance and substantial improvement in our current account balance.

The bottom panel shows the ratio of foreign real GNP to U.S. real GNP, which accounts for some of this problem.

The United States has been growing more rapidly relative to other countries of the world, so that our demand for imports has been high, while the international demand for our exports has not kept pace.

In terms of recent trends, the upper panel of the chart on page 30 shows that we are now beginning to benefit from increased dollar demand for U.S. exports, both from the change in the value of the dollar and the general change in relative growth rates in the world. Volume is trending upward now, and of course, value is also. This will make a contribution to closing the trade gap.

The bottom panel shows oil imports, which have been such a large part of the deficit. Volume escalated very rapidly, but fortunately that has shown some decline and stabilization. In terms of dollar value, we have had a period when oil prices were not increasing and we were stable for a while. This line, of course, may trend upward again with the recent OPEC increases and the condition in the international oil markets.

Page 32 traces the path of the trade-weighted value of the dollar over the last few years.

It was erratic during the seventies, as there were changes in the International Monetary System—the floating exchange rate. Immediately following the recession, the dollar was relatively strong. But because of our large trade deficit, because of our large current account deficit, and because of our high rate of inflation relative to many other countries, the dollar has been on a sharp decline since the fall of 1977.

This reached very alarming levels in the summer and early fall of 1978. From September 1977 until the end of October 1978, the dollar declined by over 20 percent. At that time, as you know, we took forceful action: the November 1, 1978, initiative included both fundamental actions, and bridging actions, to insure a stable dollar. Since that time, the dollar has, first, recovered and, second, been in a rather stable channel increasing in value about 7 to 8 percent. Overall depreciation of the dollar since the fall of 1977 has been adjusted to about 15 percent.

As to prices, let me first call your attention to the chart on page 37. One of the natural phenomena of this inflationary time has been the continuing rapid increase in compensation per hour, shown in the upper panel.

Output per hour—productivity—has been trending downward, as shown in the middle panel, and this means that we do have a disturbing, continuing upward trend in unit labor costs, which has contributed to the inflationary bias that creates so much difficulty for us.

The charts on page 38 show other components of prices. The upper panel shows nonfarm unit labor costs trending upward. GNP prices—which is perhaps our most important measure of price increases—even excluding food and energy—which have been serious problems—shows an upward bias that parallels the growth in unit labor costs.

The middle panels show the rapid increase in food prices, which has exacerbated the problem; the continued annual high rates of increase in energy prices. The bottom panel shows the total price condition: the inflation rate for 1979, measured on the GNP deflator, shows an 8.75-percent increase, a rather disturbing rate that is causing us difficulty in adjusting the economy to our long-term objectives.

Page 41 calls attention to some of the financial aspects of this cycle. The necessity for monetary restraint became apparent in 1977 and continued through 1978. In 1978, short-term interest rates moved up

3 to 4 percentage points as the Federal Reserve moved to restrain the growth of money and credit and to dampen inflationary forces.

Long-term rates, shown in the bottom panel, moved up to a lesser degree, generally about 1 percent.

Page 44 shows the performance of the money aggregates in the last few years.

The upper panel deals with M_1 . The rate of M_1 growth had slowed during the recession years of 1974-75; increased slightly in 1976; but then moved up rather rapidly to approximately an 8 percent annual rate of increase in 1977.

With the restraining monetary policy of 1978, and while there was some delay or lag in beginning to bring the growth rate down, we did end up the year with a growth of M_1 of about 7.3 percent. In the fourth quarter, as you know, the growth rate was only 4.4 percent. So we were successful toward the end of the year in bending down the rate of growth of M_1 toward what we felt appropriate.

I would point out, however, that with the new automatic transfer service that began last November 1, there has been some shift out of demand deposits into savings deposits that can be accessed by automatic transfer. Our estimate is that if ATS had not existed, there would have been about a 1-percent greater growth of M_1 in the fourth quarter. So when we say 4.4 percent for the fourth quarter, you probably should think of that as 5.4 percent in pre-ATS terms, still quite satisfactory in terms of our restraining objective.

M_2 is not influenced by this phenomenon. For M_2 we have seen the rate of growth move down from 11 percent in 1976, to about 10 percent in 1977, to 8.5 percent in 1978, consistent with our general efforts to restrain growth. The pattern is somewhat the same with M_3 .

Now, one of the new aspects of our financial system has been the money market certificates authorized last June 1. On page 46, you will see the rather interesting growth of these certificates in savings and loans, in mutual savings banks and in commercial banks. At the end of January, this form of saving had growth to about \$105 billion, and was responsible for maintaining a flow of funds to thrift institutions, and thereby a contributing factor to the maintenance of housing at a more appropriate level than otherwise would have been the case.

In previous cycles, without such certificates, there had been massive disintermediation from thrift institutions, and a lack of funds available for housing. In this cycle, because of the money market certificates, thrift institutions have been able to compete for funds, and funds have continued to flow through to housing. However, there is now some effect upon thrift earnings, and concern about how these certificates will work in future quarters.

Looking at the overall financial picture, page 48, you will see that the total demand for credit from the nonfinancial sector was more or less level between 1977 and 1978. The interesting factor here is that there was a reduction in demand by the Federal Government, which permitted an increase in funds available to the private sector. So, while aggregate demand was generally level, the private sector received a larger portion of funds, which is a trend in the right direction.

There are some developments as to the debt structure of households and businesses that are worth noting in passing, as we look at the demand for funds.

As shown on page 50, one of the developments during 1978, a continuation of the trend in prior years, was the rapid growth of household debt—not only as represented by mortgages, but in installment credit and other forms.

Part of this is no doubt for demographic reasons. There are more younger families who are in that stage of life where they need credit to form their households and support their demand for durables and for shelter.

But there is also, perhaps, a growing use of credit to meet the desire to purchase in anticipation of further price increases.

The upper panel shows this growth in household debt. It has now reached the point where repayments relative to disposable income are quite high, almost 23 percent, and while this debt is being served well and there is no increase in delinquency, it is one of the factors we want to watch closely. It will be a factor affecting overall demand over coming quarters.

The bottom panel shows that corporations have reacted to the interest rate cycle with a preference to borrow funds short term, rather than long term, but unwilling to pay the present rates for long-term funds. And so, their ratio of liquid assets to short-term liabilities has dropped as they have come to depend more on short-term borrowings to finance expansion.

Overall, the economy is in balance. In referring to the charts, I have only touched upon the analysis presented to you in the full report. I hope that my comments will provide you with the background you need to assess our plans and objectives for monetary policy and how these relate to the objectives of the administration.

Chapter 2 of the Federal Reserve report to you deals with the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year 1979. These objectives and plans are made taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices.

The objective of this Federal Reserve is to foster financial conditions conducive to a continued, but more moderate, economic expansion during 1979 that should permit a gradual winding down of inflation and the maintenance of the stronger position of the dollar in the international exchange markets. Given the limited margin of unutilized labor and industrial resources remaining in the economy, it is critically important to avoid strong aggregate demand measures that would aggravate our already serious inflation problem. At the same time, the current condition of general balance in the economy suggests that it should be possible to continue restraint to relieve inflationary measures without triggering a recession.

The particular growth rates, or ranges for growth of the aggregates, can perhaps best be illustrated to you this morning by following the charts that begin on page 59.

I have already commented on past rates of growth of M_1 , shown on this chart over the period from 1975 to the current time.

The dotted line indicates the range of growth for M_1 , that has been adopted as an objective by the Federal Open Market Committee

for the period from fourth quarter 1978 to fourth quarter 1979. The range is from 1.5 percent to 4.5 percent.

I pause to call your attention to the fact that this range has been adopted taking into account our best estimate of the effect on M_1 of the new automatic transfer service. Our best estimate is that with the automatic transfer service, M_1 would grow at a rate of 3 percent less than it otherwise would have grown.

The midpoint of our range is 3 percent. If we were to adjust upward by 3 percent for the effect of ATS, our midpoint would be about a 6-percent growth rate, as compared to a 7.3-percent growth rate in 1978.

Let me point out that we are not certain of the effects of ATS, and so our ranges are designed to permit adequate adjustment for the growth of M_1 should the effect of ATS be greater or less than we estimate.

As to M_2 , shown on page 60, it is not affected significantly by ATS. So, we are looking at growth rates that would be more or less consistent with past experience in measurement.

The range that has existed for M_2 throughout the last couple of years has been 6.5 to 9 percent. The proposed range for 1979 brings the objective down to a lower range of 5 to 8 percent.

Similarly, with M_3 shown on page 61: the previous growth range was 7.5 to 10 percent; we are proposing a lower range of growth of 6 to 9 percent.

For bank credit, page 62, the range we adopted is consistent with the other aggregates; we contemplate growth within the 7.5- to 10.5-percent range.

I would just call your attention to the fact that we have a new procedure under Humphrey-Hawkins; that is, these are ranges for an entire year. We are to report back to you in July with any adjustments we think are appropriate. We no longer have the "rolling forward" from quarter to quarter, so you are going to be judging us on the basis of a more or less stabilized objective. This may be beneficial; we may be able to keep better track of how we are proceeding.

These particular ranges have been adopted after consideration of the outlook for the economy in terms of all of its various components.

I would just call your attention to the fact that the new orders for capital goods have continued high—the chart on page 69—and so there is momentum for capital investment in 1979. Surveys indicate that capital investment will continue to expand in 1979, although at a lower rate of growth than in 1978.

The panel in the upper right points out the 3-month moving average growth in real construction contracts. This has been quite strong, picking up during 1978.

The bottom panel relates the same sort of information as to plant and equipment expenditures, real and nominal, projecting a lower but continuing expansion in 1979.

As to Federal outlays, as shown on page 66, the last few years have seen a slight decline in the rate of growth of Federal expenditures in nominal terms.

In 1978, for example, expenditures rose almost 12 percent from the prior year. The projection is for those expenditures to increase only

9.4 percent in 1979, and 7.7 percent in 1980, a slowing in the rate of expansion of Federal expenditures.

On the other hand, there will be a continuing significant gain in the growth of Federal receipts, shown in the center panel. In 1978, Federal receipts were 12.3 percent ahead of the prior year; they are expected to be 13.4 percent ahead of 1978 in 1979; and yet a healthy 10.2 percent ahead of 1979 in 1980.

This means a shrinking Federal deficit. The deficit was about \$49 billion in 1978; it is expected to be \$37 billion or so in fiscal year 1979; and there is before Congress a proposal for a \$29 billion deficit in fiscal year 1980.

Mr. Chairman, if I may turn to the final chapter, I will briefly relate these objectives of the Federal Reserve to the objectives in the President's economic report. This would then complete my verbal presentation.

Corresponding to the mandate of the Humphrey-Hawkins Act, chapter III reports to you on the relationship of the Federal Reserve's objectives and plans to the short-term goals set forth in the recent economic report of the President.

The table on page 69 shows the President's economic goals. I am not going to read all the figures, but let me call attention to a few of them.

In terms of real GNP, the President's economic goal contemplates a 2.2-percent growth in real GNP in calendar year 1979, and a 3.2-percent growth rate in 1980.

It contemplates, also, an increase in consumer prices of 7.5 percent in calendar year 1979, down from the 8.9 percent of last year; it targets a further decline to 6.4 percent in 1980.

The unemployment rate in the fourth quarter of 1979 and 1980 is now expected to be 6.2 percent.

These goals of the President contemplate expansion in nominal GNP of about 9.75 percent from the fourth quarter of 1978 to the fourth quarter of 1979.

It is the view of the Federal Reserve that the ranges that have been adopted for the monetary aggregates are consistent with achieving that rate of growth of nominal GNP.

As we have gone through this economic cycle, and as short-term interest rates have risen in response to higher inflation and the restraint on the growth of money and credit, there has been an increase in the velocity of the monetary aggregates, particularly of M_1 .

Individuals and businesses, in the face of higher interest rates, economize more and more on the holding of their money in noninterest bearing form. This phenomena is expected to continue, and we expect some further increase in velocity in 1979 and 1980. This is why we feel that the ranges we have presented for the monetary aggregates are consistent with the rate of growth in nominal GNP.

Since the President submitted his goals, we have acquired additional data that he did not have, and that the Council of Economic Advisers did not have. The initial data for January, for example, show a slower rate of growth in personal income, a slower rate of growth of retail sales, a slowing in the rate of housing starts, and a somewhat disappointingly high level of producer price increases.

All of these new data indicate that it will, perhaps, be difficult to predict that the exact mix as presented in the President's goals can be

achieved. But the mix suggested for 1979 also seems reasonable; and the aggregates seem reasonable.

It is more difficult to assess, at this time, whether future inflationary pressures or other activity in the economy will change the mix between real growth and price growth in 1980. But we feel we are within the range of reasonableness, and that the goals adopted by the Federal Reserve are consistent with the President's goals.

Recognizing the risks and uncertainties that currently exist, the administration's 1980 forecast will serve as an appropriate goal for Congress as it considers the plans for fiscal year 1980. If inflationary pressure subsequently should prove stronger than the administration has projected, then the prudent course for Government policy would be to exercise a substantial degree of restraint, even if it risks less real growth in 1980 than the 3.2-percent goal. Such a policy would lay the foundation for balanced economic growth over the years to come, and help us to maintain the integrity of the dollar.

Thank you very much, Mr. Chairman.

[Text resumes on page 89.]

[The first Monetary Policy Report to Congress pursuant to the Full Employment and Balanced Growth Act of 1978 submitted by Chairman Miller follows:]

Board of Governors of the Federal Reserve System



**Monetary Policy Report to Congress
Pursuant to the
Full Employment and Balanced Growth Act of 1978**

February 20, 1979



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1979

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its first Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
G. William Miller, *Chairman*

TABLE OF CONTENTS

Letter of Transmittal		
Chapter 1.	Recent Economic and Financial Developments	
	Section 1. Overview	1
	Section 2. Aggregate Economic Activity	3
	Section 3. Labor Markets	14
	Section 4. Productivity	20
	Section 5. Investment	24
	Section 6. International Trade and Payments	27
	Section 7. Prices	35
	Section 8. Financial Markets	40
Chapter 2.	Objectives and Plans of the Federal Reserve	
	Section 1. The Objective of Monetary Policy in 1979	54
	Section 2. Growth of Money and Credit in 1979	55
	Section 3. The Economic Outlook	63
Chapter 3.	The Relationship of the Federal Reserve's Plans to the Administration's Goals	
	Section 1. The Short-Term Goals in the <u>Economic Report of the President</u>	69
	Section 2. The Relationship of the Federal Reserve's Monetary Growth Ranges to the Short-Term Goals in the <u>Economic Report</u>	70

CHAPTER 1

**"a review and analysis of recent developments
affecting economic trends in the nation"**

**Section 108(a) Full Employment and
Balanced Growth Act of 1978**

Section 1. Overview

The current economic expansion is about to enter its fifth year. It thus outranks in longevity every prior cyclical upswing of the postwar era with the exception of that in the 1960s. Yet it has maintained considerable vigor, with real gross national product rising more than 4 percent during the past year. The attendant increases in employment and industrial capacity utilization have reduced considerably the margin of unutilized productive resources in the economy.

The narrowing of the gap between actual and potential output implies that a tighter hold on the Nation's aggregate demand for goods and services is necessary if inflationary forces are to be contained. The urgency of such restraint is reinforced by the fact that there has already been an acceleration in the rise of wages and prices. Aggregate measures of unit labor costs and prices advanced around 9 percent in 1978, appreciably more than in the preceding years of this economic expansion.

Apart from the hardship that this large and generally unanticipated surge in inflation created for many families and business enterprises, the behavior of prices deepened concerns around the world regarding the stability of the U.S. economy and the soundness of the dollar. The value of the dollar on foreign exchange markets declined through most of 1978, exacerbating domestic inflationary pressures in the process. To prevent a serious disruption of the international financial system, a broad program of corrective actions was initiated last November. The dollar has since strengthened, but remains vulnerable to shifts in sentiment among exchange market participants.

The longer-range strength of the U.S. economy and of the dollar depends greatly on our success in retarding inflation. This was recognized during the past year in actions taken to reduce the size of the Federal budget deficit, in the establishment of voluntary wage-price standards, and in efforts to curtail the inflationary impact of Federal regulation. In the monetary sphere, too, there was movement toward moderation of aggregate demand growth and restraint of inflation as the Federal Reserve acted to prevent excessive growth of money and credit.

Section 2. Aggregate Economic Activity

The current economic upswing, which began in the spring of 1975, ranks among the most durable in this Nation's history. In the period since World War II, only the expansion of the 1960s was longer, and it was marked by massive increases in military outlays associated with the Vietnam War.

The past four years have seen sizable gains in production and employment. Between the first quarter of 1975 and the fourth quarter of 1978, real gross national product rose more than 20 percent. By last month, industrial production had increased about 35 percent and nonfarm payroll employment more than 14 percent from their levels at the cyclical trough in March 1975.

The momentum of expansion, furthermore, has been well maintained. Real GNP increased 4.3 percent from the fourth quarter of 1977 to the fourth quarter of 1978--a bit slower than the average pace over the earlier part of the expansion, but still well above the trend growth of potential output in the economy. The persistent strength of aggregate demand was demonstrated by the surge in activity during the final quarter of last year, when GNP grew at an annual rate in excess of 6 percent. Available indicators suggest that the economy has remained generally strong in the opening months of 1979.

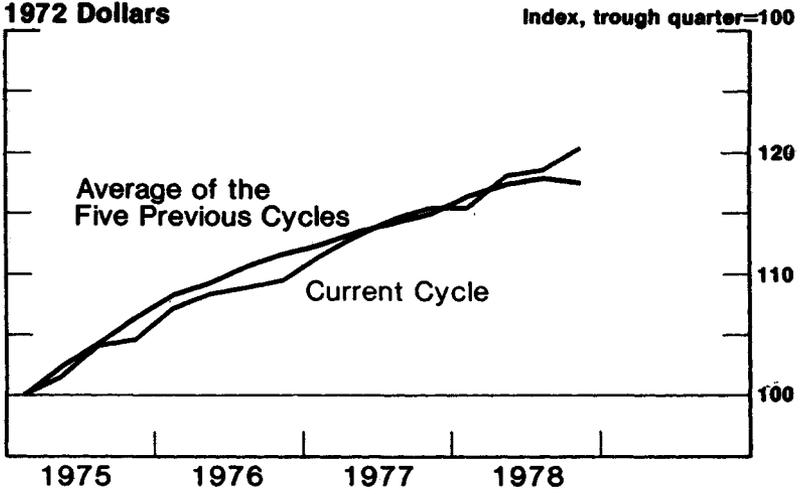
Residential construction, which provided a good deal of impetus to the early recovery, stayed on a high plateau last year in the face of rising interest rates and a continued rapid escalation in building costs. Household demands for shelter have been bolstered by demographic trends as well as by an inflation-hedging

motive. The sustained advance in economic activity also has been fostered in good part by strength in consumer spending. A marked turnaround in the willingness of consumers to spend--reflected in a sharp drop in the personal savings rate--provided much of the impetus to over-all expansion in the early stages of the economic recovery, and consumption expenditures have remained unusually robust throughout the upswing.

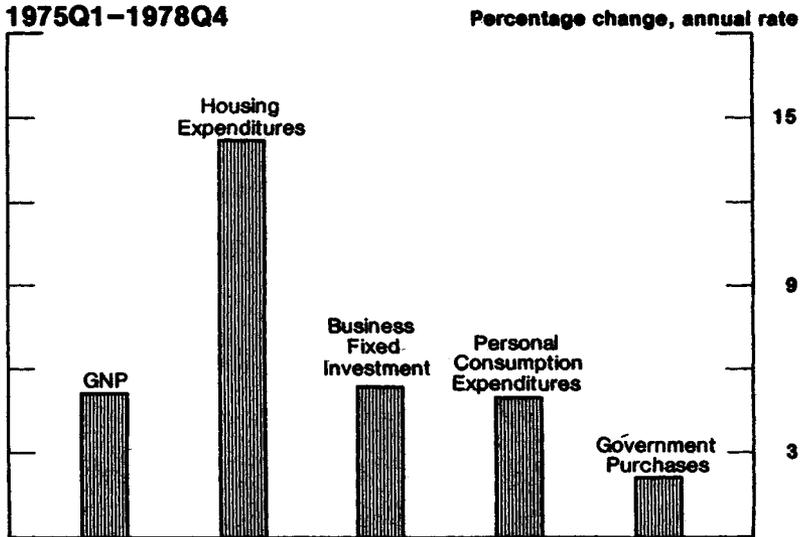
In the business sector, spending on new plant and equipment has continued to rise, but there have not as yet been the large increases seen in some earlier cycles. Business fixed investment actually declined during the initial quarters of the economic expansion, as firms concentrated on the repair of strained financial positions in an environment of low capacity utilization. Capital spending policies have continued to be characterized by considerable caution, and it was not until mid-1978 that the previous peak level of real outlays was reattained. Firms also have exercised caution in managing their inventory positions, and stocks generally have remained lean relative to sales.

Government purchases of goods and services rose briskly at both the Federal and State and local levels during the second half of 1978, but have been a moderating influence on over-all activity during most of the cyclical upswing. The over-all budgetary position of the Government sector, including transfer payments and revenues, has remained stimulative throughout the expansion, albeit in diminishing degree. An improving net export position contributed to the expansion of GNP during the early recovery phase, but deterioration in the

REAL GNP
1972 Dollars



REAL GNP AND MAJOR SECTORS
1975Q1-1978Q4

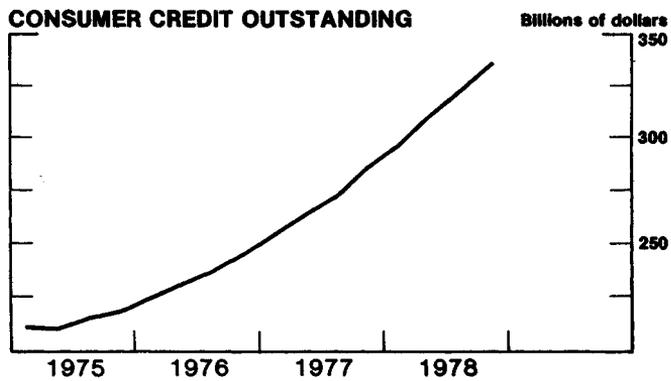
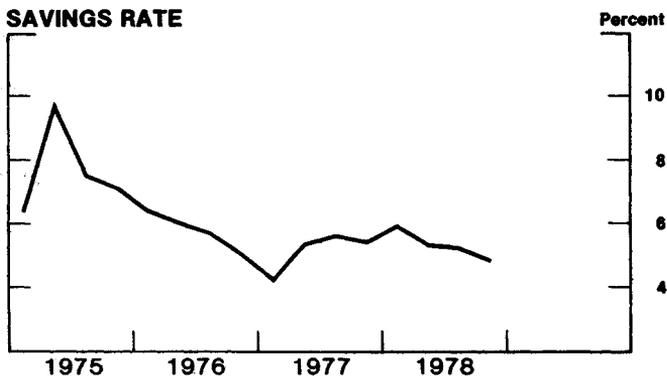
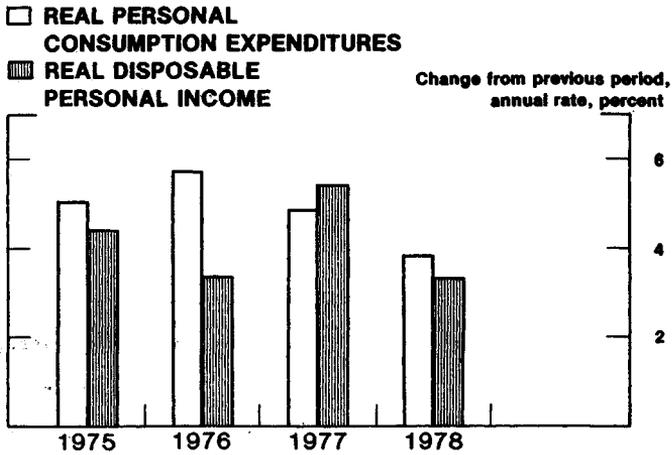


trade balance was a decidedly negative factor from 1976 to early 1978. The U.S. trade deficit did narrow over the course of 1978, however, owing in part to the strengthening of economic expansion in other major industrial countries.

Personal Consumption Expenditures

Consumer outlays grew 3.8 percent over 1978 after averaging 5-1/2 percent, at an annual rate, earlier in the economic recovery and expansion. The slower growth of spending reflected relatively smaller recent gains in real disposable income; increases in real personal income were eroded by larger tax burdens related to higher contributions for social security and the interaction of inflation and a progressive tax system.

The proportion of consumption in gross national product has held at a high level over the course of this upswing. In prior cycles this share typically fell as the expansion matured. In particular, household spending for durable goods has hovered at around 10 percent of GNP throughout the past three years, while during other economic expansions it accounted, on average, for about 7-1/2 percent. This exceptional strength in consumption and the associated rapid increase in instalment credit and low savings rates can be attributed, in part, to the higher relative number of younger households. But it also appears to be in some degree a reaction of households to persistently high inflation rates. For example, opinion surveys suggest that many consumers have been buying durable goods in anticipation of price increases.



Business Fixed Investment

Real business fixed investment rose 8-1/4 percent over 1978. This was nearly the same pace of advance as in the two previous years and almost twice the rate of expansion in aggregate activity. Recently, nonresidential construction activity has become an important source of business investment growth. In 1978, real spending for such structures increased 12-3/4 percent as outlays for commercial and industrial buildings showed particularly impressive gains. On the other hand, investment in producers' durable equipment grew about 6-1/2 percent in real terms during 1978 compared with increases of more than 10 percent in each of the previous two years. Demands for motor vehicles, which were exceptionally strong earlier in the expansion, began to tail off in 1978, while machinery outlays continued to advance at about the same moderate pace experienced since early 1976.

Inventory Investment

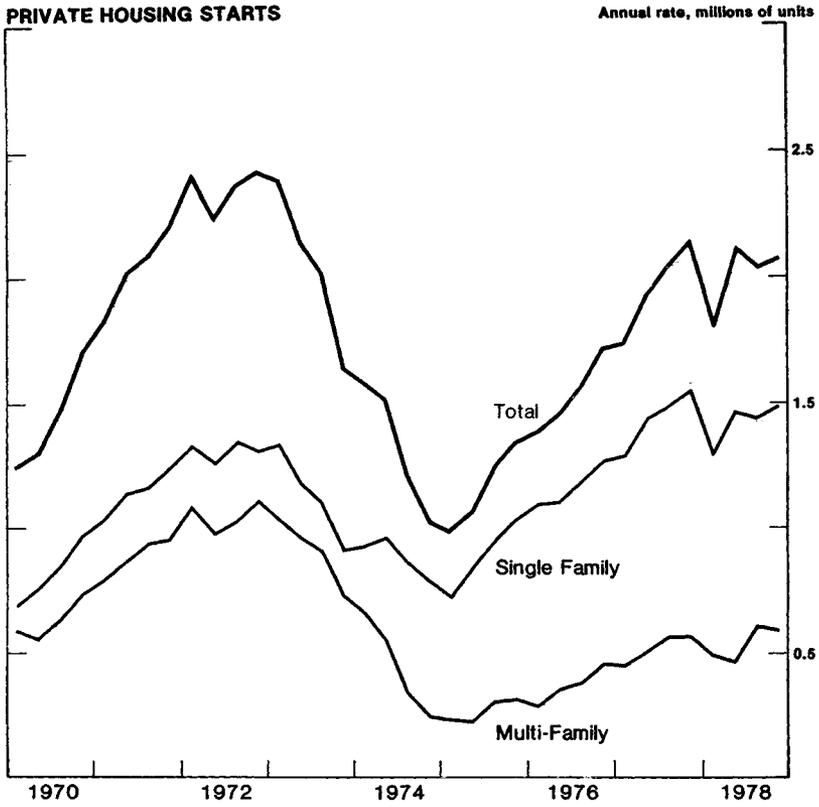
Investment in business inventories was characterized by caution in 1978, as it generally was in the three previous years. As a result, aggregate inventory-sales ratios remained at or below historical averages. This caution, which can be traced back to the severe inventory cycle of 1974-75, appears to have been responsible for the avoidance of the types of overhangs that preceded several prior cyclical downturns. Incipient build-ups of stocks have been met with prompt increases in sales promotion or curtailments of orders and production. Most recently, overhangs that developed at general merchandise retail outlets in the fall apparently were corrected by the sharp rise in

sales during the holiday season and a slowing of production of durable home goods.

Residential Construction

The rate of private housing starts advanced briskly during the 1975-77 period and in 1978 they were sustained at the high annual rate of 2 million units. Spending for residential construction in real terms increased at an average annual rate of 21 percent from the 1975 trough before leveling off in 1978. In addition to production capacity constraints, the recent developments in housing activity reflect the tightening in financial markets. Interest rates on both construction loans and long-term mortgages rose appreciably in 1978 and by year-end they had reached usury ceilings in a number of states and record postwar highs in many other areas. Even so, the variable-ceiling six-month time accounts introduced in June of last year buoyed deposit growth at key mortgage lenders and helped maintain the high rate of housing construction.

Within the housing sector, the rise in single-family starts led activity early in the recovery. More recently, multi-family starts--supported by an increase in Federally subsidized rental units--have increased while single-family starts have remained above their 1972-73 peak levels. Indeed, in the fourth quarter of 1978, total housing starts averaged an annual rate of 2.1 million units, the same as a year earlier.



International Trade

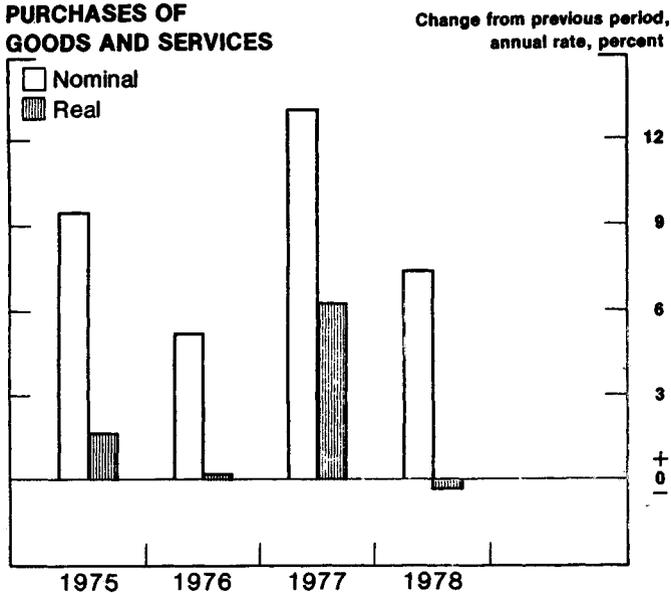
After providing some initial stimulus to economic growth during the early recovery period in 1975, the U.S. balance of trade began deteriorating. In large part this reflected the relatively stronger rate of economic expansion in the United States compared with our major trading partners. The deficit in net exports narrowed during 1978, however, as activity abroad picked up in contrast to the moderation in the U.S. expansion. In addition, the more favorable trade balance reflected a 20 percent rise in agricultural exports last year, associated with unusually poor harvests of wheat and soybeans in the Southern Hemisphere.

Government

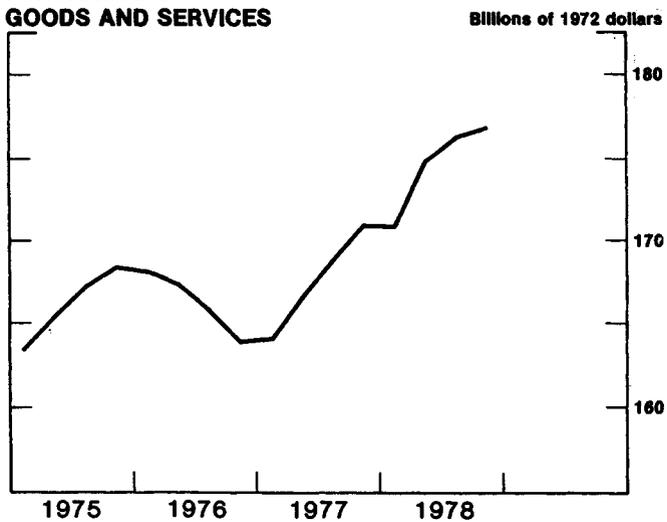
Growth of purchases by the Federal Government has been uneven in this expansion. In real terms, such purchases increased little during 1975 and 1976, rose substantially in 1977, and then--despite a surge in the second half of the year--declined slightly in 1978. Total expenditures, however, have risen consistently, reflecting increased grants to State and local governments and transfers to individuals for Social Security, food stamps, and retirement benefits. Revenues have increased even more than outlays over the past several years, so that the Federal budget deficit has declined from \$66.4 billion in fiscal year 1976 to a projected \$37 billion for the current fiscal that ends next September.

State and local government purchases also have grown irregularly over the past four years. In real terms, outlays by this sector for goods and services expanded at a 2-1/4 percent annual rate during the second half of 1978, matching the average pace over the expansion as a whole. This is well below the trend rate of increase experienced during the 1960s and early 1970s. The slowing of growth reflects changing requirements for services, associated with demographic developments, and a degree of fiscal conservatism prompted partly by the financial difficulties encountered by some communities in recent years. In 1978, however, a tendency toward tax relief--occasioned in part by voter preferences expressed in California's Proposition 13 and like measures elsewhere--outweighed the impact of spending economies on budgets. As a result, although the aggregate operating surplus of State and local governments totaled \$6 billion for the year, this was only half the size of the 1977 surplus.

GROWTH OF FEDERAL GOVERNMENT PURCHASES OF GOODS AND SERVICES



STATE AND LOCAL GOVERNMENT PURCHASES OF GOODS AND SERVICES



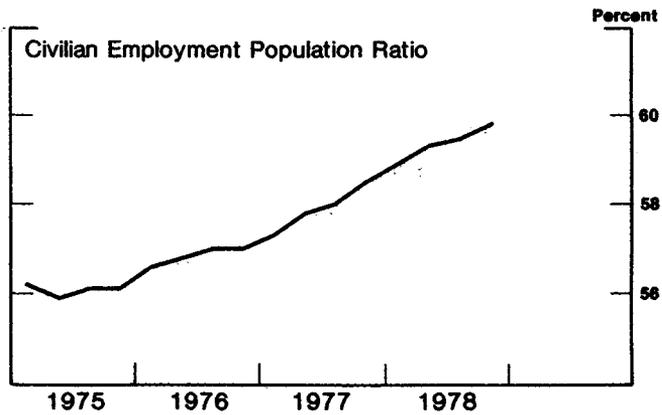
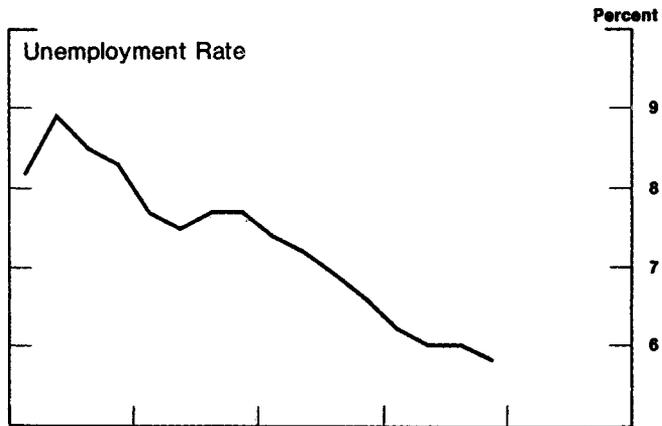
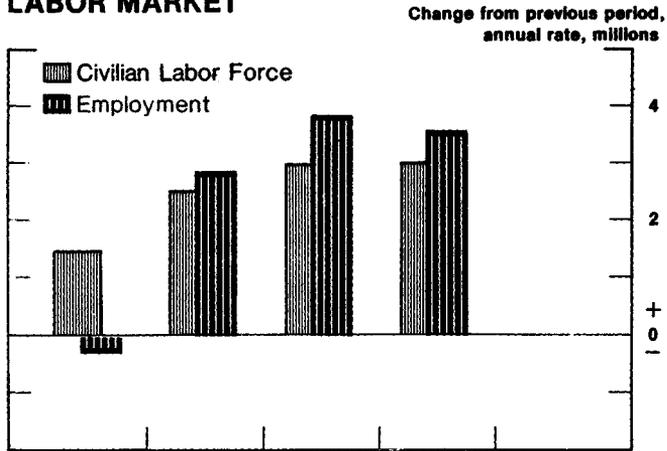
Section 3. Labor Markets

Labor demand has been strong throughout the current economic expansion. During the three years following the cyclical trough in early 1975, nonfarm payroll employment advanced at an average annual rate of 3.7 percent--compared with a 2.8 percent median rate of gain during the five previous postwar expansions. During the past year--at a stage when in earlier cycles employment levels had begun to level off or even fall--payroll employment has continued to advance at a 4.2 percent annual rate. Over the almost four years of expansion, employment has increased by 12 million, and today the ratio of employment to total civilian population aged 16 and over stands at the highest level on record.

Employment in the goods-producing sector of the economy rose rather slowly early in this recovery, reflecting in part the sluggish behavior of business fixed investment. It was not until late 1978--as a result of large hiring increases in the hard goods industries--that factory employment reached its pre-recession peak. Similarly, construction hiring showed only small increases for nearly three years after the trough. During 1978, however, employment in contract construction surged ahead to record levels.

In the private service-producing sector, employment dipped only briefly in early 1975 and has been on a steady uptrend since then--far exceeding the gains of previous expansions. The trade and service industries have continued to grow faster than other sectors, and by the end of 1978 they accounted for more than 4 of every 10

LABOR MARKET



jobs in nonfarm establishments. In contrast to the private sector, Government hiring has been modest. Federal Government civilian employment has been fairly stable at around 2-3/4 million over the past 4 years, about the same level that has prevailed since the late 1960s. State and local government employment has risen, but growth has slowed substantially in recent years as a consequence of reduced needs for education personnel and fiscal retrenchment by many units.

The reduction in educational labor demand reflects the shift in the age structure of the population that has been affecting not only school enrollments, but also the size of the work force. Growth of the teenage population (ages 16 to 19) in the late 1960s and early 1970s was exceedingly large, reflecting the attainment of working age by the postwar baby boom cohort. At the same time, labor force participation rates for teens rose sharply. In the mid-1970s, growth of the 16 to 19 age group slowed, and in 1978 the teenage population actually began to contract. Nonetheless, with participation rates still rising rapidly, the teenage labor force continued to grow at a rapid pace (up 3.2 percent in 1978 compared to 1.6 percent on average in the preceding four years).

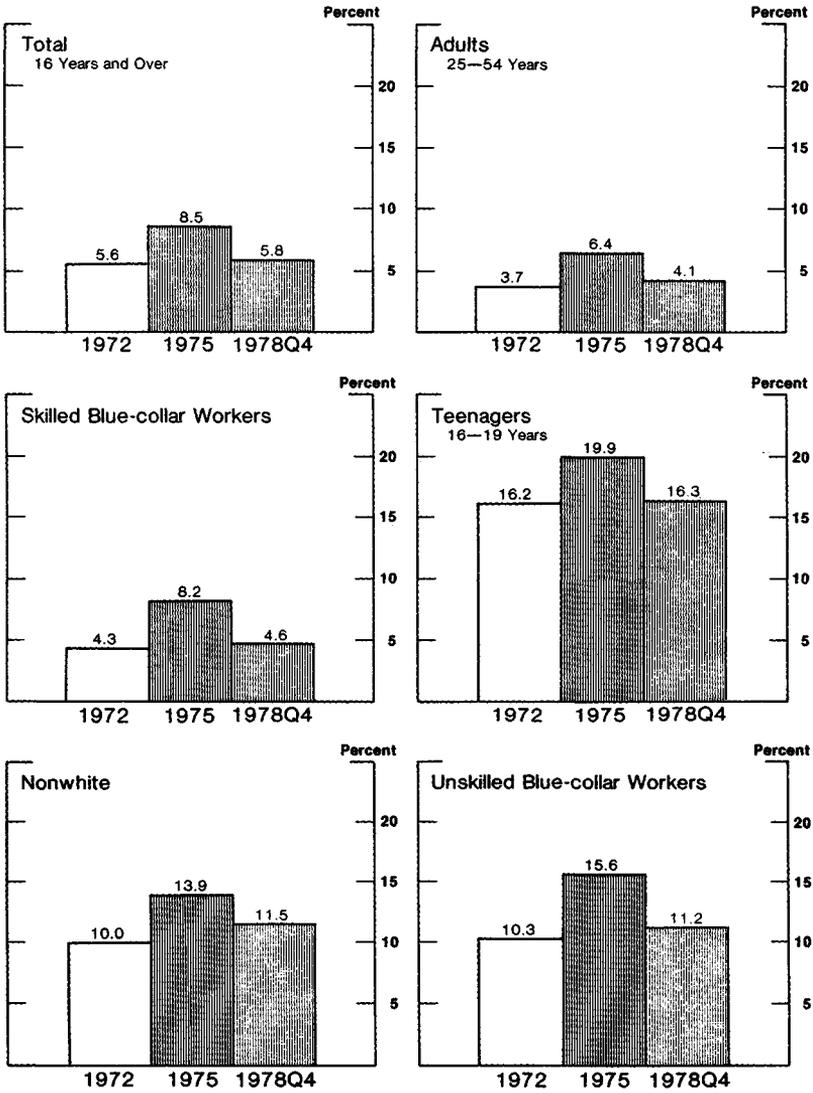
An even more significant factor in the expansion of the work force has been the continued rise in the participation rates of adult women. The longer-run trend, which reflected low birth rates as well as changing attitudes and social trends, apparently was augmented in the 1970s by a desire of families to maintain their material living standards in the face of rapid inflation. As a

result of these participation rate patterns, the total civilian labor force grew 3 percent during 1978--about the same as in 1977, but up considerably from the 2-1/4 percent annual rate during preceding years of the decade.

With the growth of employment outstripping even the large increase in the size of the labor force, the unemployment rate fell one-half percentage point over the course of 1978 to just under 6 percent. Labor market conditions improved significantly for most groups of skilled and experienced workers. For example, unemployment rates for workers 25 to 54 years old, skilled blue collar workers, and workers seeking full-time employment all were at or near the levels reached in 1972 when labor and product markets were beginning to tighten noticeably. While there was as yet no general shortage of skilled workers during 1978, many firms reportedly were finding it increasingly difficult to fill certain job vacancies at prevailing wage rates.

The improvement in employment conditions during the current expansion has not been uniform. Despite the gains made by many groups, unemployment rates for younger workers, minorities, and the unskilled were still very high at the end of 1978. For example, the unemployment rate for teenagers at the end of 1978 was 16-1/4 percent, more than four times the rate for workers 25 to 54 years old; for minority youth the rate was over 35 percent. Younger workers between 16 and 24 years of age accounted for about one-half of all joblessness in the fourth quarter of 1978.

UNEMPLOYMENT RATES



The enlarged proportion of the labor force accounted for by teenagers and women means that the over-all unemployment rate does not imply the same degree of labor force pressure that it would have in past years. These groups tend to have relatively high rates of joblessness for a number of reasons, including generally more limited training and work experience. As a rough adjustment for such structural influences, the average unemployment rate can be recomputed using the age-sex composition of the labor force in the mid-1950s. The result of such a calculation is an unemployment rate about one percentage point below its current level, which vividly illustrates that the level of labor utilization consistent with price stability may change considerably over time. To enhance the possibility of simultaneously achieving low unemployment and price stability, it may be necessary to augment monetary and fiscal policies with carefully focused programs to facilitate job placement and to provide skill-training.

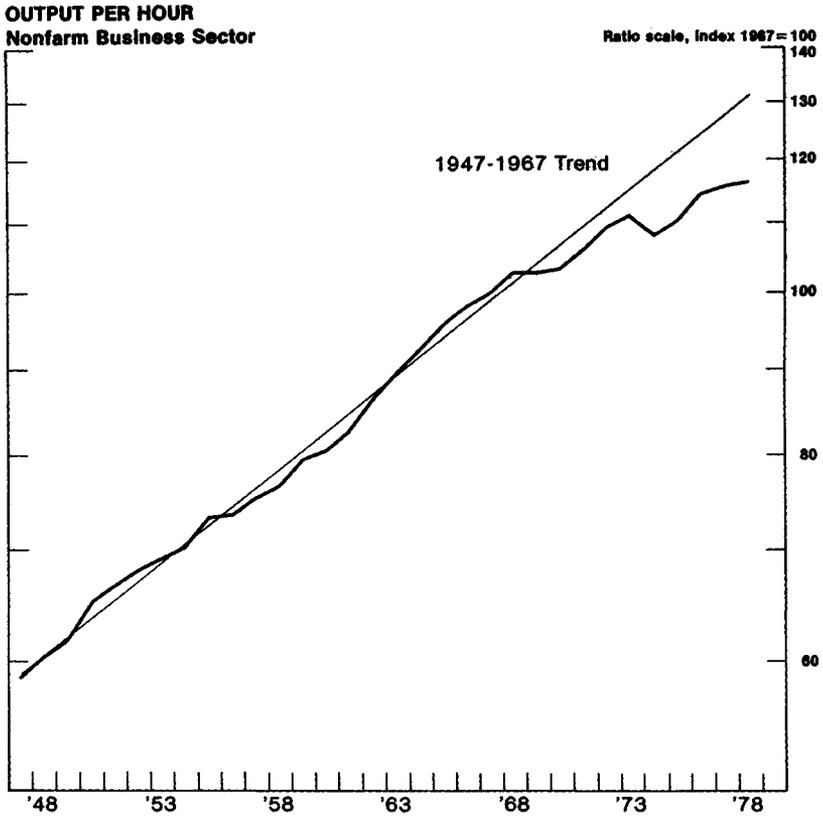
Section 4. Productivity

The 3.5 million increase in payroll employment during 1978 was much larger than would have been expected on the basis of the historical relationships between output changes and labor demand. Although real GNP growth decelerated from 5-1/2 percent in 1977 to 4-1/4 percent in 1978, businesses added to their payrolls at almost the same rate. Output per hour of work rose only slightly over the four quarters of 1978.

Much of the slowdown in productivity growth last year occurred outside the manufacturing sector; output per hour in manufacturing increased 3-1/2 percent during 1978. Normally productivity growth slows as labor markets tighten and capacity constraints are approached, but the fall-off in productivity gains in the past two years has been particularly sharp.

This poor performance of labor productivity continues a trend toward slower growth evident since the late 1960s. During the period from 1947 to 1967, productivity in the nonfarm business sector rose on average by 2-2/3 percent per annum, and accounted for almost 70 percent of the gain in output for this sector. Since 1967, the rise in output per hour has slowed, with average annual gains of only 1.2 percent recorded since 1973. As a result, less than 50 percent of output growth over the last five years can be attributed to gains in efficiency.

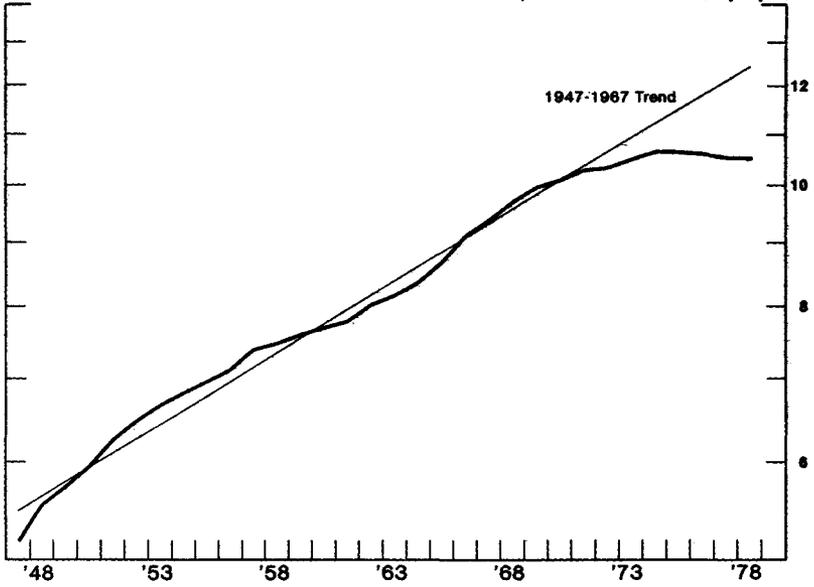
The deterioration of productivity performance in recent years is a complex phenomenon that is not completely understood. It



appears, however, that a crucial factor has been the failure to maintain an adequate rate of capital formation. Indeed, the Nation's stock of capital has shown little growth relative to the size of the labor force over the past decade; in contrast, the capital-labor ratio trended upward rapidly in the preceding 20 years. Other factors that may have contributed to reduced productivity growth in recent years are the influence of environmental and safety regulations that divert resources to uses not measured in the National Income and Product Accounts, and the increase in the proportion of young and inexperienced workers in the labor force.

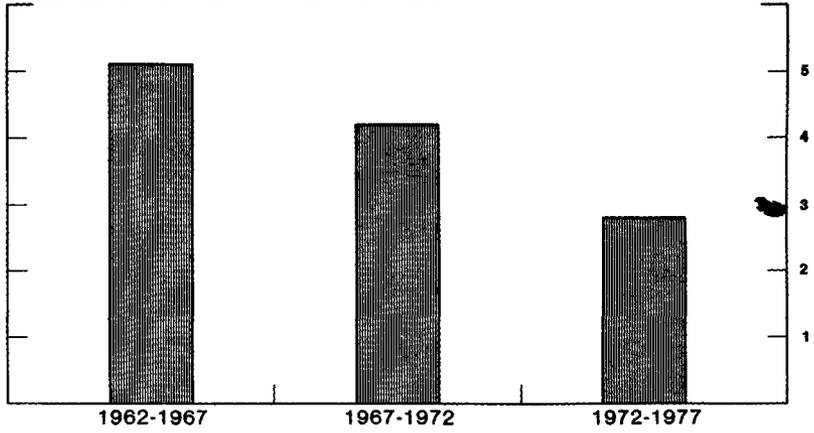
**RATIO OF CAPITAL STOCK
TO LABOR FORCE**

Ratio scale, thousands of 1972 dollars per person



AVERAGE ANNUAL GROWTH OF CAPITAL STOCK*

Percent



*Private nonresidential net capital stock measured in constant dollars

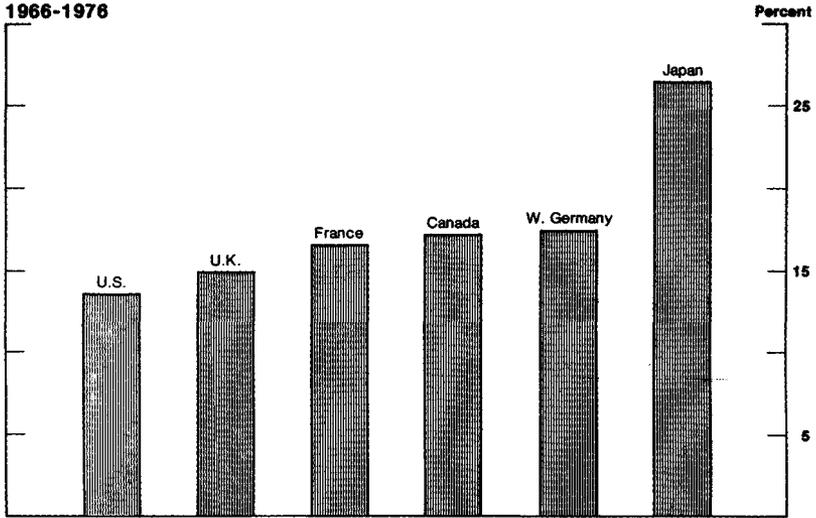
Section 5. Investment

Since the early 1960s, there has been a marked trend toward slower growth of the stock of business capital in the United States. Although real gross business fixed investment last year surpassed the 1973 record, still stronger investment activity will be needed if there is to be a sustained reversal of this trend. In part this merely reflects the arithmetic truth that unchanged absolute amounts of investment translate into declining percentage increases in a growing stock of plant and equipment. Also important, however, is the fact that it is net investment--that is, gross investment less the depreciation of existing capital goods--that adds to the capital stock, and real net investment has yet to reach its previous peak level. Because the fraction of the capital stock in the form of relatively short-lived equipment has been increasing in recent years, a higher level of gross investment is now needed simply to maintain the existing capital stock.

It also must be noted that even the figures for net investment probably overstate the contribution that capital outlays have been making recently to the expansion of productive capacity. A significant share of plant and equipment spending has been undertaken to meet Government pollution, health, and safety regulations. During the past several years roughly 5 percent of total capital spending has been for the purpose of pollution abatement, and some estimates suggest that perhaps an additional 2 percent of investment has been for improvements in health and safety conditions. Although

these outlays may well yield important benefits to society, they do not directly enhance productive capacity.

When an economy is near full employment, the commitment of additional resources to capital formation will require some near-term sacrifice of consumption by individuals or Government. However, there is ample evidence that higher levels of investment effort can enhance long-range economic growth and raise living standards. The increase in U.S. capital spending last year raised the ratio of real gross business fixed investment to GNP to 10.2 percent--the first time since 1974 that it reached the 10 percent level, but still somewhat below the average of the late 1960s and early 1970s. Although international comparisons must be made with caution, owing to differences in accounting and other technical problems, it is clear that other major industrial nations have allocated greater shares of GNP to investment and, as a result, have enjoyed substantially faster increases in productivity and output. While this does not lead to the conclusion that the United States should attempt to achieve the same investment-to-GNP ratios as prevail elsewhere, it tends to confirm the proposition that this Nation would benefit from higher proportions of capital spending to GNP than have been experienced in recent years.

**INTERNATIONAL COMPARISON OF INVESTMENT SHARES *
1966-1976**

* Real nonresidential fixed investment as percent of real gross domestic product; OECD data. Includes Government purchases of capital goods. Data for France cover the period 1970-75.

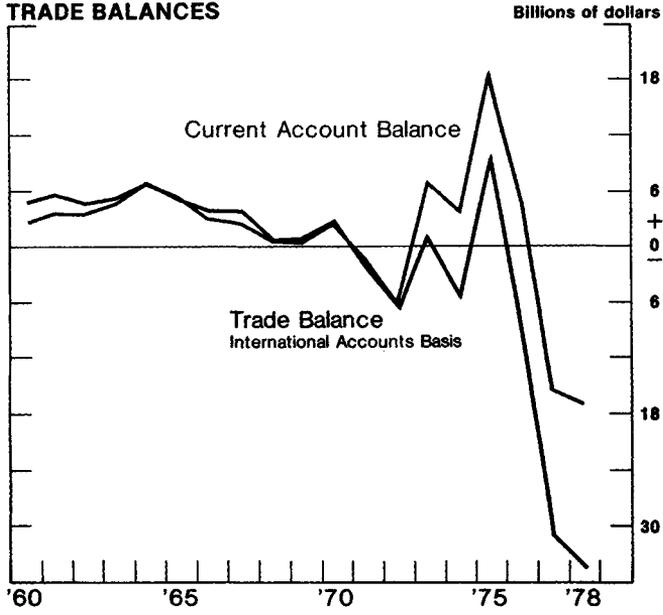
Section 6. International Trade and Payments

From the mid-1960s through the early 1970s, the U.S. merchandise trade balance moved gradually from surplus to deficit. Then, during the 1974-75 worldwide economic slowdown the United States suffered disproportionately sharp contraction, so that--despite an enormous increase in our outlays for imported oil--the U.S. trade balance swung into surplus in 1975. The surplus proved temporary, however; the subsequent economic recovery was stronger here than abroad, and this played a major role in the steep increase of our trade deficit from 1976 through early 1978.

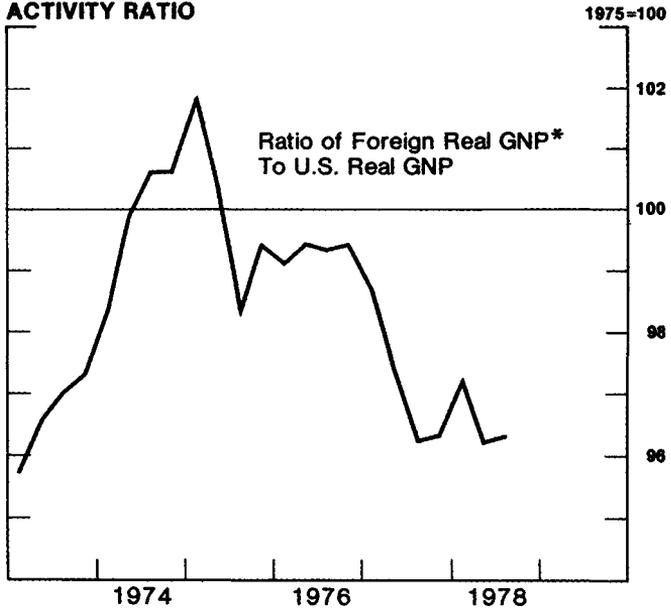
The trade deficit in 1978 was \$34 billion, slightly larger than in 1977. But the deficit peaked at an annual rate of \$45 billion in the first quarter of 1978, and developments in both exports and imports contributed to a narrowing of the imbalance to a rate of about \$30 billion in each of the subsequent quarters.

The growth of exports accelerated in the second quarter. The step-up was partly attributable to temporary causes--for example, demand for U.S. agricultural commodities was stimulated by poor Southern Hemisphere harvests. More important, however, was a strengthening of economic activity abroad and the improved competitiveness of U.S. goods resulting from the substantial depreciation of the U.S. dollar that began in the fall of 1977. The real volume of non-agricultural exports increased 6 percent in 1978, and growth picked up strongly in the second half of the year. Prices of exports increased in line with the general pace of domestic inflation,

U.S. CURRENT ACCOUNT AND TRADE BALANCES



ACTIVITY RATIO



*Weighted average of G-10 countries plus Switzerland using total 1972-1976 average trade of these countries

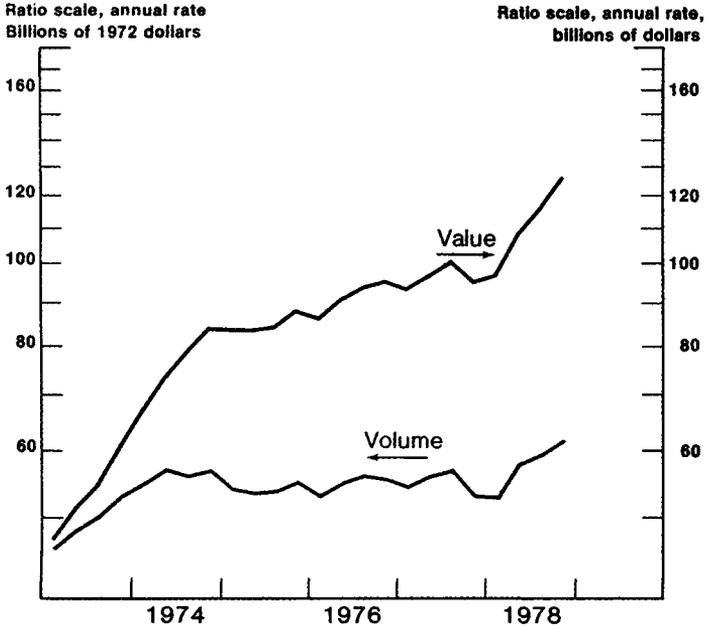
and the total value of merchandise exports rose 17 percent from 1977.

The relatively moderate rise in the volume of imports in 1978, following two years of very large increases, resulted primarily from a slower increase in nonoil imports, but it was reinforced by some decline in petroleum imports. Although total U.S. petroleum consumption is estimated to have increased 3 percent, the higher demand was more than met by increased Alaskan production and by a drawing down of inventories from unusually high levels. The total value of imports increased 16 percent in 1978 with the gain spread over most major commodity categories. Almost half of this increase was in volume terms as imports responded to the continuing strength in U.S. economic activity. Prices of nonoil imports were boosted by the decline in the international value of the dollar.

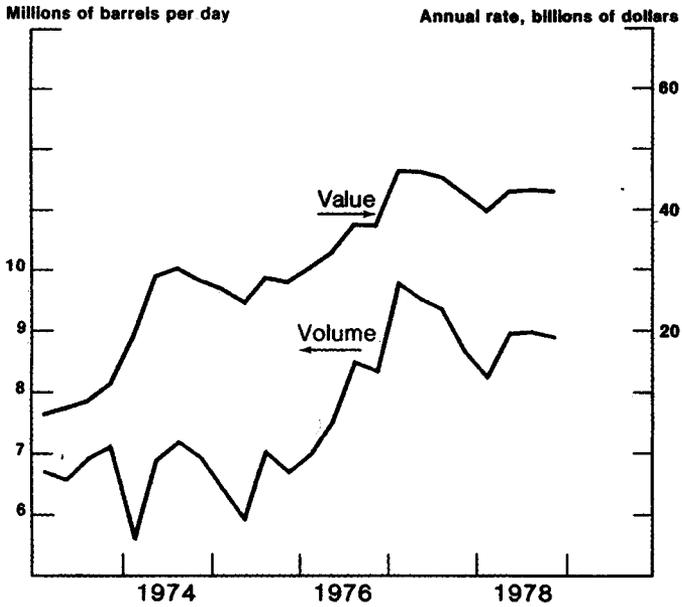
The current account deficit in 1978, estimated at \$17 billion, was slightly larger than in 1977. As in other recent years, net receipts from service transactions provided a substantial offset to the merchandise trade deficit. Earnings, fees, and royalties from foreign direct investments have shown a strong uptrend during the 1970s.

In the period between the onset of generalized floating of currencies in March 1973 and September 1977, the exchange value of the dollar went through several phases of appreciation and depreciation. The average value of the dollar increased sharply (nearly 15 percent) from October 1973 to January 1974, despite large sales of dollars by foreign central banks. Continued large sales of dollars

NON-AGRICULTURAL EXPORTS



OIL IMPORTS

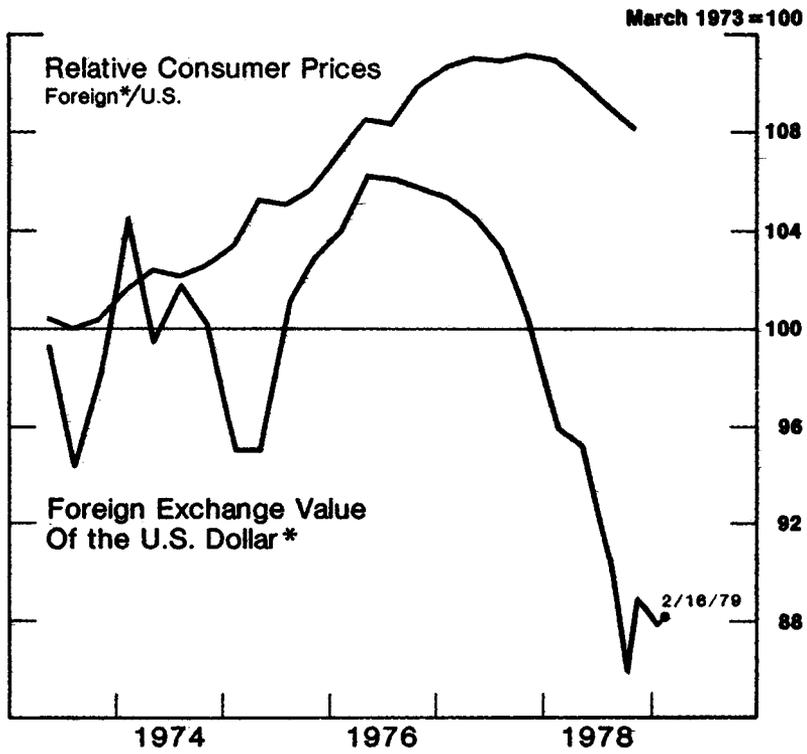


by foreign central banks in 1974, later reinforced by the easing of domestic interest rates associated with the U.S. recession, contributed to a decline in the dollar that began in the first quarter of 1974 and did not end until the spring of 1975. Thereafter, the emergence of a large current-account surplus and a relative firming of U.S. interest rates led to a substantial appreciation of the dollar until the spring of 1976. The dollar subsequently held relatively steady until the fall of 1977.

The dollar began to depreciate markedly against most major foreign currencies in late September 1977 as forecasts for 1978 suggested that the U.S. trade deficit would be no smaller than in 1977. The decline continued through the end of 1977, despite large intervention purchases of dollars by foreign central banks. An announcement in January 1978 that the U.S. Treasury would join the Federal Reserve in exchange market intervention in German marks, followed by an increase in the discount rate, improved market sentiment only temporarily, and by early April the dollar had declined about 10 percent on a weighted-average basis. Between early April and mid-May, a relative firming of U.S. interest rates contributed to a recovery, but the dollar declined fairly steadily thereafter in response to continuing concerns about the size of the U.S. trade deficit and increasing fears that U.S. price performance was deteriorating.

Although some depreciation of the dollar was justified by the need to restore external balance in the face of differential growth rates in the United States and major foreign economies and

U.S. INTERNATIONAL PRICE COMPETITIVENESS



* Weighted average against other G-10 countries plus Switzerland using total 1972-1976 average trade of these countries

a relative worsening of U.S. inflation, by midsummer it was clear that the dollar's decline was becoming excessive in trading that was increasingly disorderly. Consequently, in August the Federal Reserve announced a 1/2 percentage point increase in the discount rate and reduced to zero reserve requirements on borrowings by member banks from the Eurodollar market. The Treasury subsequently announced that it would increase the size of its regular monthly gold auctions. These measures produced a brief rally and then a few weeks of stability for the dollar. However, the dollar's slide soon resumed. After the President announced his wage-price program on October 24, the decline steepened alarmingly, threatening to undercut the anti-inflation effort at home and to lead to further erosion of confidence abroad. By late October, the dollar had fallen 21 percent from its September 1977 level.

Under these circumstances, more forceful action was required. On November 1, the Federal Reserve increased the discount rate by 1 percentage point and imposed a 2 percentage point supplementary reserve requirement on large time deposits. To increase the availability of foreign currencies for exchange market intervention, enlarged swap lines were arranged with the central banks of Germany, Japan, and Switzerland. The U.S. Treasury simultaneously announced its intention to draw on its reserve position in the IMF, to sell SDRs, and to issue foreign currency denominated securities. In addition, the Treasury announced a doubling in its rate of gold sales.

The aim of these measures was to correct the excessive depreciation of the dollar and thereby to counter upward pressures on the domestic price level. When viewed in its entirety, the policy initiative of the Administration and the Federal Reserve System indicated that the United States recognized the need for an integrated approach in addressing domestic and international economic concerns. The announcement of these measures on November 1 produced a dramatic jump in the dollar's exchange value. On that day alone the dollar advanced by 5 percent on a weighted-average basis. Heavy cooperative central bank intervention over the following few weeks provided support for the dollar as market participants tested the authorities' resolve, but the need for such intervention abated in January. As of mid-February of this year, the dollar was more than 7 percent above its October low on a weighted-average basis.

Section 7. Prices

Inflation typically has accelerated over the course of cyclical expansions in economic activity, and this upswing has proven no exception. However, the marked increase in the pace of price advance during the past year was in large measure a consequence of forces not directly related to an intensification of general demand pressures on available productive resources. Government-mandated increases in costs and special developments in the agricultural and international sectors contributed substantially to the pick-up in inflation during 1978.

Inflation moderated during the first stages of the cyclical recovery in 1975 and 1976. The earlier extraordinary pressures associated with the rise in oil prices, the sharp escalation in food prices, a worldwide boom in other commodities, and domestic price decontrol subsided, and the considerable slack in labor and product markets restrained wages and prices. Inflation began to speed up again in 1977, however, and prices then surged in 1978. The Consumer Price Index, the Producer Price Index, and the fixed-weight price index for gross business product all registered increases of around 9 percent during 1978, about 2 percentage points more than in the preceding year.

The acceleration of inflation last year reflected importantly the pressure of rising labor costs. Wage rates in the private nonfarm sector increased 8-1/4 percent, compared with about 7-1/2 percent in each of the preceding two years. A boost in the Federal

minimum wage contributed appreciably to the accelerated rise of wages; the impact was especially noticeable in the trade sector, which has the largest concentration of lower-wage workers and saw average wage increases of more than 9 percent last year.

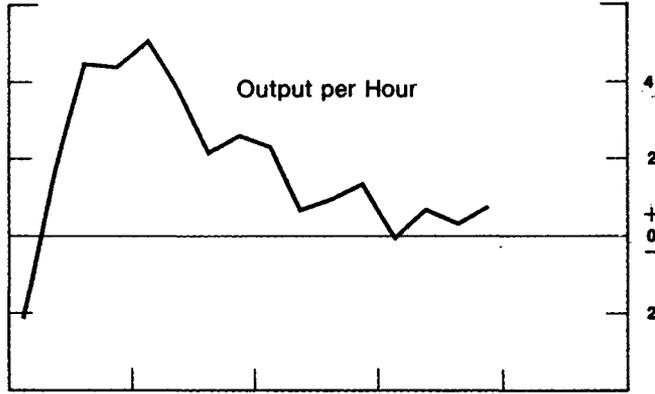
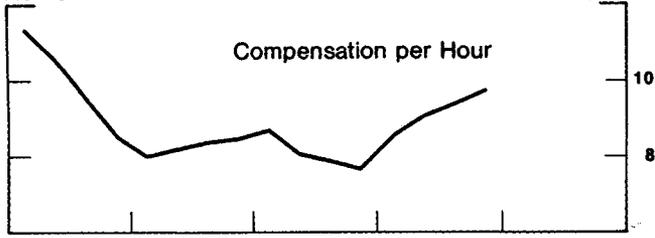
Hourly compensation, which includes, in addition to wages, the costs to employers of social insurance contributions and of privately negotiated fringe benefits, rose 9-3/4 percent--about 2 percentage points faster than in 1977. About one-quarter of the acceleration resulted from increased Social Security taxes and unemployment insurance contributions. In addition, private fringe benefits continued to rise faster than wages.

Given the weak performance of labor productivity, the larger compensation gains were translated into rapid increases in unit labor costs. Unit labor costs in the nonfarm business sector rose 9 percent during 1978 versus 6-1/3 percent in 1977. As 1979 began, labor costs again were given an upward jolt by further increases in the minimum wage and Social Security taxes.

Apart from the broad pressures exerted by rising unit labor costs, the general level of prices was affected considerably in 1978 by developments in the farm and food sector. Retail food prices rose 12 percent over the year--the largest increase since 1974. The increases at the retail level reflected a rise of almost 20 percent in farm prices during 1978 following little change in the preceding year. Meat price increases were particularly rapid, as beef production continued to decline.

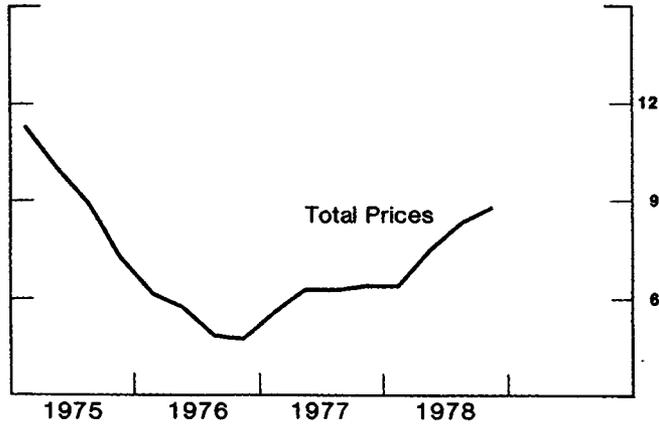
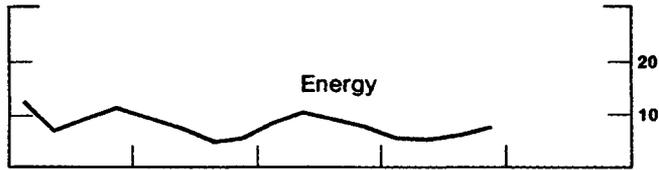
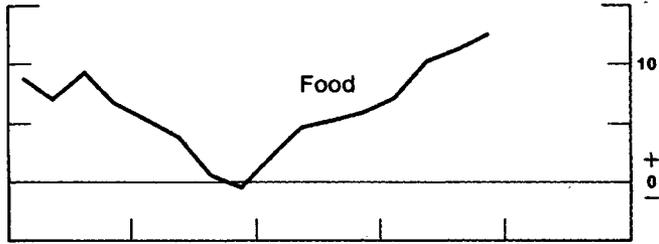
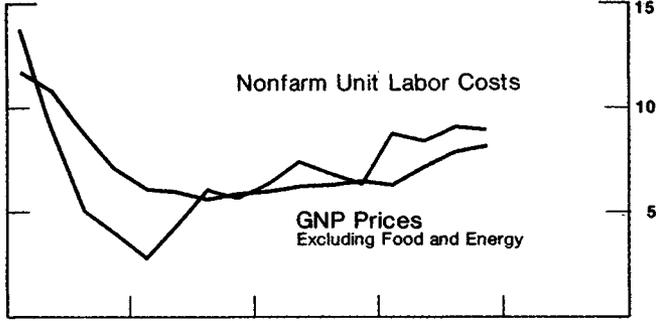
UNIT COST INDICATORS
Nonfarm Business Sector

Change from year earlier,
 annual rate, percent



LABOR COSTS AND PRICES

Change from year earlier,
annual rate, percent



The decline in the foreign exchange value of the dollar also aggravated inflation. Aside from the direct impact of higher prices for imported merchandise, the price-restraining pressure of foreign competition was weakened for many domestic products. Large price increases for domestically produced automobiles and other durable goods reflected both of these effects. The inflationary pressures associated with the steep depreciation of the dollar that began in September 1977 appear to have accounted for about 1 percentage point of last year's rise in the Consumer Price Index.

At the producer level, the inflation of prices of capital equipment accelerated considerably less than that for consumer finished goods. But crude materials prices, for both food and nonfood items, increased sharply, and prices for construction materials also rose rapidly. In the first month of this year the continuing strength of inflationary forces was demonstrated by a 1.3 percent jump in the Producer Price Index; although consumer foods posted an especially large increase, all of the major groupings of finished goods and materials showed accelerated advances.

Section 8. Financial MarketsInterest Rates

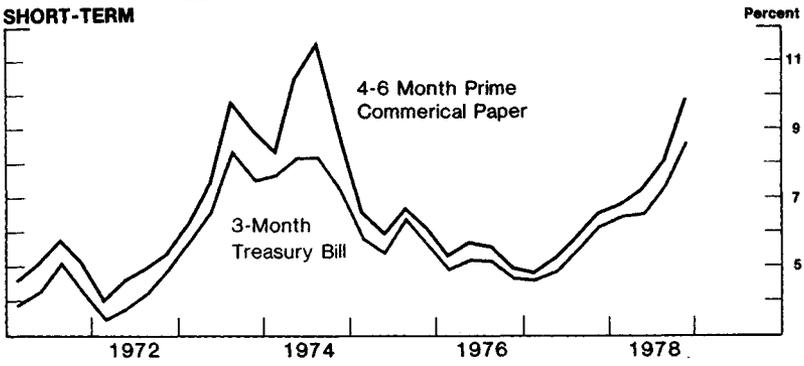
Interest rates generally declined during the early part of the current economic expansion. This departure from usual cyclical patterns probably was attributable in part to a diminution of inflation expectations associated with the observed slowing in the advance of prices and to the limited credit needs of businesses which were pursuing cautious capital spending policies. Interest rates began to move upward in the Spring of 1977, however, as the Federal Reserve acted to restrain accelerating growth in money and credit. Over the course of 1977, yields on short-term market instruments generally rose about 2 percentage points, while corporate and Treasury bond yields increased around 3/4 percentage point.

With inflation picking up, the margin of unutilized resources narrowing, and the dollar under downward pressure in foreign exchange markets, the Federal Reserve applied increasing restraint to the expansion of money and credit in 1978. This was reflected in further increases of 3 to 4 percentage points in most short-term rates over the course of the year. The combination of rising short rates and heightened inflation expectations resulted in increases of roughly 1 percentage point in bond yields. By year-end, a number of interest rates were near or above the peak levels of 1974.

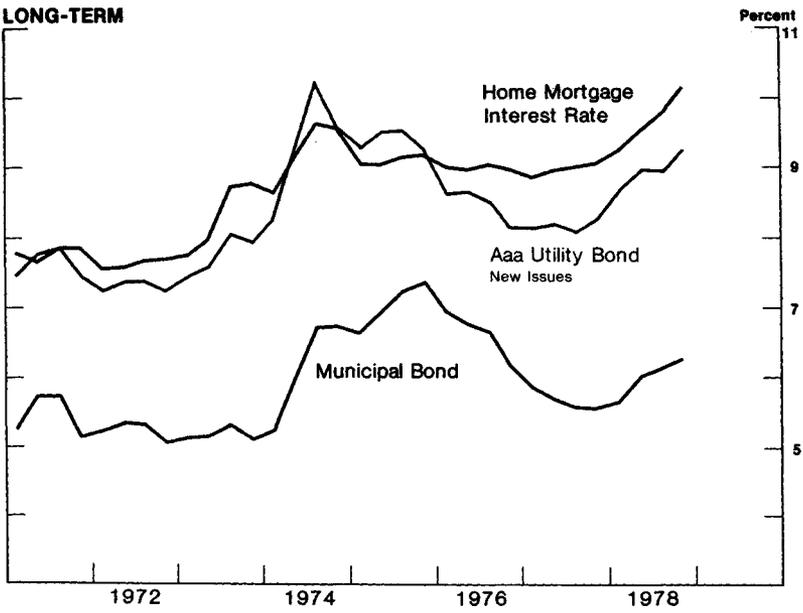
Monetary Aggregates

The monetary aggregates have exhibited some unusual patterns of behavior during the past several years. This has been especially true with respect to the narrow money stock, M-1. During

INTEREST RATES
SHORT-TERM



LONG-TERM



1975 and 1976, growth in M-1 averaged just over 5 percent per annum. Given the concurrent decline in interest rates, the sizable increases in M-1 velocity--that is, the ratio of GNP to M-1--were much larger than would have been predicted on the basis of previous historical relationships among money, income, and interest rates.

The moderation of the public's demand for M-1 may have reflected to a degree an unusually strong cyclical swing in confidence and increased willingness to spend out of existing cash balances as the economy recovered from a severe recession. However, there is also considerable evidence that other factors played an important role. The unprecedentedly high level reached by interest rates in 1974 stimulated the creation and adoption of new cash management techniques that permitted individuals and businesses to economize on nonearning demand deposits. This development apparently continued to exert a significant influence even after interest rates turned downward, and it was reinforced by several important legislative and regulatory developments and innovations affecting the payments system. These included the authorization of NOW accounts in all of New England, of savings accounts for businesses and governmental units, and of preauthorized third party and telephone transfer privileges for personal savings accounts.

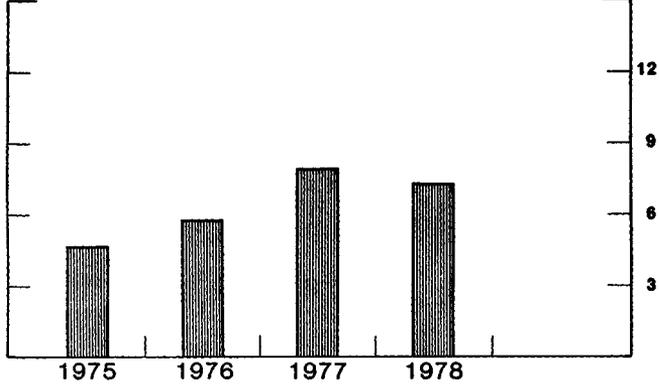
By the beginning of 1977, the level of M-1 was well below that predicted by most standard econometric models of the demand for money. This downward shift in money demand abated in early 1977, however, and growth of M-1 generally conformed to historical patterns until the final months of 1978. M-1 expanded 8 percent during

1977 and at about the same pace over the first three quarters of 1978; rising interest rates and slowing economic expansion worked to moderate M-1 growth over this span, but these influences were offset by the effect of accelerating inflation on transactions requirements.

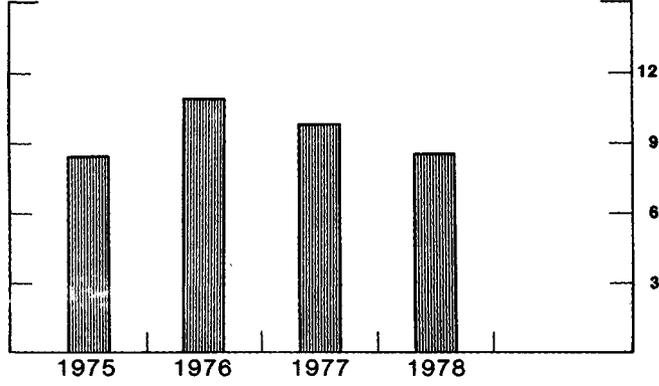
On a quarterly average basis M-1 growth in the fourth quarter of 1978 was at a 4.4 percent annual rate, but the average level of the money stock in January was slightly below that for October. A portion of this weakness is the direct consequence of the introduction of automatic transfer services (ATS) last November 1; many individuals have shifted their transactions balances from checking accounts to savings accounts from which funds are automatically transferred to cover checks. These shifts appear to have reduced M-1 growth rates by roughly 3 percentage points per month, on average. Even after allowance for this, however, growth in M-1 has been weaker than might have been expected in light of the recent expansion of income and spending. It may be that, as in 1974, interest rates have reached a high threshold level at which households and businesses are induced to seek out and adopt cash management techniques that permit major economies in demand deposit holdings. The advent of ATS--which occasioned basic changes in the checking account pricing policies of many banks--undoubtedly has caused many individuals to assess more carefully the opportunity costs of holding noninterest-earning demand deposit balances as compared not only with ATS accounts but also with other highly liquid interest-earning assets.

MONEY SUPPLY GROWTH

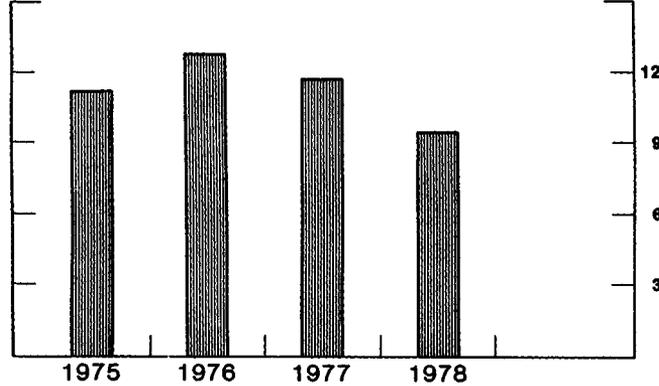
M-1 Change from previous period, annual rate, percent



M-2



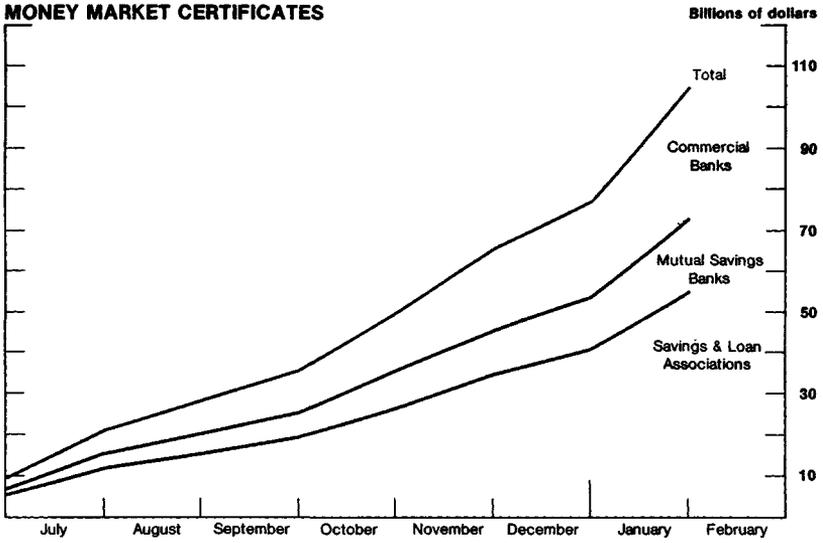
M-3



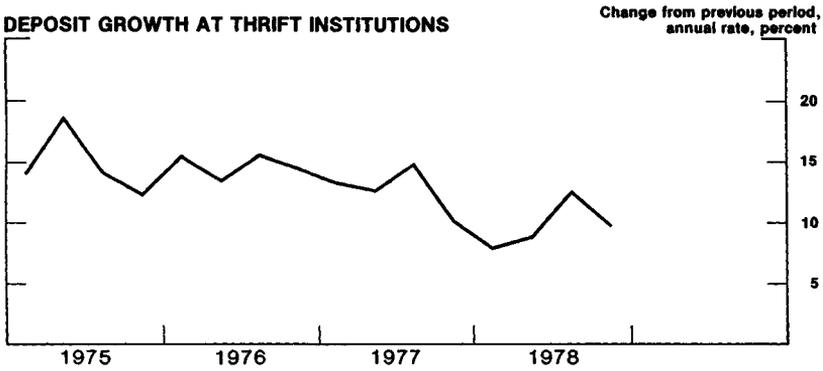
The behavior of the interest-bearing components of the broader monetary aggregates--M-2 and M-3--was generally in line with historical patterns during the first three years of the economic upswing, but there has been a marked deviation since last June. Commercial banks and thrift institutions experienced rapid growth of savings and small denomination time deposits until the latter part of 1977. At that point a gap began to develop between interest rates on short- and intermediate-term market securities and the rates permitted on insured deposits by Federal regulations. As the gap grew, inflows to savings and small time accounts gradually diminished through the spring of 1978. Commercial banks found it necessary to rely more heavily during this period on large time deposits and other managed liabilities to fund their lending activities, and savings and loan associations borrowed heavily from Federal Home Loan Banks.

To prevent a repetition of past episodes when markedly reduced deposit inflows led to an abrupt curtailment of credit to home buyers and others reliant on the depository institutions for credit, the Federal regulatory agencies authorized two new time deposit categories effective June 1. One was an 8-year account paying up to 7-3/4 percent at commercial banks and 8 percent at thrift institutions. The other was a 6-month "money market certificate" (MMC) whose maximum rate varies weekly with the average yield on newly issued 6-month Treasury bills. Given rate relationships, the 8-year certificate has not added significantly to over-all

OUTSTANDING BALANCES OF MONEY MARKET CERTIFICATES



DEPOSIT GROWTH AT THRIFT INSTITUTIONS



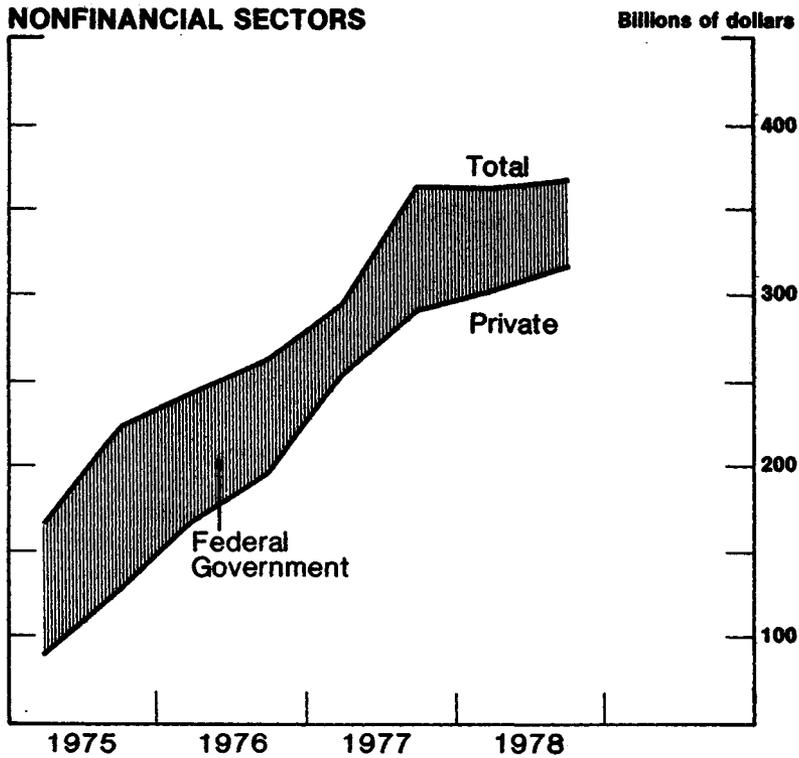
deposit flows, but quite the contrary is true of the MMCs. During the first 5 months of 1978, time and savings deposits subject to rate ceilings at commercial banks, savings and loan associations, and mutual banks grew at a 7.9 percent annual rate; since the beginning of June, these deposits have grown at a 10.3 percent rate despite substantial further increases in market interest rates. MMC balances at the end of January totaled about \$105 billion and accounted for 7-3/4 percent of savings and small time deposits at banks and almost 13 percent at thrift institutions.

The MMCs have greatly reduced the sensitivity of time and savings deposit growth to changes in market interest rates, but they have not eliminated it. Indeed, inflows have moderated during the past few months, at least partly in response to the substantial further rise in interest rates. Increased noncompetitive tenders in auctions of Treasury securities and record growth of money market mutual funds are indications that recent interest rate levels have been inducing some diversion of funds from savings and small time accounts subject to fixed rate ceilings.

Credit Flows

Although accelerating inflation has tended to dampen the impact of rising nominal interest rates on credit demands, there has been a perceptible flattening of the over-all pace of borrowing in the economy over the past year. Total funds raised in credit markets by the private domestic nonfinancial sectors have expanded only moderately

FUNDS RAISED BY DOMESTIC NONFINANCIAL SECTORS



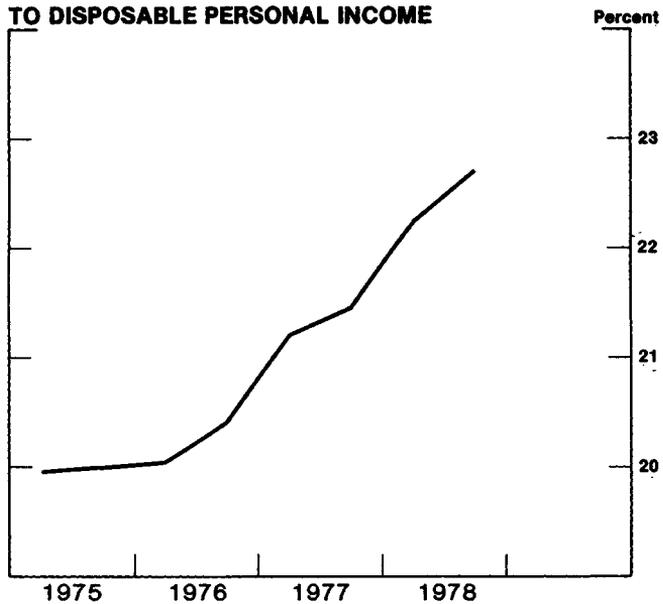
since the second half of 1977 after having risen rapidly during the earlier part of the economic expansion. Although the liquidity of depository institutions has declined over the past two years, the introduction of the MMC has prevented the disintermediation that accompanied previous interest rate cycles and permitted banks and thrift institutions to continue to account for a very large share of the funds advanced to ultimate borrowers.

Households, in particular, are heavily reliant on depository institutions for credit, and their demands for funds have remained strong. Home mortgage borrowing in 1978 was slightly larger than in 1977, and consumer instalment borrowing rose to a new record as households financed purchases of autos and other large ticket items. The aggregate flow of credit to households in 1978, at more than \$160 billion, was 15 percent greater than in 1977 and three times the volume recorded in 1975.

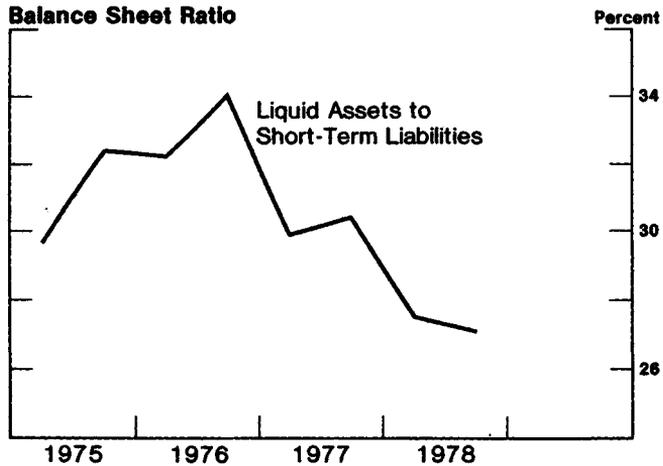
The build-up of indebtedness by households over the last three years has outstripped both the growth of this sector's financial asset holdings and of disposable income. Repayment burdens have reached record proportions. Although loan delinquency data indicate that families have not as yet encountered significant difficulty in meeting their obligations for debt service, the diminished liquidity of household financial positions suggests a greater fragility and vulnerability to any deterioration of income flows.

The nonfinancial business sector also experienced some decline in liquidity in the past year. The gap between corporate capital spending and internal cash flow widened, and firms met

HOUSEHOLD DEBT REPAYMENTS RELATIVE TO DISPOSABLE PERSONAL INCOME



**NONFINANCIAL CORPORATIONS
Balance Sheet Ratio**



a substantial portion of their external financing needs through short-term borrowings--particularly from commercial banks. While commercial mortgage borrowing increased and private bond placements remained large, many of the big, highly rated industrial firms that have ready access to the public bond markets evidently preferred to defer long-term financings in the expectation that long-term rates would eventually decline. As a consequence, the aggregate ratio of liquid assets to short-term liabilities in the nonfinancial corporate sector declined over the course of 1978, to a level only slightly above the 1974 low.

State and local borrowing was about the same in 1978 as in 1977. Advance refundings again accounted for a sizable share of tax-exempt bond issuance, but such operations virtually ceased after August owing to the combination of restrictive IRS regulations and rising interest rates. Despite some rise in the past few months, the ratio of yields on municipal bonds to those on taxable obligations has remained relatively low by historical standards, reflecting in part the continued demand for tax-exempt securities by casualty insurance companies, commercial banks, and individuals.

Borrowing by the U.S. Treasury has declined over the past year, reflecting the diminution of the Federal budget deficit. Government borrowing from the public totaled \$59 billion in FY 1978, but is projected by the Administration at about \$40 billion in the current fiscal year. The preponderance of the increase in outstanding Treasury debt during 1978 was absorbed by State and local governments, which purchased a large volume of nonmarketable Treasury securities with

proceeds of advance refundings, and by foreign official institutions, which invested dollars obtained in exchange market intervention.

Commercial banks satisfied a substantial proportion of the credit demands of households, businesses, and State and local governments during 1978. Total bank credit expanded 10.9 percent over the course of the year, with loan portfolios increasing by 14.6 percent. To meet loan demands many banks had to liquidate holdings of Treasury securities and to borrow either from correspondents or in the open market through the issuance of large CDs or nondeposit liabilities such as Federal funds and repurchase agreements. Aggregate bank liquidity ratios declined appreciably, especially among the smaller and regional institutions that have experienced the strongest business loan growth during this expansion.

Thrift institutions experienced considerable cash flow pressure during the first half of 1978, but they have been able to rebuild their liquid asset positions since the MMCs began to bolster deposit growth. Thrift institution mortgage lending declined moderately during 1978, although there was some upturn in the final quarter in lagged reaction to the midyear pick-up in deposit inflows. Outstanding loan commitments also rose during the second half, but in December were slightly below the year-earlier level.

Life insurance companies and pension funds have continued to experience large inflows of investable funds. In 1978, as in previous years of the economic expansion, these institutions absorbed

the bulk of the net issuance of corporate bonds. The insurance companies also have supplied a large share of commercial mortgage credit.

CHAPTER 2

"the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

Section 1. The Objective of Monetary Policy in 1979

The objective of the Federal Reserve is to foster financial conditions conducive to a continued, but more moderate, economic expansion during 1979 that should permit a gradual winding down of inflation and the maintenance of the stronger position of the dollar in international exchange markets. Given the limited margin of unutilized labor and industrial resources remaining in the economy, it is critically important to avoid strong aggregate demand pressures that would aggravate our already serious inflation problem. At the same time, the current condition of general balance in the economy suggests that it should be possible to continue restraint to relieve inflationary pressures without triggering a recession.

Section 2. Growth of Money and Credit in 1979

The Federal Open Market Committee has selected growth ranges for the monetary aggregates that it believes will bring to bear an appropriate degree of restraint in light of current outlook for fiscal policy and the underlying strength of private demand in the economy. Over the year ending with the fourth quarter of 1979, M-1 is expected to grow between 1-1/2 and 4-1/2 percent; M-2, 5 to 8 percent; and M-3, 6 to 9 percent. Commercial bank credit has been projected to increase between 7-1/2 and 10-1/2 percent during the year.

The growth range for M-1 calls for a marked deceleration from the pace of recent years. This reflects in part an expectation that the shifting of funds to savings accounts with automatic transfer facilities and to the NOW accounts recently authorized in New York State will continue to depress the growth of demand deposits throughout 1979. The Board's staff has projected that such shifting will damp growth in M-1 this year by around 3 percentage points. Because there has been only a brief period of experience upon which to base an analysis of the attractiveness of the ATS accounts, this projection carries a broad range of uncertainty.

The unexplained flatness of M-1 in recent months introduced another uncertainty in the FOMC's deliberations regarding the monetary growth ranges. At this stage it is impossible to tell whether the weakness of M-1 relative to what would have been expected on the basis of historical relationships among money, income, and interest rates is a transitory phenomenon or one that is likely to persist for some time. The range for M-1 assumes that the recent

weakness does in some degree reflect a change in the public's desired allocation of funds among various financial assets that may persist for some time ahead, though not so strongly as in recent months.

The breadth of the specified growth range for M-1 recognizes the considerable uncertainties that currently exist. As subsequent information begins to resolve those uncertainties, the range may be adjusted. In the meantime, M-1 may continue to be a somewhat ambiguous indicator of monetary policy, and it will be especially important to monitor carefully the behavior of other financial variables.

It may be noted that the Federal Reserve is studying possible redefinitions of the monetary aggregates. Among the proposals made in a staff paper published for public comment in the January Federal Reserve Bulletin is that M-1 be redefined to encompass ATS, NOW, and other similar transactional accounts. While such a redefinition would not eliminate the need to understand the behavior of the various financial assets, it might produce an aggregate that is more reflective of the public's need for transactions balances in light of ongoing institutional changes.

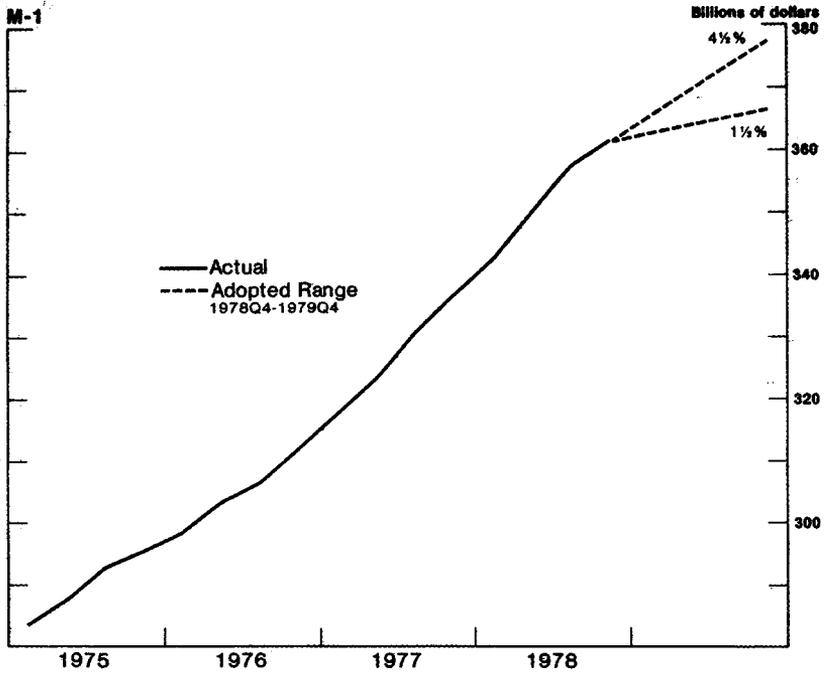
The behavior of M-1 was not the only puzzling development confronting the FOMC early this month as it considered the appropriate ranges for monetary growth during 1979. There were questions as well regarding the movements of the interest-bearing components of the broader aggregates--especially the time and savings deposits at commercial banks that, along with M-1, constitute M-2. Bank savings

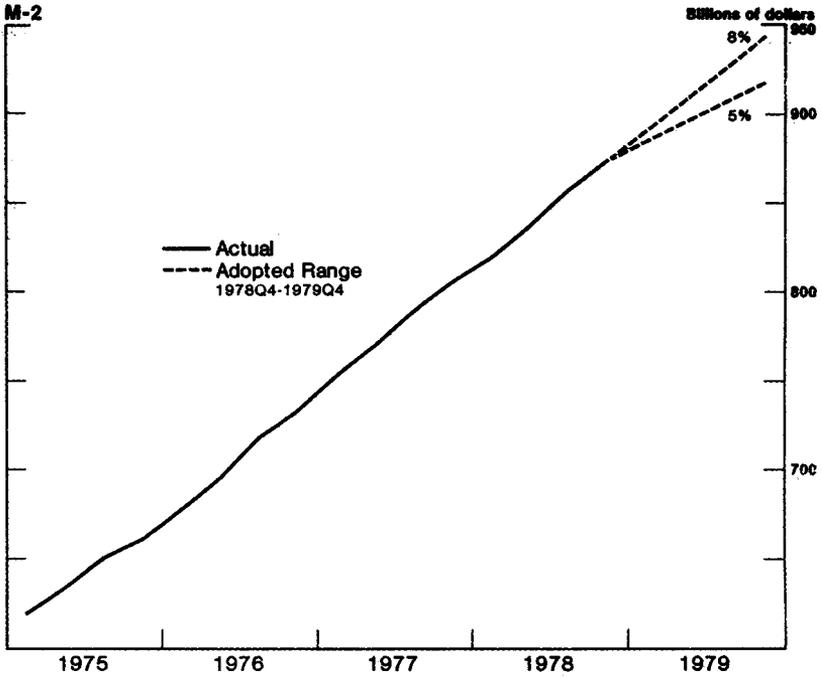
deposits have declined appreciably in the past few months, despite the influx of funds to ATS savings accounts. While savings deposit inflows might be expected to exhibit weakness when market interest rates are so far above regulatory ceilings, a large gap had existed for a considerable time and it might have been expected that most of the interest-sensitive funds had already moved into other instruments. It is possible, however, that--as perhaps with demand deposits--the recent further sharp increase in interest rates to historically high levels has prompted many people to seek out more aggressively alternative assets carrying market yields. The M-2 range adopted by the FOMC reflects an expectation that growth of the interest-bearing component will be somewhat stronger in the months ahead, buttressed by further sizable increases in the large denomination time deposits included in the total and abatement of the recent unusually large withdrawals of funds from savings deposits.

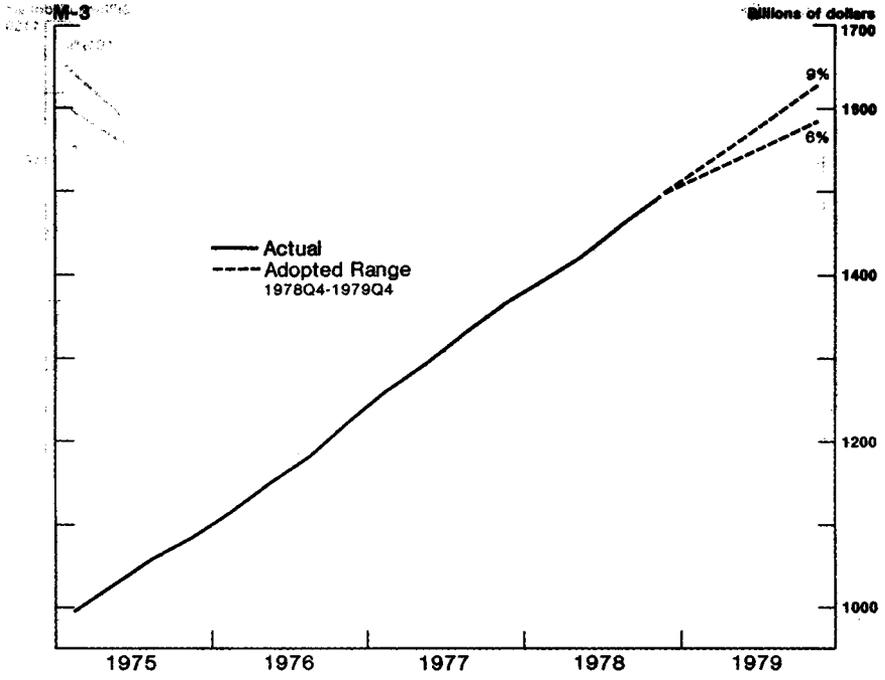
The range for M-3 implies a continued substantial growth of deposits at nonbank thrift institutions. The money market certificates have proven a reliable source of funds. While some institutions have reduced their promotion of MMCs, the certificates have continued to be widely offered at ceiling rates--although there has been some erosion of thrift institution earnings since mid-1978 as these relatively high cost deposits have taken a growing share of thrift institution liabilities.

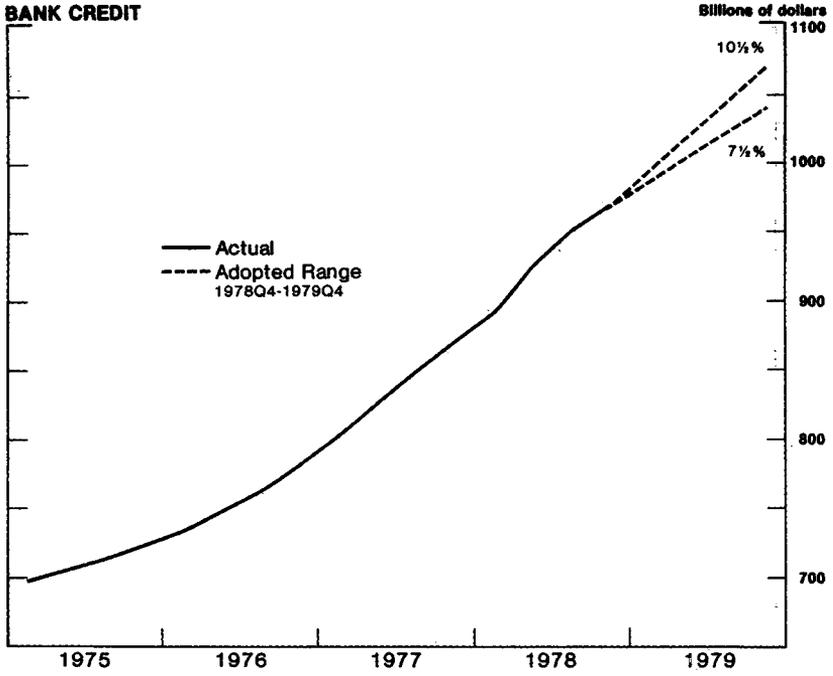
The projected range for bank credit expansion reflects an expectation that loan demands will be less intense in 1979 than in 1978, in line with the prospective more moderate growth of economic

activity. Banks likely will have to continue relying heavily on large time deposits and other money market liabilities to fund asset growth, and this implies some further decline in traditional measures of institutional liquidity.









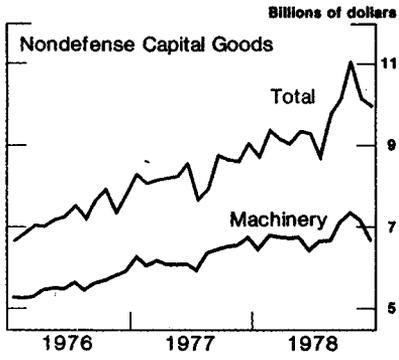
Section 3. The Economic Outlook

Despite the surge in real GNP during the fourth quarter, it appears that underlying economic and financial conditions will lead to a moderation of economic growth in the year ahead. The absence of the sorts of distortions and imbalances that have often precipitated economic downturns in the past indicates that it should be possible to slow the pace of expansion--and thereby relieve inflationary pressures--without prompting a recession. However, any further acceleration of inflation or the occurrence of severe shortages of critical commodities, such as oil, would imperil this outcome.

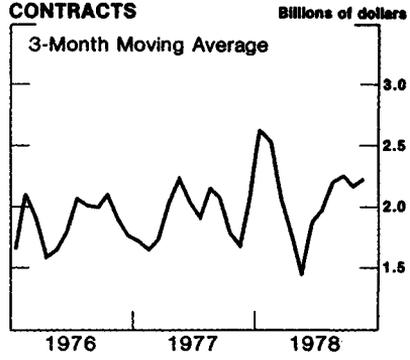
The monetary restraint applied over the past year by the Federal Reserve is expected increasingly to affect the residential construction sector. Higher costs of credit will cause land developers and builders to put aside marginally profitable projects, and the combination of higher house prices and mortgage rates will lead some families to defer home purchase. Nonetheless, owing to the MMCs and various institutional developments that have broadened the sources of mortgage funds, as well as to the strong underlying demand for shelter, the decline in housing activity should be moderate by comparison with past cycles.

Business fixed investment likely will continue to grow during 1979, but at a slower rate than in 1978. There has been some indication in the past few months of a slowing in the steep upward trend of contracts and orders for plant and equipment, and this is generally consistent with surveys of capital spending plans which

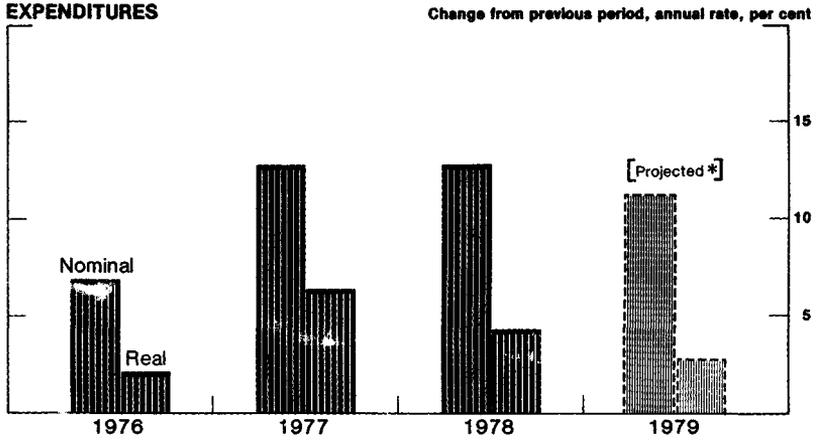
REAL NEW ORDERS



REAL CONSTRUCTION CONTRACTS



PLANT AND EQUIPMENT EXPENDITURES



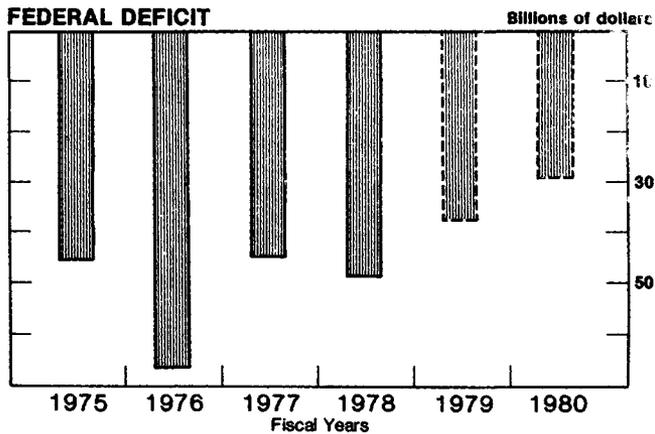
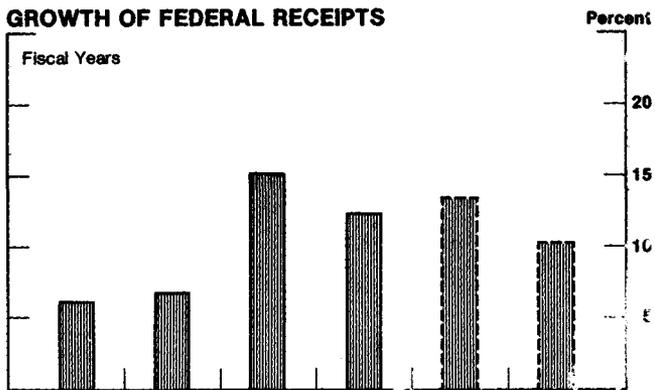
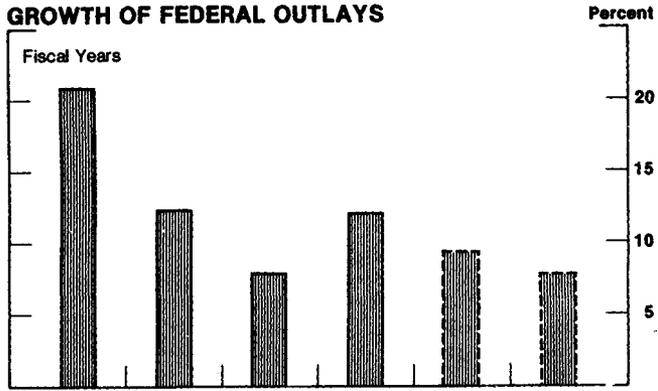
* Department of Commerce Survey of Anticipated Plant and Equipment Expenditures, December, 1978.

point to smaller gains in outlays this year than last. On the other hand, the climate for investment can be expected to improve as business managers begin to perceive some progress in retarding inflation and become more confident about the sustainability of expansion.

Government spending probably will post only a small increase in real terms this year. Indeed, real Federal purchases could decline during the first half due partly to expected repayments of Commodity Credit Corporation loans (which are, in effect, sales of agricultural stocks). At the State and local level, slower growth of Federal financial aid and the pressure for tax relief will tend to hold spending increases to small proportions.

Foreign demand for U.S. exports should tend to strengthen during 1979. Economic expansion abroad is generally expected to continue at its recent more rapid pace, and the effects of the substantial depreciation of the dollar on the U.S. trade position should become more evident as the year progresses.

On balance, the aforementioned sectors are likely to provide a reduced impetus to income growth during the year ahead. As a consequence, consumer spending is likely to grow less vigorously. Moreover, the substantial debt repayment burdens faced by many households and generally reduced liquidity of the household sector could prompt households to increase their recent relatively low savings rate. The demand for imports also should moderate this year, not only because of the slower expansion of domestic income and production, but also because of the lagged effects of the 1977-1978 decline



Note: Projections for 1979 and 1980 are from The Budget of the U.S. Government.

in the international exchange value of the dollar. Inventory investment is likely to be relatively flat in the projected economic environment.

With a slower growth of activity, pressures on productive capacity should ease a bit. Industrial capacity utilization rates, which in the manufacturing sector are not now far below past cyclical peaks, should decline slightly. In labor markets, the growth of employment should moderate from its recent rapid pace. Labor force increases likely also will diminish, as the growth of the working age population slows slightly and as labor force participation rates--especially for youth--respond to the slackening in economic expansion. Together, the prospective changes in employment and the labor force point to a small increase in the over-all unemployment rate during 1979.

The moderation of demand pressures in labor and product markets will tend to slow the advance of wages and prices and thus to reduce the present, unacceptable rate of inflation. However, uncertainties will remain as a result of highly volatile and largely exogenous influences such as farm prices and oil prices. It now appears that food prices will increase somewhat less this year than last. Unfortunately, the price of imported oil will be boosted substantially this year as a result of the decisions taken by OPEC in December, and the unsettled situation in Iran raises the possibility of even larger price increases.

Setting aside these special factors, a key determinant of the rate of inflation this year will be the performance of unit labor

costs. Although there may well be some improvement in productivity in the next few years as the work force tends to become, on average, somewhat older and more experienced, there is little reason to expect any marked acceleration of productivity growth during 1979. Consequently, if there is to be a noticeable slowing in the rise of unit labor costs, compensation gains will have to moderate significantly.

Toward this end, the Administration's wage-price program can play an important role. By providing a standard for constructive behavior on the parts of both business and labor, the program can be a vehicle for helping to brake the wage-price spiral. Broad compliance with the Administration's standards would make a significant contribution to the slowing of inflation. Of course, the wage-price program can be successful only if there is complementary restraint in monetary and fiscal policy--to contain aggregate demand pressures and to assure the public of the Government's commitment to the restoration of price stability.

CHAPTER 3

"the relationship of the [Federal Reserve's] objectives
and plans to the short-term goals set forth in the most
recent Economic Report of the President"

Section 108(a) Full Employment and
Balanced Growth Act of 1978

Section 1. The Short-Term Goals in the
Economic Report of the President

As specified by the Full Employment and Balanced Growth Act, the President's Economic Report, transmitted to the Congress last month, lays out a detailed set of economic goals for 1979 and 1980. The discussion of the Act's requirements points out that the Administration's "short-term goals for [1979] and 1980 represent a forecast of how the economy will respond over the next 2 years not only to the budgetary policies proposed by the President for fiscal 1979 and 1980 but to the anti-inflation program announced on October 24."^{1/}

The Administration's goals, along with the comparable figures for 1978, are summarized in the following table:

The President's Economic Goals			
Item	1978	1979	1980
	Level, fourth quarter		
Employment (millions)	95.6	97.5	99.5
Unemployment rate (percent)	5.8	6.2	6.2
	Percentage change, fourth quarter to fourth quarter		
Consumer prices	8.9	7.5	6.4
Real GNP	4.3	2.2	3.2
Real disposable income	3.3	2.8	2.3
Productivity	0.2	0.4	1.1

^{1/} Economic Report of the President, p. 108.

Section 2. The Relationship of the Federal Reserve's
Monetary Growth Ranges to the Short-Term Goals in
The Economic Report

The Full Employment and Balanced Growth Act directs the Federal Reserve to assess the relationship of its plans for monetary growth to the short-term goals in the Economic Report. This task is complicated by the fact that goals are specified for a variety of economic variables, and monetary policy does not affect each of them separately. Monetary policy has its most direct short-term impact on aggregate nominal GNP. Within the context of a particular nominal GNP outcome, the mix of real output gains and inflation, the growth of employment, and the movements in other variables are influenced importantly by conditions at the beginning of the period, by other governmental policies, by the structural and behavioral relationships in the economy, and by developments outside the domestic economy.

As required by the Full Employment and Balanced Growth Act, the Federal Reserve at this time has established ranges for monetary growth through the end of 1979. It will reassess these and report preliminary ranges for 1980 in July, unless developments in the months ahead necessitate earlier reconsideration. At this juncture, the monetary growth ranges and the Administration's 1979 economic goals appear reasonably consistent. The Administration's forecast implies an expansion in nominal GNP of around 9-3/4 percent from the fourth quarter of 1978 to the fourth quarter of 1979. The midpoint of the FOMC's growth range for M-1 is about 6 percent after adjustment for the expected impact of shifts of funds to ATS and NOW accounts.

This suggests an increase of M-1 velocity on the order of 3-1/2 percent, a figure somewhat above the longer-term trend, but reasonable in light of the lagged effects of the recent substantial increases in interest rates and the downward shift in money demand that has been occurring. The upper and lower boundaries of the M-1 range, of course, allow for the possibility of smaller or faster increases in velocity over the year.

The output-price mix in the Administration's 1979 forecast appears attainable if there is reasonable compliance with the wage-price standards and as long as there are no untoward shocks such as an unanticipated surge in food or energy prices. The employment and productivity forecasts appear consistent with the output goal, and the unemployment rate forecast seems consistent with reasonable assumptions about labor force growth in the projected economic environment.

Considerably greater uncertainties naturally are encountered with respect to the Administration's goals for 1980, a period that is still rather distant. Nothing in the monetary or economic projections for 1979 suggests to us that conditions prevailing at yearend will bar the achievement of the Administration's forecasted 9-1/2 percent growth in nominal GNP during 1980. At this time, however, the achievement of the output-price mix projected for 1980 appears to be more difficult.

The Administration has forecast a marked acceleration of real GNP growth in 1980 and a marked deceleration of inflation. Such an outcome is certainly attainable, but given the projected levels

of resource utilization--with the unemployment rate remaining around 6-1/4 percent--this result will require considerable progress in the lowering of inflation expectations. There will have to be broad conformance to the Administration's wage-price standards, and Government will have to give careful attention to the potential cost-raising impacts of its regulatory and legislative actions. Continued budgetary restraint also will be necessary, both to build confidence in the Government's commitment to avoid fiscal excesses and to minimize pressures on the capital markets.

Recognizing the risks and uncertainties that currently exist, the Administration's 1980 forecast can serve as an appropriate goal for Congress as it considers its budgetary plan for fiscal 1980. If inflationary pressures subsequently should prove stronger than the Administration has projected, then the prudent course for Government policy would be to exercise a substantial degree of restraint even if it risks less real growth in 1980 than the 3.2 percent goal. Such a policy would lay the foundation for balanced economic growth over the years to come and help to maintain the integrity of the dollar.

The CHAIRMAN. Thank you, Mr. Miller, for an admirable report. We will now examine under the 5-minute rule.

My first question concerns your discussion of the money supply in terms of the domestic aggregates. What are the potential consequences on monetary policy of massive shifts into this country of some of the \$700 billion floating around Europe and the Caribbean? What does the Federal Reserve do to monitor this, and what would it do to offset the inflationary effects of large-scale redeployments of dollars domestically?

Mr. MILLER. Mr. Chairman, should there be a large shift from those markets into domestic markets, the Federal Reserve would respond through the open market by absorbing excess resources and endeavoring to maintain the growth rates that we have indicated in our objectives for the year.

I would expect that if there is a shift of dollars into this country, that that would be advantageous to us long term.

As you know, the Eurodollar market generally represents deposits in the form of CD's. If that money should shift here, it would really not have an effect on M_1 or M_2 as much as it would involve some bank credit; we certainly would have to take countermeasures.

The CHAIRMAN. You say you would endeavor to sop up the shift by open market policy. Would not the possibility of using your reserve power, assuming you are left with one, also be useful?

Mr. MILLER. It could well be.

The CHAIRMAN. If there were really a massive shift?

Mr. MILLER. I think we could well have to look at reserve policy, as well as at the open market.

[Subsequent to the above colloquy, the following correspondence was exchanged between Congressman Ron Paul and Chairman G. William Miller:]

Congress of the United States
House of Representatives
Washington, D.C. 20515

February 22, 1979

Mr. William E. Miller
Chairman, Federal Reserve Board
of Governors
Federal Reserve System
Twentieth Street and Constitution
Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Miller:

For the record, would you answer one question raised by your testimony before the House Banking Committee on Wednesday, February 21?

In your reply to Chairman Reuss's question about the \$700 billion Eurodollar market, you first stated that if substantial numbers of Eurodollars were to enter the United States, the Fed would act through the Open Market Committee to "sop up" the excess dollars. Then, after some hesitation, you replied further that such an inflow of dollars would be "advantageous" to us. Would you clarify your answer?

Thank you very much for your cooperation.

Sincerely,

Ron Paul
Ron Paul, M.C.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

G. WILLIAM MILLER
CHAIRMAN

March 9, 1979

The Honorable Ron Paul
House of Representatives
Washington, D.C. 20515

Dear Mr. Paul:

Thanks for your recent request for further elaboration of my reply to Chairman Reuss' question on February 21 about the potential consequences for monetary policy of shifts into the United States of deposits now held in the Euro-dollar market.

A shift of deposits from the Euro-dollar market to the domestic offices of U.S. banks would probably take the form of an increase in large certificates of deposit issued by U.S. banks and would probably be accompanied by a corresponding shift on the asset side of banks' balance sheets. Such shifts could lead to conflicting signals regarding the appropriate stance of U.S. monetary policy. These signals would have to be assessed carefully. The Federal Reserve's response would, of course, depend on the rate of inflation, the level of economic activity, and the conditions of financial markets at the time the shifts occurred.

If these shifts led to inappropriate increases in the rates of growth of the monetary aggregates or bank credit, the Federal Reserve would take action to offset these effects. For example, loans booked at domestic banks would tend to increase as a consequence of a shift of Euro-dollar deposits to U.S. banks while Euro-dollar loans booked at banks abroad would decrease. The total amount of dollar loans would remain roughly unchanged. The need for action by the Federal Reserve under such circumstances would depend, in part, on the proportion of the total that consisted of loans to domestic residents.

Turning to the more clearly advantageous aspects of any such hypothetical shift of Euro-dollar deposits to banks in the United States, several advantages might be involved. First, to

the extent that the shift would contribute to reduce concern over Euro-currency markets, that would be helpful. Second, such a shift would also be advantageous because it would lead to some improvement in the information available to the Federal Reserve and thereby make possible a more accurate assessment of financial developments affecting the U.S. economy. Data on the assets and liabilities of banks in the U.S. are more detailed and are collected more frequently than comparable data on the assets and liabilities of banks operating in the Euro-currency markets. Third, a shift of Euro-dollar deposits to banks in the United States might lead to some appreciation of the dollar; at a time of weakness for the dollar such an appreciation would be an advantage.

I hope you find these further comments for the record helpful.

Sincerely,

The CHAIRMAN. Further, in the international field, what assumption about the foreign exchange value of the dollar and the extent of Federal intervention support was incorporated in your forecast for monetary expansion given us here today?

That is to say the exchange value of the dollar has a lot to do with inflation and the balance of payments.

Mr. MILLER. In view of the relative stability of the dollar since November 1, and in view of the expected substantial improvement in the trade and in the current account balances, the assumption for this purpose is that the dollar will stay at the present level. If our position improves, as most of us expect, you could see some slight appreciation of the dollar, but for the purposes of this analysis, we have assumed a stable dollar over this period.

The CHAIRMAN. Turning to the domestic scene, in your testimony today and particularly in your testimony on January 30, before the Joint Economic Committee, you dealt with the problem of structural unemployment.

Am I right in inferring from what you have testified in the last few weeks before the Congress, that any Congressman who, consistent with the overall budgetary target containing the deficit at a figure of \$29 billion, or even better than that, who can find funds elsewhere in the budget to switch to a targeted program of combatting structural unemployment, would have your blessing?

Mr. MILLER. Very much so. I think the place in the budget that needs to be protected is that area which is, in terms of the size of the budget, relatively small, but extremely important: those funds flowing to skill development, to aid to the transition of young people to the world of work.

I would hope that Congress will not in any way impair those funds. I think they need to be preserved. If anything, those programs need to be strengthened and made more effective.

The CHAIRMAN. I trust nobody would impair them, but I wanted you to talk about specifically adding to the funds. I take it that your testimony here is that to the extent that that can be done without impairing the overall budgetary objective, you would view that as favorable?

Mr. MILLER. Mr. Chairman, there is one pending supplemental request. As I understand it, there is an appropriation of \$400 million to fund a private sector initiative that would expand the work of the local business-industry-community-labor councils, to target in on individuals in the community who are hard to employ and to get activity at the grass roots—where it just isn't a broad brush, but deals with identified individuals with needed skills and needed opportunities.

I hope Congress will act favorably upon that request. The program was authorized in the last Congress, but the appropriation was not completed; I hope that can be done.

The CHAIRMAN. That is a highly desirable supplement, I believe, to the fiscal 1979 budget. Just to make sure of your testimony, let me review a point with reference to the fiscal year 1980 budget. Your testimony is that you would applaud efforts, consistent with the budgetary projections, with which you do not quarrel, to find other sources of funds for an expansion of the attack on structural unemployment

over and above that produced by the present 1980 budget. Is that correct?

Mr. MILLER. Absolutely.

The CHAIRMAN. Thank you very much.

Mr. St Germain?

Mr. ST GERMAIN. Thank you, Mr. Chairman.

Chairman Miller, a great many of us, and me, also, are very concerned about the long-term effects of the current high-interest rate structure that we are facing.

Frankly, I question whether the economy or an individual consumer can continue to sustain this burden.

Now, when you look at the interest rates for the figures, the national average is one thing. But when you get down to individual consumers, the burden becomes very staggering, and in many cases, it becomes impossible.

Most American consumers, frankly, I don't think, can afford 10, 11, and 12 percent mortgages on their homes, even though it is spread over 30 years.

Does the Federal Reserve have an estimate of the number of home buyers that are presently priced out of the market under the current interest rates?

Mr. MILLER. Mr. St Germain, I couldn't give you such an estimate. I would say that we will price people out of the market if we continue to have inflation escalating the price of housing. That is perhaps a bigger factor in the ability to afford housing than the current interest rates.

One of the problems with suggesting that we should create conditions to expand the demand for housing is that it would put so much pressure on the sources of housing and might drive up prices; that would do far more damage to those who need shelter.

Housing would be better off by having less swings up and down, by having more stability. I think that would bring the costs down more than if we continue to go through the kind of cycles that, as I illustrated in these charts, have been so disruptive in the past.

People could benefit during the period of the trough, because interest rates were lower. But they couldn't afford to buy houses if they were uncertain of their futures, uncertain of their jobs; many firms went bankrupt because of the denial of credit during the 1973-74 period.

Mr. ST GERMAIN. Well, you know, we look at the money market certificates that are hailed as having accomplished goals, they have averted disintermediation, and I look at your charts on page 26 on outstanding money markets.

However, I think that in reality what is happening is consumers cannot afford the high interest rates on mortgages, and the thrift institutions are not placing these funds where they are traditionally supposed to be putting them, to wit, in housing, but rather they are investing those funds in other areas, and as a result thereof, the prime purpose and the purpose of the thrift institutions is being aborted so to speak.

I am wondering on the one hand about the interest rate, but on the other hand, I wonder if the certificates haven't contributed to very high interest rates. It is one thing to say we are holding housing down to a more stable level, we are avoiding the swing, but to the family out

there that needs a house, you know, do you think that that is the answer that that family wants?

And you say you are just going to have to put up with it, we are trying to avoid the ups and downs in the housing markets, you are just going to have to stay in your apartment, and double up on the bedrooms, and what have you?

Mr. MILLER. The other choice—denying funds to housing, not building housing—is not acceptable.

You say interest rates are high. Interest rates during the recession period got down to 9 percent or so. They have gone up 1.5 percent since then, even though inflation has gone up from 6 to 9 percent. On every scale that I know of, that means that the interest rate, in real terms, has gone down. It seems to me that the proof is that families have been willing to pay those interest rates in order to buy shelter, and that we have kept housing starts at a 2 million rate. Had we not authorized money market certificates, in my view, there would have been disintermediation; there would have been many less houses built. To say that some families might have gotten a house at a lower mortgage rate is a very doubtful statement; just because you are building fewer houses doesn't make the interest rate lower.

I will certainly concur with you that recently, and only recently, there is evidence—and this is indirect, not direct evidence—that some of the thrifts are not planning to commit the funds they have raised through money market certificates to mortgages. They are uncertain of the future; they are investing their funds without making new mortgage commitments because they are not certain what the rate may be at the time of rollover. They don't want to make long-term commitments. But that is a fairly recent phenomena.

Mr. ST GERMAIN. Excuse me, Mr. Miller. We are also adding other provisos, for example, "Have you had an account with us for some period of time?" They are becoming very, very selective.

Mr. MILLER. Isn't this what the market system is about? Isn't that why we have improved it? We are learning something here that we ought to apply in a number of other areas; that is, that when the market is allowed to operate, \$105 billion flows into thrifts that otherwise would have been somewhere else. The thrifts are now going to have to learn to gage how to use those resources, in order to support their objectives.

It may be that for a temporary period, they will, in fact, be more cautious and put in nonprice restraints to expansion. These, I would think, would be consistent with our need to maintain a more moderate rate of growth of our economy so that we do not unleash higher interest rates and carrying costs for housing in the future even more onerous to our families.

Mr. ST GERMAIN. My time has expired, Mr. Chairman. But I think it is important that we do not rely on indirect information, but that we monitor very closely and determine what is happening with these funds in the thrifts, and whether the thrifts are going to continue operating or functioning, as is their mandate, in the area of housing, or are they just going to be investing in money markets themselves.

Mr. MILLER. I think we will want to keep a close watch on that; I agree with you.

The CHAIRMAN. Mr. Wylie?

Mr. WYLIE. Thank you very much, Mr. Chairman.

Chairman Reuss said we could avoid this if we had a strong membership bill, and that is why the thrift institutions would be in favor of it.

I have used that quote in many speeches before the thrifts.

The last time you were here, Mr. Miller, and this is an oversimplification, but you said that the economy is strong; that no recession is in sight, and that we have reason to feel very optimistic about the future.

Do you still feel that way?

Mr. MILLER. I have said that economic expansions don't just die of old age; you have to find some malady. It would seem to me that the economy is well balanced, and the strategy that is being proposed—that of slackening the rate of growth of the economy and keeping it in a balanced condition—gives us the probability of continuing our progress without a recession during 1979.

I cannot predict what will happen in future years, because that depends not only on how successful we are with the current strategy, but on unknowns, such as crop production, weather, international events, dislocations in oil supply, and so forth.

But generally, I have, I hope, not been either optimistic nor pessimistic, but realistic in saying, "Let us look at the data, let us look at the condition of personal income, housing, business investment, and inventories, and assess other conditions."

As I see it, we have a very well-balanced economy with no really significant overextension or underutilization, so the prospects are good for reaching the general goals that have been set in the President's economic plan; that is, lower growth rates but for a more sustained period of time, using that more moderate growth as the way to work off inflation.

Mr. WYLIE. The reason I asked the question is because I liked the statement before our committee 2 days later, although it was a disconcerting statement to me. Dr. Everett appeared before the Budget Committee, and she was not very optimistic. She said if interest rates don't come down, we are very likely to be in a recessionary period by next year. I think that is a fair appraisal or analysis of what she said.

And a question which recurs in my mail, and I know this is not on the high level that we have been talking about, but it is a very common question among constituents of mine, is there anything we can do to bring interest rates down, or is there anything that you can do, Congressman, to bring interest rates down?

They say we need to worry about bringing interest rates down. It is a problem from their point of view as far as the strength of the economy is concerned.

In your opinion, is it an indication that recession is in sight if interest rates stay at the high level they are, or if they start to climb?

Mr. MILLER. If inflation declined and demand declined, but interest rates remained high, then I think you could have a policy that impacts the economy adversely.

But if inflation stays high, interest rates should be consistent; otherwise we just unleash further demand for another boom period that adds to inflationary pressures and starts us on a worse cycle.

There is no way to solve our problem using the techniques of the past. If we administer interest rates low, and let everybody have all

the credit they want, then we are going to have inflation. If we administer interest rates low, and then allocate credit—just tell people which of them can have it—then we are into a control mode, which I believe is a rather unhealthy mode and a very unwise mode for the United States.

I think we should tend to restrain the overall availability of credit, and let the choices of spending or saving be made by individuals and businesses, rather than sit in judgment.

We have seen situations in the past where we have held the lid on things. The tendency then is to steam up the economy; we have the impression that we are containing inflation, while we are just kidding ourselves.

Eventually the lid pops off.

I think we have to have the persistence, the discipline, the willingness to pursue austerity for a period, in order to make up for our past excesses. There can't be a free lunch in this process; we just have to pay the piper for what has happened over 12 years.

Mr. WYLIE. My time has expired, but I have one last question.

Why not just put control on the money available rather than increasing the interest rate?

Mr. MILLER. The trouble, Congressman Wylie, is people sometimes have the impression that the two are unrelated; but they are related. There is no market if you can reduce supply without the price increasing.

It is the same with money as it is with wheat. If you made only so many bushels of wheat available, the price would go up; if you made more wheat available, the price would come down. That is what interest rates do in relation to the money supply. There is a bit of a misunderstanding here.

We are not trying to run the economy by pegging interest rates artificially. The supply of money and credit is related to interest rates as surely as can be, and that—

Mr. WYLIE. I am not sure that I am developing my question very well.

The last time that you were here, I asked whether the Fed would not have greater success in controlling inflation if it sought to influence the monetary aggregates directly rather than seeking to influence them indirectly through interest rates, and I believe you replied in essence that you would think about it, but you weren't sure.

Meanwhile, the Federal Reserve issued its bulletin for January, and on page 31 it says:

Thus, with a reserves operating target, control might be weaker over the proposed aggregates than over the current aggregates, unless legislation were approved extending reserve requirements to the monetary liabilities of nonmember institutions.

With an interest rate operating target, control over a monetary aggregate depends on whether the demand for that aggregate is sensitive to changes in short-term interest rates. A desired change in the quantity of a monetary aggregate is achieved by varying the attractiveness of holding the monetary aggregate through changes in short-term interest rates.

There seems to be an inconsistency there to me, and I would hope you could straighten that out.

Mr. MILLER. We could monitor policy techniques; our tools can be used in different ways.

It is possible, in terms of trying to achieve the rate of growth of aggregates that we have perceived to be appropriate, that we could operate through a technique, such as controlling reserves, rather than operating indirectly through interest rates. But the same result would take place. If you restrict through direct action, interest rates will go up. Whichever way we go, we are going to have the same consequences. The only question, therefore, is what is a better operating technique.

As far as the issue of monetary control and universal reserve requirements, I think that is a different point. To the extent that deposits are held outside of the Federal Reserve System that is, to the extent deposits move from accounts subject to reserves to accounts subject to different reserves or subject to no reserves—an unpredictability is created; the greater the unpredictability, the harder it is to operate, whatever way.

Believe me, whichever way you operate, you are going to affect both the supply and the cost of money. But, you can operate more effectively with a more complete coverage of the deposits that you are trying to influence.

Mr. WYLIE. I respect your judgment. I am not sure that the interest rate approach has worked all that well so far. That was the point I tried to make.

Thank you very much.

The CHAIRMAN. Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

I appreciate your effort to try and build the position of the legislation. It is an ambitious goal and one that we will have to work together on. Nonetheless, with respect to the monetary policy and interest rate, I am pleased to see that you see a relationship between them.

Mr. MILLER. Even if I didn't see it, it would exist.

Mr. VENTO. There was reluctance by your predecessor to recognize that fact. But there is a disturbing occurrence with regard to monetary policy as exercised by the Fed.

In your judgment, isn't it possible that monetary policy under some circumstances can be overextended in terms of what it is trying to do?

Mr. MILLER. Certainly, we should not seek to achieve our economic goals relying solely on monetary policy. I have said this consistently. We can expect monetary policy to carry too much of the burden, and that, to my mind, is dangerous. It is very important that we have, concurrently, fiscal policies, incomes policies, policies on the formation of capital, on investment, and on international trade that supplement and confirm the economic direction that we feel is correct to achieve our goals.

Mr. VENTO. One of the problems has been, of course, you pointed out the certificates of deposits that savings and loans and mutual savings banks have been permitted to offer more recently on the market applies. You also pointed out in your report the increase in the consumer debt. I might add that on a related subject, regulation Z, I know that you put out a comment period for new rules and regulations, and you have been very much involved in a regulatory capacity in terms of truth in lending in extending that particular service. I will not ask any questions about that.

I will just point out that the general nature of the rules, I think, permit a more liberalized extension of credit by second mortgages.

This whole phenomena seems to operate at counterpoint really to the objectives of monetary policy. That is to say, that a second mortgage on homes, the extension of credit, or the offering on CD's, for instance, seem to resist the restraints that otherwise exist. The negative impact on monetary policy on homes, as much as I abhor that, and the capital which relates to productivity and so forth on the nonresidential side, how do you explain that?

I don't know if it is just empirical theory that you have, or do you have any data that indicate consumers are buying now because they think there is going to be even greater inflation tomorrow. I have heard that phrase before. There might be some other things including a more liberal credit policy.

I would like to get your impression and the Board's response to that.

Mr. MILLER. Let me point out a couple of things. In the first place, I think we have to be sure that we think about each of these issues clearly. In dealing with the issue of open end credit secured by second mortgages—this, by the way, is credit already being extended; we did not create it—our purpose was not to expand aggregate credit. Our purpose was to give consumers the ability to negotiate better terms. We did not believe that a household would gain more credit; its capacity to repay won't be changed. It would merely mean better terms because of the secured nature of the credit. Our purpose was therefore to try to help families, in these difficult times, bargain for better terms.

Now, to the extent that we misjudged that—and to the extent that it is anyone's judgment that that particular regulation would expand credit—we put it out for comment. If, in fact, we perceive that there are those who view it differently and they can persuade us, we will look at that issue. We are trying to improve terms. Let's be sure we don't relate that purpose to other issues, such as overexpansion.

The proper use of credit is not had in an economy. Since we have an innovative economy, the fact that over time we have developed techniques to utilize credit to meet legitimate household and family needs should not be criticized.

In fact, in terms of nonprice credit terms there has been an inventiveness, a creativeness in the system, in trying to adapt to rapid changes in the financial marketplace.

We have not had in our lifetimes, before the 1970's, any extended period of inflation in peacetime; we have never had that experience. When we suddenly had that experience, automobiles jumped substantially in price—because of inflation and mandated requirements—and families who felt they needed an automobile started saying, "I can't make the payments in 3 years; I need some more time." And financiers said, "I will give you a few more months, because you have got a good record, and your automobile is better engineered." And so forth.

We ought to be cautious in judging that as being an overextension of credit. Maybe it is just an adaptation through this period when we want to find legitimate ways to keep the family progressing.

Mr. VENTO. The point is, though, that it does have an impact in terms of what monetary policy does.

That seems to actually move it in the opposite direction. There are actually actions by the Federal Home Loan Bank Board in conflict with what you are trying to do.

One other point that was made here is the factor of capital investment in terms of its relationship to productivity.

Isn't it possible that we have hit a plateau in terms of capital input and what we can expect back in terms of workers? Isn't that a factor in some industries, or could it be a factor?

Mr. MILLER. I think not. I think that the uncertainties of inflation, on cash flows, on future prices and markets, is the real factor at work. The fact is, too, that a lot of capital expenditures have been put into nonproductive areas; 5 to 7 percent of capital expenditures are now going into areas that do not relate to productivity.

Mr. VENTO. That leads to another question. I believe that as money is available, it goes into noncapital expenditures.

Has that historically been true in this country? Second have you made an effort to monitor the amount of capital to be invested, that is, productive capital, capital that goes for building plant and equipment, into other areas? There is American capital coming in, and capital coming from Europe, about \$30 billion last year? But where is that going? What portion goes for capital investment? What portion goes for consumer goods? That is, both from within this country and without?

Mr. MILLER. We keep close records as to what is actually going into business fixed investments. That is what we are talking about here. If you talk about financial instruments, you are talking about something that doesn't show up in productivity. Many of the institutions' holdings merely go into short-term Treasury bills: we will have had a very large growth in the foreign demand for Treasury bills, because of direct intervention, which has resulted in many countries' official institutions holding large amounts of dollars that need to be invested. That money is not going to flow into business fixed investment. The source of capital, the availability of capital, the decisions to invest, this is a different structure. Again, we have to separate those two issues.

Mr. VENTO. My time is expired, but I don't think my question was answered, at least the last one. I hope we will get back to it.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Mr. Miller, today in Bonn the United States is selling \$2.5 billion worth of D mark denominated bonds.

It strikes me that this may be a good risk, but it is also a high stakes game. In fact, it is a bit like playing Russian roulette with U.S. taxpayers' dollars, because if the value of the dollar depreciates, the debt derived from the obligations will be significantly increased by exchange losses.

What intrigues me is that there has been almost no public discussion of this issue. Furthermore, there has been no congressional debate on this issue.

I am wondering if you, as Fed Chairman, advised the Treasury in this regard?

Mr. MILLER. Mr. Leach, the offering will be 2½ billion D marks, not \$2½ billion, just let me point that out.

Let me say that I am very much in favor of these issues of foreign currency-dominated obligations.

The United States, whether we like it or not, has been running a very large current account deficit that must be financed. If we continue to find it necessary to depreciate the dollar in order to attract funds to finance that deficit, we are headed for deeper and deeper

trouble in terms of inflation, for bigger costs to the taxpayer than could possibly be involved in this important means we can use to close our gap and buy us time.

For example, the depreciation of the dollar since September 1977 added 1 percent to inflation in 1978; that was equivalent to a tax of \$15 billion on consumers. Probably 1 percent more will be added to inflation from that depreciation. We are going to do much more for the taxpayer by stabilizing the dollar.

You point out that we issue foreign currency denominated securities; why would you assume that to have a greater risk than issuing dollar denominated securities, in the sense that in either case there must be a capacity to repay or refinance?

When our Treasury borrows funds in Germany, the cost is far less than borrowing funds in this country. Any risk of depreciation of the mark is covered by a 4- or 5-percent differential in interest costs. Any exchange loss should be looked upon, annually, as part of the carrying cost of debt. If we save our dollar, save ourselves from the inflationary impact of its depreciation, believe me, we won't be incurring any further loss or risk. We will have done a great deal to stabilize the total situation and to reduce the cost of our financing our goals.

Mr. LEACH. You make a strong case, but we know that in the last few years alone, the U.S. Treasury has lost a spectacular sum of money due to devaluation of the dollar and our obligation to pay back some of our debt in Swiss francs.

The CHAIRMAN. I think we better be careful. The Roosa bonds go back—

Mr. LEACH. The Roosa bonds go back to 1961. We are still paying them off. The devaluation of the dollar vis-a-vis the Swiss franc in the last 4 years has caused a loss to the Treasury of substantial proportions—around a billion dollars—and this is admitted by the Treasury. It is a simple fact.

Let me pursue this further. In recent months the Fed has taken several significant steps to stabilize the dollar in foreign exchange markets. However, Fed policy has not been clear-cut. In late January, the Fed sold \$1 billion in 1 week for Japanese yen.

Part of the rationale was that we wanted to keep the relative value of the dollar to the yen about where it was.

In that regard, is there a desire on the part of the Fed not to allow the dollar to appreciate significantly relative to other stronger currencies, in order to maintain a competitive edge in trade or otherwise?

Mr. MILLER. I have too many questions here. I will have to take them one at a time if I am going to be responsive.

I cannot accept the proposition that hundreds of millions of dollars have been lost on the Roosa bond without looking at the underlying realities. In the first place, what interest rate has been paid over the years, and what interest rate would have been paid elsewhere? What is the annual cost of carrying and paying that debt.

Unless you look through the life cycle of the security, you can get inflammatory statements about its cost. But this is just not a factual statement about the cost of carrying the debt.

The second issue is what was our other choice? To sell gold. The United States, by saving that gold, saved \$1 billion. To look at the reality, this process has benefited the United States.

Of course, I had nothing to do with those bonds. But I want us to look at this realistically. We were in trouble in the world at the time they were issued; our choice is to sell gold at \$42 an ounce, and later find that it is worth \$250. I would gladly hold the gold.

Mr. LEACH. You are correct in taking the long-term point of view. However, if you just examine the period of this administration, where the dollar has depreciated substantially—

Mr. MILLER. This administration hasn't lost money in these markets. So, either we are going to take it one way or the other. Either Roosa bonds didn't lose us money or they did, but we haven't lost any money. We haven't sold 1 billion dollars' worth of yen. The resources that have been committed have been relatively modest. We have stabilized the dollar. We are contributing to saving the American taxpayer billions of dollars.

Mr. LEACH. Let me quote Mr. Anthony Solomon of the Treasury Department. He says the appreciation of the Swiss franc has created large actual and accrued exchange losses.

The point I am making is that over a period of 2 or 3 years, we have seen substantial losses clearly indicating that whenever you sell a foreign currency denominated bond, you are running a certain risk. That risk is undeniable, and I think it should be fully understood by this Congress, as well as the American people.

Simply arguing that there have been no losses is inaccurate. If you take 1961 as a base year, the bonds may have a benefit. However, more recently, the bonds have resulted in losses.

Mr. MILLER. I don't know where the loss is. Is the interest payment we make on the national debt every year a loss?

Mr. LEACH. That would be a liability to the American taxpayer.

Mr. MILLER. We should be careful not to mix up terms. The difference between the resources you get, and what you pay back in total—interest charges and exchange costs—that sum has to be spread over the life of the debt issues. That determines the total carrying cost, which is the equivalent of interest.

If you call it interest, it doesn't sound bad. In fact, it is functionally interest. The truth is, you know, that what you borrow Swiss francs for—what you pay in interest this year—and what you have to pay to buy those Swiss francs later to pay back, must all be taken into account in figuring out the cost of carrying that debt.

An isolated statement that we have had exchange losses doesn't specify those losses in terms of equivalency costs, or of the alternate resources that would have had to have been expended by the Nation to cover its financial obligations.

Unless you are willing to examine this that way, I am afraid you may miss the impact of the major policy decision that was made on November 1, a terribly important policy decision: the fact that in order for us to stabilize the dollar, and to acquire the resources in foreign currency that we need, we gained access to the markets to those resources, without expanding the money supply of Germany. This is extremely important.

What we had been doing up until that time was relying entirely on D marks acquired by expanding the money supply in Germany. That creates problems and inflationary risks for the Germans.

By going to the market, and borrowing from banks, we eliminated the prospect of expanding the money supply issued by the central

bank, yet the obligation to repay is no different than what we would have had if we borrowed from the Bundesbank.

The CHAIRMAN. The gentleman's time has expired.

Mr. Cavanaugh?

Mr. CAVANAUGH. Mr. Miller, in the past, you have provided the committee with your own quantitative statements for prospective real GNP growth, inflation and unemployment in the year ahead, and these have differed from the forecasts of the administration.

This time, you do not provide us with a separate quantitative forecast. Does this mean that your best forecast and the administration's goals are exactly the same? And if not, where do they differ?

Mr. MILLER. Mr. Cavanaugh, as you know, the report filed by us is the report of the Board of Governors, and the Board of Governors as a body has not been able or willing to try to make economic forecasts.

So, in the past, I have given my personal forecasts, and I would be happy to indicate to you today what I see personally.

The President's economic goals for 1979 involve real GNP growth of 2.2 percent, and consumer price growth of 7.5 percent. I would say the likelihood is that the real growth rate would be slightly less, and the inflation rate slightly more, with about the same nominal growth rate.

Incidentally, I would see the economy slowing over the course of 1979, so that when I talk about the rate for the year as coming out a little less than 2.2 percent, I am talking about a slowing toward the end of the year.

I think the unemployment rate at the end of the year will probably be fairly consistent with the outlook stated in the President's goals. I do believe that over 1979, we will have about the same average rate of unemployment as in 1978. But in 1978, we started higher and came down; in 1979, we will start lower and go up slightly.

As to 1980, it is harder, of course, to look that far ahead, but I would say that we could expect a slower growth rate in real terms than the President's goal, moving up during the year; rather than moving down, it will be moving up.

I would think, again, that consumer prices could be slightly higher than forecast for 1980. I don't see inflation coming down quite as fast. I see real GNP growth slightly slower.

This forecast is on page 69.

Mr. CAVANAUGH. Right. I am on page 69.

For example, on consumer prices, by slightly higher, can you quantify that?

Mr. MILLER. Yes; in 1979, the administration's projection is shown as 7.5 percent of inflation. I think a 7.5 percent rate would be the bottom of my expectation. My expectation is that the rate would be more like 7.5 to 8.25 percent, in that range, that would more likely be the outlook.

Inflation could go down to 7.5 percent, but I think that is unlikely.

Mr. CAVANAUGH. Your growth, would you put that below 2, or at 2?

Mr. MILLER. I would think the growth could range for real GNP from 1.75 to 2.25 percent.

Mr. CAVANAUGH. On page 55, I would like for you to comment and help clear up what appears to be a variance to me between page 55 and the bottom of page 56 and 57, where you are talking about M_1 growth, and the effect of automatic transfer facilities.

On page 55, you state that the board staff has projected that such a shifting will dampen the growth in M_1 this year by about 3 percentage points. And then at the bottom of 56, and the top of 57, you say bank savings deposits have declined appreciably in the past few months despite the increase of funds to ATS savings accounts.

How do you project in 1979 such an accelerated growth of ATS? What data do you have available now, as to what is the size of ATS accounts now, and what do you expect them to be at the end of 1979?

Mr. MILLER. ATS, plus NOW accounts in New York—perhaps not this week, but as of January—are about \$5 billion combined—about \$4 billion in ATS, and about \$1 billion in New York NOW accounts. That is amazingly consistent with the projection the staff had made as to how rapidly ATS would grow.

Let me point out, just so we are clear, that M_1 consists of currency and coin in circulation, and demand deposits at commercial banks.

M_2 includes savings and time deposits at commercial banks. The point made is that while M_2 has continued to grow, savings accounts have been slowing; the difference has been made up by time deposits. This is just a shift, internally—that is, within M_2 , among the type of deposit, occurring because we assume that there is a shift toward time deposits with higher yields. People have been putting their money where they can get more.

Mr. CAVANAUGH. Do you have a projection for the size of ATS accounts by the close of 1979?

Mr. MILLER. About \$19 or \$20 billion.

Mr. CAVANAUGH. From the current \$5 billion?

Mr. MILLER. Yes; once you get past this year, in 1980, we will be looking at M_1 figures progressively comparable to past year figures. We are going to go through one period where this adjustment to ATS makes it necessary to give you a picture of what would have been, so there won't be any confusion.

In the fourth quarter, our rate of M_1 growth, if we had not had ATS, would have been 1 percent higher. For 1979, we expect, as you just pointed out, that if we had not had ATS, our M_1 rate of growth would be 3 percent higher.

Or, put the other way, it will be 3 percent lower than it otherwise would have been.

Mr. CAVANAUGH. If I can go back to my original question.

You indicate that the Board set no goals, or determines no goals in arriving at its monetary growth targets. Does that mean that these goals related by the administration's goals are not the goals which the monetary targets the Board has presented us are designed to achieve?

Mr. MILLER. You recall that the Federal Open Market Committee is a collegial body; believe me, to get 12 people to ever adopt or agree on the precise numbers for a forecast of the economy is unlikely.

What we do, of course, is rely upon projections by our staff. Each Governor and each president who is a member of the FOMC makes his own evaluations in setting what are his or her responsibility, and that is the monetary goals.

Now, our job under Humphrey-Hawkins, as we understand it, is, once we have set those goals, to relate them back to the President's goals and report on whether they are consistent or inconsistent. The President does decide, as one person can, on his national goals.

Because of the uncertainties of an economy as large and complex as ours we have adopted a program, as other countries now have, of setting monetary goals in terms of ranges.

Once you have ranges, it is possible to have some fluctuation. What we are saying in the report, of course, is that the ranges we have set would be consistent with achieving the nominal rate of growth in GNP that has been set by the President.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Evans?

Mr. EVANS. Mr. Miller, thanks for being with us this morning. I know you were with Senator Proxmire's committee yesterday.

I am glad we have more here in the House of Representatives than we had in the Senate Banking Committee.

I commend you, sir, for your courage, as I have done on previous occasions, in the exercise of restraint in monetary standards.

I would like to take this opportunity this morning to ask you some questions relating to a couple of charts.

Page 23. It seems to me a very relevant fact in fighting inflation would be to stimulate capital formation, and those charts are somewhat alarming, but if not alarming, they underscore the need to do more to stimulate capital investment. Last year we extended the investment tax credit, which I think was a step in the right direction, on a more permanent basis, so that business would know what to expect in the future. They could make decisions with reasonable certainty, and that is good.

We also reduced the tax rate on capital gains.

What further might we do?

Mr. MILLER. Mr. Evans, I have felt that the most effective policy of the Federal Government would be to stimulate business fixed investment through higher rates of depreciation.

Business enterprises make their decisions on major investments based upon projections of markets, sales, costs, profits, the return on investment, and the discounted cash flow.

In making those decisions, the opportunity to write off investment more rapidly has a significant effect on the estimate of risk. Or, to put it another way, the faster a business recaptures capital, the less it is exposed to risk and, therefore, the more likely an enterprise would be willing to finance and to make an investment.

From the point of view of the Federal Government, accelerated depreciation also works to give us the greatest bang for the buck, in my opinion, because it does not represent a forgiveness of tax; it represents a deferral. If you give an investment tax credit, you may have to go to higher figures before you get an investment.

So looking at it from the point of view of the Treasury, you can create a credit for business investment through depreciation at lower cost to the Government. The Federal Government looks upon the cost of its money in terms of raising funds in the market, while businessmen look at a higher yield on their capital; and depreciation makes that spread more favorable.

I would very much hope that the Congress, in due course, would be starting on a phased in program toward liberalization of depreciation; that would go a long way toward eliminating this problem.

Mr. EVANS. I was glad to see the attention focused on capital depreciation.

But I agree with you that is a very relevant factor. But, unfortunately, too many people view that as a loophole.

Mr. MILLER. It never should be considered a loophole.

Mr. EVANS. I agree with you.

Mr. MILLER. If we create conditions for a flow from the savings of Americans through the enterprises of America—investment in the means of production that create jobs for Americans—that should not be looked upon as a loophole. Rather, you should give out medals for that kind of action.

Mr. EVANS. I couldn't agree with you more.

Turning now to another chart on page 38. Excluding food and energy, there would seem to be two very relevant factors in the high rate of inflation that we have.

What do you consider aside from those as major inflationary factors today?

Mr. MILLER. Putting food and energy aside, we are trying to illustrate that increased unit labor costs are a very serious, underlying cause of inflation.

Mr. EVANS. Can I interrupt at this point and ask a question about wages.

It seems to me that it is rather inconsistent to pass a minimum wage bill as the Congress did in 1978, especially without a differential, a youth differential, to have such a high unemployment rate among teenagers and minorities, that in itself is an inflationary factor.

Would you agree that we should do something to go back to minimum wage in 1979?

Mr. MILLER. Yes; I have pointed out that an increase in the minimum wage, whatever may have been its original purpose, has, in this situation, had a significant impact on inflation.

In 1978, we could trace four-tenths or one-half percent of inflation to the minimum wage increase; this year that will be less because the increase is less.

It would be desirable for Congress to defer that increase, but I don't think that has been very acceptable so far. The alternative of a youth differential, I think, would be well worth enacting; that would make it very helpful with regard to this process of closing the gap as to teenagers.

Mr. EVANS. I see that my time has expired.

When you were here testifying before on the Federal membership, I indicated that I would like to get together with you.

Mr. MILLER. Very good. Excellent.

Mr. EVANS. Thank you, sir.

The CHAIRMAN. Mr. Stanton?

Mr. STANTON. Thank you, Mr. Chairman. Chairman Miller, I apologize to you for my absence here in the last 45 minutes. I made an appointment and felt obligated.

Mr. MILLER. Somebody has to work in Washington.

Mr. STANTON. I thought your statement was certainly very fair and very equitable.

You know, the Board of Governors, and also the committee is implementing for the first time what we refer to as the "Full Employment and Growth Act of 1978." I wonder if you had had any problem at all in fulfilling the requirements in this particular legislation, and still maintaining an independence of the monetary system.

Mr. MILLER. Mr. Stanton, we have found this procedure worked out in the Full Employment and Balanced Growth Act to be, I think, quite satisfactory from our point of view.

Let me just remind everyone that when this act was being considered last year and being brought near to final dispensation, we worked very closely with this committee, and with your companion committee in the Senate, to find language that would be workable, that would look at what we really could do and should do as an independent agency. I want again to thank this committee for its understanding, and for its help in developing that language. I think it has brought us to the point where we can give a useful report.

I hope it is a report that will show consistency over the years and make a contribution to the interaction of monetary and fiscal policy; but we are not and should not hold ourselves out as a single separate authority for the committee. We are a monetary authority, not the economic authority for the Nation.

So, I have found this personally—and I welcome any suggestions or observations from the committee—a very workable format. We organized along the three mandates that were listed in the act, and it seemed to work very well from my point of view.

Mr. STANTON. This is mostly again out of curiosity. You spoke in your statement that the board had been studying the possibility of redefining the monetary aggregate, published in the January Federal Reserve Bulletin.

Have you set any particular target date to make up your mind?

Mr. MILLER. Mr. Stanton, my personal target date—and this is not a target date for the Governors—is to make a decision by the end of the year.

Perhaps that sounds rather conservative, but I have felt that the redefinition of the aggregates is a very important procedure, that we should not rush it; that we should have input from this committee and its staff, from the academic community, and from business economists and business people and financial experts; and that we should digest all of that and have as complete an exchange of views as possible.

We are not looking to win a race. We are looking for a substantive contribution to understanding the money supply, for which we need all the input that we can get.

At least, I would prefer to do this patiently and do it well, rather than to rush through in a couple of months and find out that people hadn't had a chance to run through their own calculations and see how it works. We depend a good deal upon responses from those who see our effort. We cannot, of course, force people to study this and respond. We just hope the process will attract enough attention and be important enough that we get intellectual input of high quality.

The CHAIRMAN. Mr. Green?

Mr. GREEN. Mr. Miller, I think in your response to Mr. Vento, you mentioned nonproductive investment and we have also had a discussion of Government-induced inflation.

I would like to know to what assumptions you all make, in setting your monetary targets, as to what would happen in terms of further Government-induced inflation, and to what extent you will have to change your targets if there is a series of events such as the President's proposal to raise sugar prices, for example.

Mr. MILLER. All of those factors get cranked into our projections of prices. As you know, when you deal with materials, quite apart from those which are influenced by Government actions, it is very difficult to project, with precision, how price actions will operate. Food is particularly difficult to estimate.

As to Government factors, we have put them all in. We have included the effects of the new minimum wage; we do look at the price support programs, and what they mean; and so forth.

I just would warn you that this is not an exact science, so all we can do is continue to recognize any bias built in.

We try, quite often to slice the pie in different ways. That is, we can project from the point of view of overall compensation gains, or overall materials increases; or, we can cut it another way and look at productivity, or some other factor.

Mr. GREEN. I guess if I could try to pin you down a little further: What assumptions have you made as to what is going to happen in terms of governmental regulations over the next year in reaching the monetary targets? Or have you simply assumed that the system now will stand still on the basis of existing legislation.

Mr. MILLER. In general, the latter. We have not recognized any major new initiatives on the part of the Government. We have recognized the continuing impact of existing legislation. We have not assumed any major, new changes; we have merely been extrapolating from the present program. I hope there won't be any new additions.

Mr. GREEN. Let me ask you one final question. If you had your choice of the matter, at what level would you like to see the Federal deficit for the fiscal year 1980?

Mr. MILLER. I have been a proponent of adjusting our economy to a slower growth mode, on a gradual basis, so we don't shock it, don't create dislocations, don't interrupt the process of investment in a way that would trigger a serious recession.

Therefore, I have favored a process of bringing the Federal deficit down from \$50 billion to the \$35 billion it is likely to be this year, when we get through with it, to half of that in 1980, and to as nearly balanced as possible in 1981.

If I were drawing a straight line, I would say that something in the \$20 to \$25 billion range would be more ideal for 1980. But I can't quarrel with \$5 billion more or less in an economy of this size. I don't find myself faulting an objective of \$29 billion; I think it is in the right range. The important thing is to keep going in the proper direction, which would mean that we get much nearer to a zero deficit in fiscal year 1981; certainly in 1982.

Mr. GREEN. Thank you.

The CHAIRMAN. The Humphrey-Hawkins Act requires that you "take account of the past and prospective developments in employment, unemployment, production, investments, real income, productivity, international trades and prices." You have done this in your report without quantifying your terms. Would you be able to provide the committee, for the record, with the quantitative assumptions for these estimates? I say that because in the past you have given us your estimates of the growth of GNP.

Mr. MILLER. Yes, I would be pleased to do so, Mr. Chairman.

[Chairman Miller subsequently submitted the following table for inclusion in the record responding to a question of Chairman Reuss:]

PERCENT CHANGE IN REAL GROSS NATIONAL PRODUCT AND RELATED ITEMS

	1975-IV to 1976-IV	1976-IV to 1977-IV	1977-IV to 1978-IV	Projection— 1978-IV to 1979-IV
Gross national product.....	4.6	5.5	4.3	1½ to 2½.
Business fixed investment.....	8.6	9.1	8.3	2½ to 3½.
Residential structures.....	23.6	15.3	- .8	8½ to 9½.
Net exports ¹	-9.1	-10.0	7.9	4½ to 7.
Total employment.....	3.3	4.4	3.8	1½ to 2½.
Real disposable income.....	3.3	5.4	3.3	2½ to 3½.
Output per hour ²	2.6	1.3	.8	¾ to 1¼.
Gross national product deflator.....	4.7	6.1	8.3	7½ to 8¼.
Unemployment rate ³	7.7	6.6	5.8	6 to 6½.

¹ Net change.

² Nonfarm business sector.

³ Level 4th quarter.

The CHAIRMAN. Finally, for me, in your current Federal Reserve statistics released on February 8, 1979, you have a footnote to your special supplementary table on automatic transfers and NOW accounts in New York State, which says the survey-collecting data on outstanding balances is scheduled to be conducted weekly through March 1979. Why just through March? Shouldn't this one be kept going for a while? My staff tells me it would be helpful for us to have it, and I should think for you, too.

Mr. MILLER. I think we will want to extend it. We don't want to lose track of this, because we do want to know how we adjust so as to compare previous figures.

The CHAIRMAN. So you will continue it past March as long as needed.

Mr. MILLER. Yes.

The CHAIRMAN. Mr. Paul?

Mr. PAUL. Mr. Miller, I read recently that the amount of cash held outside of the banks was as high as \$98 billion. Given a population of 220 million, that comes out to \$445 per individual, and for a family of four, \$1,800. I have a family of eight. That means I should have \$3,600, and I don't have it. I checked with my wife. She said she doesn't have it. She said she would spend it, if she did.

In light of the recent news stories about the underground economy, would you care to speculate on the location and possible use of this much cash?

Mr. MILLER. Excuse me?

Mr. PAUL. I am just wondering where that cash is and whether it could be used in an underground economy, since this is money outside the banks.

Mr. MILLER. It has been interesting to me to see the growth in the per capita amount of currency in circulation, and it makes us wonder if there isn't a growing cash economy. It may not be an underground economy, just a growing cash economy that would be of concern.

Now, we don't know enough about this. It could well be that some of that currency is literally lost, destroyed over years. Some of it could be like Eisenhower dollars, hoarded for reasons of its curio value rather than its monetary value. Or, it could be that there is a larger growth in the cash economy.

It is a riddle for which we do not have an answer, but one that makes us worry, as you do, as to whether it has some underlying significance.

I have a suspicion that, in times of high inflation, you will see more transactions outside of any recorded process. Once again, anything we can do to eliminate inflation will undoubtedly return us to a more healthy atmosphere in that regard.

Mr. PAUL. You mentioned earlier that we benefited by holding gold in the sixties rather than selling gold at \$35 an ounce. Does this mean that you might think it would be of value to us to hold the gold now and suspend the monthly Treasury sale of gold?

Mr. MILLER. No, I don't think so. I think in terms of the dollar amount and what the alternates for its use over time would be, that this is a good time to sell gold in order to lessen the inflationary or the speculative value of gold as an alternate asset for holding wealth. It also reduces our importation of gold for use in the industrial and jewelry processes, and therefore contributes positively to our balance of payments situation; and, to a more modest degree, it relieves the Treasury from borrowing. But our main purpose is to help in stabilizing the dollar and reducing our trade deficit.

I think it is a good time to liquidate the supply of gold; it is a much better time than when gold was at \$42 an ounce.

Mr. PAUL. It may go higher before it is all over.

Mr. MILLER. I am illustrating my confidence that we are going to get inflation under control.

Mr. PAUL. You mentioned in your report that the M_1 figures for the last few months are unexplainable.

Now that you have been in the job for awhile, do you believe that the institution of the Federal Reserve can regulate this money supply as you see fit, or do you think this is something that we can't possibly control.

Mr. MILLER. I think over time—over a reasonable time—the Federal Reserve can do the job. On a week-to-week basis, at least when we have so great a percent of deposits outside of the Federal Reserve System, the money supply is more difficult to predict. But, overall, I believe we can do the job. I don't think there is anything unusual or mysterious about the behavioral patterns of people; they try to economize on noninterest bearing forms of money in times of high interest rates. What we lack are precise measuring techniques for the mix of population and the alternative uses of resources in differing life cycles.

The main thing is that we should be realists, and be practical. We should not, for example, start to ease money prematurely just because there has been low growth recently. First, we are making up for some growth higher than we would have liked a little earlier. Second, we have got to judge whether the shift in the demand functions of money is such that we have to adjust before we start any relaxation. Those factors aren't that hard to judge, if one is patient and looks at what is really happening in the economy, instead of being mechanistic.

Mr. PAUL. This week, Milton Freidman criticized you rather severely in Newsweek for not increasing the money supply fast enough. This question also does come up: When do you decide to increase the money supply? Can you give me any objective point that you would

use in order to turn the money supply faucet back on? Is it an unemployment figure that is in your mind, or just what is it that you use as an objective criterion?

Mr. MILLER. It is a whole series of criteria.

One of the most reassuring aspects of the present monetary stance is the fact that both the Keynesian and the monetarist viewpoints feel it is time to ease up on monetary restraint. That is very assuring. The fact that they are both on the same side of the fence probably means that we should not ease up.

The Keynesians take the view that the full employment budget—which depends upon what you assume full employment means—is creating conditions for a fiscal drain which would exacerbate a recession. Therefore, they feel we should ease up, based on the fiscal drain.

The monetarists take the view that the aggregates have not been going very well recently, and we should ease up.

Both fail to take account of what has actually been going on in the economy and the fact that there is no constant star in the sky to guide these things. Things are shifting, and we should look at the realities before we make decisions that are very far reaching.

Mr. PAUL. My time is up.

The CHAIRMAN. Thank you. Mr. Vento?

Mr. VENTO. Mr. Miller, in looking at some of those underlying realities, yesterday before the Senate Banking Committee you said you did not expect a large external shock to hit the economy from the oil producers in general, and Iran in particular.

Suppose there were such a shock, large increase in oil prices, for example. An increase in oil prices has two effects. It adds directly to inflation, and I guess to the OPEC. The National Journal reports that there is seven-tenths of 1 percent increase in the Consumer Price Index.

Of course, it also acts like a tax—I guess worse than a tax because we don't get any feedback from it.

The implication from our monetary policy is that it is very ambiguous. How can monetary policy respond to those realities that we face?

You said that monetary policy shouldn't and can't do everything by itself, and I heartily agree with you. I think we should do our part. I will get back to that in a minute. I am interested in what your reaction is. It is very likely that this sort of circumstance can occur this year, unfortunately.

Mr. MILLER. I hope what I said yesterday is that it is not possible to predict what can happen in the oil situation, and that that is a risk factor. If there should be a disruption in supply, then the goals we are looking at could be subject to some degree of uncertainty.

Let me hasten to point out that my first preference, in terms of the oil supply situation, is to suggest that monetary policy is not the appropriate policy. We can either continue to restrain the overall amount of money and, therefore, if money shifts to oil, it will have to be denied someplace else; or, we can accommodate increases and create more inflation.

Either alternative is unattractive. What we need to do to respond to energy issues is an energy policy. It would take only a 2 or 3 percent reduction in the demand for oil in the world to solve the whole problem.

Why shouldn't it be more possible to get a more vigorous, more intensified, and more understood conservation program in this country? I am sure that everyone in this room could use 15 percent less gasoline than they used last year and do no harm to their standard of living. I could do it, and I am sure you could do it. If we would all do that, we wouldn't have to worry about monetary policy doing something we are not willing to do ourselves.

Mr. VENTO. I think the reality, though, since 1973, is that it hasn't occurred. I don't know what it is going to take to make it occur. There are certain forces. We have been successful in raising interest rates, and increasing, and accommodating it, through inflation, I guess, is what has happened. So that is likely what is to happen in the future. I hope that we can develop a comprehensive policy, or at least one that makes some sense in terms of providing some alternatives. But the alternatives especially represent long-term type goals.

The other question I have, Mr. Miller, is that for consideration of the budget in fiscal year 1979, we tried to work in coordination—I think we worked effectively in terms of the fact that we dealt with the deficiency, of some \$40 billion, and the interest rates caused it to rise some \$2 billion as a result of that, which is not affected by the decisions of the Board of Governors.

Second, we tried to keep the tax bill in the range that we talked about. After we left and finished our work in mid-October, toward the end of the month, a crisis occurred, and it seemed as though some of the work we had been doing in trying to coordinate, that is, in keeping interest rates down, keeping the deficit down within a certain range, was negated. Some of these actions contradicted what we had been working for, which was to see a kind of balanced approach as a solution; I know the events that occurred were beyond your control. But how can we avoid such a situation, or can't we avoid that in the future?

Mr. MILLER. The interrelations that you talk about depend very importantly upon our success in abating inflation. If we don't succeed in doing that, I don't think it is possible to expect interest rates to move down.

Now, if the economy slows, as we expect and as everyone expects—I guess the only question is whether the slowing down will be a recession technically, or merely a lower rate of growth; we happen to believe it will not be a recession—then a couple of things will happen.

One is that there will be less income and therefore less revenues to the Treasury from taxes.

And, to the extent there is a slowdown, there may be more Government expenditures brought about by unemployment or some other need. Therefore, Congress will have to work even harder to maintain its budget deficit objective at \$29 billion.

Likewise, if the economy slows down, the demand for money and credit will slow down and there will be a tendency, all things being equal, for interest rates being too loose. Neither you nor I can control the fact that if there is some reason for inflation to accelerate—be it war, a revolution in Iran that affects oil supply, or a crop failure somewhere—if then, unfortunately, we can't control the interactions in financial markets, we can only work on the scenario probabilities, and hope that more times than not we will be right.

I think our strategy is correct. Those things that we can control, I think, have been working in remarkable harmony. I think the Congress, the administration, the Federal Reserve, have been in better harmony in recent months than I would have expected. That is very much to be commended. But none of those three bodies can control the Iranian situation, for example.

Mr. VENTO. I appreciate your response. Thank you for your attention.

The CHAIRMAN. We want to thank you, Chairman Miller. We will now stand in adjournment until 10 o'clock tomorrow morning, at which time we will hear further witnesses.

[Whereupon, at 12:25 p.m., the hearing was adjourned, to reconvene at 10 a.m., on Thursday, February 22, 1979.]

CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced Growth
Act of 1978, Public Law 95-523)

THURSDAY, FEBRUARY 22, 1979

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

The committee met at 10 :05 a.m. in room 2128 of the Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss, St Germain, Minish, Hanley, Blanchard, LaFalce, Cavanaugh, Watkins, Wylie, Hansen, Kelly, Evans of Delaware, Green, Paul, Bethune, and Hinson.

The CHAIRMAN. Good morning.

The committee will be in session to continue our hearings on the conduct of monetary policy. We meet in the fifth year of sustained recovery from the recession of 1974-75, in a climate of substantial doubt that there will be a sixth. As the economic expansion ages, the twin risks of accelerated inflation and renewed recession continue with us; as time passes, we are less and less certain that we can continue to maneuver between them.

Yesterday we heard testimony from G. William Miller, Chairman of the Federal Reserve Board, and received into the record the Federal Reserve's first report pursuant to the Full Employment and Balanced Growth Act of 1978. In that report, the Federal Reserve promised to aim for moderate rates of monetary expansion. Chairman Miller testified that such a policy can work to squeeze out inflation over 6 or 7 years, while avoiding recession and the stop-go pattern that has crippled anti-inflation policy in the past. He testified that the administration's economic goals for 1979—7.5-percent inflation, 2.2-percent real growth, 6.2-percent unemployment, are achievable, but that they hinge on a greater success for the President's voluntary wage-price policy than Chairman Miller is willing to predict.

Our witnesses today are operating under a slight disadvantage, in that they have not had much time to study the Federal Reserve's report. Nevertheless, I should like to ask each of them, as he testifies, to bear in mind three questions about the conduct of monetary policy:

One, is the policy of the Federal Reserve, as announced this week for calendar year 1979, consistent with the economic goals specified by Humphrey-Hawkins?

(115)

Two, is the present and recent past behavior of the Federal Reserve, particularly the high level of short-term interest rates and, apparently, the lack of growth of M_1 since September, consistent with the Federal Reserve's announced policy and with the administration's forecast of a no-recession economic path for 1979 and 1980, which the Federal Reserve has largely endorsed?

Three, are the goals of Humphrey-Hawkins, as specified by the administration for 1979 and 1980 and by law for the period through 1983, themselves mutually consistent and obtainable without changing the present predominance of aggregate fiscal and monetary policy in the policymaker's arsenal? If not, what combination of policies would be required to achieve them?

We have scheduled four distinguished witnesses for today. They are: Dr. Karl Brunner of the University of Rochester; Prof. Martin Feldstein of Harvard; Prof. Robert Lekachman of Lehman College, City University of New York; and Dr. Lester Thurow of MIT.

I am told that because of weather conditions Boston is isolated and that MIT and Harvard are not able to be with us. Professor Lekachman is also not able to be with us.

Statements have been received from those who could not make it, and they will be entered, in full, into the record.

[The statements of Professors Lekachman and Feldstein appear at the end of the proceedings of this day.]

So Dr. Brunner, we are delighted to have a person of your distinction with us, and I know I speak for Congressmen St Germain, Watkins, Lowry, Wylie, Kelly, Paul, Bethune, and Hinson, as well as for all members of the committee, in welcoming you. Would you now proceed, Dr. Brunner, to either read your statement or summarize it in any way you please.

STATEMENT OF DR. KARL BRUNNER, PROFESSOR, UNIVERSITY OF ROCHESTER, ROCHESTER, N.Y.

Dr. BRUNNER. I appreciate very much the opportunity to present my views to this committee and to talk about how to best achieve the goals laid down in the Full Employment and Balanced Growth Act of 1978.

The goals, as I understand them, are to bring down inflation by 1983 to 3 percent and by 1988 to squeeze it out of the economy, and in a similar way that unemployment should be brought down to 4 percent for the age group of those over 16 years old.

Now, if you look at the drift of our events and the U.S. economy over the past 14 years, we have seen that the inflation has been drifting up consistently intermittently with some declines of location, and also, basically, the unemployment rate has been drifting up over this period.

I think it is important to understand that this drift in inflation and unemployment was not simply the result of mysterious social forces, that basically what happened is a result of the trend in our policies which we have pursued essentially since 1965. We have in the past had periods of amazing stability in our economy. From 1960 to 1965 our price level was essentially level. Possibly, if we make proper measurements in terms of prices actually paid, our price level may have actually declined over this period.

We also have this stability: We have the stability in terms of economic expansion; we have the stability in terms of interest rates. The prime rate was 4½ percent for 4 or 5 years; it was not 11½ percent.

Now, what happened is essentially that in terms of our monetary policy we have engaged in the past in the postwar period since 1965 on a basically inflationary course, a very persistent inflationary course, and that is the difference in our policymaking now than before.

Now, given this background, what can we do about it? In my statement I indicate this in section 3, the general program of monetary policy that should be laid out. Essentially, in order to cut out inflation or in order to get down the inflation, what we have to do is that the growth rates in the monetary base, instead of being at 9 percent, approximately the rate it was last year, it should be brought down to 2 percent.

Now, around 2 percent, if you take account also with the trend of the monetary multiplier, the trend in monetary velocity, and get to the average about an increase, a trend increase in nominal gross national product of about 3 percent with a normal growth rate of approximately 3 percent, this would deliver about a stable pricing.

Of course, there are all sorts of estimation errors in that, but the estimation errors involved are comparatively small, relative to the inflation rate which we have inherited at the moment.

The crucial aspect of the program is the gradual decline in monetary growth. The shadow open market committee has over the past years repeatedly recommended such a policy. It would be important, however, that the Federal Reserve authorities would really maintain such a program over the next 5 years. We should also acknowledge that our economy will suffer a temporary recession on this new track. I wish I knew, or others would know, how to lower monetary growth to a non-inflationary level without causing any social costs. But it seems most important, just in view of the potential social costs, that a credible policy program be formulated beyond this year which covers the period mentioned in the Full Employment and Balanced Growth Act of 1978.

Now, having stated the general outline, we still have to face the problem of implementation, how to implement this goal from 9-percent growth in the monetary base to a 2-percent growth in the monetary base. Of course, there are immediately at least two major alternatives. You say why can't we go immediately from 9 percent to 2 percent? The consequence of that would be rather definitely that we would have a recession, and not just a very mild or minimal recession, we would have a recession certainly of the magnitude of about 1948-49 or 1953-54 or 1957-58, of this magnitude.

I still would like to indicate that even if it would go immediately that way, it would still be a substantially smaller retardation in the growth of the monetary base than we had experienced in 1920-21 or 1937-38, where the retardation by our monetary policy assumed some brutal proportions, which we certainly don't want to imitate anymore, I hope, in the future.

Now, an alternative procedure is the following: An alternative procedure is to say, "Well, all right, according to the Full Employment and Balanced Growth Act of 1978, we have to get our inflation

down systematically over the next 3 years." And I think, in terms of the uncertainty which we face, how exactly the reactions of the economy are, that we suffer some uncertainty indeed in this respect, and that to play a sort of game of minimizing that social cost of transition, it seems to me best advised to distribute the reduction in the growth rate of the monetary base over time, to instruct the Federal Reserve to go down, say, from last year to this year, possibly by 2 percent and then subsequently every year thereafter by 2 percent or simply each year by 1 percent—I would not want to die on the barricade about that difference—but essentially to go down each year by 1 percent until we reach 2 percent; and that the Federal Reserve should be instructed to announce that very loud and very clear, so to make the strongest, clearest commitment to this course of action as to gradually hopefully to gain some credibility as to what it plans to do and hold on to what it plans to do over the longer run and not jump around every few quarters in a new direction as we have experienced in the last 14 years.

We had four aborted attempts at anti-inflationary policies in the last 14 years. In 1966, when we had the minirecession and there prices responded very aptly, the price inflation rates dropped by 50 percent within less than 1 year—within 8 months. Again, we tried it in 1969, and then we gave up again in January 1970. In January 1970, after 8 months, the Federal Reserve reversed itself again.

And then we got again on track in August 1971 to April 1972. Well, gentlemen, I am sure you all know the sad sorry of 1972. And then again we tried to get on track in 1975, but the Federal Reserve abandoned this again in 1976, and more than almost trebled over the 2½ years of growth rate the money stock and essentially increased rapidly also the growth rate of the monetary base.

That is, basically, the Federal Reserve would really have to stay on track and hold onto this track.

Now, the next point which I wish to emphasize in this context are a few more points which need to be considered; namely, the implementation, which I indicated, has also some further consequences in terms of Federal Reserve procedures. In order to carry through this program, the Federal Reserve would have to change substantially its internal procedures and also the prevalent conceptions about monetary policy and how to go about it, which it has held up and maintained over many, many decades.

Together with my friend, Alan Meltzer, I had occasion 15 years ago, in 1964, to submit to this committee the detailed report on Federal Reserve policymaking, where we essentially brought and emphasized that the internal procedures, implementation procedures of the Fed, the way they are structured, as well-designed to make an adequate monetary control possible, that they contribute basically to the instability in our monetary growth, and they contribute to the instability in the performance of our economy; once we had initiated an inflationary thrust, they would contribute to reinforce this inflationary thrust in the long run.

So, the Fed would have to be instructed to change these implementation procedures and to develop procedures appropriate for the control of the monetary aggregates which are required if we want to get out of inflation.

Other central banks were able to do so. I don't see why the Fed should not be able to do so. It can be done. The Swiss National Bank has shown it. The German National Bank has shown it. The Spanish National Bank has shown it. If it were so permitted by the political process—again, there have been some changes there in recent years—even the Bank of England has learned the lesson and is shifting to another attitude and another stance, quite explicitly, in this respect, and it is remarkable to see that.

Now, another aspect of this context which is important is the following: We need also attention, in order to improve the policy-making which is required for anti-inflation purposes, to the arrangements, to the institutional arrangements in our monetary system. Some of them create problems in terms of inadequate controls. I simply refer to the reserve requirements, the way we have them structured at the moment, over the last 10 or 11 years, are not well designed for this purpose.

The Federal Reserve has their direct immediate opportunities to change it. It could also propose changes which are more adequate which require legislation in this respect, and all that would help to get to better monetary control which is necessary for our purposes.

Another point which is very important at this stage: We have become increasingly subjected to measurement error. The data, particularly in M_1 and M_2 , suffer under a very serious measure of error. I think the measurement errors might reach up to 10 percent at this stage for M_1 . Also, therefore, we have a serious problem to assess what is really going on in terms of our monetary growth, measured in terms of M_1 and M_2 .

Now, there is nothing in here that is technically impossible to get an accurate picture. It is very important that the Federal Reserve follow up on the recommendations of the Bach committee in order to carry through the necessary work on the data so that it knows what it is doing in terms of the task assigned to it by Congress and the general nature of our political process.

Now, this is, incidentally, the reason why for the moment I formulated my proposal in terms of the monetary base, because we do not have the measurement problem there. The Federal Reserve controls every dollar of the base if it so wishes to do. And, in addition, we do know that in the average over time the thrust which the monetary base exerts will push through in the behavior of the monetary aggregates. There is no need to wait until there have been new committees or new studies made by the Fed on M_1 and M_2 , the proper measurements of M_1 and M_2 , to implement the proposal. We can get started immediately this year. And, meanwhile, the Fed should also do the work on the data so that we have better information.

Now, there are various objections that have been raised against the proposal. One of them is that the cost, the social cost, of transition is too high. Another one is that monetary policy has nothing to do with inflation. The third one is that, "Well, we need various supplementary actions."

Let me indicate only quickly this: In terms of the social cost, we do have probably a social cost of transition. I simply do not know how to avoid that. I wish I knew. I wish that somebody knew. But the fact of the matter is we don't have the necessary detailed, very spe-

cific knowledge of the detailed reaction structure of the economy. So, the best we can do through a gradual process to minimize this social cost of transition. What is important to realize is that this is a temporary cost, but still it exists.

The crucial point, however: What is the social cost of the alternative? The alternative is a permanent inflation, and permanent inflations, well, we know how they work. We have 100 years of experience in Latin America; this is highly rapid inflation. Highly rapid inflation would also be the fate of the United States if we continue. This rapid inflation would mean continuous—again, a drop in output between intermittent surges in unemployment and, over 10 or 15 years, that would mean a social cost which is a vast multiple of the social cost affecting coming out of inflation once and for all.

Now, the second point in terms of monetary policy has nothing to do with inflation. Well, the answer there is very simple: All we have to do is look at any inflation we experience. There simply was never any inflation without preceding excessive monetary growth. And whenever and wherever in medieval times, in ancient times, in modern times, in the 19th century, the United States or Yugoslavia or Turkey or whatever, if monetary growth declines consistently, inflation will drop and ultimately disappear.

We had many experiments made again in the last years. Switzerland lowered its inflation rate from 13 percent to zero by just getting hold of monetary growth, lowering monetary growth from 20 percent to 4 or 5 percent on the average. Other countries have done it. We can also.

Now, the next point is in terms of supplementary measures. The supplementary measures, for instance, of income policies, orchestrated action of this and that as a means to do something about inflation, are simply essentially irrelevant and do not contribute anything in terms of inflation. They actually sidetrack attention from what we really have to do in this respect.

It is contended sometimes that general measures, monetary policy, fiscal policy, have failed, but that is simply not true. That is exactly the story, like, suppose somebody sits in a car, fumbles with the ignition or confuses the brake and the accelerator, the car doesn't work, and then he says, "There you see, Detroit has done a lousy job. The car has broken down."

You have to know how to drive a car, and that is essentially what we have: We have not tried to carry through an anti-inflationary policy in this country so far; and if we do, it will work like in any other country, but we have to be patient. That is a crucial point in this respect.

Now, fiscal policy, I simply wish to emphasize that this does not play, by itself alone, the crucial role for the inflation problem. It plays an important role in terms of our real growth in the future, whether we absorb a lot of resources from the capital markets and finance the deficit and so on, but in terms of inflation it only plays an indirect role in terms of the political pressure. The large deficit imposes upon monetization of the deficit by the central bank, so lowering the deficit helps. It will contribute to stay on the course of a noninflationary monetary policy.

Lastly, what about unemployment and growth, as indicated by the Full Employment and Balanced Growth Act of 1978? The point is simply this—that we have to recognize that monetary policy cannot solve all the problems. Monetary policy can solve the inflation problem, but monetary policy cannot lower the measured unemployment rate under our present institution to 4 percent for the age group indicated, or the 3 percent to the other age groups.

There are many things that can be done: The changing of institutions in a variety of ways that would contribute to the lowering of the unemployment rate. I regret very much that Martin Feldstein is not here, because he has actually through his work over the past 5 years elaborated in some detail on what could be done in this respect to lower the unemployment rate.

But to use monetary policy to force unemployment down will only create a vast failure. The unemployment will stay high. It will actually drift up under the permanent rapid inflation. We will get more inflation.

So, the course I propose, we do get in at least one respect nearer to the goals of full employment and balanced growth.

Thank you.

[Dr. Brunner's prepared statement follows:]

PREPARED STATEMENT OF DR. KARL BRUNNER

1. THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

I appreciate the opportunity to present my views to this Committee concerning the course of monetary policy best designed to promote the goals of the Full Employment and Balanced Growth Act of 1978. This Act establishes medium and long term goals for both inflation and unemployment. Inflation should be lowered to 3 percent p.a. by 1983 and completely vanquished by 1988. Unemployment for individuals aged twenty and over need be reduced to 3 percent and among all persons aged sixteen and over to 4 percent. These unemployment levels should be realized by 1983 and subsequently maintained into the future. The Act also declares Congressional intentions addressed to capital formation, rising productivity and increasing real income per capita. Congress rejects thus the prospects of permanent stagnation advanced by assorted groups advocating a "non-growth economy". Congress also rejected the views advanced with increasing frequency that we should accept a permanent inflation and accommodate our policies to this fate.

2. THE INFLATIONARY HERITAGE OF PAST POLICIES

The apparent interest of Congress in price-stability and economic growth at least as expressed in the Act of 1978, should stimulate concern about the performance of our economy in the 1970's. The drift in inflation and unemployment was not produced by blind fates beyond our reach. We contribute to this drift with the dominant trend in our economic policies. This fact holds most particularly for the case of inflation. The differences in the behavior of the general price-level between the period 1960-1965 and the 1970's and similar differences in other countries or between countries are not determined by mysterious social forces. Nor is the relative intractability of recent inflation in the USA particularly surprising. The level and persistence of our inflation is essentially the product of our monetary policy pursued since 1965. This policy produced a monetary growth pushing nominal gross national product at a rate of expansion exceeding the average rate of real growth. Economic agents in the private sector unavoidably adjusted their price and wage setting to this nominal expansion maintained over many years by the Federal Reserve Authorities. The sequence of abandoned attempts at an anti-inflationary policy (1966, 1969, 1971/72, 1974/75) confirms prevalent expectations of a persistent inflationary policy. Wage- and price-setters show little inclination under the circumstances to adjust their behavior to a temporary reduction in mon-

etary growth and to the passing retardation of nominal demand. Both our current inflation and its apparent intractability result from the pattern of policies cultivated by our monetary authorities.

3. A GENERAL PROGRAM OF MONETARY POLICY

The recognition of the underlying cause driving our inflation determines the course of policy pushing the economy nearer to the goals expressed by Congressional legislation. A stable price-level requires that the Federal Reserve hold the growth rate of the monetary base to around 2 percent p.a. The combination of this growth with the expected trend in the monetary multipliers and monetary velocity produced by a gradual diffusion of institutional innovations determines approximately a trend growth of 3 percent p.a. in nominal gross national product. This implies under the circumstances a normal rate of growth in real output of about 3 percent p.a. and a stable price-level. With a different normal real growth or a different trend in multiplier and velocity than implicitly used in the previous assessment suitable revisions in the medium term growth rate of the monetary base yield closer approximation to the stability of the price-level required over time. A well managed Federal Reserve Authority with a definite commitment to its public responsibility would learn from experience as the situation evolves the approximate magnitude of the non-inflationary growth rate of the monetary base. At the moment and on the basis of our available information it seems quite adequate to use 2 percent as a benchmark for 1988 or even somewhat earlier. The probable errors are small relative to the magnitude of the current inflation. The path of the monetary base determined by its initial position (around 9 percent p.a. in 1978) to the benchmark level set for 1986-1988 would assure an unambiguous reduction of the rate of inflation to a small fraction of the inflation emerging during the winter 1978/79.

4. THE IMPLEMENTATION OF THE PROGRAM

The implementation of this general program requires some attention. The non-inflationary level can be approached in many different ways. If we knew with certainty the economy's complex dynamic structure and the patterns of changing expectations induced by new information the move to a non-inflationary state could be realized under optimal conditions in terms of the social costs associated with the transition. The revisions of expectations would moreover induce rapid changes in price-wage setting in case the new policy is (miraculously) accepted by the public with full confidence as an expression of a determined and sustained effort. The social costs of the transition would be lowered to a minimal level under the circumstances. Unfortunately we do not possess this information and we must grope for a path in a murky fog. An immediate reduction of the growth rate of the base from 9% to 2% induces most likely a recession with losses in output and employment. The low credibility attached at this time to any sustained anti-inflationary monetary policy raises the social cost of the transition as it lengthens the time required for the adjustment in price-wage setting behavior. It should be noted however that the moderation in the growth of the base required for our proposal is substantially smaller than the retardation observed in 1920/21 or in 1936/37. It would be somewhat larger than the retardation imposed by the Fed in 1948/49 and other postwar recessions. The loss in output and employment resulting under the circumstances fosters most likely political pressures forcing a reversal of monetary policy onto a renewal of the inflationary game. I know of no way to determine a path for the monetary base which will assure us the absence of any social cost of transition or promise that we move along an optimal trajectory in terms of social cost. My best suggestion under this uncertainty shared by all of us indicates a gradual approach explicitly announced and well articulated to the public. According to this approach the Fed should announce once and for all in a manner conveying a convincing commitment that it plans to lower the growth rate of the monetary base each year by one percentage point until we achieve a stable price-level.

This policy need be announced now and initiated for 1979. The White House should also commit its prestige, as it is, in support of this policy and make clear that it will not tolerate any deviation from the announced path.

5. THE IMPLEMENTATION OF THE PROGRAM : CHANGES IN PROCEDURES AND CONCEPTIONS GOVERNING THE FED'S POLICYMAKING

The simple proposal involves no technical complications and difficulties. The Federal Reserve Authorities possess all the technical means for an effective execu-

tion of such a policy. It will require however somewhat of a revolution in the conception and procedure of the Federal Reserve's bureaucracy. The Federal Reserve continues to formulate and implement policy according to an old pattern. This pattern, and its consequences with respect to economic stability, has been described in detail in a study on Federal Reserve Policy Making jointly prepared for this Committee in 1964 by myself and Allan H. Meltzer. The Shadow Open Market Committee also commented repeatedly in recent years on this problem. The Fed's traditional procedure seriously impairs the control of monetary growth and the growth of the monetary base. It obstructed in the past four years the realization of Congressional intentions expressed by HC 133 (March 1975) and the recent revisions of the Federal Reserve Act. This obstruction was reinforced by the Fed's conception traditionally dominating its views of monetary events and monetary processes. The conception inherited by the Fed's bureaucracy essentially denies the relevance of monetary aggregates and blinds the Fed to the crucial role of monetary growth in the inflation process. The internal procedures combined with the old conceptions explain the fact why the Fed so miserably failed to satisfy the Congressional intentions over the past four years.

6. THE IMPLEMENTATION OF THE PROGRAM: INSTITUTIONAL REFORM OF ADEQUATE INFORMATION

The change in procedures and conception of the Fed's bureaucracy must be supplemented with two other groups of measures in order to improve our policy-making in a manner better suited to achieve Congressional goals. Some of the institutional arrangements in the US monetary system are not well designed for an effective control over monetary growth. The prevailing structure of reserve requirements and the ceiling on interest rates imposed on checking and time deposits produces under inflationary circumstances serious distortions in the measured monetary aggregates. These distortions lower the information content of the data and impair any rational assessment in policymaking. These distortions have recently been aggravated by increasing errors impounded into the traditional measures of M_1 and M_2 . Institutional innovations (AFT accounts, NOW accounts, broker and money market fund checkable accounts and overnight repos) in the financial industry erode the meaning of the published data. There remain however some questions concerning the adequacy of the published data even in the absence of the evolving institutional innovations. Several years ago a special Committee constituted by the Federal Reserve Authorities recommended several modifications in the assembly and preparation of data for the measurement of monetary aggregates. It seems most urgent at this time that the Federal Reserve Authorities be advised that their responsibility defined by the Federal Reserve Act and the Full Employment and Balanced Growth Act requires a systematic reexamination of their measurements. Inadequate measures increase the uncertainty confronting policymakers and economic agents. They also offer opportunities for useful exploitation by the Fed's bureaucracy in order to produce sufficient verbal smog to obstruct the movement to a noninflationary path of the relevant monetary magnitudes.

It is important to emphasize in the present context however that we need not suspend any relevant action until the studies of new Committees or the enquiries made by the Fed are terminated. The Fed can immediately initiate the necessary changes in implementation proposed by the Shadow Open Market Committee in recent years, modify some arrangement (e.g. reserve requirements), actively propose some other modifications (structure of reserve requirements, interest ceilings on deposits) and most particularly announce a commitment to lower the growth rate of the monetary base by one percentage point each year in the manner indicated above. We note in passing that the monetary base suffers at most vanishing measurement problems. It suffers on the other hand under the Federal Reserve's systematic refusal to recognize its central position in the money supply process.

7. THE SIGNIFICANCE OF FISCAL POLICY

My statement concentrated thus far on monetary policy. A short comment bearing on the role of fiscal policy need be added at this point. The direct effect of budget and deficit on the rate of inflation is comparatively negligible. An expansion of government expenditures on goods and services tends indeed to raise the price-level. But such expansions contribute (directly) little to our inflation. A similar situation holds for the deficit. The direct effect of the deficit on the rate of inflation vanishes in comparison to the importance of the mode of its financing. The deficit exerts however an indirect effect of some importance on

the inflation motor. The nature of the political process lowers the likelihood of a non-inflationary monetary policy under the circumstances of a persistent and large borrowing requirement by the Federal Government. It would thus seem advisable that fiscal policy contribute with a balanced budget to the goal addressed by Congress. The comparative irrelevance of the direct effect of budget and deficit on inflation does not imply however the irrelevance of these fiscal magnitudes in terms of our welfare. A large and increasing budget absorbs resources by the government sector. These resources are used less productively and more wastefully in this manner than in the private sector. Rising government expenditures on goods and services lower in the average real investment and real consumption and lower over time our economic welfare. Rising government expenditures in any form expand moreover the power and reach of the bureaucracy. The citizen's control over an ever expanding government sector forms a major problem for our political future beyond the threat of permanent inflation.

8. THE OBJECTIONS TO ANTI-INFLATIONARY MONETARY POLICY

The program submitted in my statement is hardly uncontested. It is opposed on the grounds that the social cost of transition to a stable price-level is too high. The argument asserts in particular that the social cost of permanent inflation is small when compared to the social cost of an anti-inflationary policy. This discrepancy in social costs determines that policy should rationally accommodate a persistent inflation built into the economy. Another objection contends that inflation involves a social process essentially independent of monetary growth. A reduction in monetary growth produces under the circumstances a permanent loss of output and employment. It is useless and harmful in this view to tame inflation by means of monetary control. Lastly, one may concede some usefulness to monetary-fiscal restraints but argue that such "general measures" be supplemented by "specific and structural" measures.

(a) *The social cost of anti-inflationary policy*

The case for a permanent inflation in terms of the social cost of anti-inflationary policy involves essentially an irrelevant comparison. It compares the transition to a stable price-level with a stable and fully anticipated inflation. But this comparison is hardly relevant for our purposes. It assesses an anti-inflationary policy against the standards of Never-Never-Land. Permanent inflation actually means an erratic inflation with large variations in the spread between expected and actual rate of inflation. A policy of permanent inflation induces thus substantial variations in output and unemployment. The cumulative loss of output from intermittent recessions whenever inflation abates exceeds probably the social cost of a once and for all transition. Permanent inflation imposes additional social costs beyond this cumulative output loss resulting from intermittent "stagflationary" recessions. The erratic course of permanent inflation increases the uncertainty confronting economic agents. The higher level of uncertainty shortens the horizon of investment projects, curtails the average pay-off period, and tends thus to lower the rate of investment in human and non-human capital. These repercussions are further aggravated by our tax structure. Permanent inflation typically fosters furthermore intermittent controls over prices, wages, and interest rates. Every new wave of inflation encourages the formation of new agencies and watchdogs "supervising" prices or fosters extended powers to already existing agencies. The bureaucracy expands and the power of government increases. The resources invested in this manner by the government sector hardly affect the ongoing increase in costs and prices. They do provide however substantial incentives encouraging a wasteful and distorted use of our productive opportunities. These repercussions lower over time the trend growth of normal output.

(b) *Irrelevance of monetary policy and monetary growth?*

The second objection against an anti-inflationary monetary policy implicitly argues that the social cost imposed by such a policy is indefinitely high. This follows from the view that inflation evolves irrespective and independently of monetary growth. This theme has become quite fashionable in wide circles. Its attraction follows to a large extent from the political message implicit in the view. It offers some further justification for massive social engineering and most particularly for the replacement of markets with political institutions. The evidence accumulated from a wide array of inflationary experiences drawn from many different historical circumstances and countries thoroughly refutes how-

ever this contention. No inflation ever emerged without an excessive monetary growth usually produced by the government. This holds for the French inflation in the middle of the 14th century just as well as for the Latin American inflation of the last 150 years, or the Italian, English, Turkish, Spanish, etc. inflation of the past ten years. We find in particular that every major or persistent acceleration of monetary growth is followed by rising inflation. Substantial variations over time within any given country or differences between countries at any given time in the level of monetary growth are clearly reflected by prevailing magnitudes in the rate of inflation. But the evidence shows more. It also reveals that inflation disappears whenever monetary growth subsides to a level determined by normal real growth and the trend in velocity. Recent experiences in West Germany, Switzerland and the United Kingdom offer remarkable instructions for our purposes. West Germany and Switzerland were more exposed to the real shocks produced by OPEC and the failure of agricultural crops than the USA. They still managed by a determined reduction of monetary growth below the excessive rates reached in 1972 to lower inflation to vanishing levels. There are many other cases from other periods and other countries which exhibit unambiguously that a persistent and sufficient decline of monetary growth effectively reduces the rate of inflation. Any contention that inflation proceeds irrespective of monetary policy and independently of monetary growth finds no support in the reality of inflation experiences.

(c) *A need for supplementary measures?*

Lastly, it is argued on occasion that general measures based on monetary and fiscal policy cannot form the sole instruments of an anti-inflationary policy. They need to be supplemented by "specific and structural" measures. But this position is fundamentally untenable and contradicted by the facts summarized by the previous paragraphs. In particular, the contention that general policy measures have been unable to lower inflation is simply false. The failure observed over fourteen years in the USA is not due to price movements being disconnected in a "new world governed by new social structures" from falling monetary growth produced by unstinting efforts of our Federal Reserve bureaucracy. The facts are very different. Our monetary policy never settled on such an effort and never showed any determined attempt to reduce monetary growth to the levels required for a noninflationary growth. One might just as well attribute the failure of a car to move because the driver confuses brake and accelerator or fumbles with the ignition to a breakdown of the car. An emphasis on supplementary measures lowers the likelihood of an effective anti-inflationary policy as it directs attention away from the basic requirement to lower monetary growth. The Federal Reserve bureaucracy essentially rejected in the past years and still rejects this very notion of monetary control for the purpose of taming inflation.

Supplementary measures are basically useless as anti-inflationary devices. "Income policies", "social contracts", "orchestrated approaches" or simple coercion all failed to contain inflation. We need not invoke ancient history and the futile exercise of Diocletian, Julian the Apostate, Jean Valois II of France, Edward III of England and others. The experiences of the postwar era are quite sufficient to reveal that such measures may modify somewhat the shorter-run path of inflation with little longer-run effect in the face of a persistently excessive monetary growth. Moreover, the measures mentioned above hardly contribute to raise the credibility of a new attempt at anti-inflationary monetary policy. The uncertain and unreliable record of policymakers will not dissolve with the cultivation of irrelevant and ineffectiveness measures. Even under the best circumstances when they initiate a more efficient use of our resources the effect of specific or structural measures on the rate of inflation is minimal. It is quite illusory to cope with an 8% p.a. rate of inflation in such terms. It should be noted however that the irrelevance of supplementary (structural) measures with respect to inflation does not imply their irrelevance in terms of their cumulative effect on our general welfare. But I also wish to emphasize that some of the supplementary measures occasionally proposed are more likely to foster price increases and a wasteful use of our resources.

9. UNEMPLOYMENT AND GROWTH

The Full Employment and Balanced Growth Act 1978 imposes joint goals for inflation and unemployment. Policymakers are thus addressed to pursue a course of action lowering both inflation and measured unemployment. This course should also foster economic growth. Some clarification of the role of monetary policy in this context may be useful in view of many prevalent confusions. The case

for an effective anti-inflationary monetary policy is frequently dismissed as expression of "Republican values" favoring higher unemployment and lower inflation. This argument misrepresents unfortunately the actual issues confronting us. The choice is not between lower unemployment and higher inflation on the one side or higher unemployment and lower inflation on the other side. Our choice lies between a temporary increase of unemployment in the present above its normal level in conjunction with a return to the normal level and no inflation in the future on the one side, or, on the other side, permanent inflation with intermittent spurts of unemployment beyond its normal level augmented very likely by an increase in the normal level. It is unfortunate that we do not possess a sure way out of inflation without suffering most likely some temporary increase in unemployment. But there is really no alternative. All attempts to avoid lower monetary growth, exemplified by my proposal in a previous section, which insist on a variety of "specific or structural" measures are committed to failures. They will produce an apparently more and more intractable inflation and the final "Latin-Americanization" of this country. And most importantly, the country will move even further away from the goals declared by Congress.

A determined and generally understood sustained effort to reduce monetary growth does remove inflation. It will not raise the normal level of unemployment but neither will it lower this level significantly at this stage of our inflationary heritage. The normal level of unemployment settled probably around 6% under the current institutions. Any effort to lower this level moves our attention beyond monetary policy. Monetary policy could lower the measured unemployment rate substantially below 6 percent only for a short period and would unleash thereby accelerating inflation. A reduction in the normal level of unemployment must be accomplished by major changes in our social institutions, (among others: minimum wage, the modus of food stamp plan and unemployment compensation or benefits). Government policies reenforced in the USA the upwards drift in the normal (and measured) unemployment rate beyond the range due to demographic trends in our labor force. A similar pattern holds for the fall in the rate of real growth observed in the USA. The proper approach to lower unemployment and higher real growth involves under the circumstances a systematic reassessment of a wide range of inherited government policies and regulatory procedures. This reexamination with appropriate actions should indeed be welcomed and encouraged. Our society would benefit and general welfare rise. But our political process may not produce this result and Congress may prefer to continue the prevailing arrangement. But this also means under the circumstances that one should rationally accept the consequences expressed in terms of unemployment and growth rate. In particular, these consequences offer no justification for an "expansionary" monetary and fiscal policy intended to force a lower rate of unemployment and higher rate of real growth. Monetary policy will not deliver this result. It would only yield on this course accelerating and erratic inflation with unstable output and rising level of normal unemployment. And lastly, any attempt at curing the problem of low growth and high measured unemployment with larger doses of the "specific and structural" measures which produced these problems contributes to accelerate the trend into stagnation and permanent inflation.

The CHAIRMAN. Thank you very much, Dr. Brunner. As always, you have given us a very clear position.

In essence, what you describe, what you and the Shadow Open Market Committee passed, which is: you have as a target for the money supply, M_1 or M_2 , an annual decrease of about 1 percentage point. Stick with it.

With reference to Chairman Miller's and the Fed's 1979 targets, as you probably know, their M_1 target is really a band of $4\frac{1}{2}$ to $7\frac{1}{2}$ percent. It was phrased as " $1\frac{1}{2}$ percent to $4\frac{1}{2}$ percent," but then there is a 3 percent add-on to that because of automatic transfer savings accounts and NOW accounts.

Would you have felt good about a Federal Reserve position which said, "All right, for the coming year, 1979, our band will be $4\frac{1}{2}$ to $7\frac{1}{2}$ percent, of which the middle is 6 percent. Thereafter, we are going to 5 percent in 1980, 4 percent in 1981, 3 percent in 1982, 2 percent in

1983, ad infinitum." Would that kind of a statement have been what you were looking for?

Dr. BRUNNER. That indeed goes in the direction toward which I and my friends are looking for. It is really a 4½ to 7½ percent, really, the way it was presented, and I think we should look at it this way. That certainly would be a retardation in the direction where we have to go relative to what we had previously. And it would also imply, I think—and I think we should face up to it—the fact that it really carries it through.

We will have a beginning of the economy during that track, and as I said, I wish I knew how to get around it, but I simply don't know and I don't see that anybody could know how we could avoid that.

Now, and again, like you said, we should continue, definitely. The announcement should be supplemented that this is continued each year by a further percentage reduction of both boundaries so that the ultimate zeroing in of the monetary gross, say, for example, and one should be about 2 or 3 percent at the most by about the middle of the eighties.

The CHAIRMAN. Toward the end of your paper and toward the end of your discussion you talk about the need for supplementary measures. You say, no, let's not have any "specific structural" measures. You then go on to talk about and to dismiss wage-price-incomes policies, however clothed they may be. I certainly don't have any difficulty philosophically with that position. But the word "structural" certainly means to me a great many things other than wage-price-incomes policies, meek or brutal.

I want to bear down on this a bit with you. Don't you think the structure of our economy, most of it, government-induced, I will grant you, has a lot to do with inflation, and if your monetarist ideas are to succeed, it really would be wise to do something about the structure?

Let me just tell you what I am talking about. Look at the composition of our 9-percent current consumer price index inflation. Food is a very large part of that. As you came in here today, you noticed our friends from the agricultural regions of this country who are down here saying that they want higher price supports.

People point out to them, the farmers, that they are in trouble very largely because the price of land has been bid up by the capitalization of existing price support levels and by their being overextended at the bank and that to raise the price by governmental fiat will just make matters worse, and so the ratchet will go on indefinitely.

Isn't structure thus very important and isn't your monetary light at the end of the tunnel going to be snuffed out if we leave the ramshackle structure of our economy as it is? First, let me say that the answer to me in terms of our farm prices would be to cease the ever-increasing mandated, man-made, Government-made farm prices, and instead to compensate family farmers by whatever direct payment the Government felt necessary in order to keep people on farms. What do you think of other methods such as the Homeowners Loan Corporation which is intended to reduce human tragedy when a bank starts to foreclose on a mortgage because the price of land doesn't continue to go up fast enough at the local level. Land costs deeply affect both food production and housing.

What do you think of the way our localities tax land and homes and factories with an artificially low land valuation and a correspondingly too great valuation on improvement? In the minds of some of us neo-Henry Georgites, we would be much better off if we changed the mix and got the same revenue from the local real estate taxes we now do, but upped the tax on raw land and downed the tax on improvements. I give you two examples of structural conditions as I ask you: Do you really believe structure is irrelevant?

Dr. BRUNNER. There are several aspects I have to deal with. Really, there are several questions involved which you raised. Let me indicate in one fashion—I think we really have to differentiate—and that is what you are really bringing out in your elaborations, several meanings of structure which are relevant in this context.

There are at least about two, and I want to address myself to them. One of them I can best describe if I indicate the experiences of a few other countries. Last week I just happened to be in Italy and Turkey in order to work out some problems there with some friends. The inflation problem in both countries is to a large extent the structural problem in a very specific sense.

Look at, for instance, Turkey. They have not only the traditional range of the Government, but then the large part of the remaining economy is the state enterprise system. The competition between the two major parties prevents to adjust the prices on the state enterprise system to the reality, to the market reality.

The result is that the state enterprise is a—has a permanent deficit which is financed by the central bank. So there is in a way the structural problem there related to that, to the political process, which explains why we have an excessive monetary growth in Turkey. But this inflation is the result of this excessive monetary growth.

Your question and argument involves several issues and we need to discern several aspects or strands in the “structural problem.” One important aspect bearing on the inflation problem came to my attention at the occasion of a recent visit in Italy and Turkey. The latter country’s “political-social structure” is indeed a major factor in the large inflation—about 60 percent in 1978—observed there. The political process produced a vast state enterprise system and also obstructs adjustments of the price charged by state enterprises to the realities of the market place. The massive deficit of this “extended political sector” is financed by the Central Bank. The political forces shaping this social structure thus induce the monetary expansion pushing the price level. The “structural strands” of the Turkish society do not, per se, directly create the observed inflation. Their relevance for the inflation is conditioned by their effect on monetary expansion. If the Turkish Central Bank would lower monetary growth and refuse accommodation of the deficit, inflation would stop. The so-called “sheltered system” of the Italian society contributes in a similar vein to the Italian inflation via involvement of the Banca d’Italia in the money-producing business.

But your question addressed substantially some other aspects of a “structural problem.” You mentioned increasing land values and the resulting pressure to raise the support level of agricultural prices. We should recognize in this context that land values essentially reflect the inflation unleashed over the past 14 years by our monetary policy. Real estate and land are probably the best hedge against inflation for the

individual investor. The resulting pressure on support prices for agricultural products just forms a further consequence of the inflationary policies pursued by our financial authorities. It is also noteworthy that the occurrence or nonoccurrence of these structural elements do not discriminate between countries which effectively lowered and those which raised the rate of inflation. The support programs for agricultural products are in West Germany and Switzerland at least as extensive as in the United States, but these countries still managed to lower inflation. The structural problems mentioned in your statement certainly affect the efficient use of our resources and our welfare. They hardly affect, however, the ongoing rate of inflation. We should avoid the pervasive confusion of the inflation problem with aspects bearing on relative prices of different goods and services. The observed increase of any price in the economy is the sum of a component common to all price increases and a specific component. The common component reflects the inflation problem and measures the ongoing rate of inflation. The specific component expresses specific supply and demand conditions associated with particular goods or services. The specific component of different types of goods, fuel, and so forth, vary quite substantially over time relative to the common component. Unfortunately, public attention often confuses these gyrations of the specific component in particular price increases with the inflation problem and attributes inflation to the special supply-demand constellation in a particular market. "Structural" consideration addressed to the evolution of the specific component may well be appropriate in terms of efficient resource utilization but will never cope effectively with the inflation problem.

The CHAIRMAN. Thank you very much. My time is up. Before calling on Representative Kelly, I want to welcome Dr. Thurow, and I guess I will ask Dr. Brunner his preference. After Mr. Kelly has an opportunity to ask you some questions, would you prefer that we continue with our committee questioning of you and then go to Dr. Thurow, or if your time permits, I would then call on Dr. Thurow.

Is that all right?

Mr. BRUNNER. That is fine.

The CHAIRMAN. But I think you do have to go, Mr. Kelly, so I will recognize you.

Mr. KELLY. Thank you, Mr. Chairman.

Dr. Brunner, I would like to ask you, do you think that in the order of things the monetary and fiscal policy as it is controlled by the Fed and by the Government probably has an overwhelming impact on the question of whether the economy is inflated or not as compared with activity in the private sector and otherwise?

Dr. BRUNNER. I had a little difficulty to hear you. You seem to ask whether monetary and fiscal policy has an overwhelming effect in which respect?

Mr. KELLY. That the overwhelming cause of inflation is created by the monetary and fiscal policy as it is controlled by the Fed and the Government; do you agree with that?

Dr. BRUNNER. Yes; indeed. That is my central thrust.

Mr. KELLY. According to your testimony, over the last 15 years, the Federal Reserve for its part has not controlled the monetary policy consistent with that which is required in order to avoid inflation. Let me ask you this: Is that a fair statement?

Dr. BRUNNER. The Federal Reserve essentially produced the monetary expansion experienced since 1965. It has shown little interest ever to understand the issue and to overcome its confusion.

Mr. KELLY. Then for whatever reason, the conduct of the Federal Reserve Board with regard to properly controlling the monetary policy has just been inadequate. It has not done what was necessary to avoid inflation, for whatever reason.

Dr. BRUNNER. That is exactly the point.

Mr. KELLY. Now, to the extent that fiscal policy also makes a contribution to inflation, the fiscal policy also has not been consistent with maintaining a level of economy as opposed to inflated economy. Would you agree with that?

Dr. BRUNNER. When we speak about the role of fiscal policy we need to remember the following: First, fiscal policy importantly affects our welfare and the development of our resources but exerts little direct influence on inflation. Second, there is however an indirect effect of the deficit on inflation via the political pressure on the central bank to monetize the deficit.

Mr. KELLY. Then when one considers the impact of the activity, the pricing activity of the private sector, as a cause of inflation compared with the cause by the monetary and fiscal control of the Government, it is a relatively minor part. In other words, it probably plays even less a part than the fiscal policy and substantially less than the monetary policy.

Dr. BRUNNER. Well, the pricing behavior of the private sector is simply an adjustment to the monetary and fiscal policies pursued.

Mr. KELLY. So it is simply a response to what is established by the monetary and fiscal policy?

Dr. BRUNNER. That is exactly the point. That is why we find these differences between the various countries.

Mr. KELLY. Then let me ask you this: Can we then really have any—can the American people, the people that are really paying the price for all of this nonsense, present and prospective, can they really hope for any relief with the President's voluntary guidelines? Isn't that more a diversionary tactic to just draw attention away from the real causes than anything? It is sort of a public relations-type of thing as far as it having any real impact on inflation.

Dr. BRUNNER. Indeed, guidelines of any kind, voluntary or mandatory, misdirect our attention from the central aspect of inflation. They form a sort of handwaving to obscure the basic responsibility of the Government. They cannot cope with inflation but damage our economy.

Mr. KELLY. If I understand you then, that this will have no impact on the rate of inflation?

Dr. BRUNNER. That is right.

Mr. KELLY. There has been a pretty substantial effort or sentiment expressed here in the Congress that in order for us to get our act together for a sound economy in America, what we need to do is to have a little more political control over the monetary policy so that there won't be any inconsistencies between the monetary policy and the fiscal policy so that the same people that are controlling the reins of the fiscal policy will also be able to control the monetary policy so that they can go in unison.

My question to you: It is the failure of the Fed to perform with any kind of courage and consistency their obligation to control the monetary policy in a way that would create a sound economy which endangers the strongest argument for independence of the Federal Reserve System.

Would you agree with that? In other words, if the thing isn't working, what difference does it make whether it is independent or controlled or whatever? But if it does work, there is a strong argument for its independence.

Dr. BRUNNER. The crucial issue confronting us is really the public accountability of the central bank. The central bank is a political institution which need be made accountable for its action. This accountability hardly exists in any relevant sense in this country. The persistent obfuscation cultivated by the Federal Reserve bureaucracy protected the Fed from the accountability really required in a democratic government. The Fed invested a massive political effort to obscure the fact of its responsibility for the large depression from 1929 to 1933. It again used all the political mechanisms available to obscure its responsibility for the inflation in recent years.

It is interesting to compare the Fed with the Swiss National Bank in this respect. The latter actively mobilized a tacit but powerful coalition including most of the political spectrum to support a noninflationary course of monetary policy. This coalition suffered last year a serious setback and at the time the survival of a noninflationary policy is really on the line.

Our major problem currently is to find a procedure which forces the Fed against its entrenched bureaucratic instincts to a pattern of meaningful public accountability. Congress could assume an important role in this respect by insisting that the Fed provide useful data that specify unambiguously the monetary target conducive to a stable price-level by 1985 or so and that the Fed be held responsible in public to satisfy their obligation.

And in this respect, appropriate measures should be taken.

Mr. KELLY. Dr. Brunner, my time has expired, and I thank you for the opportunity to inquire.

The CHAIRMAN. Dr. Brunner, we will now hear from Dr. Thurow, and then we will resume our questioning.

Welcome. We appreciate your long wait through difficult conditions.

STATEMENT OF DR. LESTER THUROW, PROFESSOR OF ECONOMICS AND MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS.

Dr. THUROW. I apologize for being late but the Washington airports weren't open either last night or this morning. So I spent several hours in the air.

At the moment, all forecasts, Government and private, call for a sharp slowdown in the pace of economic activity late in 1979 or early in 1980.

Unemployment rises under all forecasts and a technical recession occurs in most of the private forecasts. While there has been an argument as to whether a recession will actually occur, this argument should

not be allowed to obscure the consensus on a sharp slowdown and a rise in unemployment.

If you remember that monetary and fiscal policies only affect the economy with a time lag, there is a real question as to whether current and planned monetary and fiscal policies are appropriate. These policies should now be adjusted to prevent a recession or slowdown from occurring. To be forced to adjust the policies to fight a recession during a recession is to engage in a policy action that cannot work because of time lags.

Under the pressure of rising unemployment, policymakers are also apt to adopt monetary and fiscal policies that will be too strong with respect to long-run inflationary problems. A recession by definition is not good for unemployment and it is, as I shall argue in a minute, also not good for inflation.

Instead of being moderated now to prevent the expected recession at the end of the year, both monetary and fiscal policies have recently been tightened and are expected to be tightened further. This is completely inappropriate and will only make the recession or slowdown at the end of the year worse.

Since September the money supply, M_2 , has risen at an annual rate of 4 percent and short-term interest rates have risen by 2 percentage points. Over the last 1½ years interest rates on commercial paper have risen by 5 percentage points.

This tight monetary policy is not necessary to counteract loose fiscal policies. Fiscal policies are now tight and scheduled to get tighter. With the Federal Government now paying 25 percent of all State and local government bills, government budgets have become integrated and it is no longer possible to judge the tightness of fiscal policies by looking at the Federal budget.

In the last three quarters, State and local governments had a \$27-billion surplus—at annual rates—the Federal Government had a \$22-billion deficit, and was at the same time giving State and local governments \$78 billion.

Overall Government has been running a \$5-billion surplus for the past three quarters and it is scheduled to keep running a surplus unless a recession occurs and lowers revenues. Under the proposed Carter budget, this surplus will rise by \$7 billion to \$8 billion in 1979 and another \$6 billion to \$7 billion in 1980.

Thus, both fiscal and monetary policies are tight and fiscal policies are scheduled to tighten further at precisely the time when a recession or slowdown is predicted to occur. This hardly seems like monetary and fiscal policies coordinated in the way in which the Full Employment and Balanced Growth Act of 1978 intended.

In addition, the economy is going to be hit by the full deflationary shock of the scheduled OPEC oil price increases—and price increases induced by the Iranian shutdown—in late 1979.

An increase in the price of oil is equivalent to a domestic sales tax in oil. At one and the same time it raises the price of energy and reduces the demands for other goods and services. More of our income is now diverted to Government, in this case a foreign government, and less is available for the purchase of other goods and services.

While history never exactly repeats itself, I think that we are setting ourselves up for a replay of 1974. High inflation became the

sole concern and in the process monetary and fiscal policies were tightened to the point where they caused the sharpest recession since the Great Depression. We have not yet tightened monetary policies to 1974 levels, but we are headed in that direction. Throw in a run on the dollar and you can easily imagine the Federal Reserve Board devastating the economy as it did in 1974.

Let me turn for a moment to the causes and cures of inflation.

Like generals condemned to fight the last war, the Federal Reserve Board does not seem to realize that the experience of double-digit inflation and recession in 1974-75 has altered the characteristics of the economy. A mild recession or slowdown would have moderated the rate of inflation in the fifties and sixties, but by the end of the seventies, it does not work. Mild tightenings of monetary and fiscal policies have lost their ability to control inflation since the economy has indexed itself.

This is not the place to go into detail on the evidence as to how the private economy has indexed itself or to recount the number of de facto and de jure cost-of-living escalator clauses that appear in private contracts or Government programs, but it is the place to remind ourselves of the consequences of indexing.

What happens if the economy is heavily indexed?

Suppose that inflation is running at 8 percent in a 10-percent indexed economy. With indexing, all wages and prices go up by 8 percent in year 2 to counteract the inflation of year 1. But if all wages and prices go up by 8 percent, the rate of inflation is 8 percent. Hence, wages and prices go up by 8 percent in year 3, et cetera. In a fully indexed world only two things can reduce the rate of inflation: one, favorable international events such as a fall in oil prices, or two, a basic wage settlement which is for less than the rate of growth of productivity.

Monetary and fiscal policies can be tightened in an indexed world, but they only produce unemployment and idle capacity. They do not produce a reduction in the rate of inflation.

It is possible to argue that a truly dramatic recession and rise in unemployment would drive the indexes and the expectations out of the economy, but this would require an enormous cost in terms of lost output and unemployment. Exactly how high and how long the unemployment would have to last is a matter of controversy, but no one thinks that a mild short recession will work.

It does not have the necessary shock value.

The current acceleration in the inflation rate was not caused by overstimulating the economy and it will not be cured by slightly deflating the economy in 1979 and 1980. If you look at the causes of the acceleration during 1978, it can be traced to food price increases, half caused by Government policies, a fall in the value of the dollar, an increase in the minimum wage, a rise in social security taxes, an increase in the costs of homeownership, half caused by rising interest rates, and a variety of other factors such as steel reference pricing. If excess demand played any role at all, it was very limited and in such specific sectors that it cannot be controlled by general economy-wide policies.

If you look at the 1978 causes of inflation, most are apt to be repeated in 1979. Meat prices are still going up, with the increase in the price of oil the dollar is apt to fall further, the minimum wage will

once again rise, social security taxes went up in January, the full effect of rising interest rates has not yet been felt in the costs of homeownership in the indexes.

In addition, oil prices are going to rise very rapidly. The Council of Economic Advisers predicted in its report that the rate of inflation in the implicit price deflator for the GNP would fall from 8.3 percent in 1978 to 7.5 percent in 1979. I think that this is highly unlikely. Inflation will be as high or higher in 1979 as it was in 1978. Indexing will carry most of the 1978 inflation into 1979 and we are going to add to this inflation with the set of actions just mentioned.

If a solution to inflation is to be found, it must be found in either a workable incomes policy or a sector-by-sector attempt to reduce prices, the deregulation of trucking, the abandonment of steel and agricultural price supports, and so forth.

A policy of sustained, modest rates of real growth can contribute to this effort, but stop-go economics and a mild recession or slowdown are not going to solve the problem.

Let me talk for a minute on defending the dollar. To some extent, monetary policies are now focused on supporting the price of the dollar. I have no objection to supporting the price of the dollar if it can be done, but I am afraid that the Federal Reserve Board is making the U.S. economy hostage to an untenable position. One cannot defend the indefensible. Defending the dollar only makes sense if the equilibrium value of the dollar is as high or higher than the current value of the dollar. If this is not true, it is only a question of time until the defender is beaten.

In the process of being beaten, the U.S. taxpayer will take large capital losses on the foreign currency borrowings that have been made in his behalf, but an attempt to defend the dollar can be even more costly if it leads to tight monetary policies during a period of slow economic growth such as that which we are now facing.

Tight money and a recession already underway produced the collapse of the U.S. economy in late 1974. With rising oil prices, the pressure on the dollar is apt to be most acute in late 1979, but this is exactly the time when a recession may be underway. Defending the dollar may well collapse the economy.

As a result, I think that this committee should ask for the technical studies showing that the equilibrium value of the dollar, given current and expected oil prices, is as high or higher than the current price of the dollar. If the Federal Reserve Board cannot present such evidence, it should not be in the business of defending the dollar. Without such evidence, it is doing something that is in neither the short-run nor the long-run best interests of the U.S. economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Dr. Thurow.

It is, incidentally, a very active confrontation generated by your testimony and that of Dr. Brunner's, which I am sure can be explored during questioning. In your testimony you place considerable store on getting some reforms in the structure of our economy: whereas, Dr. Brunner takes the view that while that may be desirable for reasons of income distribution or equity, it doesn't have much of anything to do with inflation.

So we return to that.

But I, having had my initial round of questioning, will wait until others have had a chance to examine.

Mr. Lowry?

Mr. LOWRY. Thank you, Mr. Chairman.

Dr. THURLOW, my question isn't really directly to all of the things you have touched upon, but what we are facing here, fiscal policywise in this Congress, are requests for a decrease in the rate of the increase of the deficit from \$10 to \$20 billion, perhaps.

What do you think as far as the effect on inflation, of decreasing the annual deficit would have, say, if we ended up with a \$15- or \$20-billion annual deficit this year, as opposed to \$40 billion?

Is that a definable effect on inflation?

Dr. THURLOW. Well, one of the things I would want to refer to that comes back to my testimony, is I do think that the American economy has heavily indexed itself.

Now Brazil has legal indexing, which means that the Government passes a law that says that every contract, implicit or explicit, has a cost-of-living escalator clause in it.

The classic objection to legal indexing is if you do it, it means that neither monetary nor fiscal policies can have the impact on prices that they otherwise would have.

Now we have a good hunk of legal indexing, indexes that have been put into government programs. But we, the private economy, haven't indexed itself in both wages and industrial contracts.

Now in an indexed world, modest tightenings of fiscal policies and modest tightenings of monetary policies don't have any substantial effect on the rate of inflation. All they do is produce a little bit higher unemployment.

Now if you are willing to go whole hog and have really a dramatic recession, then, since these indexes are put into the economy by the private decisionmakers, they just won't be honored and will be taken out of the private economy. But raising the unemployment rate from 6 to 7 percent doesn't cause indexing to leave the economy.

The other thing I would want to say is whatever you think the right degree of fiscal tightness is, you can no longer look at the Federal budget with this huge amount of grants-in-aids. We just have changed the structure of the American economy and we have a government budget which is Federal, State, and local, and you can only judge fiscal policies in terms of the surplus or deficit in that government budget. You can't look at one fraction of it.

Like, take the last 9 months where, as I mentioned, the States have had a \$27-billion surplus, the Federal Government a \$22-billion deficit, and the Federal Government was giving the States \$78 billion.

Well, as a bookkeeping measure, you could reduce grants-in-aid to the State and local governments by \$27 billion. If that doesn't cause any changes in their plans, they then would have a balanced budget. The Federal Government would have had a \$5-billion surplus. But that wouldn't change anything in terms of the economy.

The fact of the matter is, government has had a surplus for the last 9 months.

And you can make an argument that perhaps that total surplus ought to be bigger, and that is a discussion I would be willing to have but I think it is completely inappropriate to look at the Federal

budget by itself and try and decide whether fiscal policies are good or bad.

Mr. LOWRY. There is, of course, a lot of discussion that the psychological impact of the Federal Government making that obvious effort to tighten would have an impact on the economy and on inflation.

Do you think that holds water?

Dr. THURLOW. There are two ways to look at it: One, you can think of the economy as being indexed—and in that case, let us say that the rate of inflation has already started and you have indexes in the economy. Then the rate of inflation essentially gets propagated because, given that inflation was 8 percent last year, the indexes carry it forward as 8 percent this year.

To some extent, expectations play a role and I would not want to deny that.

But the real question is: Can modestly tightening, let us say this total government budget, so instead of having a \$5-billion surplus, you have a \$15-billion surplus, is that going to change anybody's expectations?

I doubt it.

If you were willing to stand up and say, look, I am really going to crack the American economy. I am going to have really severe monetary and fiscal policies, and I am just going to tolerate whatever level of unemployment and whatever level of disruption that causes, then you might buy something in that round.

But I think that there is a real argument as to whether the kind of modest tightenings in the current world really have a payoff.

Mr. LOWRY. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Green.

Mr. GREEN. Dr. Brunner, I wonder if you would care to comment on the argument that indexing frustrates the monetary or fiscal approach to dealing with inflation?

Dr. BRUNNER. Let me see if I understand correctly. Would I comment on the arguments made now by Professor Thurow?

Mr. GREEN. Well, I understood Professor Thurow to be arguing that, in fact, fiscal and monetary policy were hopeless in the face of an economy which has as much indexing, contractual or legal, as that of the United States.

Dr. BRUNNER. Two issues require our attention here, the asserted uselessness of monetary policy in the context of indexing and the more or less implicit suggestion that we need "structural reforms" which would be nothing more than another variation on the old price control theme.

The assertion that monetary policy is powerless to cope with inflation in the context of inflation is simply false. Brazil was thoroughly indexed and still, the large variation in monetary growth produced corresponding waves in the rate of inflation. Professor Thurow has no analysis to back up his claim.

The claim for controls is also fallacious. We have acquired some experiences over 2,000 years which governments are always willing to disregard. I draw your attention to the description in Barbara Tuchman's book, "A Distant Mirror." She describes how the French King produced inflation in the middle of the 14th century with his persistent tampering with the coinage. And in a fashion most typical for our

times also, after creating inflation he promptly accused the private sector and imposed statutes preventing increases of wages and prices. But these statutes had little effect on inflation. The world has changed in many respects but not in this. If we continue on the track of an inflationary monetary policy with the excuse of indexation, we will experience rates of inflation up to 20 percent per annum and a stagnating economy in 10 years.

Mr. GREEN. Can I just press that point a little further? You have argued that wage and price controls won't work, but you haven't really responded to the argument that the monetary and fiscal policy won't work, and that because of the indexing built in——

Dr. BRUNNER. I was certainly surprised to hear that indexation condemns monetary policy to impotency. There is simply no economic analysis supporting such a contention. We should also note that the extent of indexation depends on the course of inflation. With a persistent fall in the rate of inflation, the extent of indexation declines. Indexation expands on the other hand with accelerating inflation. But with or without indexation, the rate of monetary expansion determines the ongoing rate of inflation. I have already referred to Brazil. Beyond the point previously mentioned should be noted that we learn from Brazil that the cost of transition to a widely indexed economy is not trivial.

Mr. GREEN. I would be happy to give Professor Thurow a chance to respond.

Dr. THUROW. One, I was not advocating incomes policy because I think the preferred strategy is essentially to take the sector-by-sector approach, like the deregulation of trucking, and wherever that allows prices to go down, you then want to have tighter monetary policies because I am also not arguing that monetary policies are hopeless.

They can make the situation a lot worse, and I think we should have monetary restraint.

What I am basically arguing is that we should aim for monetary and fiscal policies which keep the economy growing at a positive real rate, around 2 or 3 percent a year, because I think if we let them tighten so far that we cause a recession, then for political reasons, and other reasons, we are going to have to let them go very easy for a period of time, and that is worse than keeping the economy growing at that modest rate during that period of time.

Mr. GREEN. Are you persuaded that we can fine tune the economy tightly enough to make that distinction between 2 or 3 percent growth and zero growth, for example?

Dr. THUROW. I am sure that we can. We may not be able to succeed, but we don't deliberately pump monetary policies into the economy that will cause that kind of a recession to occur.

Let me say one thing about the slowdown in the Swiss rate of inflation because as long as we are going to have a controversy here, we might as well have it full blown.

Imagine the following world. Now, these are not the Swiss numbers, but this indicates the Swiss situation. Imagine that you have a domestic rate of inflation of 10 percent and a rate of inflation in every country in the world of 10 percent, but you import 50 percent of your GNP and your currency goes up 20 percent in value.

Now, what does that mean happens to the cost of your imports? They are going down 10 percent. You get minus 10 percent rate of inflation on half of your GNP, plus 10 percent rate of inflation on half of your GNP, and you have a zero rate of inflation.

And a big part of the downturn in both the German and the Swiss inflation have to do with an appreciating currency in economies that have very large imports.

Now, let me say one further thing on indexing.

It isn't a matter of analysis; it is a matter of simple logic. And I don't know any American economist who would argue that if the world is 100 percent indexed—now, we can argue about whether the world is 100 percent indexed, but if it is 100 percent indexed, then monetary policies lose a lot of their power because legally, every wage and price goes up in the following year because the rate of inflation was 8 percent last year.

And in that kind of a world, as I mentioned, there are only two things: If everybody has 100 percent indexing, that will cause the rate of inflation to slow down; favorable international events or a basic wage settlement which is less than the rate of growth or productivity; that is, 1 percent in our economy at the moment.

There is nothing else that will work.

Now, you can say, well, the economy isn't 100 percent indexed. I would admit that it is not 100 percent indexed, but it is very close to it. If you look at labor contracts, they are close to 100 percent indexed.

Now, you can say, well, only 20 to 25 percent of the American labor force belongs to unions. But if labor contracts are indexed, then General Motors is going to give the same increase to its white-collar workers who are not unionized. If General Motors is giving the cost-of-living escalator increase, then nonunion companies like Xerox are going to have to do it to keep their labor force, or to keep unions out.

If large corporations are giving cost-of-living increases, then small companies have to do it or they lose their best workers.

I do a fair amount of speaking to business groups, and I have taken to asking the rhetorical question, how many people in this room would sell the commodity that they produce for delivery a year from now with a contract without the protection of a cost-of-living escalator clause.

I have never gotten a single hand raised. And I think this economy is very highly indexed, even if it is not 100 percent indexed.

Dr. BRUNNER. Mr. Chairman, may I comment?

The CHAIRMAN. Yes; Mr. Green's time is up, but surely, you may comment.

Dr. BRUNNER. Thank you very much.

The rise in the Swiss franc was neither a gift of the gods nor a curse imposed by demons. It resulted from the radical difference between the monetary policies pursued in Switzerland and in other countries. It was this policy which induced the rise in the Swiss franc and lowered import prices in francs.

We should however also examine movements in domestic prices. There is hardly an item more domestic or "nontraded" than building materials. It is noteworthy that building material costs mostly fell since 1975.

Lastly, I do not wish to pursue a technical discussion of indexation, inflation, and monetary policy before Congress. But I do invite Professor Thurow to present a paper with an analysis supporting his contention. I guarantee him that I will publish it in the *Journal of Monetary Economics* for the public inspection by the profession.

The CHAIRMAN. Thank you.

Mr. Wylie?

Mr. WYLIE. Thank you very much, Mr. Chairman.

Dr. Brunner, I am glad to see you again. I am just sorry you are not still at Ohio State and a constituent of mine, as you once were. I apologize for having to leave for a moment, but I had to look into the Federal gas plant closing in Columbus.

You mentioned the Swiss situation, and I know your feeling on that, having talked to you about it before.

Is Switzerland really an analogous situation that we can look to for guidance? There are only about 6½ or 7 million people in Switzerland and we are talking about 220 million people in the United States. And they have a fiscal policy which says that if a welfare program is to be increased, they have a plebiscite for the program in Switzerland to see if the voters want to pay for the increase in welfare expenditures. I know you make frequent trips there. Are you still teaching at the University of Berne?

Dr. BRUNNER. Yes.

Mr. WYLIE. Do you really think there is an analogy that we can look to as far as the fiscal and monetary solution to the problems are concerned?

Dr. BRUNNER. The trends in the government budget and fiscal policy in major Western countries do show some remarkable analogies. The Shadow European Economic Committee has repeatedly emphasized this point in recent years. In all cases the expansion of the budget did not result from the government's purchases of goods and services but from an explosion of transfer payments.

This also happened in Switzerland. However it is also worth noting the taxpayers' and voters' reaction to the legislators and the administrations largess. The referendum provided by the Constitution offers the voters a veto power over Parliament. Budgetary bills proposed by the administration and approved by Parliament were repeatedly rejected with a large margin by the Swiss voters. This political mechanism worked effectively as a brake on budget expansion and deficit.

Mr. WYLIE. The point I am making is that in Switzerland, they don't run substantial budget deficit like we do.

Dr. BRUNNER. They have. They have a budget deficit.

Mr. WYLIE. What is the percentage of gross national product?

Dr. BRUNNER. It is probably less in proportion to gross national product than in the United States.

Mr. WYLIE. You are a monetarist and you feel that fiscal policy doesn't mean all that much, as I gather from your statement.

Dr. BRUNNER. For inflation. It means a lot for many other things.

Mr. WYLIE. But not as far as inflation is concerned?

Dr. BRUNNER. Right.

Mr. WYLIE. What do you think about the bill which provides for a constitutional amendment to say that we don't spend more than we take in except in time of war or economic necessity? Now some 26 States

have ratified a resolution calling for a constitutional convention to prohibit deficit spending.

Dr. BRUNNER. I certainly am in favor of some form of constitutional limitation on the Government's budget. But we need to ponder somewhat about the form of such limitation. A constitutional requirement to impose a balanced budget seems least desirable in my judgment. Limitations on the magnitude and growth of spending, taxing, and indebtedness seem to me more useful. We should be concerned however about the potential escape mechanisms. Government may be instance delegate tasks and powers to more or less autonomous public corporations and grant them the right of independent indebtedness or offer extensive financial guarantees. The limitation on spending should explicitly cover the current value of all liabilities arising under various forms of financial guarantees. This should certainly include the current value of the implicit obligation imposed on the Federal Government by our social security system.

Mr. WYLIE. I will want to read the record back and develop a better understanding of your answer to that. But what do you think of the decline in Fed membership?

Dr. BRUNNER. The decline of Federal Reserve membership is essentially a result of inflation. I apologize to sound like Cato.

Mr. WYLIE. From your viewpoint as a monetarist, is that a serious problem?

Dr. BRUNNER. Inflation drove interest rates to high levels and raised thus the cost of membership. The revenues forfeited as a result of the comparatively high reserve requirements imposed on member banks rose with the level of interest rates.

The decline in membership poses by itself no problem to monetary policy. All the computations I made on several occasions clearly indicate that the changes in the proportion of the membership have no relevant effect on the controllability of monetary growth. The extent of membership affects the political clientele of the Fed but not the execution of monetary policy.

There is really a simple solution to satisfy the Fed and encourage membership. All we need to do is to abolish the reserve requirements. No case has ever been made over 200 years in support of the contention that reserve requirements contribute to a better control of monetary growth. Monetary policy does not need reserve requirements. Once they are abolished this particular cost of membership vanishes.

Mr. WYLIE. I have been given a note that my time has expired. I wonder if I might ask one more question.

The CHAIRMAN. Without objection.

Mr. WYLIE. Because it refers to his testimony; on page 6 of your statement you list institutional innovations in the financial industry, that erode the meaning of published data, as you put it; do overnight repos constitute the bulk of repurchase agreements? That is one question.

And if you were asked to state a given percentage of distortion introduced into the estimates of traditional measures of the money supply, such as M_1 and M_2 by the institutional innovations which you have mentioned on page 6, what would that percentage be for all of the innovations, and what would it be for the repurchase agreements alone?

Dr. BRUNNER. Some rough computations were prepared for the March session of the Shadow Open Market Committee. These computations suggest that the retardation of measured M_1 by 11 percentage points experienced in the last 4 months seems to overestimate the true retardation by somewhat more than 4 percentage points. The error appears to be smaller in the case of M_2 . In either case Congress and the public are confronted by a serious information problem. The published data for M_1 and M_2 are quite inadequate. Until the Fed has clarified our data base, monetary policy should best be formulated in terms of the monetary base.

Mr. WYLIE. Thank you very much. I do have one more question that I asked the Chairman of the Federal Reserve Board, Mr. Miller, and I ask you to respond to if you will, please. And I ask that for the record.

The CHAIRMAN. That will be submitted to you, Dr. Brunner, and if you could perhaps respond for the record, I know it would help Mr. Wylie very much.

Dr. BRUNNER. I would be glad to do that.

[Congressman Wylie's questions and Dr. Brunner's response follow:]

QUESTIONS SUBMITTED BY CONGRESSMAN WYLIE TO DR. BRUNNER

Question. My question is essentially the same one that I asked Chairman Miller, and it is in two parts. First, do you believe the Federal Reserve would have greater success in controlling inflation if it controlled the monetary aggregates directly rather than by operating indirectly through interest rates? Second, in light of the fact that the Federal Reserve uses interest rates rather than monetary aggregates as a basis for its operating targets, do you believe it is necessary, as the Federal Reserve has argued it is, for Congress to pass legislation extending reserve requirements to the monetary liabilities of nonmember institutions?

REPLY RECEIVED FROM DR. BRUNNER

Answer. The answer to your first question is indeed in the affirmative. The existing implementation of policy based on setting a target range for the Federal Funds rate produces a poor control over monetary growth. This point has been made by many economists and over many years. The Fed has never supplied an adequate justification of its traditional procedure. An effective anti-inflationary policy requires that the Fed specify first meaningful targets for monetary growth. This target need, secondly, be translated into a required growth rate of the monetary base. This involves appropriate estimates of the monetary multiplier. Thirdly, the requirement growth of the monetary base must be translated into specific instructions to the account manager in terms of the volume of net purchases to be carried out over a month and quarter. The procedure has been presented in more detail in various position papers of the Shadow Open Market Committee. I also refer to the technique developed along these lines at the Swiss National Bank. This new procedure should be supplemented by simplification of reserve requirements. All interest ceilings imposed on any bank liabilities should, moreover, be abolished. We can expect that under the circumstances the efficacy of monetary control would be substantially improved. The Fed's traditional procedure and conception contributed in the past on frequent occasion to aggregate our problems. It produced an accelerated monetary growth during expansions or in periods of rising inflation and lowered monetary growth during recession. The Fed's procedure is well designed to destabilize the economy. Other Central Banks have learned their lesson. Could we not expect even the Fed's bureaucracy to learn from the experience of others in this respect?

Concerning the second question the Fed has shown little interest in reserve requirements beyond their effect on the Fed's political clientele. My work bearing on these matters shows that the differentiation between member and non-member banks exert comparatively small effects on the behavior of monetary aggregates and particularly on their degree of controllability. The existing structure of reserve requirements imposed on member banks produces actually larger

problems. An extension of the arrangement covering member banks to non-member banks would hardly raise the level of monetary control. It is more probable that this extension worsens the potential degree of monetary control. It should be noted here that no systematic case has ever been presented to that reserve requirements contribute to improve monetary control. The Fed's own behavior over the past supports this contention. It never used changes in reserve requirement for purposes of monetary policy over the postwar period. Every single change in requirements was usually offset to a large extent by open market policies. Requirement policy thus was essentially a tax policy applied to banks without Congressional consent. The best solution would be no reserve requirements to play with by the Fed. The next best are uniform (and low) requirements on liabilities of all financial institutions. The requirements should be fixed by law and not be subject to manipulation by the Fed. As a third best, I suggest, a small range for possible manipulation without any discrimination however between institutions or magnitude of deposits. Such discriminations tend to complicate the problems of monetary control.

The CHAIRMAN. Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman. Professor Brunner, you mentioned in your testimony that you think we should pay more attention to the monetary base, and I have observed that most economists usually talk only about M_1 and M_2 . I would like you to comment on the reasons for that, and also comment on how M_1 and M_2 and interest rates would be affected if the Fed concentrated only on the monetary base?

Dr. BRUNNER. I have to apologize. I have to ask again. I do have for a few days a pressure on my ears which makes a bit of a problem. Can I have it again, that the problem is how to explain—

Mr. PAUL. I observed that many economists are interested only in watching M_1 and M_2 , and you mentioned in your paper that you are interested in the monetary base. I was wondering why and how you think that concentration on the monetary base would affect M_1 and M_2 and interest rates.

Dr. BRUNNER. The issue is not that the monetary base is everything and the end of our consideration. The monetary base is a major determinant of the monetary aggregates and is free of the measurement errors currently embedded in M_1 and M_2 . I conjecture that the movement of the true measures for M_1 and M_2 over the past months is much closer to the path followed by the monetary base than indicated by the currently available data. We also observe that the velocity of the monetary base exhibits a remarkable regularity. This fact and the reliability of the data pertaining to the monetary base determine my proposal. If the Fed lowers over the next 5 or 6 years the growth rate of the base to 2 percent per annum, inflation will be lowered to a trivial level. We can attend to this program irrespective of our current difficulties with the available data on M_1 and M_2 . I most definitely would object to any overreaction so frequently shown by the Fed. The year-over-year growth rate of the base has already descended from an average of 9.5 percent, for the 7- and 12-month periods ending in June 1978 to December 1978, to 8 percent for the 12-month period ending February 1979. This is sufficient for the moment. The goals of the Full Employment and Balanced Growth Act would be best served with an 8 percent growth this year followed by a 1 percentage point decline in each subsequent year until the base grows by about 2 percent per annum or a bit less.

So in this respect what I am aiming at essentially, that we should control the monetary growth, and that is what we have to do over the

next 5 or 10 years. Now, my emphasis on the monetary base at the moment is essentially simply this: at the moment we have, for instance, a very large retardation in M_1 and M_2 jointly since last October.

It is not very clear at the moment, given the measurement errors, to what extent this is associated with measurement errors that, for instance, the overnight repos have ballooned in the last years with interest rates on certificates of deposits, to which extent it is essentially a transitory event of the certificates of deposits and similar things, and the retardation in the monetary base has so far been relatively moderate.

It has gone down from about 9 percent to 7 percent, the retardation in the last 3 months. So the issue is therefore to focus on what we know with certainty. This is the growth rate in the monetary base and direct attention by the Fed that it should move along a path as indicated, and at the same time shape up its information pertaining to the monetary aggregates.

And the justification I gave is that the movement of the monetary base, whatever the measurement errors are in M_1 and M_2 will ultimately prevail in whatever the true measures of M_1 and M_2 are; not in a week, not in a month, not in a quarter, but certainly in the average over a year.

Mr. PAUL. Also you mentioned that in 1972 and 1976 the Federal Reserve abandoned all monetary restraint. Is it a coincidence that these were also election years?

Dr. BRUNNER. Well, the concern I have in this respect—and possibly I mean our concerns overlap here with Professor Thurow—is the following: namely, that the Federal Reserve in realizing now that it has to do something about inflation moves too fast and too far.

The way it is usually done, very frequently done in the past, I definitely would not want the Federal Reserve to lower monetary growth, say for instance, to 2 or 3 percent this year. I would not want the Federal Reserve to immediately lower the monetary base, from an average growth rate of 8 to 9 percent to 2 to 4 percent, not until the fall of next year.

I think in my judgment that the social cost of transition would immediately loom fairly high and particularly as a result of that, the probability of the Federal Reserve reversing itself again next winter would be very, very high because the economy would start weakening rapidly late this year. And, well, there is a presidential election year coming up, and the pressures on the Fed will mount under the circumstances, in my judgment, and reverse itself.

So we are simply starting the old path again and again of these circumstances.

Mr. PAUL. Thank you.

The CHAIRMAN. Thank you, Mr. Bethune?

Mr. BETHUNE. Thank you, Dr. Thurow, I was privileged to hear you at Harvard, and I was impressed with your presentation then. Now on listening to you today, it seems that there is some difference in the presentation, at least my perception of the presentation; you seem to be suggesting that there are alternatives to fiscal and monetary restraint, yet when we get to the point concerning the alternatives, I don't find much help. And I was a little frustrated when we got to that point in your presentation.

You mentioned workable incomes policies, and then twice you relied on deregulation of trucking as having some potential for price relief to reduce crisis. And I would like to propound this question to you: Are you relying there on the experience in the airline industry as some evidence that there would be price relief in the trucking deregulation proposition?

Dr. THURLOW. One, I think you slightly misinterpret me because I think we should have fiscal and monetary restraint. Without those nothing else works. And in the last statement made by the other witness, I think we are very close because if you assume that the monetary base has been growing at 8 percent and since the fall it has been growing at 4 percent, then I say that is too low. And the other witness also said that is too low.

We may very well be able to compromise at 6 or 7 percent and both agree that that is the appropriate thing to do from different perspectives. The strategy I think we need to follow in fighting inflation is to have modest fiscal and monetary restraint because I think fiscal policies have some impact on the system or can at least make the system worse.

But if you want to have any noticeable reduction in the rate of inflation, you have to do other things along with those modest fiscal and monetary policies; making them too tight I think will do exactly what was mentioned in the last question. The pressures will build up to overstimulate the economy again. And so I think a recession is really counterproductive, and to deliberately cause one is doubly counterproductive, not just with respect to getting people reelected but with respect to having a good economy.

And if you think about—essentially I am not in favor of incomes policies as a solution because I think they are very difficult or impossible to make them work for any extended period of time in the American economy.

If you think about the sector-by-sector approach, the argument is that there are many things which the Government does where it could lower the rate of inflation or lower prices in some area, and by lowering prices in that area, if the economy is heavily indexed—let us just say, for example, that by deregulating airlines you reduce airline prices and that reduces the Consumer Price Index from 7 to 6½ percent. Then under the cost-of-living escalator clause, the next year, instead of giving 7-percent wage and price increases, people only get 6½ percent, and so you have bought something in the long run, if you have monetary policy that accommodates along with that reduction in the rate of inflation.

Now, if Professor Houthakker at Harvard a few years ago listed, I think, 50 some such areas—for example, agricultural price supports—and I don't remember whether your district has a lot of farmers or not—half were classified food inflation last year, and that makes some difference in the system.

Steel reference pricing added \$40 to a ton of steel. Maritime subsidies add a lot to the price of sea transportation and maritime regulations. Trucking regulations add a lot to the price of trucking. Now, if we could go down that road of getting rid of some of those things, they would be good in and of themselves, and they would also allow the Fed to have tighter monetary policies without making unemploy-

ment higher because I think the unemployment thing is one of the things you have to think about seriously, and that is one of the differences between Switzerland and the United States. I don't remember how many people the Swiss sent home, but the West Germans sent 1½ million Yugoslavs, Turks, Italians, and Spaniards back to those countries.

If you can export your unemployment, then you don't worry about unemployment so much because you just send it back to Yugoslavia. But the problem in the United States is we don't send the unemployed back to Yugoslavia. They are Americans. And in Switzerland and Germany, a lot of the unemployed were foreigners who were sent home.

And so I think we have to take the whole unemployment thing much more seriously than the West Germans or the Swiss do because they can export it directly.

Mr. BETHUNE. Dr. Thurow, we very frequently look to these other propositions that you mentioned and assume that there can be some relief from high prices, and we just categorically say, well, we need to deregulate trucking, and that is going to provide some relief from inflation. The airline industry had some success with this because prices there are sensitive to demand or demand in that area is sensitive to price reduction because you are dealing with passengers, and they are more liable to fly when the price gets lower.

I am, however, persuaded that the demand in the trucking industry is not necessarily as sensitive to prices as the general economy.

Dr. THUROW. I think you are probably right. The demand elasticities in trucking are not high, and so there is a big difference between deregulating trucking and deregulating airlines.

Deregulating airlines was good for airline profits. Deregulating trucking would undoubtedly be bad for trucking profits. But the thing to remember is that when we talk about trucking regulation, the big thing we are not doing is protecting the trucks against the railroads. They don't need any protection against the railroads.

What we are doing is protecting the interstate trucking company from farm trucks, many of which are unused a large fraction of the year, and farmers could set up little trucking lines and be carrying goods at much lower prices. And so the real threat to the big interstate trucking companies doesn't come from the railroads; it comes from underutilized farm trucks.

I don't think there is any doubt that the price would go down. I also think it would be very devastating to the position profitwise and any other way you would like to think of it, of existing large interstate trucking companies. I don't think they would benefit the way the airlines have.

Mr. BETHUNE. I would like to pursue this with you, but my time has expired. Thank you.

The CHAIRMAN. Dr. Brunner, since last September the growth of M_1 has been flat, nonexistent. It is today at the level where it was at the end of September. In the light of what you have said this morning, is it your view that the Federal Reserve has now done too much of a good thing and that it should relent a bit on the supertightness of M_1 , both for its own sake and lest it be tempted with the terrible temptations of presidential election years to offset its present tightness with too much of a swing in the other direction.

What is your view, if in 6 months there is no growth of M_1 ?

Dr. BRUNNER. The data on M_1 and M_2 since last September are indeed troublesome. There is no question that the growth rate of the monetary base declined by a substantial margin. But the decline in the growth of M_1 and M_2 exceeded the decline of the growth of the base by a factor of 3 for M_1 or more than 2 for M_2 . If this movement expressed the relevant monetary thrust and would also persist I would be quite concerned. But there are good reasons to think that some portion of the apparently excessive declaration is due to temporary factors—Treasury funds, CD expansion, currency drain—and that another portion reflects increasing measurement errors of both M_1 and M_2 . After all these corrections were made there probably still remains a retardation corresponding to the decline in the growth rate of the monetary base. Everything depends now on the Fed's further behavior. A continuation of the retardation would endanger in my judgment the long-run program required for the final goal of price-stability. I would urge that the Fed prevent any further decline in the growth of the base and the true measures of M_1 and M_2 . It should in particular maintain for the next quarters a growth rate of about 8 percent per annum in the base.

The CHAIRMAN. Well, let me try to recapitulate what I think you have said, but you may correct me. I think you have said that the flatness of M_1 over the last 4 or 5 months, while somewhat disturbing to you, may be explicable by other factors which you have named. Therefore, you are not quite ready to say that the Fed has gone too far in M_1 tightening. However, it is also your view that if M_1 doesn't pick up pretty soon, then you would feel that the Fed is going too far and should loosen.

Is that a reasonable statement?

Dr. BRUNNER. That is correct.

The CHAIRMAN. Turning to a more cosmic subject, it is indeed fortunate for this committee that we have an eminent monetarist and an eminent nonmonetarist ranged side by side here. This committee always grasps pathetically at whatever chance there may be to reconcile the apparently inharmonious testimony of witnesses.

I empathized with Dr. Thurow here a moment ago when he said, look, Dr. Brunner, we may not be so far apart. Of course he was not here earlier when you and I had our little exchange about the structural elements.

When I asked Dr. Brunner if getting rid of high agricultural price supports and substituting something else in their place, income supports for the family farmer, a system of avoiding financial tragedy by some sort of a Homeowners Loan Corporation approach to overstretched farmers; when I asked if these actions were a good approach to take, his answer, again subject to his correction, was, well, those things might be desirable in and of themselves, but that it wouldn't really have any impact on inflation. He said money alone was really important for inflation because doing something about bringing farm prices upward, which is what the farmers assembled here in Washington want, would be at the expense of somebody else's prices and thus would not affect inflation.

I would have tried, if we had endless time, to answer that by saying, well, I am not so sure because the other's prices don't go down; they

are ratcheted. Hence, I don't think I agree with Dr. Brunner's point on that. But be that as it may, he is unwilling, I believe, to make the step toward a joint monetarist-nonmonetarist national policy. Let me inquire how willing you are, Dr. Thurow, to make such a gesture. You have said that, of course, you need monetary and fiscal tightenings in moderation; that all is lost unless we do this. You have then added, however, don't make them too tight or the cure will be worse than the disease. Furthermore, tightness is not going to work, even moderate tightness, unless you accompany it by structural methods, which you define as a workable incomes policy, and attention to agricultural price supports, trucking regulations, tax policies, and many, many other things.

My question is: Would you sail for your policy of attacking the commanding heights of price increases by direct methods such as you have described? The forms would include fiscal policy among them, and also you would make a proprietary bow toward the monetarists by saying, all right, Dr. Friedman, Dr. Brunner, and the business community and the banking community, as far as that goes, we will sail for a Federal Reserve statement backed by the administration of M_1 targeted growth for 1979 of 6 percent, as the Federal Reserve suggests.

Good fellow that you are, would you go for that?

Dr. THURLOW. I am always the great compromiser. I would certainly be the first one to say that none of these other policies will work if you don't have a Federal Reserve Board doing sensible things at the same time. And I think "sensible things at the same time" means a money supply rate of growth. I think M_1 has kind of lost all meaning, given the recent change in banking institutions. So, I don't even like to talk about M_1 any more, but let us say we are talking about M_2 , that you have to have some modest, slow deceleration in the rate of growth of M_2 or the money base or whatever you want to look at.

I think, however, that if you think about the structural policies, what the structural policies allow the Federal Reserve Board to do is tighten monetary policies further and faster without producing unemployment than they otherwise would. Because I am with you. I am on the ratchet effect. If you had a perfectly competitive economy, it is quite right, as long as you kept the money supply constant, every time some price went up, regardless of whether it was due to monopoly power or a Government program or anything else, some other price would go down by an equally equivalent amount, and the cost-of-living index would not change.

But I just don't think that is our economy. Where are these sectors where prices will fall when agricultural prices go up? Where are these sectors that will fall when we raise the price of steel \$40 a ton with reference pricing? I just don't think they exist to any substantial extent, and, therefore, you have to worry about these actions that raise prices, because the Fed—let us say you take one of these actions, like steel referencing prices and raised the price of steel \$40 a ton, the Fed then has two choices: If it doesn't let the money supply grow, the rate of unemployment goes up; if it lets the money supply grow, it is essentially monetizing the price increase and making the rate of inflation worse.

And it just seems to me that in a democracy, if we put the Fed in that choice, we know what the Fed is going to do: It is going to monetize the price increase, because it is and should be a political animal in a democracy. And, therefore, I really think the structural policies are an important part of allowing the Federal Reserve Board to lower the rate of growth of money supply below what it otherwise would be.

Dr. BRUNNER. Mr. Chairman, could I comment on one point?

The CHAIRMAN. Take as long as you want, because I think we are in an interesting area here.

Dr. BRUNNER. Thank you very much.

Professor Thurow asks, "Where are the other prices which have fallen if agricultural prices are pushed up?" The point at issue is really very simple and some of my previous comments extend to the present case. I indicated before that all price changes are the sum of a common and a specific component. I repeat that the common component represents the rate of inflation and the specific component is composed of all the particular supply and demand factors for this market. Professor Thurow's comment should properly be addressed to the specific component alone and not to the actual change in price. The larger the inflation rate—that is, the larger the common component in the array of price movements—the less frequently you will encounter falling prices. Professor Thurow thus misdirects our attention to an irrelevant aspect. The relevant movements for our purposes involve the fact of falling relative prices or the occurrence of a negative specific component in the price change.

There is a further problem implicit in Professor Thurow's statement. He appears to suggest that general price movements are determined by the most rapidly increasing relative prices. This view, quite frequently encountered, is simply false. It implies, for instance, that the velocity of the monetary base accelerates and decelerates with the rate of inflation. An inspection of the data yields no support for this contention.

Dr. THUROW. I think it is a great mistake to go back to 1965 and say in 1965 some price fell, because I think the key thing to note is that in 1973-75, when we were hit with double-digit inflation and almost double-digit unemployment, the structure of the economy changed.

Recently, as Mr. Bethune down there knows, I have gone through and I have looked at relative wages—I haven't done it in all relative prices—trying to figure out where have relative wages fallen in this economy, given that you have high unemployment rates.

Now, you would expect, given these enormous unemployment rates for teenagers, that if you went out and looked at the wage rates for teenagers who were working, you would find some fall in the relative wage rate. The fact of the matter is you don't. It even went up slightly. The relative wage rates of teenagers for those employed went up slightly from 1972 to 1977, and it has nothing to do with the minimum wage since the average wage rate for this group is well above the minimum wage.

Massive unemployment just has not had the effect on the relative earnings of teenagers that it should have had.

Dr. BRUNNER. Well, I don't know whether I can comment.

The CHAIRMAN. Please do.

Dr. BRUNNER. There appears to me an important issue at this stage. The Brookings group tends to relate accelerations or decelerations of inflation to some measure of a "market gap." Much of our work and the work of others indicate that the ongoing inflation in the context of perceived monetary expansions is highly insensitive to the magnitude or change in "market gaps."

Dr. THURLOW. Let me interrupt. I wasn't talking about the rate of inflation; I was talking about real relative wages.

Dr. BRUNNER. I let you finish your point and you surely can grant me the courtesy to finish my point. The dominant issue is inflation and the fact that we should not expect any moderation of price movements with the pervasive perceptions of unabated monetary expansion.

Dr. THURLOW. All I am saying is I did not say one word about the rate of inflation. I said the high youth unemployment has not reduced the relative wages, the wages of young people relative to the wages of adults, since 1972. If this was the kind of competitive economy that you are imagining, 20-percent youth unemployment rates for whites, 40-percent youth unemployment rates for blacks, 30-percent youth unemployment rates for Hispanics, that would lower their relative earnings; it simply hasn't.

Dr. BRUNNER. Well, Professor Thurow, I am very happy to look at the facts. Until then I must suspend judgment.

The CHAIRMAN. Returning to my wistful guest here, Dr. Brunner, while you tend to brush aside structural reforms as a method of inflation-fighting, you favor, do you not—as a descendant of Adam Smith, which I take it you are—the elimination of structural stickiness and structural impediments as a step toward a free economy?

Dr. BRUNNER. Many "structural measures" are quite important in terms of their effect on our welfare. We have become an "overregulated and overgoverned society." Professor Houthakker has assembled a long list of measures which would contribute to better use of our resources. But all these measures, however important their cumulative effect in terms of our welfare, constitute no relevant approach to inflation. We should not sell them on the political market place with the promise to curb inflation. If we do that and disregard monetary policy, as President Carter did, we will just invite failure. I am also concerned that a "structural emphasis" in matters of anti-inflationary policies opens the door to new controls and income policies under new names and disguises.

The CHAIRMAN. For example, while I am sure you sympathize with the social plight of the embattled farmers that you see here, you do not advocate the kind of rise in the Government-mandated price support for their products, largely feedgrains, which they are asking, do you?

Dr. BRUNNER. Government price support for what? Which economic branch were you referring to?

The CHAIRMAN. I am talking about the farm movement, which is now encamped here in Washington. What they want is higher price supports on wheat, corn, barley—

Dr. BRUNNER. I am quite dubious about the farm support program. If the voters and Congress wish to grant income transfers to farmers

there are much better ways to achieve this end than with the aid of price support and production controls. I would suggest that the present support system be abolished.

The CHAIRMAN. Good for you. Your views, as just stated, are very like what I think Dr. Thurow's views are, and they are certainly like my own.

That being so, wouldn't the Nation be well off if the President and the administration would announce a two-pronged anti-inflationary program: One, your kind of monetary program—and I won't repeat it because we have repeated it several times this morning; and, two, a 10-year long attack on the structural problems, which we have already adequately defined.

Such a program would be 50-percent satisfactory to a monetarist believer, like yourself, whom I respect. You may be right. I have never been able to make up my mind—and all you would be asked to add to your monetarist dream program is some structural activity, which you favor anyway, though on other grounds.

Equally, I ask the question to Dr. Thurow, the antimonetarist, who believes that structure is the real central approach but that monetarism cannot be disregarded, both on its merits and because it is a view deeply felt by a wide segment of Americans and thus should not be dismissed lightly. Dr. Thurow would have to sit still for a program half of which he thought was great and the other half of which he thought was of decidedly less importance.

Why isn't it perfectly possible for both sides of this "War of the Roses" to disarm?

Dr. THUROW. I am disarmed.

The CHAIRMAN. Would you, in this spirit, go to Jerusalem, too?

Dr. BRUNNER. I certainly would support it. There remains, however, the need for clarification about the meaning of "structural policy." My support is full and clear in case this means abolition of many unnecessary and dubious regulations and Government maintained monopoly positions. But I oppose "structural policies" imposing new constraints and inducing new patterns of waste in our resources.

The CHAIRMAN. Like what?

Dr. BRUNNER. I still suffer from an uneasy sense that "structural policy" could easily subsume, whenever political circumstances demand, any measure involving new types of income policies or controls. Professor Thurow speaks about a "sectorial approach" and I have difficulty to understand what that means. I would appreciate a clarification.

Now, I may be mistaken, but if it is that, then I would have reservations about that.

Dr. THUROW. For example, it seems to me what we did in January with respect to the rate of inflation in terms of the social security tax and the income tax was crazy. Let us imagine the two increases and decreases were equal in magnitude—they weren't, quite—but we raised a tax which, by the way the indexes are constructed, show up in the cost-of-living indexes, which means it is going to get built into all those escalators. We lowered a tax which is not in the indexes, given the way the indexes are constructed.

So, in real terms, people are equally well off: One tax goes up, another tax goes down. But the indexes show it has an increase in the

cost of living, which then gets built into the escalators, and so forth, in the economy. That is the kind of action I just don't think we ought to be taking if you are serious about fighting inflation.

Dr. BRUNNER. Thank you.

The CHAIRMAN. Do any other members have additional questions?

Mr. PAUL?

Mr. PAUL. I have one short question.

Professor Brunner, we mentioned a little while ago that monetary policy sometimes varies in an election year, and we also talked about the Swiss franc doing quite well.

Do you think that the fact that there is some legal requirement for the Swiss central bank to have gold reserves has helped? Do you think gold reserves are a legitimate guidance for monetary policy?

Dr. BRUNNER. Let me see if I understood you correctly. You seemed to inquire about the background of Swiss monetary policy?

Mr. PAUL. I was saying that the Swiss central bank is required to have gold reserves, and we commented earlier that the monetary policy of the Swiss was rather restrictive and provided for a strong Swiss franc. Do you think that we could give any credit for the fact that they were required to restrain their monetary policy to the fact that they had to hold a gold reserve?

Dr. BRUNNER. No; the legal requirements bearing on the assets on the Swiss National Bank play no role. The Swiss National Bank abandoned a policy of fixed exchange rates for the simple reason that this policy produced in the early years of this decade a rapid acceleration of price movements. Inflation reached to 13 percent per annum in 1972-73. The Swiss National Bank moved at the time to a noninflationary policy with the full political support of the large majority of Swiss. The inflationary experience from 1970 to 1972 shaped the political basis for the noninflationary policy introduced in 1973 and maintained until late 1977.

Mr. PAUL. Thank you.

The CHAIRMAN. Mr. Lowry?

Mr. LOWRY. Dr. Thurow, at Harvard you also told a delightful story about economists, but we have here before us legislation designed to correct the declining membership of the Federal Reserve. How important do you believe the membership of the Federal Reserve, as far as most of the commercial banking institutions, is to having the type of monetary policy out of the Federal Reserve that we need?

Dr. THUROW. I think it is undoubtedly true that even if nobody belonged—no banks belonged—to the Federal Reserve System, through the open market operations that the Federal Reserve Board could conduct its policies. Undoubtedly, it is somewhat easier if they do, because then, in addition to open market operations, you have various kinds of administrative disciplines that you cannot apply to the banks, too.

And so, I think that the falling number of people in the Federal Reserve System is not a serious thing with respect to having whatever you think the appropriate degree of monetary restraint is. I do think, however, when you think about reserve requirements and regulation Q, I think I would be supporting Dr. Brunner here, that I think that both of those things could be gotten rid of. Getting rid of one without the other, I think, is terribly unfair. But if you were willing to get rid of

regulation Q and force banks to pay competitive interest rates for all the money they borrow, then I don't see any need to have reserve requirements.

Mr. LOWRY. Thank you.

The CHAIRMAN. Returning to the matter of Federal Reserve monetary policy, we are most grateful for the wide-ranging discussion you have both conducted this morning. I think it has been a fascinating session, one of the best we have had. It makes a real contribution to the difficult task of this committee; namely, to provide a report to Congress, telling our colleagues wherein we should walk in the next few years.

Thank you both very much.

We now stand adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[The statements of Professors Lekachman and Feldstein referred to by Chairman Reuss in his opening statement follow:]

STATEMENT OF PROF. ROBERT LEKACHMAN

Possibly because I prepared these brief remarks in ignorance of Chairman Miller's testimony before this committee yesterday, I record a measure of sympathy for him and his colleagues on the Federal Reserve Board. Not for the first time in its history, the Fed appears to be operating the only game in town. Whatever disposition Congress ultimately makes of President Carter's budget proposals, fiscal policy is not now operating against inflation. Even if one accepts the administration version of the prospects for the wage-price guidelines, they will have minimal impact upon inflation. At present rates of inflation, in excess of 17 percent compounded, prudent Americans are saving very little of their income, assuming a heavy burden of installment debt, and bidding home prices up to new speculative heights weekly. Why shouldn't they? Inflation rewards grasshoppers, not ants.

Only the Fed is so situated as to respond swiftly, effectively,—and calamitously. That redoubtable critic of monetary policy, Milton Friedman, only last week expressed fear that according to precedent the Fed would go too far. In his February 19 Newsweek column, Dr. Friedman uttered these monitory words:

"Past history demonstrates that the danger of unduly restrictive policy is not an idle one. That is exactly what occurred in 1974, as it has repeatedly, during the whole of the Fed's history. The golden mean has had a way of escaping the Fed, which has tended to be extremist—either pumping up the money supply too rapidly, or holding it down too rigidly."

On the record, Mr. Miller fears recession more than his predecessor. The danger is nevertheless substantial that in the absence of other responses, the Fed will further tighten credit, raise interest rates, inflict customary damage on small businessmen, local governments, and home buyers, and precipitate the economy into recession.

Although milk once spilled cannot readily be rebottled, it is a pity that Jimmy Carter as President did not adhere to the position on mandatory controls that he held as a mere candidate. Two years have been wasted during which an inflationary psychology has begun to distort business and consumer decisions. The hour is perilously late. I much fear that unless Congress or the White House takes a new initiative, a year from now unchecked inflation will be combined with rising unemployment, deepening recession, and panic-stricken resort by a discredited administration to measures that ought to be taken immediately without a day's further delay.

What ought to be done is naturally easier for me to prescribe than Congress to enact and the executive branch to administer. Let me sketch the bare essentials of an anti-inflationary program into which monetary policy will fit as a part, but only a part of a coherent whole.

PRICE-WAGE POLICY

A sixty or ninety day general freeze is essential. It should be followed by selective controls over key prices and wage bargains in concentrated industries, hous-

ing, and the health sector. No need to regulate retailing, a genuinely competitive sector of the economy.

In the interests of equity and, despite the technical difficulties involved, other forms of income besides wages should be subject to limitation—rent, dividends, interest, and executive compensation. It cannot be reassuring to trade unionists nagged by Alfred Kahn and their employers to accept 7 percent wage improvements, that COWPS has apparently abandoned any attempt to set standards for bank profits.

Charity impels me to say no more about present “voluntary” guidelines than this: they stand on shaky legal ground, they exclude items which comprise a large proportion of family budgets, and they operate inequitably. They are otherwise splendid.

ENERGY

Probably no single measure would be more reassuring to our friends and thought-provoking to our antagonists than some hard evidence of collective willingness to restrict consumption of gasoline and fuel oil. In the wake of the Iranian cataclysm and the spreading wave of new increases in the price of crude petroleum, we should move to gasoline rationing. Coupons issued to the owners of registered vehicles should be freely transferable on white markets.

MONETARY POLICY

Here the crucial policy is allocation. Rather than allow credit stringency to damage the most valuable borrowers, we should substitute effective limitations upon consumer credit and reasonable flows of funds into the hands of small business borrowers. I note that that astute observer Alfred Neal, former president of the Committee for Economic Development, urged credit controls some months ago.

Two concluding observations. No control program is exempt from the tangles of bureaucracy, but exemption of the retail sector greatly simplifies administrative tasks. Economists routinely complain that controls distort market signals. Their criticism is appropriate where markets are competitive. Where they are not, the market signals are already distorted. Offered a choice, I'd rather have public bureaucrats, subject to congressional and media oversight, administer markets in concentrated industries than anonymous private bureaucrats responsible only to corporate management.

Finally, the goals of Humphrey-Hawkins are valid and indeed essential to the health of this society. We stand at this moment in the gravest danger of discarding them as we cope with inflation by ensuring serious recession. I note an ominous inclination, reminiscent of the 1950's, tacitly to redefine acceptable levels of unemployment. The current Economic Report states with apparent neutrality that “The evidence suggests that under current labor market conditions the danger of accelerating wages begins to mount as the rate of unemployment falls significantly below 6 percent.” (page 65) Tremblin in the air is the connotation that we dare not pursue the 4 percent Humphrey-Hawkins target. We dare not pursue it. But unless, Congress or the President, and preferably both respond with appropriate vigor to this inflation, Humphrey-Hawkins will become one more failed promise.

STATEMENT OF PROF. MARTIN FELDSTEIN*

MONETARY POLICY FOR 1979 AND BEYOND

Thank you, Mr. Chairman. I am very pleased to have this opportunity to participate in this first set of hearings on monetary policy under the new procedures that were mandated by the Full Employment and Balanced Growth Act of 1978. Although the report that the Board of Governors submitted to you earlier this week was not available to me when I prepared this statement, I will be happy to comment on the Board's report during our general discussion.

Before turning to the details of my analysis, I can summarize briefly my basic conclusions: It is now unusually difficult to judge the tightness of existing monetary conditions on the basis of either interest rates of monetary aggregates.

* President, National Bureau of Economic Research, and Professor of Economics, Harvard University. The views expressed here are my own and should not be attributed to any organization.

It is, however, clear that the level of real aggregate demand is excessive. We need to slow the growth of real demand below the potential growth of the economy in order to reduce the prevailing inflationary pressures. The appropriate policy for the Federal Reserve is therefore one of greater monetary tightness. It is particularly important that this tightness be seen as part of a longer-term strategy of monetary deceleration. Although it is difficult to set short-term goals for monetary aggregates, I think the middle of the 5 percent to 9 percent range for the M2 growth rate (that the Board announced earlier this year) in on balance a good compromise for the coming months.

In recent years, economists have grown increasingly aware of the difficulty of evaluating the ease or tightness of monetary conditions. At the present moment, monetary conditions are particularly ambiguous and hard to judge. Although some economist have pointed to the high interest rates and the slow recent growth of the monetary aggregates as indicating monetary tightness, my own analysis does not lead me to this conclusion. I will begin by considering the high interest rates and then turn to the sluggish growth of the money supply.

"High" Interest Rates

Most interest rates reached new highs in 1978 and now stand at two to three times their levels of 15 years ago. It is, however, now widely recognized that these high nominal interest rates reflect primarily the high expected rate of inflation and do not represent high real interest rates. Indeed, when you consider the tax deductibility of interest expenses, it is clear that the high nominal interest rates will not deter investment.

The implication of tax deductibility is seen most easily in the demand for owner-occupied housing. A married couple with \$20,000 of taxable income faces a marginal federal income tax rate of 28 percent. A 10 percent mortgage interest rate implies a net-of-tax rate of only 7.2 percent. A borrower who anticipates a 6 percent rate of inflation over the life of the mortgage is borrowing for a real net-of-tax cost of only 1.2 percent!¹ Fifteen years ago, the mortgage interest rate was 6 percent, implying a net of tax rate of 4.3 percent. Since a reasonable estimate of inflation would have been less than two percent,² the real net interest rate presumably appeared higher in 1963 than it does today. The apparently high cost of mortgage borrowing is unlikely to deter the demand for mortgages.³

For corporate borrowers, the analysis is somewhat more complex because inflation changes the effective tax rate on investments as well as the real net-of-tax interest rate.⁴ With a 46 percent corporate income tax rate, the 10 percent interest rate on commercial paper and long-term bonds represents a net-of-tax cost of only 5.4 percent, clearly less than the short-term expected inflation and probably less than most firms' intermediate range inflation forecasts. However, historic cost depreciation reduces substantially the after-tax yield on investments in plant and equipment. The balance between the lower real net interest cost and the lower real net return on investment depends on the corporation's debt-equity ratio and the difference between the yields that must be paid on debt and on equity funds. In a preliminary analysis of this, Lawrence Summers and I concluded that the rise in the nominal interest rate caused by inflation is less than the rise in the maximum interest rate that the firms could afford to pay.⁵ Although the high rate of inflation and its uncertainty may independently reduce firms' willingness to invest, the high nominal interest rates as such are not a deterrent.

Two final comments reinforce the point that current interest rates do not represent tight money. In the past, high interest rates—even high nominal rates—could check aggregate demand by drawing funds away from housing; the new money market certificates and the secondary mortgage market have now insulated housing from such supply side constraints. It is also worth noting

¹ Recall that the CPI inflation has averaged 6.1 percent over the last 8 years and that most mortgages remain in force for no more than that period of time.

² The CPI inflation rate averaged 1.8 percent for the previous 8 years and exceeded 2 percent in only 2 of those years.

³ Individuals may be deterred by the cash flow required for the high monthly payments but even this will be avoided by variable repayment mortgages in which the monthly payment rises with time.

⁴ In the case of homeowners, I ignored any tax on the nominal capital gain on the house. Such a tax, if any, is levied at the lower capital gains rate, is postponed, is only on the excess over \$100,000, and may be avoided if the property is bequeathed.

⁵ See Martin Feldstein and Lawrence Summers, "Inflation, Tax Rules and the Long-Term Interest Rate," *Brooking Papers on Economic Activity*, 1978, especially Table 3.

that short-term interest rates have turned down since the beginning of the year during the period of apparently constant nominal loan demand.

Slow Monetary Growth

I turn now to the argument that the slow growth of the money supply during the past year implies that money conditions are tight. The slow growth of M2 since last year is unquestionably quite striking. Between 1970 and 1977, the M2 velocity (i.e., the ratio of GNP to M2) remained in a narrow band between 2.35 and 2.43 without any discernible trend. It has climbed steadily since then: from 2.43 in the first quarter of 1978 to 2.50 in the next two quarters, and 2.54 by the fourth quarter of 1978. With nominal GNP growing at about 10 percent and M2 up only 0.3 percent between the end of November and the end of January, the current month presumably began with an M2 velocity of approximately 2.6. This represents an increase of 7 percent in one year.

A strict monetarist interpretation, based on the view that the velocity must return to its old level, implies that we are headed for a substantial fall in nominal GNP. Since prices are relatively slow to adjust, this fall in GNP would be primarily a fall in real output with a corresponding rise in unemployment.

I do not accept the view that there is a fixed long-run velocity to which the economy will necessarily return. I believe that the rise in velocity over the past year represents the combined effect of higher interest rates and new institutional developments. Recall that money market interest rates rose 50 percent between the 7 percent level prevailing in the beginning of the year and the 10.5 percent level at the end. There was a dramatic rise in the funds invested with money market mutual funds to take advantage of these rates. Thrift institutions used the new Money Market Certificates to attract funds and then often invested these funds in large CD's or commercial paper, thereby extending the range of institutions meeting the financing needs traditionally met by commercial banks. The secondary mortgage market also grew during the year, tapping the resources of insurance companies and pension funds to meet demands that would otherwise have been directed to banks. Consumer credit continued its rapid expansion, further reducing household demand for M1. Moreover, many of these practices and institutions that have developed in response to high nominal interest rates are likely to continue after interest rates fall. The economy is likely to have achieved a permanent increase in velocity.

On balance, I am therefore inclined to believe that the rise in velocity does not represent a temporary departure from a fixed norm but a natural movement to a new equilibrium level. Further support for this view that money is not tight is the fact that short rates have recently fallen even though there seems no reason to believe that expected inflation during the first quarter of 1979 is lower than it was six months ago.

Excess Real Demand

Although I believe that the evidence does not favor the view that money is tight, I should again emphasize that the evidence is difficult to judge. Because of this ambiguity about monetary conditions, it is particularly important to look at the real side of the economy. Here we have evidence of tight labor markets and an increasing rate of price and wage inflation. The number of employees on payrolls grew more than four percent during 1978. Average hourly earnings rose 8.8 percent, up from 7.7 percent the year earlier despite the growth of new entrants. Non-union wages are rising as fast or faster than union wages, a key indication of labor market tightness. And the manufacturing layoff rate is as low as it has been in the past 20 years.

The current inflation is likely to persist until there is a sustained period of slack in labor and product markets. The record shows that a fall in the rate of wage inflation is preceded or accompanied by an increase in the rate of unemployment. Monetary policy should therefore lean in the direction of slowing the growth of demand. A slowdown in real demand growth in 1979 and 1980 should be welcome and should not be resisted by expansionary monetary or fiscal policy.

It is not contradictory to emphasize, as I have, an inability to measure how tight money is and yet to counsel monetary restraint. A perspiring man may not know the temperature in the room, but he knows he will be more comfortable if the thermostat is turned down. We may not be able to measure monetary tightness but the inflation rate tells us that we will be more comfortable if the economy is cooled down.

Most economists now agree that there will be some slowdown in 1979. The rapid expansion of labor force participation experienced in 1978 cannot be sustained. Housing demand has already shown some decline. The General Motors strike that is expected later this year will have a widespread depressing effect on inflation. But there is also a general consensus among economists that the slowdown later this year or early next year is likely to be both small and short-lived, and then to be followed by a vigorous expansion in 1980. Whether the slowdown will be substantial enough to meet the NBER standard of being a recession, obviously cannot now be determined. But few if any serious forecasters are expecting this slowdown to turn into another recession of the sort experienced in 1973 through 1975.

Monetary Policy

Unfortunately, a very short slowdown of the type predicted will reduce employment and output while having relatively little effect on inflation. To bring the inflation rate down permanently, we need a more sustained period of economic slack. The 1973-1975 gains in fighting inflation were quickly lost by reflating too soon and too much. The expectations developed because of the experience of 1973-1975 will mean that the inflation response to the current slowdown will be even smaller. But if we sustain market slack for a few years—enough slack to keep the unemployment rate about one percent above the level at which wage and price inflation starts accelerating—we will succeed in gradually bringing down the rate of inflation. As the policy is seen to be working, expectations will shift and the inflation rate will come down more rapidly. This in turn will be reinforced by a strengthening dollar which will reduce the cost of imports and the dollar value of potential exports.

It is important to bear in mind that a sustained but temporary period of slack demand will achieve a *permanent* reduction in inflation.⁶ Failure to accept greater slack in the next few years merely postpones the problem or leave us committed to a permanent higher rate of inflation. Moreover, if we do not eliminate the current inflation, every new shock will be regarded as the beginning of further inflation and will merely add to the existing rate of inflation.

The knowledge that we can achieve a permanent reduction in inflation by accepting a temporary period of slack should reinforce the widespread public sentiment that reducing inflation is the number one priority for macroeconomic policy. Despite this, maintaining slack for a long enough period will require significant political courage. Fortunately, our unemployment compensation system will eliminate much of the personal hardship that would otherwise accompany cyclical increases in layoffs.⁷ Moreover, it is possible to proceed with labor market policies that reduce the unemployment rates of young people and other high unemployment groups at the same time that macroeconomic policies maintain slack in the demand for experienced skilled workers.

It is difficult to say what specific monetary policy is needed to keep the unemployment rate at about one percent above the rate at which wage inflation begins to accelerate.⁸ In addition to the ambiguity of the changing institutions to which I have referred, there are also uncertainties about fiscal policy and about the changes in aggregate demand. If the federal deficit is limited to the \$30 billion proposed by the administration and there are no surprises in the other sources of exogenous demand, a growth rate of M2 in the middle of the 5 to 9 percent range should be suitable for the next few months. To be effective, this monetary restraint must be seen as part of a longer term strategy to decelerate the growth of liquidity. In the context of such a strategy, a generally tight monetary policy in the months ahead may be the beginning of a permanent fall in the rate of inflation.

⁶ See M. Feldstein, "The Welfare Cost of Permanent Inflation and Optimal Short-Run Economic Policy," NBER Working Paper No. 201.

⁷ See M. Feldstein, "The Private and Social Costs of Unemployment," *American Economic Review, Proceedings*, 1978.

⁸ With no change in other labor market policies, this target would now correspond to an unemployment rate of approximately 7 percent.

APPENDIXES

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

APPENDIX I.—BRIEFING MATERIAL SUBMITTED

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

BRIEFING MEMORANDUM, HEARINGS ON THE CONDUCT OF MONETARY POLICY PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978, PUBLIC LAW 95-523

(Prepared by the staff of the Committee on Banking, Finance and Urban Affairs)

MONETARY POLICY AND THE ECONOMY

Growth, Inflation and Unemployment

Real Gross National Product (GNP) grew by just under 4.3 percent from the fourth quarter of 1977 through the fourth quarter of 1978, according to preliminary estimates. This is in the midrange of the personal projection of 4 to 4.75 percent growth presented to this Committee in March, 1978 by Federal Reserve Chairman G. William Miller. It is somewhat better than the consensus of business and professional economic forecasts for the same period, as reported in December, 1977 by the American Statistical Association and the National Bureau of Economic Research. Unemployment averaged 5.8 percent in the fourth quarter, also within Chairman Miller's projected range of 5.75 to 6 percent. Inflation, measured by the GNP price deflator, was more rapid than anticipated by Chairman Miller: 8.3 percent from the fourth quarter of 1977 through the fourth quarter of 1978, as compared with a forecast range of 6.5-7 percent. In short, while Chairman Miller's forecasts of real growth and unemployment, presented to this Committee a year ago, have proved accurate, his forecast of the inflation rate turned out to be understated.

Money

1978: IV marked the sixth consecutive quarter in which the growth of the money stock (currency plus demand deposits at banks) exceeded the upper limit of the target range established a year previously by the Federal Reserve. More broadly defined monetary aggregates, M2 and M3, have been within the ranges of growth forecast for them. These facts suggest that the growth ranges presented by the Federal Reserve to Congress in the past 10 quarters (from 1976: III to the present) for M1, M2 and M3 (which imply, for instance, a much more rapid growth of time and savings deposits in banks than of demand deposits and currency) have not been mutually consistent. To the extent that the announced ranges of growth of M1 receive a disproportionate share of attention from Members of Congress and observers of the monetary oversight process, it may also be that the unrealistic ranges of growth that have been announced for this variable have generated public misunderstanding of the Federal Reserve's true policy.

The growth rate of M1, while above target, has been declining, from a peak rate of 8.2 percent in the year ending in 1978:II, to an annual rate of increase equalling 7.3 percent in the year ending in 1978:IV. Moreover, these annual figures mask a sharp deceleration in annual rate of new money creation from the third to the fourth quarter of 1978: from 8.4 to 4.4 percent. Looking at weekly data, it appears that the absolute level of the money stock peaked in

mid-October 1978, and has fallen from 364.3 billion dollars then to 357.6 billion as of the last week in January, 1979.

The significance of this deceleration is unclear. It is not reflected in the quarter-to-quarter growth rate of more broadly defined monetary aggregates, such as M2 (M1 plus time and savings deposits other than large negotiable CD's). The annual growth rate of M2 from the third to the fourth quarter was 8.0 percent, just under the annual average growth rate for the year as a whole (8.5 percent). Looking at weekly data, M2 did decelerate in the past 16 weeks *pari passu* with M1. But, when large negotiable Certificates of Deposit are included with M2, as in the very broad aggregate M4, no major deceleration is apparent even on a weekly basis. This suggests that, while there has been a substantial shift away from money and demand deposits toward interest bearing securities, e.g. from "money" to "near-money", and especially so among large depositors, the high interest rate policy of the Federal Reserve has not yet had the effect of depressing transactions-related balances taken as a whole. The very significant increases in the Income Velocity of M1, M1+, and M2, as shown in the attached charts, would tend to bear out this impression.

Interest Rates

Short term interest rates rose sharply in the second half of 1978. The Federal Funds rate led the way, jumping from 7.6 percent on average in June and 8.45 percent on average in September, to about 10 percent in December, at which level it remained through January, 1979. Persistent reports that the funds rate has peaked, abetted by hints from the Federal Reserve, have yet to show up in the data.

Long-term interest rates continued to rise in the second half of 1978. Now home mortgage yields, a prime component of the cost of housing, rose by 56 basis points, from 9.46 percent in June to 10.02 percent in December. This followed a similar rise in the first half of the year, which was the first increase in mortgage rates since 1974. The prime rate charged by banks rose even more sharply: by 312 basis points, from 8.63 percent in June, 1978 to 11.75 percent in January, 1979.

Government Deficit

As a percentage of Gross National Product, the Federal deficit continued to decline in 1978. On a National Income Accounts basis, the federal deficit in calendar 1978 amounted to 1.4 percent of GNP (\$29.4 billion) compared with 2.5 percent in 1977 (\$48.1 billion). (It is the national income accounts basis that gives the truest measure of the impact of federal spending and taxation on the economy.)

Investment and Capacity Utilization

Gross Private Domestic Investment rose at a brisk rate in 1978. Nonresidential fixed investment rose by 8.3 percent in real terms. Residential investment did not rise over the year as a whole, but did remain stable at a high level: housing starts exceeded 2 million units at an annual rate in every month after March. Inventory/sales ratios remained stable throughout the year.

Most indices of capacity utilization climbed substantially in 1978, but remain below the peak levels achieved in 1973. The Federal Reserve's capacity utilization index for total manufacturing rose from 83.0 to 85.9 percent from December, 1977 to December, 1978, and averaged 84.2 for the year as a whole, compared with an average figure of 87.5 in 1973.

Balance of Payments

The balance of payments deficit on current account stood at \$3.1 billion in 1978:II and \$3.8 billion in 1978:II, down from about \$7 billion in the two preceding quarters. The gain is attributable to a rise in exports of about \$4.5 billion between the first and second quarter: the merchandise trade deficit fell from \$11.1 billion in the first quarter to about \$7.7 billion in the second, and held steady at that level for the rest of the year.

Foreign Exchange

After falling by over 10 percent in the first 11 months of 1978, the value of the U.S. dollar, on a trade-weighted basis, stabilized in November, December and January in response to a policy of massive coordinated intervention.

MONETARY POLICY AND THE HUMPHREY-HAWKINS ACT

Section 108 of the Full Employment and Balanced Growth Act of 1978 (Public Law 95-523) prescribes new and expanded requirements for the Federal Reserve's reports to the Congress on the conduct of monetary policy. A copy of the legislative language is appended. On January 31, 1979, in a letter to Chairman Miller, Senator Proxmire and Congressmen Reuss, Hawkins and Mitchell spelled out their understanding of the intent of Congress in imposing these new requirements. They said:

"According to the new law, the written reports that are to go to the Banking Committees are to discuss three related items:

"1. Recent developments affecting economic trends in the nation;

"2. The objectives and plans of the Board and the Federal Open Market Committee with respect to the ranges of growth of the monetary and credit aggregates for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices; and

"3. The relationship of the Federal Reserve's objectives and plans to the short-term goals (for the current year and for the next year) set forth by the President in his most recent Economic Report and to any short-term goals approved by the Congress.

"In order to evaluate the Federal Reserve's intended policies, the Congress will need to make informed judgments about the relationship between those policies and the nation's economic goals. Thus, it is important that the Federal Reserve's reports to the Congress be in a manner that is conducive to understanding that relationship. The information to be presented should be in a form consistent with that used to set forth the short-term goals in the Economic Report. The monetary policy plans and objectives should be specified in terms of growth rates fourth quarter to fourth quarter.

"The Federal Reserve's discussion of the relationship between monetary policy plans and the President's short-term goals must be clearly and carefully stated if the Humphrey-Hawkins Act is to make a meaningful difference with regard to the role of monetary policy in the achievement of our economic goals. The Board and the Senate Banking Committee agreed to specific language in the report on the legislation to clarify the intent of the word 'relationship'. The purpose of that legislative history was to make explicit the expectation of the Congress that the Federal Reserve would provide both a qualitative discussion and a quantitative analysis of the linkage between intended monetary policy and established goals. The legislative history says:

"In explaining the relationship of the Board's objectives and plans to the short-term goals established by the President in his Economic Report and any subsequent goals established by the Congress, it is expected that the Board would provide the Congress with a full discussion concerning the extent to which the Federal Reserve's intended policies would help to achieve those goals."

"Our interpretation of this agreed upon language is that the Board's written report will be structured in a manner that will indicate in explicit and detailed terms: (1) whether and to what extent the numerical monetary growth targets adopted by the Board and the Federal Open Market Committee will achieve numerical economic goals for the current year and the next year that have been established by the President; and (2) whether the numerical economic goals themselves are mutually consistent and obtainable through the combination of fiscal policies proposed by the President and the Federal Reserve's proposed monetary growth targets."

Tables on pages 9 and 10 of the attached background material from the Congressional Research Service report the Administration's goals in 1979 and 1980 under the Humphrey-Hawkins Act for employment, unemployment, consumer prices, real gross national product, real disposable income, and productivity. The CRS has also provided, at our request, comparable forecasts for these items by three prominent private econometric forecasting groups: Chase Econometrics, Data Resources, Inc., and Wharton Econometric Forecasting Associates. We expect the Federal Reserve to provide this Committee with a detailed, substantive analysis of the relationship between the monetary growth ranges it will be promulgating and the economic goals of the Administration.

REPORTING REQUIREMENTS UNDER THE FULL EMPLOYMENT AND BALANCED GROWTH ACT
OF 1978

SEC. 102. (a) Section 2A of the Federal Reserve Act is amended by striking out the second and third sentences and inserting in lieu thereof the following: "In furtherance of the purposes of the Full Employment and Balanced Growth Act of 1978, the Board of Governors of the Federal Reserve System shall transmit to the Congress, not later than February 20 and July 20 of each year, independent written reports setting forth (1) a review and analysis of recent developments affecting economic trends in the Nation; (2) the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregate for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices; and (3) the relationship of the aforesaid objectives and plans to the short-term goals set forth in the most recent Economic Report of the President pursuant to section 3(a)(2)(A) of the Employment Act of 1946 and to any short-term goals approved by the Congress. In addition, as a part of its report on July 20 of each year, the Board of Governors shall include a statement of its objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year following the year in which the report is submitted. The reports required under the two preceding sentences shall be transmitted to the Congress and shall be referred in the Senate to the Committee on Banking, Housing, and Urban Affairs, and in the House of Representatives to the Committee on Banking, Finance and Urban Affairs. The Board shall consult with each such Committee on the reports and, thereafter, each such Committee shall submit to its respective body a report containing its views and recommendations with respect to the Federal Reserve's intended policies. Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided*, That in the subsequent consultations with, and reports to, the aforesaid Committees of the Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans."

(b) The amendment made by subsection (a) takes effect on January 1, 1979.

NOTE ON MONETARY STATISTICS

The Federal Reserve's present estimates of the narrowly-defined money stock (M1) are considered by many observers, including the Federal Reserve Board itself, to be unreliable guides to policy at the present time. In recent weeks, growth of the money stock has undergone a very sharp apparent deceleration. If past relationships between measured M1 and the economy hold true (e.g., if velocity does not rise to offset the deceleration of M1), then this deceleration could augur a severe recession in mid-1979. On the other hand, it may be that institutional innovations and inadequacies in the reporting system have destroyed the correspondence between measured M1 and "real money"—actual transactions balances available to individuals and companies in the economy. In this case, the observed deceleration of M1 would be an illusion from which no policy implications should be drawn.

There are four principal sources of possible distortion in the estimation of M1:

1. Repurchase agreements. Many private corporations routinely withdraw their checking balances just before bank closing time and buy an overnight loan, redepositing the funds the following morning. This practice is mutually beneficial to company and bank: it allows the company to earn market interest rates on its deposits, and it allows the commercial bank to evade reserve requirements. Such borrowings are not reported as part of M1, and they are not regularly or accurately monitored by the Federal Reserve. On the basis of December 1977 data, the total of these borrowings was estimated to be \$27 billion nightly. It is probably much greater today, as high interest rates reinforce the incentive for this kind of behavior.

2. Money held in banks that do not report regularly to the Federal Reserve. Twenty-seven percent of all deposits are held in banks that are not members of the Federal Reserve System and that therefore do not make frequent reports of their deposits to the Fed. Misestimation of lending by these small institutions can badly distort the reported money supply, and such errors are corrected only when call data comes in on a quarterly basis.

3. Near-money. Checkable accounts in thrift institutions, automatic transfers from savings to demand accounts in commercial banks, checkable money-market, and other new transactions-related instruments are coming into increasing use. The Federal Reserve now publishes estimates of some of these items, but weekly reports are not available, and the estimates are somewhat unreliable.

4. Seasonal adjustment. Faulty seasonal adjustment procedures have plagued Federal Reserve money supply estimate—and many others as well—for years. They may be responsible for some inaccuracies now.

BRIEFING MATERIALS PREPARED FOR THE QUARTERLY HEARING ON MONETARY POLICY
BY THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

Exhibit 1.—Exhibit 1 breaks the 1954–1977 period into eight consecutive 3-year periods: 1954–1955, 1957–1959, etc. For each 3 year period, Chart 1A relates average M1 growth to the average rate of rise in the CPI (inflation); Chart 1B relates average M1 growth to the average rate of interest on 3-month Treasury bills; and Chart 1C relates average M1 growth to the average rate of unemployment.

The exhibit shows that there is a close positive relationship between money growth and inflation (Chart 1A) and between money growth and the rate of interest (Chart 1B). It shows that as money growth increases, so do both inflation and the rate of interest. However, it also shows that there is no relationship between the rate of money growth and the rate of unemployment (Chart 1C). This belies the Phillips Curve theory that inflation is inversely correlated with unemployment.

The closeness of these relationships is denoted by the lines which were fitted in between the points on the graphs. Note the straight lines which were easily drawn in Charts 1A and 1B. It was impossible to fit one line into Chart C.

EXHIBIT 1

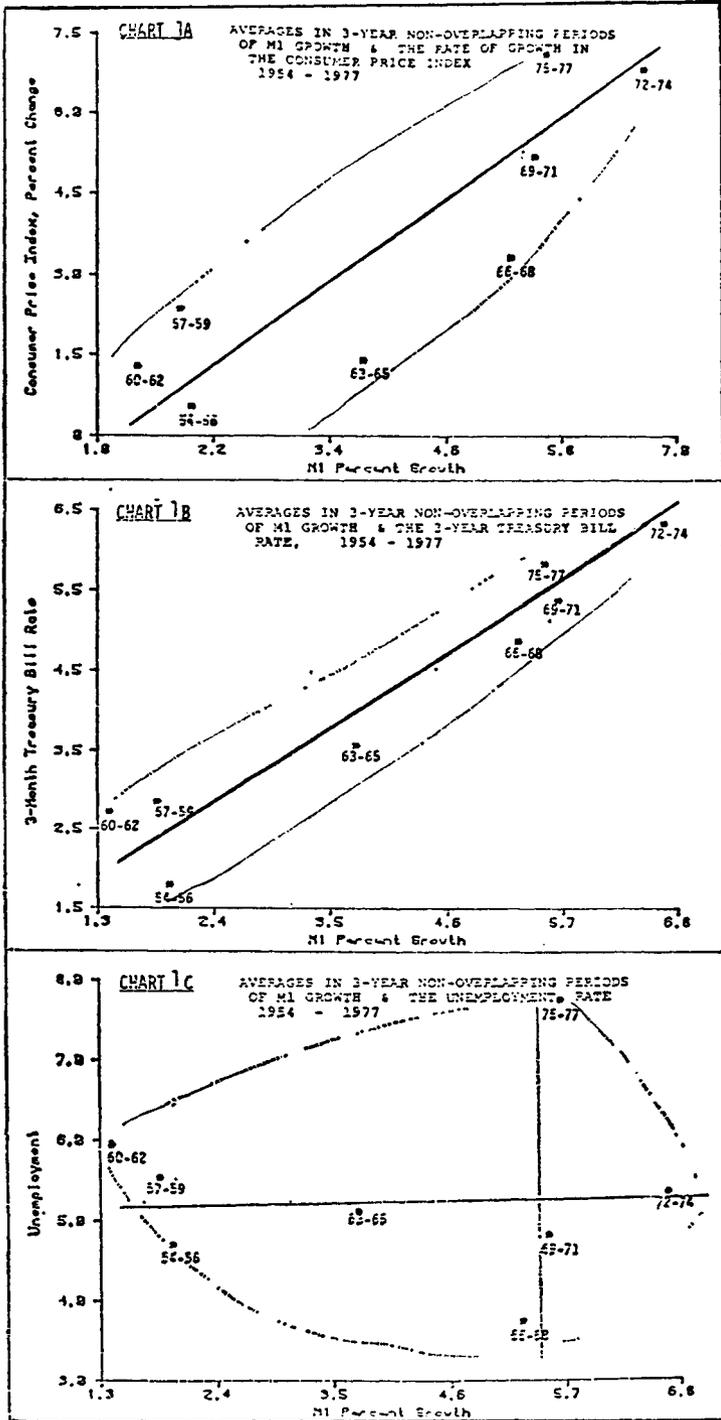


Exhibit 2.—In April 1977, M1 growth hit the top of the target range. In July 1977, it burst through the top of the range, and continued to accelerate faster than the announced target growth range until September 1978. Since then M1 growth has decelerated sharply whether defined inclusive or exclusive of ATS accounts.

The April 1977–September 1978 rapid acceleration helps account for the recent upsurge of inflation. The essentially flat profile that has occurred since September, especially coming as it does in the wake of rapid acceleration will trigger another recession if continued much longer.

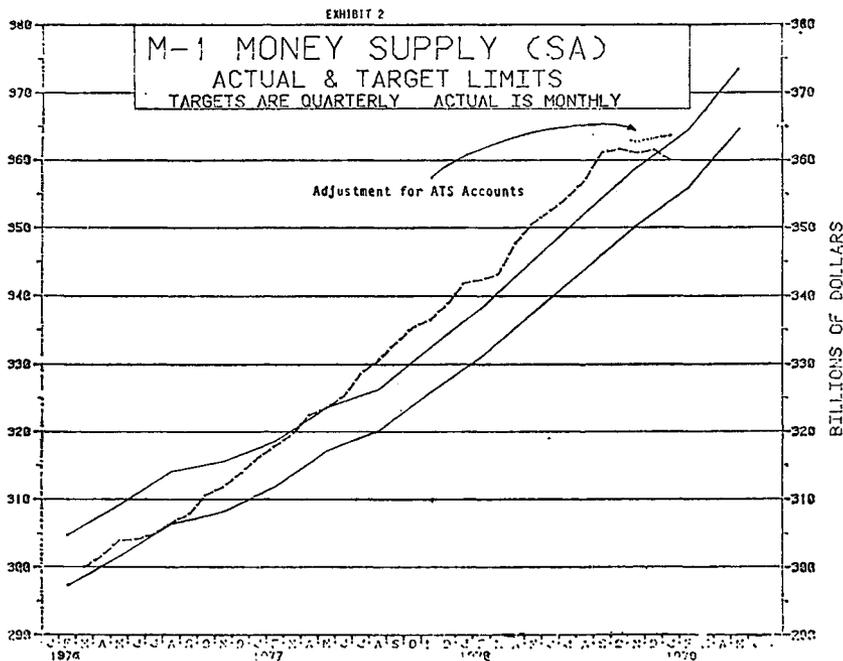


Exhibit 3.—M1 growth measured between the same months of adjacent years (for example January 1947 to January 1948), cycled down and up seven times between the end of World War II and 1978, and now after a prolonged upsurge appears to be headed down once more.

Our economy's performance in the post World War II period is mirrored in this chart of money growth. Inflation was broken after World War II and again after the Korean War by sustained low money growth. It was rekindled after 1964 by upsurges in money growth in the late 1960s, 1971-73 and 1977-78. Recessions, which are delineated by the vertical lines on the time axis, occurred in the wake of decelerations in M1 growth, as the chart shows.

The chart indicates that we are now headed for another recession. It is not, however, too late to avoid another recession. It can be done if year-over-year money growth this year is held in the 6-7 percent range.

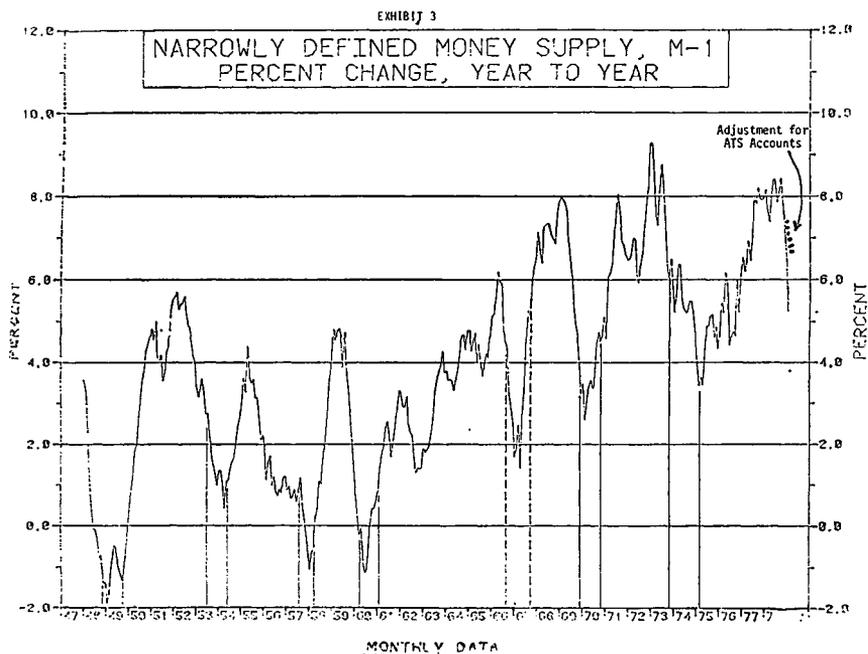
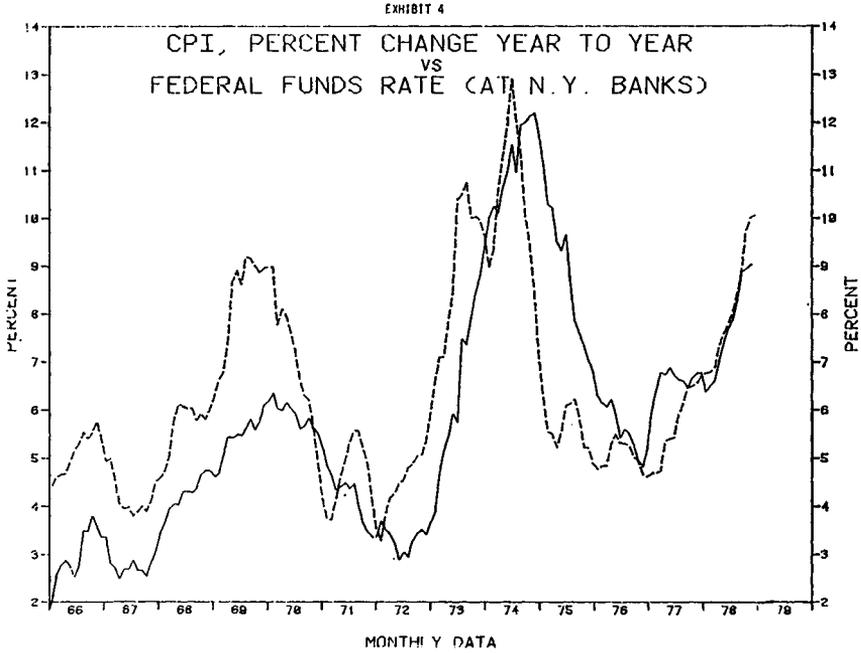


Exhibit 4.—Exhibit 4 plots the percentage changes in the CPI measured between the same months from one year to the next and the Federal funds rate—the overnight inter-bank interest rate—in the last month. It shows that monthly movements in the Fed funds rate occur very closely together with changes in the inflation rate measured from the same month a year ago. It also shows that at times, as in recent weeks, Federal Reserve tightening can cause the funds rate to exceed the rate of inflation.

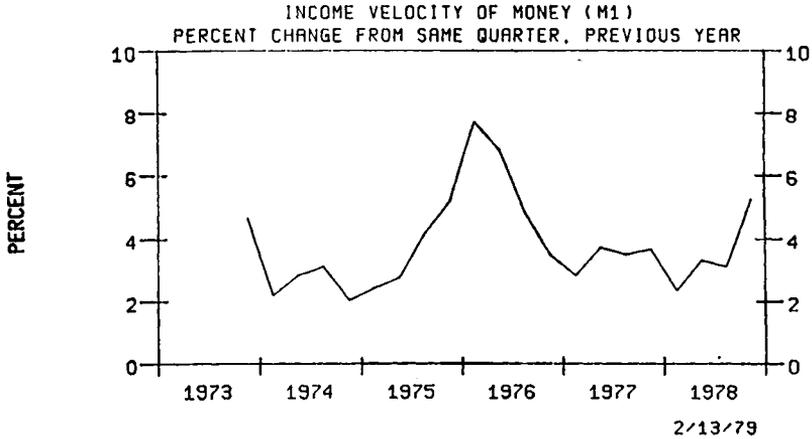


THE LIBRARY OF CONGRESS,
 CONGRESSIONAL RESEARCH SERVICE,
 Washington, D.C., February 16, 1979.

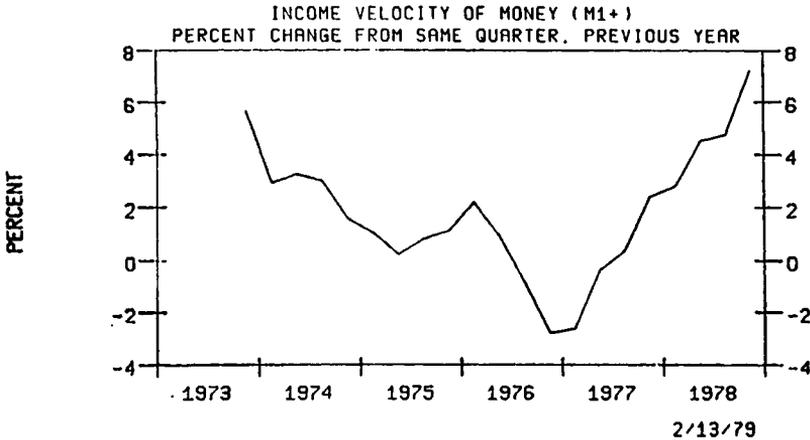
BRIEFING MATERIALS FOR MONETARY POLICY OVERSIGHT

(By F. Jean Wells, Robert S. White, Specialists in Money and Banking;
 William Jackson, Analyst in Money and Banking, Economics Division)

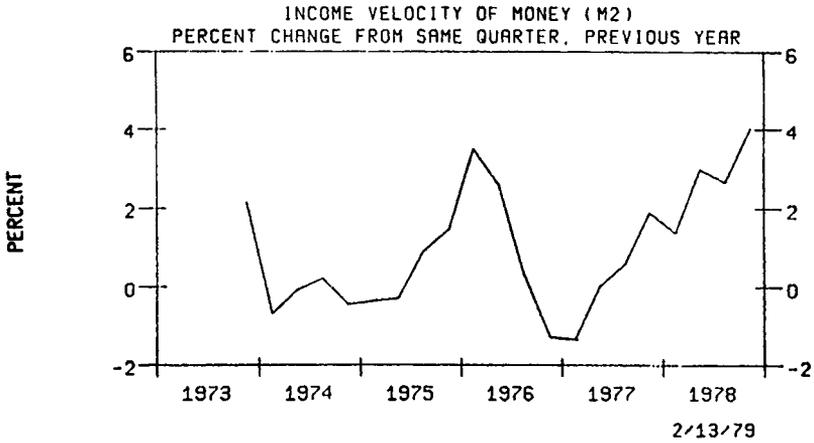
This briefing document has been prepared to assist the House Committee on Banking, Finance and Urban Affairs in monetary policy oversight conducted pursuant to Public Law 95-523. It includes selected indicators for the economic setting in which monetary policy operates as well as presenting indicators of the direction of monetary policy itself. Assistance in preparing this report was obtained from Valerie L. Amerkhail and Gregg A. Esenwein of the Quantitative Section of the Economic Division.



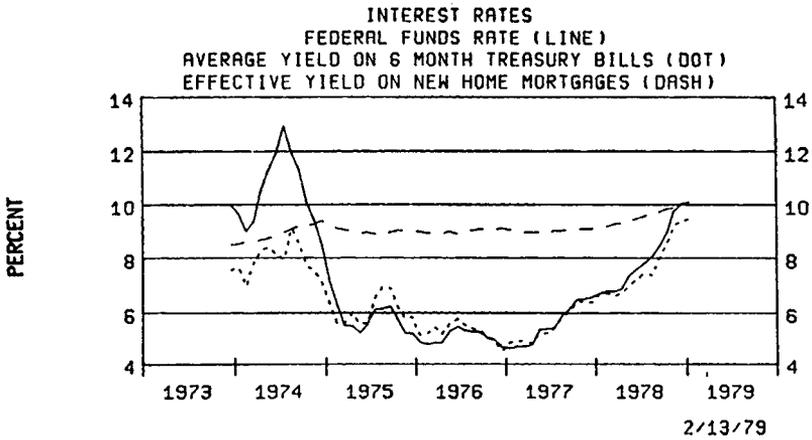
SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
 DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS.
 PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS



SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
 DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
 PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS



SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS



SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DEPT. OF THE TREASURY AND THE FEDERAL HOME LOAN BANK BOARD
PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

FEDERAL RESERVE SYSTEM 1-YR TARGET RANGES AND ACTUAL GROWTH RATES FOR MONETARY AGGREGATES

[Growth rates in percent]

Period	M-1 ¹		M-2 ²		M-3 ³	
	Target	Actual	Target	Actual	Target	Actual
March 1975 to March 1976.....	5.0-7.5	5.3	8.5-10.5	9.7	10.0-12.0	12.2
1975:						
Q2 to 1976: Q2.....	5.0-7.5	5.3	8.5-10.5	9.6	10.0-12.0	12.1
Q3 to 1976: Q3.....	5.0-7.5	4.6	7.5-10.5	9.3	9.0-12.0	11.5
Q4 to 1976: Q4.....	4.5-7.5	5.8	7.5-10.5	10.9	9.0-12.0	12.7
1976:						
Q1 to 1977: Q1.....	4.5-7.0	6.5	7.5-10.0	11.0	9.0-12.0	12.9
Q2 to 1977: Q2.....	4.5-7.0	6.8	7.5-9.5	10.8	9.0-11.0	12.5
Q3 to 1977: Q3.....	4.5-6.5	8.0	7.5-10.0	11.1	9.0-11.5	12.7
Q4 to 1977: Q4.....	4.5-6.5	7.9	7.0-10.0	9.8	8.5-11.5	11.7
1977:						
Q1 to 1978: Q1.....	4.5-6.5	7.7	7.0-9.5	8.8	8.5-11.0	10.5
Q2 to 1978: Q2.....	4.0-6.5	8.2	7.0-9.5	8.6	8.5-11.0	10.0
Q3 to 1978: Q3.....	4.0-6.5	8.1	6.5-9.0	8.6	8.0-10.5	9.6
Q4 to 1978: Q4.....	4.0-6.5	7.3	6.5-9.0	8.5	7.5-10.0	9.4
1978:						
Q1 to 1979: Q1.....	4.0-6.5	(4)	6.5-9.0	(4)	7.5-10.0	(4)
Q2 to 1979: Q2.....	4.0-6.5	(4)	6.5-9.0	(4)	7.5-10.0	(4)
Q3 to 1979: Q3.....	2.0-6.0	(4)	6.5-9.0	(4)	7.5-10.0	(4)

¹ Private demand deposits plus currency.² M1 plus bank time and savings deposits other than large negotiable CD's.³ M2 plus deposits at mutual savings banks, savings and loan associations, and credit unions.⁴ Not applicable.

Notes: Actual growth data are based on seasonally adjusted money supply series of the Board of Governors of the Federal Reserve System as revised in February 1979. Target ranges are those announced before House and Senate Banking Committees beginning in May 1975 according to procedures developed under H. Con. Res. 133 of the 94th Cong. and Public Law 95-188. Beginning in 1979, target ranges will be announced in accordance with provisions of Public Law 95-523.

MONETARY AND CREDIT AGGREGATES

[Percentage change, seasonally adjusted annual rates]

	1975 ¹	1976 ¹	1977 ¹	1978 ¹	1977: IV ²	1978				Federal Reserve targets: 3d quarter 1978 to 3d quarter 1979
						I ²	II ²	III ²	IV ²	
Monetary aggregates:										
M-1.....	4.6	5.8	7.9	7.3	7.5	6.9	9.5	8.4	4.4	2.0-6.0
M-1 ³	8.8	12.6	9.3	5.3	6.8	5.1	7.4	6.2	2.5	4.0-6.5
M-2.....	8.4	10.9	9.8	8.5	8.1	7.2	8.6	10.3	8.0	6.5-9.0
M-3.....	11.1	12.7	11.7	9.4	10.5	8.3	8.7	10.8	9.7	7.5-10.0
Deposits at nonbank thrift institutions... Bank credit ⁴	15.6 4.1	15.6 8.1	14.5 11.2	10.6 11.5	13.8 10.1	10.0 10.6	8.8 15.9	11.5 11.3	12.2 8.3	NA 8.5-11.5
Reserves:										
Required.....	-5.9	.1	3.8	11.0	6.4	8.7	6.7	9.0	20.0	NA
Nonborrowed.....	-2.7	.2	1.2	11.1	3.5	15.4	-.1	6.7	23.8	NA
Monetary base.....	7.6	8.4	8.8	9.6	9.3	10.4	8.2	9.7	10.1	NA

¹ From 4th quarter of previous year to 4th quarter of year indicated.² From previous quarter.³ M-1+ = M-1 plus savings deposits at commercial banks, NOW accounts at banks and thrift institutions, credit union share draft accounts, and demand deposits at mutual savings banks.⁴ Total loans and investments at commercial banks.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of St. Louis.

SELECTED INTEREST RATES, 1975-79

	1975	1976	1977	1978	1978				1979, January
					March	June	September	December	
3-mo treasury bills (new issues).....	5.84	4.99	5.26	7.22	6.32	6.71	7.84	9.12	9.35
10-yr treasury securities (constant maturity).....	7.99	7.61	7.42	8.41	8.04	8.46	8.42	9.01	9.10
Corporate Aaa bonds (Moody's).....	8.83	8.43	8.02	8.73	8.47	8.76	8.69	9.16	9.25
Prime commercial paper, 4 to 6 mo.....	6.33	5.35	5.60	7.99	6.80	7.63	8.44	10.43	10.32
Prime rate charged by banks.....	7.86	6.84	6.82	9.06	8.00	8.63	9.41	11.55	
New home mortgage yields, FHLBB series.....	9.01	8.99	9.01	9.54	9.26	9.46	9.63	10.02	11.75
Federal Reserve discount rate.....	6.25	5.50	5.52	7.52	6.50	7.00	7.75-8.00	9.50	NA
Federal funds rate.....	5.82	5.05	5.54	7.93	6.79	7.60	8.45	10.03	10.07

Sources: Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, and Moody's Investors Service.

FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

	1975	1976	1977	1977(IV)	1978(I)	1978(II)	1978(III)
Total funds raised, by instrument.....	220.2	301.3	399.4	438.2	491.3	454.5	428.4
Investment company shares.....	-.1	-1.0	-1.0	.9	-.2	-.9	-1.8
Other corporate equities.....	11.2	12.4	4.8	6.5	1.2	2.1	1.8
Debt instruments.....	209.1	289.8	395.6	430.9	490.2	453.3	428.3
U.S. Government securities.....	98.2	88.1	84.3	91.7	105.1	92.9	97.5
State and local obligations.....	15.6	19.0	29.2	25.0	22.2	35.8	37.6
Corporate and foreign bonds.....	36.4	37.2	36.1	40.1	29.9	33.7	34.2
Mortgages.....	57.2	87.1	134.0	152.4	137.3	137.9	143.2
Consumer credit.....	9.4	23.6	35.0	36.2	38.0	51.6	43.4
Bank loans, n.e.c.....	-13.9	6.4	32.2	30.9	67.3	33.5	26.6
Open market paper and Rp's ¹	-2.4	13.3	19.8	15.0	50.8	36.7	21.4
Other loans.....	8.7	15.3	25.1	39.6	39.7	31.1	24.5

¹ Repurchase agreements.

Source: Board of Governors of the Federal Reserve System.

1979 ECONOMIC FORECASTS AND ADMINISTRATION GOALS

	Administra- tion goals	Chase forecast	DRI forecast	Wharton forecast
HUMPHREY-HAWKINS ACT GOALS				
Level, 4th quarter 1979:				
Employment (millions).....	97.5	96.5	96.9	97.4
Unemployment rate (percent).....	6.2	7.3	6.8	6.3
Percent change, 4th quarter 1978 to 4th quarter 1979:				
Consumer prices.....	7.5	7.6	8.1	7.9
Real gross national product.....	2.2	-.6	0	1.9
Real disposable income.....	2.8	1.7	2.8	3.4
Productivity total economy: ¹	.4	NA	NA	NA
Private business.....	NA	.4	NA	1.3
Private nonfarm.....	NA	-.7	.1	NA
MONETARY POLICY VARIABLES				
Money supply (M-1).....	NA	5.2	3.1	4.9
Money supply (M-2).....	NA	6.7	7.0	6.7
Level, 4th quarter 1979: Federal funds rate (percent)...	NA	7.7	10.3	9.6

1980 ECONOMIC FORECASTS AND ADMINISTRATION GOALS

HUMPHREY-HAWKINS ACT GOALS				
Level, 4th quarter 1980:				
Employment (millions).....	99.5	99.0	98.8	98.7
Unemployment rate (percent).....	6.2	7.3	6.8	7.0
Percent change, 4th quarter 1979 to 4th quarter 1980:				
Consumer prices.....	6.4	6.1	6.9	7.1
Real gross national product.....	3.2	4.1	5.4	1.3
Real disposable income.....	2.3	3.1	4.2	2.6
Productivity total economy: ¹	1.1	NA	NA	NA
Private business.....	NA	3.3	NA	1.0
Private nonfarm.....	NA	2.9	4.5	NA
MONETARY POLICY VARIABLES				
Money supply (M-1).....	NA	6.2	5.8	7.3
Money supply (M-2).....	NA	9.7	9.7	8.6
Level, 4th quarter 1980: Federal funds rate (percent).....	NA	6.4	9.3	8.7

¹ Based on total real GNP per hour worked.

Source: U.S. Council of Economic Advisers; Economic Report of the President, Washington, U.S. Government Printing Office, 1979, p. 109; Chase Econometric Associates, Inc., standard forecast of Jan. 25, 1979; Data Resources Inc., control forecast of Jan. 22, 1979; Wharton Economic Forecasting Associates Inc., control forecast of Feb. 1, 1979.

SUMMARY OF ADMINISTRATION'S ECONOMIC GOALS CONSISTENT WITH THE OBJECTIVES OF THE HUMPHREY-HAWKINS ACT¹

Item	Year				
	Goal forecasts		Goal requirements		
	1979	1980	1981	1982	1983
Level, 4th quarter:					
Employment (millions).....	97.5	99.5	102.6	105.5	108.3
Unemployment (percent).....	6.2	6.2	5.4	4.6	4.0
Percent change, 4th quarter to 4th quarter:					
Consumer prices.....	7.5	6.4	5.2	4.1	3.0
Real gross national product.....	2.2	3.2	4.6	4.6	4.2
Real disposable income.....	2.8	2.3	4.4	4.4	4.0
Productivity ²4	1.1	1.8	2.0	2.0

¹ "The short-term goals for 1979 and 1980 represent a forecast of how the economy will respond over the next 2 yr not only to the budgetary policies proposed by the President for fiscal 1979 and 1980 but to the anti-inflation program announced on Oct. 24. The medium-term goals for 1981 to 1983 are not forecasts. They are projections of the economic performance that would be required to reach the 1983 unemployment and inflation goals specified in the act." Ibid., pp. 108-109.

² Based on total real GNP per hour worked.

Source: U.S. Council of Economic Advisers; Economic Report of the President, Washington, U.S. Government Printing Office, 1979 p. 109.

FEDERAL BUDGET RECEIPTS AND OUTLAYS

[In billions of dollars]¹

Fiscal year or period	Budget receipts	Budget outlays	Budget surplus or deficit
1975.....	281.0	326.2	-45.2
1976.....	300.0	366.4	-66.4
Transition quarter.....	81.8	94.7	-13.0
1977.....	357.8	402.7	-45.0
1978.....	402.0	450.8	-48.8
1979 (estimates) ²	456.0	493.4	-37.4
1980 (estimates) ²	502.6	531.6	-29.0
Cumulative totals 1st 3 mo:			
Fiscal year 1978.....	84.5	113.3	-28.8
Fiscal year 1979.....	99.4	123.2	-23.8

¹ Unified budget basis.

² Estimates from Budget of the U.S. Government, fiscal year 1980.

Source: Economic Indicators, January 1979.

TRADE BALANCE¹ CURRENT ACCOUNT BALANCE² AND TRADE-WEIGHTED EXCHANGE VALUE OF THE
U.S. DOLLAR³

[In billions of dollars; quarterly data seasonally adjusted]

	1975	1976	1977	1978 ⁴	1978				
					IV	I	II	III	IV ⁴
Trade balance.....	9.0	-9.4	-31.1	-34.2	-10.2	-11.1	-7.7	-8.0	-7.4
Current account balance.....	1.7	18.4	4.3	-15.3	-7.0	-6.9	-3.1	-3.8	NA
Index of the weighted-average ex- change value of the U.S. dollar.....	98.34	105.57	103.3	93.14	100.4	95.9	95.2	90.6	87.81

¹ Merchandise, excluding military, on balance of payments basis (adjusted from census data for differences in timing and coverage).

² Merchandise trade balance plus net investment income, military transactions, travel and transport receipts other services, remittances, pensions and other unilateral transfers.

³ Index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries and Switzerland. March 1973 17.6=100. Weights are 1972-1976 global trade of each of the 10 countries.

⁴ Preliminary.

Sources: Trade balance and current account balance, Economic Indicators, January 1979.

Trade-weighted exchange value of the U.S. dollar, Board of Governors of the Federal Reserve System.

APPENDIX II.—STATEMENTS OF ASSOCIATIONS

NATIONAL RETIRED TEACHERS ASSOCIATION,
AMERICAN ASSOCIATION OF RETIRED PERSONS,
February 28, 1979.

Attention: Mr. Robert Auerbach.

Subject: Hearings on the conduct of monetary policy held pursuant to the Full Employment and Balanced Growth Act of 1978.

HON. HENRY S. REUSS,
Chairman, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR CONGRESSMAN REUSS: Our Associations with a combined membership in excess of 12 million persons, believe that if full employment and low rates of inflation are to be achieved the value of the U.S. dollar will have to be stabilized. That we think will require that monetary policy be conducted in a manner very different from that of the recent past.

We wish to see an end to the "stop-and-go" monetary policies of the 1970's that emphasized stable interest rates and other short term goals and deemphasized the importance of long-range planning of money supply growth. We wish to see an end to monetary policy heavily guided by political expediency. We believe that monetary policy during the 1970's has been disruptive: it has accentuated economic boom and recession. Monetary policy is currently heading the country into another recession, after playing a heavy hand in restoring double-digit inflation.

In our statement for the record of the hearings, our Associations propose that monetary policy be conducted on the basis of planned, long range goals for money supply growth. The planning period should cover 5 years. The rate of money supply growth should be guided by realistic expectations for the growth of real Gross National Product during the period. Much weight should be given to those private sector forecasts of GNP, which tend to assess properly the influence of such factors as declining productivity, declining investment in productive assets, and rising costs of energy. We believe that real GNP in the early 1980's will not be growing by much more than 3 per cent a year; this growth rate should also be the target rate for the growth of monetary expansion.

In the most recent quarters, the Federal Reserve Board has sharply reduced the money supply expansion rates from the peak rates reached during 1977 and 1978; we believe this policy will produce a recession and then be reversed to pull the country out of it and create a boom.

We propose that a plan for phasing down past excessive rates of monetary expansion be adopted, effective this year. Based on the M1 money aggregate, we would establish a growth rate of 6 per cent for 1979 (over the 4 quarters) to be reduced by 1 per cent in each succeeding year until M1 expansion is no greater than the rate of growth of real GNP. At that time a new long range forward plan

for money expansion would take effect based on realistically anticipated GNP growth rates.

Our Associations are well aware of the fact that the M1 money aggregate has altered significance because of changes in bank and savings institution lending practices during 1978 and the current year. Our testimony has not discussed these complications in detail; the text emphasizes the importance of long range planning for monetary expansion. If your Committee will accept the principle of long range, planned monetary expansion we are satisfied that the tools and guidelines are available to do the job.

Sincerely,

PETER W. HUGHES,
Legislative Council.

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS ON THE CONDUCT OF MONETARY POLICY

THE ASSOCIATIONS AND THE ELDERLY

The National Retired Teachers Association and the American Association of Retired Persons have a membership in excess of 12 million persons. This is a significant portion of an elderly population that is increasing very rapidly. In 1950 there were 18.5 million persons age 60 and over. By the year 2000, there will be 40.6 million.

The 75 and over segment of the elderly population is increasing even faster. In 1950, there were only 3.9 million persons in that age category. But by the year 2000, there will be about 13.5 million—3½ times more than there were in 1950.

The Associations have been leading proponents of the idea that the elderly should, to the extent possible, be encouraged to remain productive and useful members of our society. We feel that the proportion of the elderly who are working is much too small; only 1 out of 5 men and only 1 out of 12 women 65 years of age and older are now working. But even if this proportion is significantly increased (as it must be if the elderly are to enjoy a reasonably adequate standard of living in the future), the majority of the elderly will be either fully retired or working only part time. Thus savings and private and public pensions will continue to be the primary sources of income for most persons in their later years of life.

Yet these primary income sources are seriously threatened. The rapid decline in the value of the dollar during the past decade has drained away a significant portion of the income of many of the elderly in real terms. Our Associations are convinced that the monetary policy pursued during this period was a major contributor to the weakening of the dollar and the price inflation that account for that loss.

Congress has the power to promote long range monetary policies that would gradually reduce the currently high (and rising) level of inflation. Regrettably, much time has already been lost. There has been a refusal over the past decades to face the fact that the money supply has been excessively expanded year-after-year. The lack of discipline in controlling the expansion of money has been obscured by much discussion of the details of money markets and general macroeconomic objectives, and by an increasing acceptance of the idea that "money does not matter".

The levels of persistent ("hard core") inflation have been rising over the past decade. For this phenomena there is no single or simple explanation; yet too often academic and government economists have attributed it to "exogenous" shocks of various kinds, which the economy cannot shake off or to a number of microeconomic factors (the majority of which have long been in existence but failed to raise the rates of inflation significantly before the 1970's).

THE 1970'S: ECONOMICS IN DISARRAY

The 1950's and the 1960's were years of rapid and sustained real wage and economic growth in this country. In contrast, the years of the 1970's afford little comfort to any sector of the economy. The decade began with prices tending to rise so fast that mandatory controls on wages and prices became a component of the economic stabilization policy of the U.S. Government (August 1971 to April 1974). This experiment was followed by accelerated inflation: in 1974 prices increased at an 11 percent rate in the United States and at even higher rates

abroad. In late 1974 and early 1975 the deepest recession of the post-war period set in. While the rate of inflation moderated, it still remained high but was now accompanied by high rates of unemployment. The conjunction of these two factors, formerly thought to be largely mutually exclusive, led to the popularization of the word "stagflation".

The economic recovery, which began in 1975, has been long and is continuing. However it has been marked by declining productivity, declining rates of investment and stabilized unemployment levels that are relatively high (between 6 and 7 percent). In addition, the annual inflation rates have been high and persistent. Because of the sustained inflation levels more and more families have found it necessary to have both husband and wife working to attain any significant increase in living standard or just to maintain what they already had. Real wages have risen little if any during the 1970's. For the elderly living on relatively fixed income—and especially for the elderly middle class—these years have been a disaster.

Economic disarray has not been confined to this country. Stagflation has become endemic in many of the older, industrial countries. However, although prices have been rising abroad, the United States has found that it has been losing its ability to compete with many of the products of foreign industry like steel, electronic equipment and textiles.

It can be argued, with some force, that much of the economic disarray on the international scene dates from the August 15, 1971 suspension of the convertibility of the dollar into gold for international settlements. This, in effect, ended the Bretton Woods agreement under which exchange parities between currencies had been fixed and during the life of which post-war trade had flourished.

The second devaluation of the dollar (February 12, 1973) suspended the Smithsonian Agreement. This was the death knell of any serious attempt, on a world-wide basis, to reestablish fixed parities among the major currencies. Since the collapse of this agreement, international conferences have brought little order to the international monetary scene. As the currency of the dominant free-world power, however, the U.S. dollar continues to be the reserve currency of most countries and provides much of the liquidity needed for international transactions.

Unfortunately, the dollar has continued to decline in value against such major currencies as the German mark, the Japanese yen and the Swiss franc. Unless the U.S. begins to pursue tough anti-inflation policies, this decline is likely to continue, contributing further to instability abroad and exacerbating inflation at home.

There have been many who have felt that the U.S. dollar has been undervalued and that the falling value of the dollar in the foreign exchange markets should be treated with "benign neglect". However, as long as foreigners see U.S. productivity declining, inflation running apparently out of control and the U.S. money supply expanding too briskly, they are likely to continue to discount the dollar.

The dollar's abrupt decline in the foreign exchange markets during 1977 and 1978 prompted the government's rescue attempt last November. But while the government's intervention in the exchange markets has halted the slide in the dollar's value, this type of intervention—as the British found in their many post-war attempts to support the pound sterling—is only a palliative. The attack on the dollar will cease when we mend our economic ways and that entails a "disciplining" of money supply expansion.

Also in the 1970's an important change has occurred with respect to this country's balance of payments. Not only have trade deficits appeared, but they are persistent and increasing in size. During 1977 the deficit was \$26.7 billion. This was four times larger than the previous 1972 record and demonstrates how far we have drifted from the trade surplus situation which prevailed prior to 1971. The problem is not just due to the cost of energy imports (now running in excess of \$40 billion) but also to an increasing trade deficit in manufactured goods. The international competitive environment has changed; several countries (notably Japan) have become more productive and innovative in manufacturing than we have and the governments of those countries support their exports trade more aggressively than we do.

If it seems that we are unfairly painting the decade of the 1970's as chaotic in the United States (and abroad), we would point out that the 1978 "Economic Report of the President" carried a detailed discussion of the "Origins of the Current World Economic Disorder." Cited as the principal sources of disorder

were prolonged inflation, rising unemployment and large current account imbalances. While the report cites the strong expansionary policies existing everywhere in 1972, the rising rates of inflation were attributed to non-monetary factors: the demand for raw materials and grains during the early years of the decade, OPEC's quadrupling of crude oil prices in 1973, and the wage/price momentum which had become institutionalized in the economics of any industrialized states. The Council of Economic Advisors, which prepared the report, has, in our view, however under-estimated the contribution that overly expansive monetary policy has made to the economic instability of the 1970's.

In an October, 1978 Boston interview the well-known Cambridge economist, Joan Robinson, spoke of the capitalist world's arriving at a deep crisis, with the foundations of its economies shaking loose. She thought that the capitalist world was up against the limits of its resources, with no easy way out of the mess. Americans, she said, were "bastard Keynesians" in that they believe that the capitalist economies were essentially stable and that government spending could bring unending growth and prosperity.

During the 1950's and early 1960's, this country experienced unparalleled prosperity. If the foundations are now coming apart, perhaps it is because we have tried to follow Keynesian economic prescriptions too closely since the mid-1960's. According to this school of economics, it is not enough to give counter-cyclical fiscal help; the economy must be perpetually fine-tuned. An emphasizing of income stream manipulation has led to a deemphasizing of money value stabilization. Increasingly, the value of money has ceased to matter.

In fact, however, money matters a great deal in a capitalist society (and to the elderly in such a society). If money is not reasonably stable, savings, investment, and enterprise are at a disadvantage. If money becomes highly unstable, substitutes must be found, or industry will grind to a walk.

RESTORING ECONOMIC ORDER

The Associations believe that a fundamental (but by no means the only) cause of the economic disorder of the 1970's had been the lack of stability of the dollar. If economic order is to be restored in the 1980's the dollar must be stabilized in a dynamic sense by assuring that over the long run the rate of growth in the money supply is tied to the rate of growth in real (non-inflationary) Gross National Product (GNP). The Council of Economic Advisors should set real GNP growth rate targets for five year periods. These targets and the statistics that accumulate during the period should be forwarded to the appropriate Congressional Committees so that long term plans for the money supply as proposed by the Federal Reserve, can be closely coordinated.

Because present law requires the Federal Reserve Board to submit a statement of its policy only for the one year period for which the report is written, the scope of the policy in terms of the time period covered is much too short. What are we proposing is a five year plan, which will, of course, be subject to annual review and adjustments. We think a plan of this length is needed so that the rate of expansion of the money supply, to the extent it exceeds the rate of real GNP growth, can be brought down gradually and systematically, without generating a serious recession.

The rationale for our proposal is this. The country's economic machine will apparently be capable of only an annual real growth rate of between 2 and 3½ percent during the coming years. Therefore the money supply growth rate ought to be brought down gradually to this same range. Obviously, the monetary expansion policy we call for is quite the opposite of what has been pursued in the recent past.

A simple comparison between the growth of M1 money stock and the growth of real GNP reveals that in the first two decades after World War II M1 grew at a slower rate than real GNP.¹ However, for the 9 years from 1967 through 1976, real GNP grew at an annual rate of only 2.6, while the money stock grew at a 5.8 percent annual rate. In the following pages we cite much refined analysis of post-war money supply growth to support what appears from a superficial examination of the data—money stock growth rates have become so high that they are supporting elevated rates of inflation.

We recognize that enabling legislation would be needed to carry out our proposal for gradually reducing the money supply growth rate and ultimately coordinating that growth rate with the real GNP growth rate planned over a five

¹ See Table I in Appendix, *infra*.

year period. Immediately, however, the Federal Reserve Board can commence a phased reduction in the money supply growth rate without any new legislation. The Banking Committees ought to use the consultation process with respect to the monetary policy proposals (that the Federal Reserve Board must present each year under last year's Humphrey-Hawkins legislation) to make sure such a gradual reduction is undertaken.

A PHASED REDUCTION IN THE GROWTH OF MONEY STOCK

If any significant progress toward price stability is to be made, the uncharacteristically high M1 growth rates of the 1970's must be substantially lowered. To avoid a serious recession, the reduction should be at a steady rate, phased in over a period of years.

A careful econometric examination of the possibilities of this approach was made by Peter I. Berman, recently a senior economist with The Conference Board.² Dr. Berman investigated the usefulness of a number of measurements but derminded upon the M1 money stock for his final, econometric model, about which he had this to say:

"The correct specification for the M1 model is a stable 10 quarter distributed lag with uniformly sized weights. Since 1956, this model explains about 70 percent of the variability in inflation. For the 1963-1971 period R2 increases to 80 percent and the normally distributed residuals imply that, stochastically, money growth completely explains inflation, i.e. the real sector price effects are adequately captured in the trend term."³

Mr. Berman assessed the effects of increases in the M1 money stock as follows: ". . . a permanently maintained 1 percent increase in M1 growth will eventually increase inflation by 1.4 percentage points provided there is no change in the net influence of the real sector on the price level. By inference, the quantity theory may not hold in the near term."⁴

The value of the model of course must be based on its ability to forecast. On this subject Dr. Berman had the following to say:

"An out-of-sample forward simulation beginning in mid-1971 gives impressive forecasts. For 1976 and 1977, the average forecast error is only 0.5 percentage point, and the forecast errors do not show any sign of progressive deterioration. . . . Only one quarter 1977/2 has a forecast error exceeding two standard errors, 1.6 percentage points. At the very least, the M1 model is a useful forecasting tool."⁵

According to Berman, a phased reduction of 1 percent a year in the M1 growth rate would reduce inflation by about 4.5 percent over a five year period. A 1½ percent a year reduction would reduce inflation by 4 percent over a 4 year period. A 2 percent a year reduction—a "crash" program—would reduce inflation by 4½ percent in 3 years.⁶

The Associations would be satisfied with any phase-down program (like the ones cited in the above paragraph) that could be adopted without generating a major recession. Because of changes in banking practices, M1 may have to be redefined; M2 might be a better aggregate to serve as a standard for the phase-down. The main thing, as we see it, is to slow down the growth of the money stock in a gradual and systematic fashion. This recommendation calls for a gradual slowing of the money supply growth rate until it is brought into line with the rate of growth in real GNP. This recommendation also requires that GNP be targeted for monetary policy purposes. In other words, the target GNP real rate of growth figures must not be made so large that more inflation is promoted.

Recommendations that monetary policy focus on planned money stock growth over a five-year period and that the size of the money stock be disciplined in accordance with the needs of an expanding (or contracting) real GNP are recommendations which represent substantial change from monetary policy as practiced in the past. The proposed policy would be focused on changes in monetary aggregates rather than on changes in interest rates. We think such a shift in focus is called for. The fact is that the dollar is now an inconvertible paper currency. Thus, we cannot afford to continue to give in to popular demands for cheap money and abundant supplies of money because this makes the growth of the money supply, and the inflation such growth facilitates, a secondary consideration for the central bank.

² P. Berman, *Inflation and the Money Supply in the United States, 1956-1977* (1978).

³ *Id.* at 6.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 120.

A STABLE ECONOMY VS. STABLE MONEY MARKETS

With the adoption of House Concurrent Resolution 133 on March 24, 1975 the Congress began to emphasize the importance of money stock aggregates, requiring the Federal Reserve Board to propose ranges of growth of monetary aggregates for a twelve month forward period. Historically, however, the primary objective of central bankers including our own Federal Reserve has been to keep "the financial structure on an even keel" and the ideal situation for them has been financial stability, with interest rates stabilized.

Our objection to having interest rate stability as the primary focus of monetary policy is that supplies of bank credit and money became determined by the demand for them. Because changes in money supply are induced by changes in private demands for money and credit, a rate stabilizing policy results in money supply changes which tend to amplify business fluctuations, rather than countering them. Expanding the money supply in order to moderate increases in interest rates is effected at the cost of increasing price inflation. The correct approach it seems to us, is to keep the money supply growing at a relatively steady rate in accordance with the needs of an expanding or declining real GNP. Interest rate fluctuations should then be no cause of great concern, since they would not be indicators of either an excessively deflationary or an excessively inflationary policy. The history of the monetary policy of the 1970's—a disaster in terms of its inflationary consequences—has led us to conclude that pre-occupation with interest rates as the primary guide for monetary policy is just not the correct course to follow.

Because this country has had a history of low inflation rates, we are only now beginning to appreciate the significance of the inflation premium that is being added to real interest costs. Expanding the money supply to keep down interest rates only yields temporary success; lenders soon perceive that they will be paid back in a devalued dollar and thus must include an inflation premium in their rate of interest. The long-term result is a rise in interest rates. As expansionary monetary policy to keep interest rates down will, if it contributes to more inflation, lead to even higher interest rates in the future.

REDUCING THE MONEY STOCK GROWTH RATE: WILL IT BRING ON A RECESSION?

We have proposed a phased reduction in the rate of growth of the money stock over a period of years to bring it into line with real GNP growth rates. One question that will be raised is whether or not this course of action will eventually produce a recession. We think it will not. A gradual slowing of the money stock growth rate has not produced recessions in the past. As the chart in the appendix on page 34 indicates, the gradual money stock growth rate reductions that occurred in 1955, 1962, 1965, 1971 and 1976 did not spawn recessions. Only when the reductions were very sharp, as they were in 1959, 1969 and 1973, did they tend to bring on recessions.

A sharp reduction in growth rates will not be needed and a serious recession can be avoided if a phased and systematic reduction is pursued in the years immediately ahead. The sharp reduction in money stock growth rates in the 4th quarter of 1978 and the 1st quarter of 1979 is likely to provoke a recession, if continued into the 2nd quarter of 1979. This abrupt restraining of money supply growth might not have been needed if monetary policy had been oriented since 1976 to steady growth, rather than to interest rate stability.

Since the last quarter of 1976, when M1 grew at a rate of 7.7 percent on an annual basis, and up until the last quarter of 1978 when the present restraint began, the M1 growth rate has dipped below 7 percent only once—during the 1st quarter of 1978. These high and sustained growth rates have virtually institutionalized inflation in the 6 to 8 percent a year range.

MONETARY POLICY FOR 1979

This Committee has responsibility for reconciling the short term goals of the President's Economic Report with the short term goals and targets of the Federal Reserve Board and its Open Market Committee. The Committee will be receiving proposals for various ranges for the monetary aggregates from the Board for the coming quarters and proposals for interest rates to be established for Federal Funds. We hope the Committee agrees with one of the main points of this statement: the Federal Reserve system cannot, at this juncture, adequately control both monetary aggregates and interest rates; if the focus is on interest

rate stabilizations, control of money stock growth will be sacrificed; if the focus is on the monetary aggregates, interest rates will fluctuate. Our recommendation is to abandon the past emphasis on interest rate stabilization and concentrate instead on control of money stock growth in the context of a longrange—preferably 5 year—plan.

It follows from our recommendation that we believe the Committee should relate the proposals of the Federal Reserve Board for the control of monetary aggregates to the expected growth of real GNP for the coming years. The President's January 25 Economic Report has estimated the real GNP will grow at a rate of only 2¼ percent during calendar year 1979. This is optimistic when compared to the -0.1 to 1.9 percent real GNP growth rate which the Congressional Budget Office projects for the period 1978:4 to 1979:4. The CBO estimates real GNP growth for 1979:4 to 1980:4 in the range of 2.7 to 4.7 percent. While the Economic Report speaks of monetary restraint, there are no specifications whatsoever for restraint under the discussion of "Policies to Control Inflation." This failure to be specific about monetary restraint by relating money stock to the needs of the economy as measured by real GNP is puzzling. Could it be the Administration has failed to recognize the connection between the economic disorder of the 1970's and the undisciplined expansion of the U.S. money supply?

It appears that an annual four percent real economic growth rate is not attainable in the immediate future. Declining investment, declining productivity, rising energy costs and other factors appear to preclude that. Politicized goals for real GNP growth cannot be trusted as a gauge for the expansion of the money supply. The Wharton School's econometric projection of real growth in GNP for the 5 years ending with 1985 is an annual average rate of 3.2 percent. As a long range goal, we think an average annual rate of growth in the money stock of 3 percent would be appropriate and non-inflationary. However, we ought to move toward this optimum growth rate over a period of years to avoid bringing on a severe recession by decelerating too quickly from the very rapid growth rates of the recent past.

For simplicity we are specifying our plan for reducing money stock growth in terms of M1. Nevertheless we recognize that changes in the ways banks and thrift institutions handle accounts may make it necessary to restate the resulting M1 stock aggregates in nominal currency. If so, the Federal Reserve Board is fully capable of making such a re-statement. Alternatively, the Federal Reserve might wish to use another aggregate such as M2. But the objective is to arrive, in a systematic manner at the end of a period of years at a money supply rate of expansion that is no greater than the rate of growth of real GNP.

The phased reduction that we propose would proceed in accordance with the following schedule.

Year :	Average M ₁ money stock growth 4 quarters (percent)
1979 -----	6
1980 -----	5
1981 -----	4
1982 -----	3

If this schedule does not reduce the inflation rate to 2 percent a year, a further reduction in the growth of money stock could be made in 1983, so that annual inflation is reduced to this rate.⁷

The adoption by Congress and the Federal Reserve system of a disciplined method for controlling the expansion of the money stock should begin to dampen inflationary expectations immediately. The world will be put on notice that this country intends to defend the value of the dollar on a long range basis. Persistent, elevated rates of inflation should gradually fall. Vigor should be restored to our capital markets, both in equity offerings and in fixed securities, since lenders will be able to calculate real long range returns with reasonable accuracy. New enterprise should be promoted with the elimination of the uncertainties affecting the return on investment created by fluctuating, elevated rates of inflation. The return of relative stability to the dollar should eliminate the enormous inflationary burdens that the social security system would otherwise have to bear. Finally, the growing elderly population should be better able to sustain themselves through savings.

⁷ P. Berman, *supra* note 1, at 14, 20.

EMPLOYMENT AND INFLATION

We know the Committee will be reviewing short term monetary policy against the economic goals set forth in The Full Employment and Balanced Growth Act of 1978. The Associations have expressed on many occasions our support for counter-cyclical action by the Federal Government to promote employment and business activity during the declining phase of the business cycle. However, we are much opposed to the Federal Government's pursuit of stimulative monetary and fiscal policies as full employment is approached. We believe that the pursuit of stimulative policies in both good economic times and bad has been another major factor contributing to the lifting of the inflation rate levels. The Federal Reserve system has found itself obliged during recent quarters to try and brake the inflation rate which has once again risen to double digit levels by freezing the expansion of the money stock and by raising the Federal Funds rate to very high levels. This action is certain to promote uncertainties of all kinds in the business community and to induce a severe recession if continued.

We hope the Committee will agree with the point of view of our testimony that monetary policy ought not to be used to expedite short term economic goals but instead should focus on the long term goal of expanding the money supply in accordance with the rate of expansion of real GNP. Because many researchers have found that the money supply tends to act slowly on prices and business activity, monetary policies should not be changed on an ad hoc basis from quarter-to-quarter or even from year-to-year; underlying all changes in policy should be sound long range planning. The failure to follow a long range policy of expansion has made for stop-and-go policies (even during the present economic recovery) that have had damaging effects on employment and on the rate of persistent inflation.

The Humphrey-Hawkins bill was intended, in the eyes of some of its sponsors, to be a blueprint for economic action by the Federal Government. However, not only do we consider its goals to be rather "dated", but we have also found that the methods of control implied by the bill—fine-tuning of the economy—work poorly as evidenced by the results of the past decade. Full employment goals in the 3 to 4 per cent range fail to take account of important changes in the working population. Phillip Cagan of the American Enterprise Institute has estimated that full employment at which inflation neither increases nor decreases is somewhere between 5.9 and 6.3 per cent. We believe that the goals of full employment and low inflation for the United States can best be promoted by stabilizing the value of the dollar by methods we have outlined in the previous paragraphs.

MONEY: THE QUANTITY MATTERS

The thesis of our statement is that the quantity of money issued by government is an important determinant of the exchange value of that money and to stabilize its value, long range monetary policy should center on a planned expansion of the money stock in accordance with the expansion (or contraction) of GNP in real terms.

While we have referred to certain studies in previous paragraphs, we would like to conclude our statement with descriptions of two more, one by the Federal Reserve Bank of St. Louis, and one by the Brookings Institute. Both find a close association between money supply expansion rates and rising price levels. However, before proceeding to these, we would like to refer to an older study of great depth, which was done by Milton Friedman and Anna Jacobson Schwartz, "The Monetary History of the United States 1867-1960." One of their most important findings is summarized in the following quotation from that study:

"Throughout the near-century examined in detail we have found that:

1. Changes in the behavior of money stock have been closely associated with changes in economic activity, money income and prices.
2. The interrelation between monetary and economic changes has been highly stable.
3. Monetary changes have often had an independent origin; they have not been simply a reflection of changes in economic activity."

Although it is nearly twenty years since these conclusions were formulated, we have no reason to believe that they are other than fundamentally sound. In saying this we are not trying to make money stability the touch-stone of economic prosperity. We are simply affirming again that money changes—which are long range in their effect on economic activity and on prices—are important—so important that they must be made according to a long range plan. We simply

can no longer afford "stop-and-go" monetary policies or policies that shift with the political winds.

MONETARY GROWTH AND PRICES

A December 1978 study by the Federal Reserve Bank of St. Louis demonstrated that there is a simple monetary guide to the rate of inflation: the rate of change in prices over the next year will be about equal to the average rate of growth of the money stock over the previous five years.⁸

As shown in Table II of the appendix (page 33), over the nineteen year period 1953-71 the average difference between the actual rate of inflation and the rate indicated by the past rate of monetary expansion was only 0.2 of a percentage point. In two-thirds of the years the error in the predicted rate was 0.5 of a percentage point or less. It was found that although prices oscillated around the trend rate on a quarter-to-quarter basis, the rate of change of prices returned consistently to that dictated by the rate of monetary expansion.

Also during this period it was found that the five-year trend in the growth of money accurately indicated changes in the year-to-year rate of inflation, up or down. For example, as the trend in the growth of the money slowed in the period 1958-63 the rate of inflation slowed down. Over the next eight years the trend in the growth of money accelerated steadily from around 2 per cent a year to 5 per cent and this corresponded with a rise in the annual inflation rate from 2 to 5 per cent.

Over the short run the level of prices may be strongly influenced by factors other than the trend in the growth of the money supply. However, after the effects of the non-monetary factors (frequently described as shocks) have been absorbed into the economy the level of prices tends to revert to the trends indicated by the past growth in the money supply. Table II shows that prices in 1974 and 1975 rose far higher than what would be indicated by the past five-year growth in the money supply. The shocks that raised prices over the trend lines were the two separate dollar devaluations of 1973, which raised the costs of imports in the following years, the worldwide food shortages of 1973 and 1974, the four-fold increase in world crude oil prices dating back to mid-1973, and raw material shortages. Price levels in those two years were probably also boosted by widespread expectations of inflation. But in 1976 and 1977 the inflation rates reverted to those indicated by past growth in the money supply; the 1977 inflation rate of 5.9 per cent was only 0.1 percentage points off target.

We do not cite this study as proof that there is a mathematically verifiable relationship between the level of prices and the growth of the money supply; it remains possible that other factors could account for the apparent relationship between price levels and past money supply growth rates. However, elaborate econometric models of the economy have been failing to forecast the rate of inflation with reasonable accuracy since the rates began to accelerate in the late sixties. The money stock method for predicting inflation rates ought at least to be deemed a useful tool. In addition, it raises the possibility that more elaborate demonstrations may prove a casual relationship between money supply changes and changes in the rates of inflation.

WORLD INFLATION AND MONETARY ACCOMMODATION

An important econometric study of the sources of inflation in this country and several other industrial countries was described in the "Brookings Papers on Economic Activity, 2: 1977."⁹ The Report was supervised by Robert J. Gordon of Northwestern University. The research was supported by the National Science Foundation. The period analyzed covered the years 1958 to 1976.

The major alternative explanations for the acceleration in the rate of inflation since 1965 and the advent of world wide inflation have been monetary expansion, (an increase attributable primarily to the excessively expansionary monetary policy of the United States) and wage-push inflation, promoted by the strength of labor unions. The paper assumes that in the long run inflation is a monetary phenomenon, confirmed by many studies on the connection between the growth of world money and prices. However, this is to be regarded as an initial step in the understanding of the inflation process, because the sources of change in the money supply remain to be explained. In other words, we may correlate

⁸ Albert E. Burger "Is Inflation All Due to Money?", Bulletin of the Federal Reserve Bank of St. Louis (December 1978).

⁹ R. Gordon, "World Inflation and Monetary Accommodation in Eight Countries", Brookings Papers on Economic Activity (1977).

world prices and money but we do not rule out wage-push as a source of world monetary growth. We ought not to regard the behavior of the monetary authorities and wage-push factors as competitive explanations for inflation, because the monetary authorities may be expanding the money supply to accommodate wage-push and other causal factors like fiscal deficits, supply shocks and the counter-cyclical monetary reaction function. Thus, if we are analyzing why the monetary authorities are expanding the money supply at certain rates, we must investigate the various factors that may be affecting their judgment. The reason that wage-push factor assumes so much importance is that central bank must—for political reasons—expand the money supply so that it is adequate to ratify any given level of money wages, regardless of how the wage levels are determined. If they fail to do so, excessive unemployment may be the consequence.

Econometric analysis of the relative importance of the various sources of inflation is a difficult task. The results of the study can only be accepted with reservations. Nevertheless, the study is solid in one respect: the growth of the money supply was found to be a critical factor in determining the inflation rate and control of money supply growth was found to be essential to control of inflation. The importance of this conclusion is such that we quote this particular summation as set forth in the study.

“Is the control of the money supply sufficient to control inflation?” Money growth has a significantly positive impact on wage growth in four major countries making up 72 percent of the 1976 GNP of the eight countries considered here. Not only does this tend to deny the contention of some wage-push proponents that wage claims are numbers “picked out of thin air,” but it also supports the international-monetarist position that control of world monetary growth is a crucial requirement in the determination of the world inflation rate. A qualification is that in the remaining four countries the effect of money on wages is weak or nonexistent. A further qualification is that the estimated elasticity of wages with respect to money is small, and that of prices with respect to money is smaller still. Finally, this effect of money on prices apparently operates in conjunction with the effect of money on output.”

TABLE 1.—POST-WORLD WAR II TRENDS IN NOMINAL AND REAL GROSS NATIONAL PRODUCT AND IN MONEY STOCK (M1 AGGREGATE) 1947/1977

[All figures in billions]

Year	Nominal GNP	Money stock M-1 aggregate	Real GNP in 1972 dollars
1947	\$232.8	\$113.1	\$468.3
1948	259.1	111.5	487.7
1949	258.0	111.2	490.7
1950	286.2	116.2	533.5
1951	330.2	122.7	576.5
1952	347.2	127.4	598.5
1953	366.1	128.8	621.8
1954	366.3	132.3	613.7
1955	399.3	135.2	654.8
1956	420.7	136.9	668.8
1957	442.8	135.9	680.9
1958	448.9	141.1	679.5
1959	486.5	143.4	720.4
1960	506.0	144.2	736.8
1961	523.3	148.7	755.3
1962	563.8	150.9	799.1
1963	594.7	156.5	830.7
1964	635.7	163.7	874.4
1965	688.1	171.3	925.9
1966	753.0	175.7	981.0
1967	796.3	187.3	1,007.7
1968	868.5	202.2	1,051.8
1969	935.5	208.8	1,078.8
1970	982.4	219.6	1,075.3
1971	1,063.4	233.8	1,107.5
1972	1,171.1	255.3	1,171.1
1973	1,306.6	270.5	1,235.0
1974	1,413.2	283.1	1,214.0
1975	1,516.3	294.8	1,191.7
1976	1,692.4	311.9	1,265.0
30 yr average annual growth rate (percent)	7.1	3.6	3.5

Note: M1 growth rates: 1947/1957 -1.9 percent; 1957/1967 -3.3 percent; 1967/1976 -5.8 percent. Real GNP growth rates: 1947/1957 -3.8 percent; 1957/1967 -4 percent; 1967/1976 -2.6 percent.

Source: Data from various Government sources as given in the 1977 Economic Report of the President.

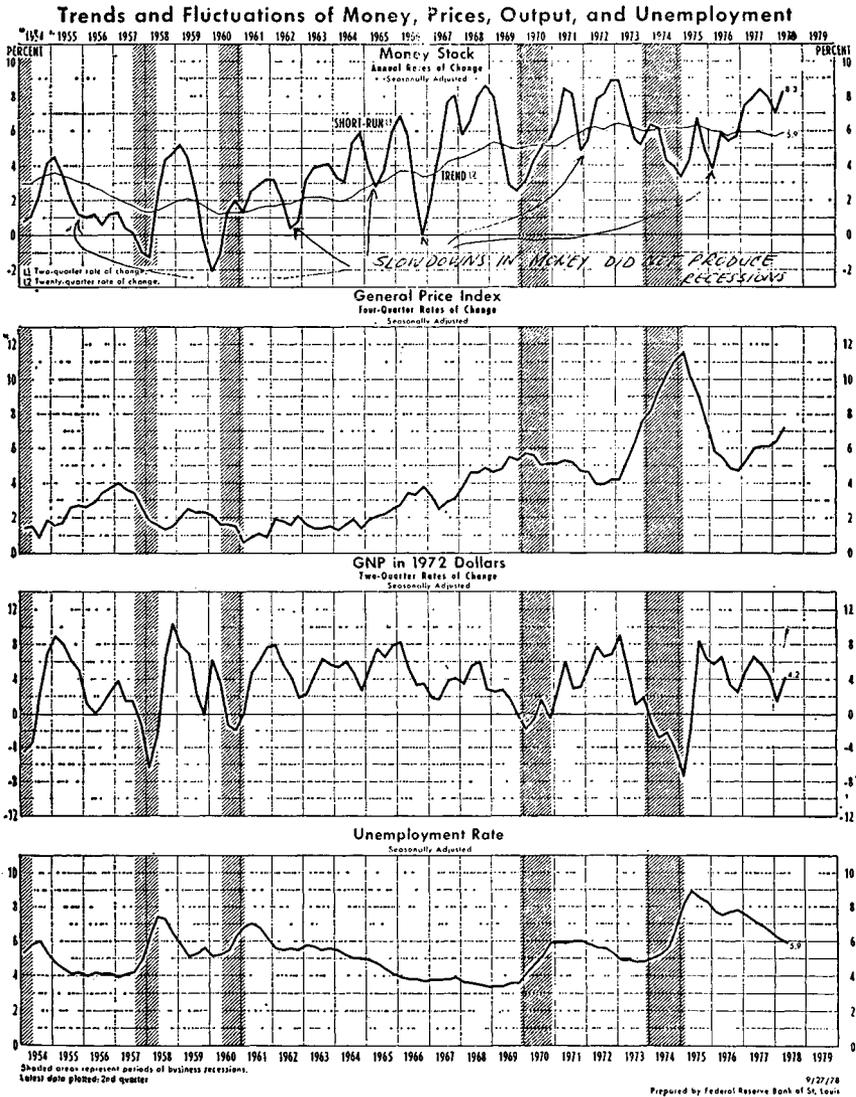
TABLE II.—MONETARY GROWTH AS AN INDICATOR OF INFLATION

[In percent]

Period	Growth rate of money (1)	Period	Growth rate of prices (2)	Col. (1) minus Col. (2)
1947-52	2.3	1953	1.5	.8
1948-53	2.7	1954	1.4	1.3
1949-54	3.2	1955	2.2	1.0
1950-55	3.3	1956	3.1	.2
1951-56	2.7	1957	3.4	-.7
1952-57	1.8	1958	1.6	.2
1953-58	1.5	1959	2.2	-.7
1954-59	2.0	1960	1.7	.3
1955-60	1.3	1961	.9	.4
1956-61	1.5	1962	1.8	-.3
1957-62	1.8	1963	1.5	.3
1958-63	2.2	1964	1.6	.6
1959-64	2.2	1965	2.2	0
1960-65	3.1	1966	3.3	-.2
1961-66	3.6	1967	2.9	.7
1962-67	4.0	1968	4.5	-.5
1963-68	4.8	1969	5.0	-.2
1964-69	5.2	1970	5.4	-.2
1965-70	5.1	1971	5.1	0
1966-71	5.5	1972	4.1	1.4
1967-72	6.1	1973	5.8	.3
1968-73	6.2	1974	9.7	-3.5
1969-74	6.1	1975	9.6	-3.5
1970-75	6.2	1976	5.2	1.0
1971-76	6.0	1977	5.9	.1

Source: Table reproduced from p. 9, December 1978 Review of the Federal Reserve Bank of St. Louis, "Is Inflation All Due to Money?"

FIGURE 9a



APPENDIX III

Union Calendar No. 11

96TH CONGRESS } <i>1st Session</i>	HOUSE OF REPRESENTATIVES	{	REPORT No. 96-32
---------------------------------------	--------------------------	---	---------------------

REPORT ON MONETARY POLICY FOR 1979

MARCH 12, 1979.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. REUSS, from the Committee on Banking, Finance and Urban Affairs, submitted the following

REPORT

together with

SUPPLEMENTAL VIEWS and DISSENTING VIEWS

Submitted herewith is the first report of the Committee on Banking, Finance and Urban Affairs pursuant to Public Law 95-523, the Full Employment and Balanced Growth Act of 1978. This legislation amended the Federal Reserve Act at section 2A to require the following:

MONETARY POLICY

SEC. 108(a) "In furtherance of the purposes of the Full Employment and Balanced Growth Act of 1978, the Board of Governors of the Federal Reserve System shall transmit to the Congress, not later than February 20 and July 20 of each year, independent written reports setting forth (1) a review and analysis of recent developments affecting economic trends in the Nation; (2) the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted, taking account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices; and (3) the relationship of the aforesaid objectives and plans to the short-term goals set forth in the most recent Economic Report of the President pursuant to section 3(a)(2)(A) of the Employment Act of 1946 and to any short-term goals approved by the Congress. In addition, as a part of its report on July 20

of each year, the Board of Governors shall include a statement of its objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year following the year in which the report is submitted. The reports required under the two preceding sentences shall be transmitted to the Congress and shall be referred in the Senate to the Committee on Banking, Housing, and Urban Affairs, and in the House of Representatives to the Committee on Banking, Finance and Urban Affairs. The Board shall consult with each such committee on the reports, and thereafter, each such committee shall submit to its respective body a report containing its views and recommendations with respect to the Federal Reserve's intended policies. Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided*, That in the subsequent consultations with, and reports to, the aforesaid committees of the Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans."

(b) The amendment made by subsection (a) takes effect on January 1, 1979.

Our economy has been expanding continuously since the spring of 1975. However, the expansion has been marred by accelerating inflation, a deteriorating dollar abroad and difficult structural unemployment problems. Today, moreover, continuation of the expansion is threatened by a variety of factors including feedback from accelerating inflation. The committee takes the view that monetary policy should persistently promote economic stability rather than alternating between stimulus and restraint. Alternating between fighting unemployment and inflation has failed to achieve either full employment or price level stability.

a. Anti-inflationary policies must not cause a recession

The committee recognizes that reducing inflation will require persistent, measured monetary and fiscal restraint. Policies which attempt to break inflation quickly would lead to recession and high unemployment and defeat themselves. Such policies would not stop inflation because they are too costly in terms of lost output and employment. As a result, they would be abandoned before they were in place long enough to stop inflation and replaced instead by policies designed to fight unemployment which would rekindle inflation.

The committee notes with concern the many economic forecasts, including those of the administration and the Federal Reserve, that project higher unemployment for later this year. Many economists go further and forecast an outright recession by early 1980. Recent economic events lend some support to this pessimistic view:

The sharp slowdown in the growth of the monetary aggregates since October 1978.

The sudden slowdown in housing starts in January, from an annual rate of 2 million in December to 1.7 million.

The increases in oil prices, past and expected, which have the effect of draining purchasing power from our economy.

Because of the danger of recession, the committee cautions the Federal Reserve to pursue monetary restraint with special prudence in the year ahead.

b. The Federal Reserve's target ranges for monetary growth are appropriate

On February 21, G. William Miller, Chairman of the Federal Reserve Board, testified that:

As required by the Full Employment and Balanced Growth Act, the Federal Reserve at this time has established ranges for monetary growth through the end of 1979. It will reassess these and report preliminary ranges for 1980 in July, unless developments in the months ahead necessitate earlier reconsideration. At this juncture, the monetary growth ranges and the administration's 1979 economic goals appear reasonably consistent.

Specifically, the ranges established are as follows: M1, 11½ to 4½ percent; M2, 5 to 8 percent; M3, 6 to 9 percent; commercial bank credit, 7½ to 10½ percent.

Regarding the target for M1, Chairman Miller told the committee that:

The growth range for M1 calls for a marked deceleration from the pace of recent years. This reflects in part an expectation that the shifting of funds to savings accounts with automatic transfer facilities and to the NOW accounts recently authorized in New York State will continue to depress the growth of demand deposits throughout 1979. The Board's staff has projected that such shifting will damp growth in M1 this year by around 3 percentage points.

The committee believes that the target ranges for the growth of the monetary and credit aggregates as established by the Board of Governors and Federal Open Market Committee of the Federal Reserve System are appropriate. If achieved, they will promote the objectives that we desire—reducing inflation while avoiding a recession. If, however, it should appear in the course of 1979 that the switch to automatic transfer and NOW accounts is not proceeding at a rate equal to 3 percent of M1, as the Board's staff projects, then the M1 growth target should be revised and the revision reported to Congress.

More generally, if during 1979, measurements reveal that the Federal Reserve's target ranges for the growth of the other monetary and credit aggregates are not being met, the Federal Reserve should take immediate corrective steps and report to this committee on its actions.

c. Overnight repurchase agreements must be monitored

One institutional innovation that has caused some concern in recent years has been the growth of short term securities sales by commercial banks to large depositors with agreements by banks to repurchase them. When the agreement requires repurchase the next business day, the transactions could bias downward the measurement of M1. The Federal

Reserve should begin immediately to monitor such agreements and report totals on a weekly basis so that their importance can be ascertained.

d. Monetary restraint must be accompanied by measures to solve structural problems

It is widely recognized that monetary restraint, however necessary to reduce inflation, will not solve our economy's difficult structural problems.

Your committee agrees that special initiatives are needed to reduce structural unemployment. Structural unemployment reflects poor schooling, lack of job training, high job-search costs to both employers and the unemployed, and excessive regulation. These problems can be remedied at the same time that monetary restraint is being used to reduce inflation.

Your committee further agrees that structural measures to improve productivity, reduce regulation and increase competition could greatly assist in the battle against inflation.

In summary, as a necessary accompaniment to monetary restraint, the administration and the Congress should actively pursue structural policies to reduce inflationary biases in the economy, and to eliminate structural unemployment.

e. Long-term monetary growth targets should be adopted

The Humphrey-Hawkins Act calls for achieving 4-percent unemployment and 3-percent inflation by 1983 and zero inflation by 1988. Achievement of the interim 1983 goals would be promoted by steady deceleration in the average annual rate of monetary expansion over the next 5 years. Specifically, the annual growth of M1, measured inclusive of automatic transfer and NOW accounts, would be reduced to 3 percent by 1983 (assuming a continuation of the present approximately 3 percent yearly velocity growth trend). M1 grew by 7.6 percent from the fourth quarter of 1977 to the fourth quarter of 1978. The mid-range of the Federal Reserve's growth path of M1 (adjusted for the new automated transfer accounts) in 1979 is 6 percent. This should be achieved, and thereafter, deceleration of M1 growth by 1 percentage point per year through 1982 should be the aim. Commensurate long-run targets should be established for the other monetary and credit aggregates.

*Recommended percent growth 4th quarter to 4th quarter M1 (adjusted)
1978-83¹*

	<i>Percent</i>
1978 -----	7.6
1979 -----	6.0
1980 -----	5.0
1981 -----	4.0
1982 -----	3.0
1983 -----	3.0

f. The strength of the international dollar depends on that of the domestic dollar

The committee affirms that the strength of the U.S. dollar in foreign exchange markets depends fundamentally on the purchasing power

¹ Assuming continuation of the present approximately 3 percent velocity growth trend.

of the dollar within the United States. The policies recommended by this committee are consistent with a fundamentally strong dollar abroad. By restoring stability domestically, these policies will, over the long run, improve confidence in the dollar abroad.

The committee recognizes the possibility of transitory instability in foreign exchange markets. However, we caution the Federal Reserve to stay on the long-run track during these ephemeral episodes. Monetary policy should not be made more restrictive than it is at present in the interest of propping up the dollar.

g. Conclusion

Economic stability depends strategically on moderation and consistency in monetary policy. The Federal Reserve promises moderation of monetary growth in 1979. Your committee notes that the Federal Reserve has made this promise before, but has been either unwilling or unable to keep it perhaps because of actual or perceived congressional pressures. We hope that this first report, pursuant to the Humphrey-Hawkins Act, will make it clear to all, at home and abroad, that the House and the Federal Reserve are in agreement on the necessity for persistent moderation in the conduct of monetary policy.

ADDITIONAL VIEWS OF HENRY B. GONZALEZ

Monetary policy is a crucial and much neglected part of this country's economic policy. The diligence and concern of Chairman Reuss makes it possible for this committee and the Congress to at least provide coherent views on the subject, though control of monetary policy remains with the Federal Reserve. The country is truly indebted to Chairman Reuss for his efforts to provide meaningful participation by Congress in the conduct of monetary policy, which heretofore has been the exclusive province of appointees, rather than elected officials.

The current report of the committee, like its predecessors, could be much improved by the addition of a discussion of what the recommended policy is expected to do, and what alternative policies might be expected to do.

It is one thing to endorse a Federal Reserve policy that is aimed at reducing the rate of growth of the money supply, and quite another to explain clearly what the consequences will be. The report should explain in plain terms what the policy it endorses will do to interest rates, what it will do to the rate of employment, and how it will affect overall economic performance, including the rate of inflation. The expected impacts need to be set forth as clearly as possible, so that there can be no mistake about what the committee is recommending.

Likewise, the report should spell out what the alternatives may be and how they would affect the economy.

Information of this kind would not only enable the committee to make more intelligent choices; it would also enable the public to better understand what has been done and why. Only if we provide this kind of information can we ever hope to bring the importance of monetary policy into the consciousness of the general public and thereby end the long neglect of this subject.

The report, as far as it goes, provides a needed and useful service. I hope that in the future we can improve the product and make it much more useful to ourselves and the public at large.

HENRY B. GONZALEZ.

(6)

SUPPLEMENTARY VIEWS OF PARREN J. MITCHELL,
WALTER E. FAUNTROY, AND ROBERT GARCIA

This is not a dissent. The points we want to make are complementary to the committee's report.

In general, we share the committee's views and recommendations on monetary policy. In October 1977, one of us, Congressman Mitchell, acting as chairman of the Subcommittee on Domestic Monetary Policy, expressed concern about the high money growth policy the Federal Reserve had been pursuing for nearly a year. There was apprehension that this policy would accelerate inflation, and it has. Last summer, Congressman Fauntroy joined Congressman Mitchell in recommending that the Federal Reserve play its part in our quest for economic stability by reducing M1 growth 1 percentage point a year over the next 5 years. All of us are delighted that the committee now recommends essentially the same strategy.

Although sharper deceleration of money growth would court recession, as the committee has cautioned, there is little to fear from a slow persistent cutting back of monetary growth to a rate "commensurate with the economy's long run potential to increase production," as is required by law. The facts show that faster money growth is fully dissipated within 2 to 3 years in faster inflation and higher interest rates, and this lays the groundwork for recession and higher unemployment. Thus the strategy for monetary policy which the committee recommends, and which we support unequivocally, will not impede achieving the employment goals of the Humphrey-Hawkins Act, and should help to achieve these goals.

However, as our colleagues understand, the employment goals of the Humphrey-Hawkins Act cannot be achieved by monetary policy alone. We need direction in fiscal policy as well as prudence in monetary policy. And direction in fiscal policy means expanding public service and other job programs and subsidies, and also training programs and subsidies. There is absolutely no reason why, at the same time as the Federal Reserve is slowing money growth, fiscal policy cannot be directed to employing the jobless, especially long term unemployment persons in the black and Spanish speaking inner-city communities, and training 16 to 19 year olds throughout the Nation who need and want job training. It would only take about \$3 billion a year to fully employ 500,000 persons at the minimum wage. Another \$3 billion annual fiscal expenditure would provide on-the-job training opportunities for all or nearly all youngsters who need and want initial training and skill development. In short, we can make substantial progress in solving our unemployment problem with minimal additional Government spending, while at the same time using monetary policy to reduce inflation. As Prof. Martin Feldstein put it, in testimony received by the committee, paraphrasing, we can pursue microeconomic policies that reduce

the unemployment rates of high unemployment groups and prepare young people for work while at the same time proceeding with macro-economic (monetary) actions that slowly reduce nominal or dollar aggregate demand growth to our economy's long run potential for real growth. We can and we should do both.

PARREN J. MITCHELL.
WALTER E. FAUNTROY.
ROBERT GARCIA.

SUPPLEMENTAL VIEWS OF MR. BARNARD

I concur with the committee that a moderate and consistent monetary policy is necessary to reduce inflation and promote sound economic growth, but I want to stress that it must be accompanied by a responsible fiscal policy.

Far too often, Congress has overreacted to shifts in the growth of the economy with deficits that are higher than necessary. To make matters worse, we have continued massive deficits far past the point that there has been any economic justification for them. In future recessions, Congress must carefully consider what action that it can take that will improve the situation without overreacting. Just as the Federal Reserve must be careful to follow a moderate monetary policy, Congress must follow a moderate fiscal policy and return to a balanced budget as soon as possible.

Restrained and responsible fiscal policy does not mean a reduction in all efforts to solve the structural problems of the economy, but rather a careful examination of all spending priorities in light of the state of the economy and likely benefits of a program, and making hard choices. We do not help solve structural problems when we add inflation on top of them.

In summary, with my colleagues I support the Federal Reserve's goals of a moderate and consistent monetary policy and recognize the need for continued programs to remove structural problems in our society. However, if they are accompanied by a fiscal policy that is too expansionary and has too high a deficit, the result will be continued inflation. Monetary policy cannot end inflation or recession by itself; it must be accompanied by a moderate restrained fiscal policy, and in most circumstances this means a balanced budget.

DOUG BARNARD, JR.

MONETARY POLICY REPORT MINORITY VIEWS

We are in general agreement with the broad thrust of the committee's Report on Monetary Policy for 1979. However, we believe there are substantive matters which deserve fuller development.

No one can deny the importance of a proper monetary policy to the resolution of our current economic problems. Nor can anyone deny the ultimate constitutional responsibility of Congress for monetary policy. The duty that Public Law 95-523 imposes on this committee relative to this report is a serious one, to be approached with due deliberation.

The committee's report rightly recognizes that a stable monetary policy alone cannot be expected to carry the full burden of curing all our economic ills. But we think this point could be further clarified by a more complete discussion of what else is required. We take occasion here to examine only a couple of these matters.

We are particularly worried by the recent behavior of American productivity. If the goals of the Humphrey-Hawkins Act are to be realized, the decline in productivity growth that has characterized the American economy during the 1970's must be reversed.

The Board of Governors of the Federal Reserve System noted in their Monetary Policy Report to the Congress (February 20, 1979) that:

During the period from 1947 to 1967, productivity in the nonfarm business sector rose on average by $2\frac{2}{3}$ percent per annum. * * * Since 1967, the rise in output per hour has slowed, with average gains of only 1.2 percent recorded since 1973.

Growth of productivity is essential if standards of living are to rise without inflation. Growth of productivity in turn is significantly related to capital formation.

The inescapable conclusion is that government policies—both tax and regulatory as well as monetary—must address the issues of productivity and capital formation more aggressively. Congress made a start in that direction with passage of the so-called Steiger amendment to the Revenue Act of 1978. We must do more.

Elimination of large Federal deficits during periods of economic expansion would be extremely helpful, since such deficits have tended to be monetized by the Federal Reserve to avoid politically unacceptable "crowding out" of the private sector. Treasury borrowing on the scale encountered in the last several years has created enormous pressures on credit markets. Each and every consumer, business, school district or local government that seeks to borrow money pays higher interest rates as the price for the Treasury's overwhelming competition for the saver's dollar. In short, fiscal policy is an important source of inflationary pressures in this country via credit markets, and the resulting monetization insures constantly advancing prices. We in

Congress must cooperate with the Federal Stable fiscal policy working with stable monetary policy would result in stability in the capital and money markets, particularly after such policies have reduced inflationary pressures. The reduced uncertainty in the investment environment would greatly encourage capital formation and thus productivity.

More generally, we agree that establishment of a stable monetary policy is necessary to the control of inflation, and we agree that structural reforms—especially with respect to government-induced inflationary pressures—are also necessary. But we believe further that inflation is inherent as big government increases and that no final solution to the inflationary problem can succeed until the growth of government is arrested.

Specifically, we believe that excessive monetary growth is but the means by which inflationary pressures are financed and that those pressures, particularly runaway government spending, must be restrained if prices are to be dependably stabilized. As desirable and even necessary as a stable monetary policy is, the restraint of all government, particularly as measured by government direction of resources, must be achieved if inflation is to be defeated.

J. WILLIAM STANTON.
 CHALMERS P. WYLIE.
 STEWART B. MCKINNEY.
 GEORGE HANSON.
 HENRY J. HYDE.
 RICHARD KELLY.
 JIM LEACH.
 TOM EVANS.
 BILL GREEN.
 RON PAUL.
 ED BETHUNE.
 NORMAN D. SHUMWAY.
 CARROLL A. CAMPBELL.
 DON RITTER.
 JON HINSON.

DISSENTING VIEWS OF RON PAUL

While I applaud the committee's recognition of the fact that "reducing inflation will require persistent, measured, monetary and fiscal restraint," I believe that the committee is still looking at the Federal Reserve through rose-colored glasses. Throughout its 65 year history, the Federal Reserve has pursued a policy of deliberate inflation and manipulation of the money supply, a policy which has caused numerous recessions, massive unemployment, double-digit price inflation, international exchange crises, and the largest and longest depression in our national history. The committee does note that the Federal Reserve had promised moderation and consistency in monetary policy before, but that it has been either "unwilling or unable" to keep its promise. I concur with the committee's view of the importance and necessity of the Federal Reserve keeping its promises on monetary policy, but I am skeptical nonetheless. One need only look at the record of the Federal Reserve, which I have briefly recapitulated above, in order to understand my skepticism. The only permanent and practical solution to the problem of inflation—the only way to implement the Federal Reserve's and this committee's goal of persistent monetary restraint—is to decouple money and politics altogether, removing control over the money supply from any governmental or quasi-governmental institution. The deregulation of money, not simply a slowing in the growth of the money supply, must be our goal. The committee is looking in the right direction, but it has not yet seen the correct destination.

There seems to be a growing consensus among economists that the American people will suffer through another government-caused recession later this year or early next year. The committee takes note of this view and expresses its concern. What it does not seem to realize, however, is that the persistent policy of monetary inflation pursued by the Federal Reserve makes these recessions inevitable. The timing of the next recession may be a matter of guessing; the fact of the next recession is not. In view of this fact, it is not enough to express concern and then declare that the Federal Reserve's monetary growth targets are appropriate. They are not. If we intend to pursue a genuine anti-inflationary policy, it is not appropriate to endorse a growth in the money supply. Nor is it appropriate for the committee to endorse even greater inflation should "measurements reveal that the Federal Reserve's target ranges for the growth of the other monetary and credit aggregates are not being met."

The committee is correct in demanding monetary restraint from the Federal Reserve; the problem is that it does not demand enough restraint and allows the Federal Reserve to exercise entirely too much discretion in its control of the money supply. Thus, of course, is not to argue for congressional control of the money supply, but it is to

argue that discretionary and arbitrary control over the money supply by any governmental agency must be abolished. If any responsibility is granted to the government with respect to money, it should be to insure that the value of the money is maintained, not systematically destroyed through a policy of deliberate inflation. In medicine there is a term for diseases caused by physicians: iatrogenic. Inflation might correctly be called politicogenic, for it is caused by the politicians (including the officers of the Federal Reserve) who for 65 years have declared that they intend to cure inflation.

One hopes that the Federal Reserve abides by its promise to decrease the rate of monetary growth; it definitely should keep its word. But its past record is not encouraging, and the committee should consider legislation to curtail the Federal Reserve's discretionary powers and to begin the process of depoliticizing money altogether. Fiat money, with which we have been forced to live, requires extensive control and management at all times, with the hope of not disrupting the functioning of the economy too greatly. As the failure of the money managers becomes more and more apparent, other programs will be declared "necessary" and "required" by those same managers: Price and wage controls, rationing, import controls, capital market controls, and so on. All these programs will be imposed on the people at the sacrifice of personal freedom and the destruction of a market economy, should our present policies of monetary management continue. Sound, honest money needs no managers. The integrity of our leaders should insure money of real value. If this were so, inflation would disappear and our economy could be put on the road to recovery.

RON PAUL.