

CONDUCT OF MONETARY POLICY

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

HEARING BEFORE THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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CONDUCT OF MONETARY POLICY

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

TUESDAY, JULY 17, 1979

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

The committee met at 2:35 p.m., in room 2128, of the Rayburn House Office Building; Hon. Henry S. Reuss (chairman of the committee), . presiding.

Present: Representatives Reuss, Gonzalez, Hanley, Mitchell, Neal, Blanchard, LaFalce, Cavanaugh, Oaker, Vento, Barnard, Watkins, Lowry, Stanton, Wylie, McKinney, Hansen, Kelly, Leach, Evans of Delaware, Green, Bethune, Campbell, and Ritter.

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

We are very happy to welcome Chairman G. William Miller to our second hearing under the Humphrey-Hawkins law.

In the months ahead, Mr. Miller, the Federal Reserve will face perhaps the most difficult test and the most challenging opportunity of your tenure. A great many things, including the future of the energy program announced yesterday in Kansas City by President Carter, will hinge on whether the fire brigade at the Federal Reserve can prevent the economy from burning before the necessary structural reforms toward which we now appear to be moving are in place.

The months ahead will be difficult because, in addition to the high inflation which has beset us since last year, we now see the multiplying signs of a recession. Slower growth in retail sales, especially in autos and durable goods, declining industrial production, and surging import bills have combined to convince a majority of economic opinion, and now even the administration, that a recession is under way.

The task facing the Federal Reserve today was, I think, well expressed by this committee in its report to the Congress in March. We stated:

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.

We should not respond to every weakening of aggregate demand by rushing in a panic to embrace tax-cuttery and other forms of fiscal foolishness. But I believe, this committee believes, and I hope that you believe, that the recession which may be upon us is the enemy, not the friend, of a successful policy to spur investment, and thus to increase productivity and fight inflation. Therefore, it is the Federal Reserve's clear responsibility to insure so far as possible that the threatened recession either does not occur, or that it occurs in only the most benign form.

The months ahead represent an opportunity for the Fed as well as a challenge. You have on many occasions, to the press and before the Congress, let it be known that in your opinion the Federal Reserve, not the Treasury, should take the activist role in bringing the economy out of any recession. This is a position that many economists, from Keynes himself in 1930, have long urged on central bankers with little success.

Of course, your immediate task today is to update and revise the monetary policy plan you presented to us in February, and to present preliminary estimates of monetary expansion, in 1980. I want to call your attention to one point which I hope you will clarify in your remarks. As you know, growth of M_1 , the narrowly-defined money stock, has proceeded in the past 2 quarters at a 2.7 percent annual rate. This would place M_1 growth squarely in the middle of your announced 1.5-4.5 percent track, and would correspond to a sensible 5.7 percent annual growth rate of M_1 in the old preautomatic transfer days, but if and only if the shifting of funds to ATS and NOW accounts has proceeded at the 3 percent annual rate that your M_1 growth target subsumed.

If ATS and NOW accounts have been substituting for M_1 at a slower rate, then the "true" growth rate of M_1 is lower than the sensible target range you are committed to pursue. As you are the custodian of the truth in this matter, we look forward to enlightenment.

One final matter, by no means the least important: This week, perhaps tomorrow morning, the House of Representatives will have an opportunity to vote directly on legislation rationalizing the structure of commercial bank reserve requirements and providing, we hope, the tools that the Federal Reserve needs for an effective monetary policy. H.R. 7 will solve the Federal Reserve's membership problem, and, in so doing, it should go a long way toward ending the confusion that has characterized measurement and interpretation of fluctuations in the monetary aggregates in recent months. As such, it will make a substantial contribution both to the fabrication of good monetary policy and to a clear understanding of what that policy is by the public at large.

So, I ask you, like myself, to pray for H.R. 7. And I want to thank you for the excellent semiannual report which you and your associates on the Board of Governors have handed to us. I think it is not too much to say that it is historic in that for the first time the Federal Reserve, pursuant to the requirements of the Humphrey-Hawkins law, have projected such future economic matters as growth, inflation, and employment. We believe you are doing your job very nobly, and we are delighted to have you here.

Mr. Stanton and Mr. McKinney.

Mr. MCKINNEY. Mr. Chairman, if I might, I would just like to, due to a change in schedule, express my apologies to Mr. Miller for the fact that I will have to leave, and to thank him for his note and to reassure him that I will read his testimony in full.

The CHAIRMAN. Mr. Miller, your full report, under the rule and without objection, is received into the record, with thanks. Would you now proceed in your own way.

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

Mr. MILLER. Thank you very much.

I would like to say to the committee that I apologize for the change in schedules and the delay that has perhaps made it a little more difficult for all of us to get together for this important review. The action expected in the House has changed our testimony from tomorrow to today, and we are getting a little later start today. So I would like to suggest, Mr. Chairman, since the report is available—and since it does recap many of the factors that we reviewed earlier with this committee—that I make very brief remarks and then turn to questions.

The CHAIRMAN. Excuse me. I am told that your microphone is not on.

Mr. MILLER. There we are. Now can you hear?

The CHAIRMAN. Thank you.

Mr. MILLER. I think they are on now. I apologize. I did not realize they were off.

I was saying that because of the delays I would suggest making brief remarks and then turning to the questions and concerns of the committee.

The main event that has taken place since the report to this committee in February has been the oil price shock, and this is indeed difficult news for us to face. The oil price shock will have the effect of increasing inflation this year, of slowing real growth in the economy, and therefore of setting us back in both our timetable and the level of inflation we must deal with in the overall strategy to combat inflation.

Without this oil shock, we had looked forward to an economy that would slow, that would come to relatively low levels of growth, but without a technical recession this year or next year.

With the oil shock, we now expect that there will be a recession this year. It will be moderate and the economy will begin to recover as we progress through the year and into 1980. We expect that we will have, as you will note from our report, a negative growth rate of somewhere between minus 2 and minus one-half percent for the period fourth quarter of 1978 to fourth quarter of 1979, and a growth rate probably somewhere between a minus one-half to plus 2 in 1980, on the positive side.

The oil price shock, as I say, sets us back in our timetable for winning the war against inflation. It had been our report to this committee that with the strategic policies being put into place—involving fiscal discipline, involving incomes policy, involving dollar and international account policies, involving energy policies, and involving

monetary policies—we would wring out inflation over 5, 6, or 7 years.

We have been put back in that timetable, in my opinion, by 1 year or more. And we are now going to start downward in wringing out inflation from a higher plateau than we otherwise would have reached. The effect of the oil price shock will probably add about 2 percent to inflation this year, and 1 more percent to inflation next year; this is the level of additional difficulty that we are going to have to overcome in our long-term program to wring out inflation.

In the meantime, on Sunday, the President took some initiatives through a series of policies to reduce our dependence upon petroleum as a source of energy and to reduce our dependence upon imported petroleum. In the aftermath of that particular announcement, we still must cope with the short-term and the intermediate-term problems of the economy and be sure that we continue to commit ourselves to firmness and determination in combating inflation and that we commit ourselves once again to a determination to maintain a sound and stable value of the dollar.

If we relent in our fight against inflation, if we relent in our concern for the dollar, we will set ourselves back further. So it is important not only that we absorb the shock that we have been given, but also that we avoid imposing any further delay or any further impediment on our steady march forward to wring out inflation.

Mr. Chairman, I call your attention to the structure of our report. There is an introduction that points out the performance of the economy, the shocks that I have just mentioned, and their effect upon our intermediate-term goals and long-term goals. Chapter I, in accordance with the Humphrey-Hawkins Act, is a review and analysis of recent developments affecting the economy; it begins on page 4. Chapter II is a recitation of the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of monetary aggregate growth or diminution; it begins on page 40.

I wanted to point out to you with the charts on pages 44, 45, and 46, in chapter II that, as you have already mentioned, the growth of the monetary aggregates are well within the ranges that were established for this year in our report to you in February. I say that because this is the first opportunity I have had since becoming Chairman of the Federal Reserve in March 1978 to be able to report that. I was afraid you wouldn't notice it, so I wanted to call it to your attention.

I might just try to say that we did intend to have ranges that we think are correct and to live within them.

The CHAIRMAN. Since this committee approved your ranges, it will note this now.

Mr. MILLER. Mr. Chairman, chapter II also includes the consensus of the Board of Governors on the outlook for the economy and its important aspects: nominal growth, real growth of GNP, the implicit price deflator, and the expected unemployment rate. These are set forth in a table on page 48, and demonstrated in other charts on the following pages.

And finally, I call your attention to chapter III, which is our report on how our monetary stance, our monetary objectives, relate to the most recent plans of the administration with respect to the eco-

conomic performance of the Nation. Here, we have variance from the President's report in terms of the outlook for the economy. But the ranges that we have provided as a consensus of the Board of Governors encompass and therefore are consistent with the outlook for the economy as reported in the President's Economic Report to Congress.

Mr. Chairman, I would close simply by saying that the events since my last report are historic. They will test our will and determination as to whether we are going to continue on a course with the commitment to curb inflation and to wring it out of our economy, or whether we are going to relent and to give way to transitory forces and therefore, in my opinion, do more harm to the economy long term by merely letting the fight against incipient inflationary forces be put off to some other year or to some other generation.

The overall stance of the Federal Reserve is one of maintaining a strong anti-inflation policy, one of maintaining the belief that we have within the capacity of this Nation both the policies, the will, and the determination to win this war. We commit to you that we are going to continue to play our role in cooperation with other elements of government to achieve this.

Thank you very much.

[The Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978, submitted by Mr. Miller follows:]

For use at 2 p.m.,
July 17, 1979

Board of Governors of the Federal Reserve System



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

July 17, 1979



Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 17, 1979

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

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

Sincerely,
G. William Miller, *Chairman*

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INTRODUCTION

The Problem Posed by Accelerated Inflation

The performance of the economy this year has been distinctly unsatisfactory. Starting from a base of rapid inflation and the lagged effects of the 1977-78 dollar depreciation, a series of unexpected events this year has disrupted economic activity and intensified inflationary pressures. These events have included labor disputes, severe weather, and adverse agricultural supply conditions, but the most disturbing development, in terms of its implications for future economic performance, has been an enormous increase in the price of imported oil. The adjustment to this oil price shock poses major problems for governmental policy and represents a serious setback to progress toward the longer-range goals enunciated by the Full Employment and Balanced Growth Act.

Increased energy costs have greatly aggravated our inflation problem. In February, when the Board submitted its first report to the Congress under the Humphrey-Hawkins Act, it was anticipated that oil prices would rise moderately this year, entailing some small upward pressure on the general level of prices. However, the developments since then--including the effects of the Iranian revolution and the latest OPEC decisions--are generating major increases in the prices of imported oil and, consequently, in the prices of other energy sources as well.

The inflationary effects of the energy price increases could, in principle, be offset if other prices on average declined or at least rose less than they otherwise would have. There will be some tendency

in this direction as the diversion of a larger share of spendable income to energy results in a reduction in demand for other goods and services. In recent years, however, nominal wages and prices have not generally exhibited much flexibility in a downward direction; rather, relative price adjustments typically have occurred in the context of an overall rise in the average level of prices as economic units attempted to avoid losses of real income.

It also must be recognized that the rise in the relative price of imported oil involves a transfer of real income and wealth from the U.S. public to foreign oil producers. This loss will, in turn, have at least temporarily depressing effects on domestic economic activity as the demand by foreign countries for U.S. exports expands only with a lag.

Thus, over the next year or two, it appears that exogenous forces will be causing both intensified inflationary pressures and downward adjustments in the demand for goods and services. Clearly, the problems confronting monetary policy, and macroeconomic policy generally, have been made much more difficult. If monetary policy encourages a more rapid expansion of money and credit in an attempt to strengthen aggregate demand, it risks building even greater inflation into the economic system through the aggravation of the price-wage-price spiral. On the other hand, if no account is taken of added upward price pressures in the formulation of policy, the risks are increased of deepening or lengthening the transitional downward adjustments in real economic activity that now appear in train.

The Federal Reserve remains firmly resolved to direct its policies toward a reduction in the rate of inflation. But in the current circumstances, a combination of added inflationary pressures, a slowing of economic activity, and a probable increase in unemployment may delay progress toward price stability. This problem highlights the need to solve some of the major structural defects in our economy. It is important that we begin to break down the barriers, both private and governmental, that inhibit innovation and competition and thereby contribute to the inflationary bias of the economy. We must ensure that our system of taxation does not discourage the saving and capital investment necessary to reverse the deterioration of productivity performance observed in recent years.

And it is absolutely essential that this nation develop an energy program that reduces its reliance on foreign sources of energy.

CHAPTER 1

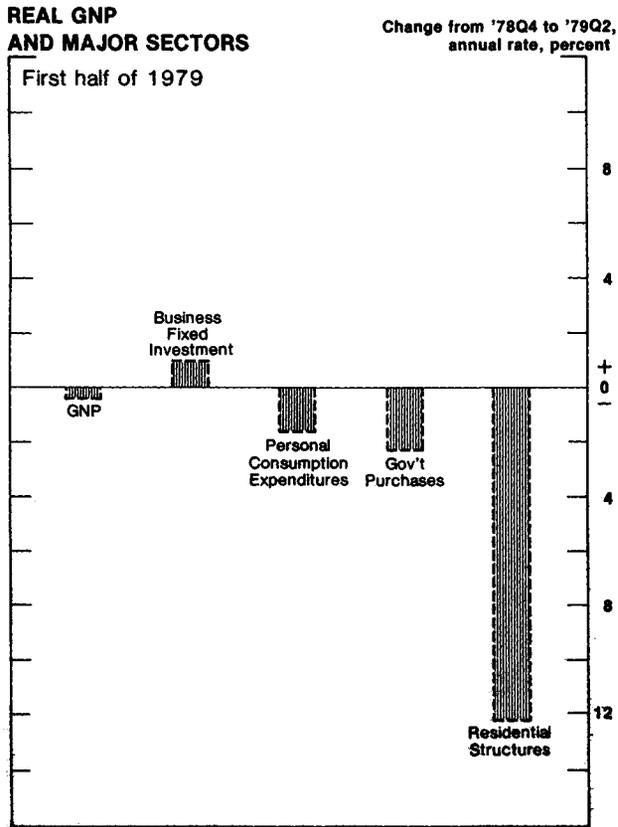
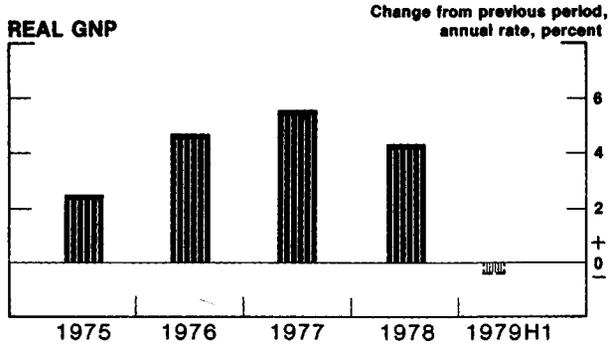
"a review and analysis of recent developments
affecting economic trends in the nation"

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

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1979

Official Commerce Department data for the second quarter of this year have yet to become available, but it appears likely that they will indicate that real gross national product declined somewhat after advancing only marginally in the first quarter. The sluggishness of overall economic activity thus far in 1979 stands in marked contrast to the 4-1/4 percent gain in real GNP registered in 1978. Although the events of the first half do not in themselves compel a conclusion that the economy has entered a recession, the pause in growth does represent a significant interruption of the relatively long cyclical upswing that began early in 1975.

The sluggishness of economic activity since the beginning of the year is partly a consequence of the rising inflationary pressures of 1978 but is also traceable in considerable measure to special exogenous factors--as distinguished from such problems as widespread inventory overhangs or other fundamental imbalances or distortions, which have characterized the terminal stages of previous cyclical expansions. During January and February, production in many parts of the country was disrupted by unusually inclement weather; the construction industries were especially hard hit, but other sectors also were affected. In the early spring, labor contract disputes in the trucking, airline, and rubber industries interfered with activity in many areas of the economy. However, a more pervasive--and less transitory--influence on the course of the economy this year has been the sharp rise in energy and food prices. The resultant acceleration of inflation has had a serious impact on real disposable personal income and has had a broadly adverse effect on consumer spending attitudes.

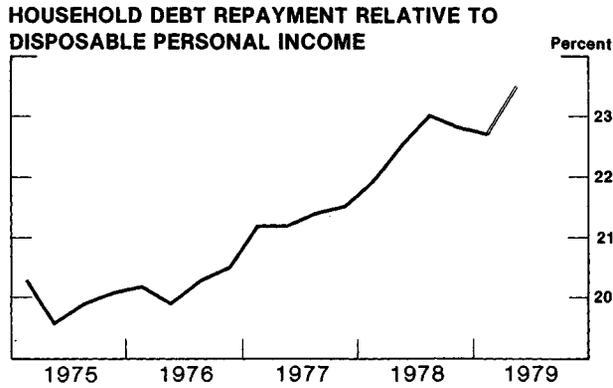
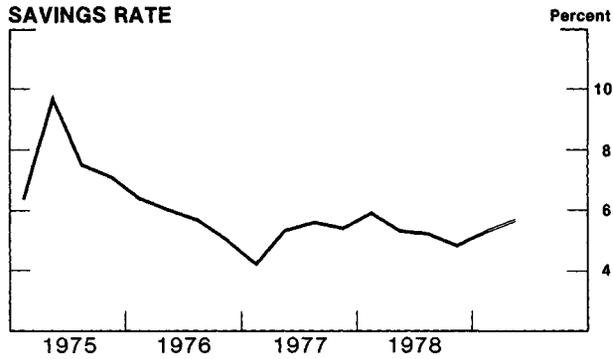
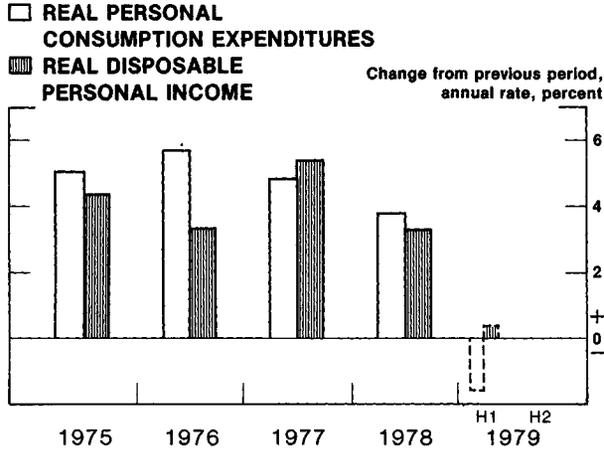


Data for the first half of 1979 are partially estimated. ...

Personal Consumption Expenditures

Personal consumption expenditures account for almost two-thirds of GNP, and their weakness during the past two quarters has been an important element in the flatness of overall economic activity. Some softness in consumer demand was not unexpected following the surge in spending during the final months of 1978. However, retail sales in real terms exhibited a clear downward trend through the first six months of this year, with the June level sharply depressed by a drop in auto sales. Rising gasoline prices and uncertainty about gas supplies initially had a mixed impact on auto sales: sales of large, fuel-inefficient cars plunged, while sales of smaller domestic and foreign cars recorded an offsetting increase. Most recently, however, the weakness in auto sales has broadened; this may in part reflect supply constraints as domestic makers shift facilities to the manufacture of small cars, but there appears to have been a general falloff in demand during June.

The weakness in consumer spending has extended beyond the market for motor vehicles, and it appears symptomatic of broader pressures on household finances. The personal savings rate reached historically low levels last year, so that a further rise in the spending propensities of households seemed unlikely. Moreover, the record indebtedness and debt repayment burdens of the household sector suggested that consumers might manifest, on the whole, a more cautious spending behavior. These influences have been substantially reinforced this year by the effects of accelerated inflation on the real disposable income of households. The budgets of many families have been squeezed by the upsurge in the prices of food, fuel, and other basic necessities. This has increased their uneasiness about their personal financial positions and contributed to a noticeable deterioration in consumer sentiment, as measured by most surveys.



Data for the first half of 1979 are partially estimated.

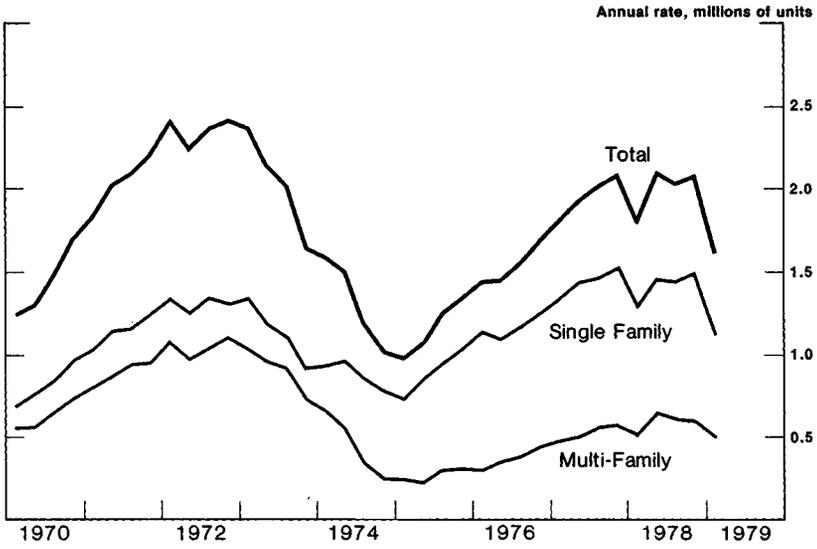
Residential Construction

As noted above, adverse weather depressed building activity during the opening months of 1979. Private housing starts, which had consistently run at an annual rate of just over 2 million units since a similar weather-related disruption the previous winter, fell to a 1-1/2 million rate in January and February. However, as construction picked up again in subsequent months, the rate of housing starts remained below the 1978 pace, averaging about 1-3/4 million units in the March-May period. Thus, there has been a moderate, but significant, downturn in residential building since the end of 1978.

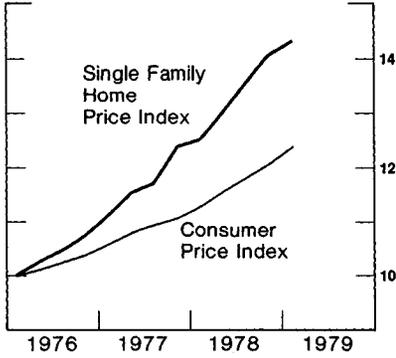
Several fundamental economic and demographic factors have continued to bolster the demand for housing--especially single-family dwellings and condominium apartments. One of these is the widespread view, based in large part on the actual experience of the past several years, that houses are a good hedge against inflation and therefore an attractive investment apart from the shelter services they provide. Another is the movement of a large portion of our population into the age group in which the rate of initial home purchases historically has been relatively high.

Nonetheless, other underlying supply and demand influences have acted to constrain the construction of new housing units. The rise in interest rates and the general tightening of credit markets over the past year have been particularly important factors. Homebuilders have found that lenders are charging substantially higher rates for land development and construction credit, and that they are showing greater selectivity in the projects they will finance. At the same time, potential builders and homebuyers have been affected by increasingly stringent terms on mortgage loans and, in some localities, by shortages of mortgage credit

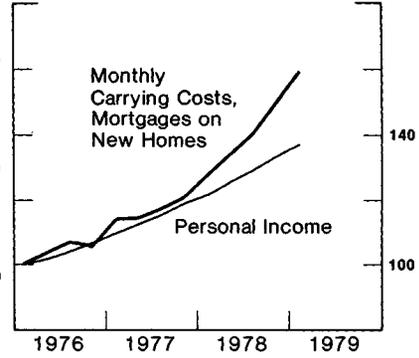
PRIVATE HOUSING STARTS



NEW HOME PRICES AND CPI



MONTHLY CARRYING COSTS AND PERSONAL INCOME



caused by usury ceilings. The combination of inflated house prices and record mortgage rates implies costs of homeownership that bulk large relative to the current incomes of many families. This fact has deterred some potential homebuyers and caused lending institutions to reject some credit applications. It also has given impetus to the development and use of graduated payment mortgages, which are designed to alleviate the cash-flow problems encountered in the early years of the traditional level payment loan in an inflationary environment; however, these instruments have not thus far attained an important role in the mortgage market.

In recent months, localized shortages of gasoline and generally uncertain prospects about future fuel prices and supplies likely have been another factor deterring home purchase and prompting a reassessment of building plans. Still, unit sales of new and existing single-family houses have declined only moderately this year from the record pace of 1978. Stocks of unsold single-family units, while perhaps less comfortable than a few months ago when demand was stronger, do not appear to be a significant depressant on new building activity. Nor, in major contrast to the last--and severe--housing cycle, is there a substantial overhang of multifamily rental and condominium units for rent or sale.

Business Investment

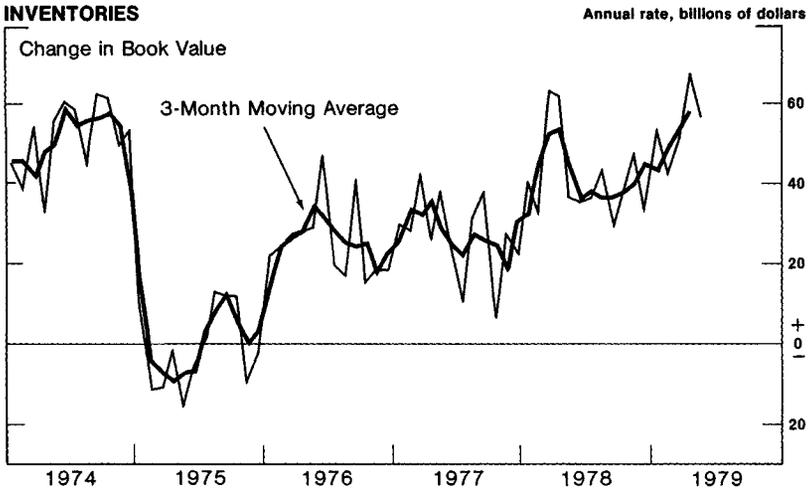
Business firms have continued to pursue generally cautious spending policies, but their investment in inventories and fixed capital nevertheless appears to have expanded significantly in real terms during the first half. Despite this further advance in business spending, there is little evidence to date of the development of broad imbalances between stocks or productive capacity and final sales that might seriously impede the resumption of economic expansion.

The surge in final sales in the last quarter of 1978 drew down stocks in many lines to the point where it seemed quite likely that some rebound in inventory investment would occur in ensuing months. However, the book value of business inventories increased very rapidly in the early part of 1979, causing some concern that the unexpected strength of demand at year-end and the acceleration of inflation might have prompted a speculative hoarding of commodities--perhaps reminiscent of 1973-74. These concerns abated as it became clear that the accumulation of inventories was relatively well balanced across sectors and across levels of processing and that much of the acceleration in the rise of book values reflected nothing more than the replacement of merchandise bought earlier at lower prices with stocks acquired at current, inflated prices. GNP accounts data for the first quarter in fact indicate that, while there was an appreciable pickup in real inventory investment, the rate of accumulation remained moderate.

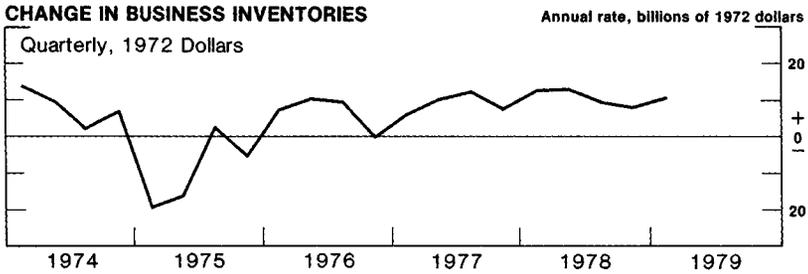
Inventory data for the second quarter are fragmentary. Book-value figures showed exceptionally high rates of accumulation in April--especially at manufacturing concerns--but this evidently was attributable in part to delays in shipments caused by the labor dispute in the trucking industry. Inventory growth, again on a book-value basis, slowed in May; however, it appears likely that real inventory investment for the second quarter as a whole was considerably above the pace of the first quarter.

Nevertheless, inventories appear generally to have remained in reasonably comfortable alignment with sales. There are, of course, exceptions, the most notable being in the motor vehicle sector. With the drop in demand for large cars this spring, dealers' stocks became very sizable in relation to the current pace of sales. Stocks of smaller

MANUFACTURING AND TRADE INVENTORIES



CHANGE IN BUSINESS INVENTORIES



RATIO OF BUSINESS INVENTORIES TO SALES

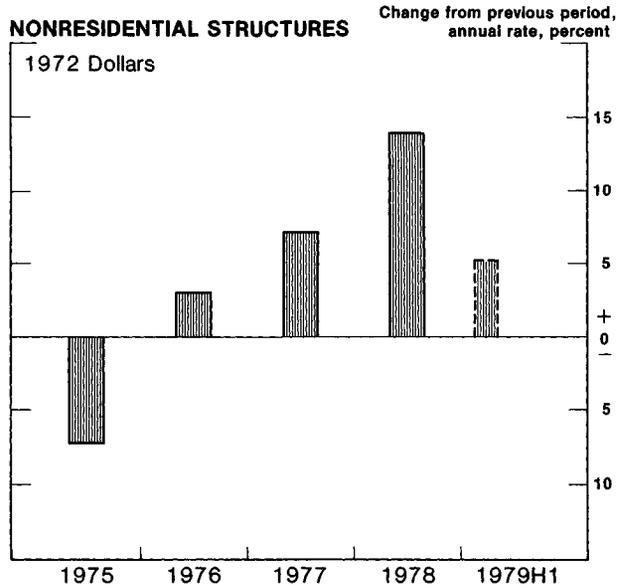
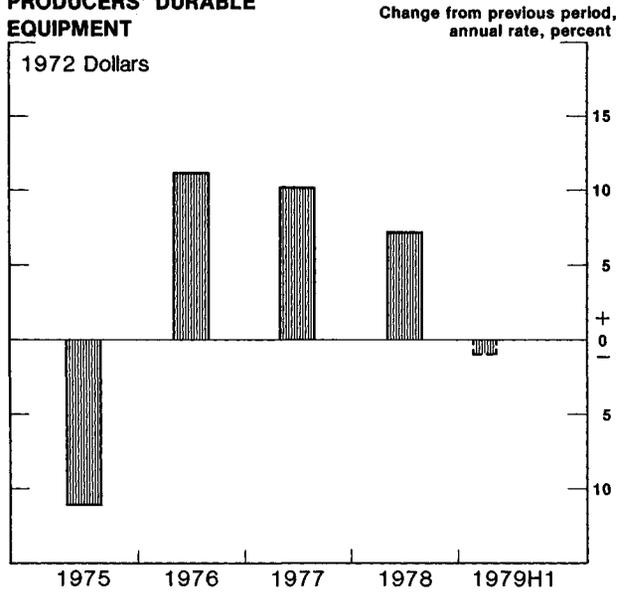


cars, in contrast, have been very lean in recent months, and customers desiring particular models and features sometimes have encountered long delivery lags. On balance, the aggregate ratio of real business inventories to real sales in the first quarter was well in line with recent norms, but there probably was some deterioration in the picture during the second quarter.

Business spending for new plant and equipment rose strongly during the first quarter, providing substantial impetus to overall economic activity; however, available evidence suggests that some decline occurred during the second quarter. The first quarter surge reflected a sharp rise in equipment purchases. Outlays for transportation equipment--especially airplanes and automobiles--accounted for a good deal of the strength. During the spring, outlays for equipment apparently retraced their earlier advance, owing in part to delays in shipments caused by the labor disputes in trucking. In contrast, spending on nonresidential structures lagged in the first quarter, as the adverse weather conditions interfered with building activity, but then snapped back smartly in the spring.

An important factor bolstering demands for fixed capital has been the higher rates of industrial capacity utilization that have prevailed since the latter part of 1978. Slower growth of industrial production has resulted in a slight decline in utilization rates, but the rates have remained at levels that have been associated in the past with periods of strong investment demand. Despite deep cutbacks in auto production, capacity utilization in manufacturing last month averaged about 85 percent--only three percentage points below the peak of 1973 and a fairly high level historically. Capacity utilization rates in the materials producing

**REAL BUSINESS FIXED INVESTMENT
PRODUCERS' DURABLE
EQUIPMENT**



Data for the first half of 1979 are partially estimated.

industries are not, on average, as close to the 1973 peaks. However, that period was marked by extraordinary pressures on production facilities caused by a worldwide boom in demand for basic commodities, and by normal standards operating rates currently are quite high in some materials sectors.

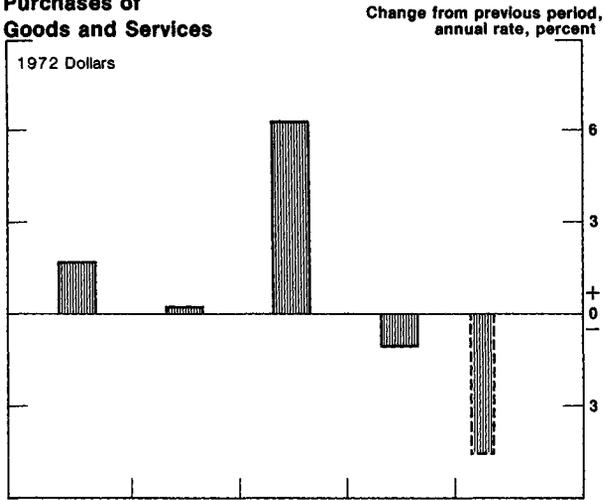
Government Spending

Budgetary policy at both the federal and state and local levels of government has continued to be characterized by restraint in spending. Indeed, government outlays for goods and services declined in real terms during the first half of 1979.

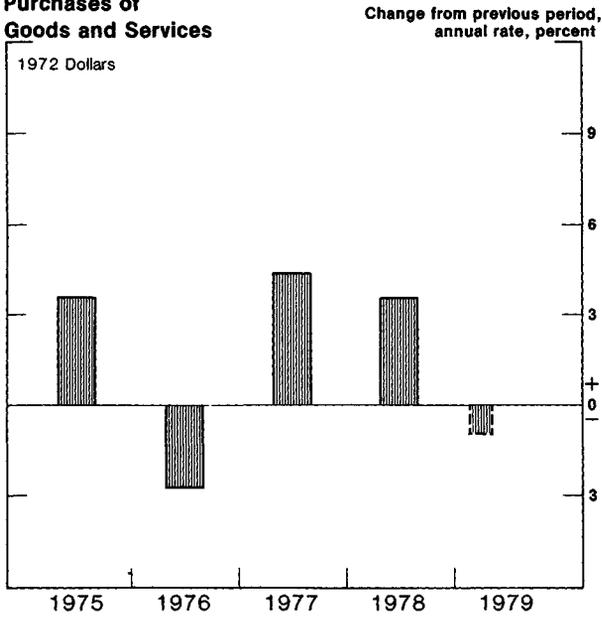
Federal purchases had fallen slightly, after adjustment for inflation, during 1978, and declines were recorded in each of the first two quarters of this year. Total federal expenditures--including transfer payments as well as outlays for goods and services--have been running just a bit higher in nominal terms than had been anticipated in the administration's budget plans. However, the impact of inflation on incomes has resulted in considerably stronger tax receipts than were projected, so that the budget deficit has been substantially smaller than expected.

At the state and local level, weather-related curtailments of construction reduced spending in the first quarter. However, the subsequent rebound in building activity was sluggish and may be indicative of a tendency to defer further capital expenditures following a surge last year. Moreover, states and localities also have been limiting spending by holding down employment: the number of workers on their payrolls in June was about the same as one year earlier.

**Federal Government
Purchases of
Goods and Services**



**State and Local Government
Purchases of
Goods and Services**



Data for the first half of 1979 are partially estimated.

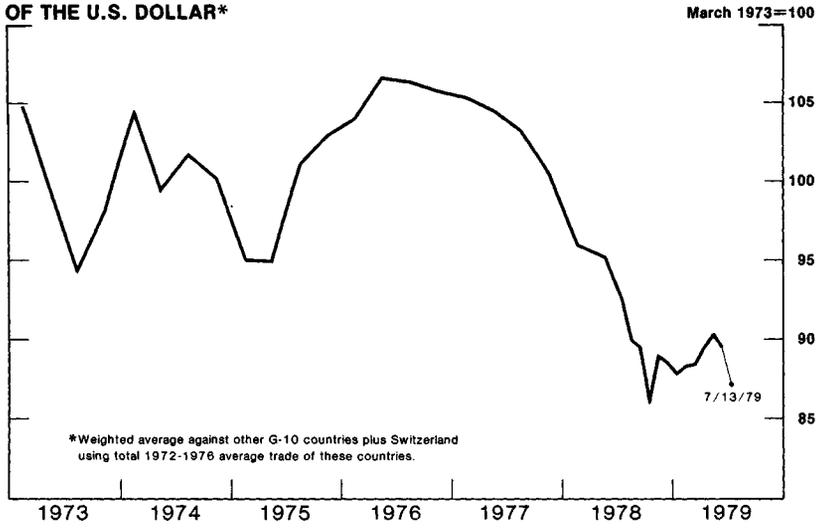
The growth of the economy after 1975, combined with tax rate increases enacted earlier, had led to the development of sizable surpluses in the budgets of many states. This pattern was reversed in the past year. Numerous tax cuts were passed in 1978, and as a result personal tax receipts were 5 percent lower in the first quarter of this year than in same period last year--even though the tax base had increased 16 percent. With nominal expenditures therefore rising relative to receipts, the operating surplus of state and local governments fell to \$3.8 billion, at an annual rate, in the first quarter; it appears that the operating budgets may have moved into slight deficit in the second quarter.

International Trade

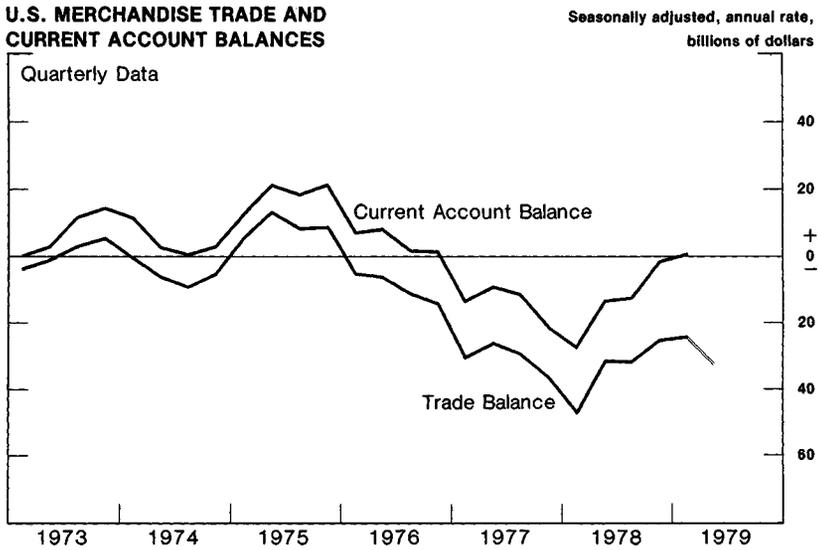
The large decline in the exchange value of the dollar in 1977 and 1978 has enhanced foreign demands for U.S. exports. This, along with a relative strengthening of economic expansion abroad, has brought about a distinct trend of improvement in the U.S. trade position. The nation's merchandise trade deficit--although quite variable from month to month--has been considerably smaller this year than on average during 1978. Moreover, the current-account balance edged into modest surplus in the first quarter for the first time since 1976 as receipts from overseas investments remained strong.

Total exports advanced further in real terms during the first quarter despite a falloff in shipments of agricultural products. The impact of the 1977-78 dollar depreciation was also evident in continued relatively slow growth of non-oil imports. On the other hand, the volume of oil imports averaged about 9.3 million barrels per day (MMB/d) during

**WEIGHTED AVERAGE EXCHANGE VALUE
OF THE U.S. DOLLAR***



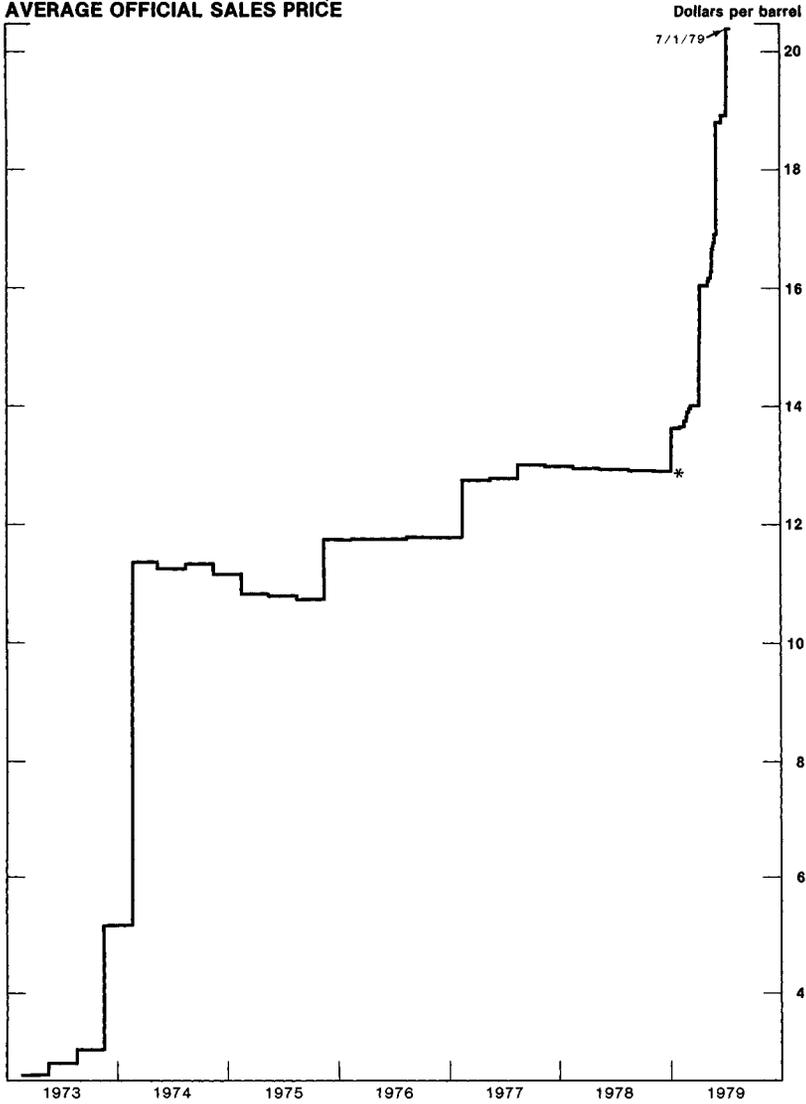
**U.S. MERCHANDISE TRADE AND
CURRENT ACCOUNT BALANCES**



the first three months of the year as compared to an average of 8.7 MMB/d during 1978. In April and May the trade deficit widened as exports remained at about their first-quarter level while the value of both oil and non-oil imports advanced. A fall in the quantity of oil imported to 8.7 MMB/d in April and May was more than offset by price changes that began to reflect the OPEC price increases and surcharges. The unit value of imported oil in May was 22 percent above its level in the fourth quarter of 1978.

The improvement in the U.S. trade and current accounts this year has helped to bolster the private demand for dollars in foreign exchange markets. The dollar rose almost 5 percent, on a trade-weighted average against other major currencies, during the first five months of 1979--even while the United States and other governments unwound the heavy official intervention of late last year. Over the past month, however, the dollar has come under downward pressure; despite official support, it has lost much of the earlier gain. A relative firming of money market conditions abroad has been a factor in this recent weakness, but is not likely in itself a full explanation. Foreign exchange market participants seem to have been questioning whether the United States will be able to deal successfully with its inflation problem, particularly in light of the recent oil price jolt.

**OPEC CRUDE OIL:
AVERAGE OFFICIAL SALES PRICE**



Note: Average price includes surcharges.

*Data are quarterly through 1978 and daily for selected dates thereafter.

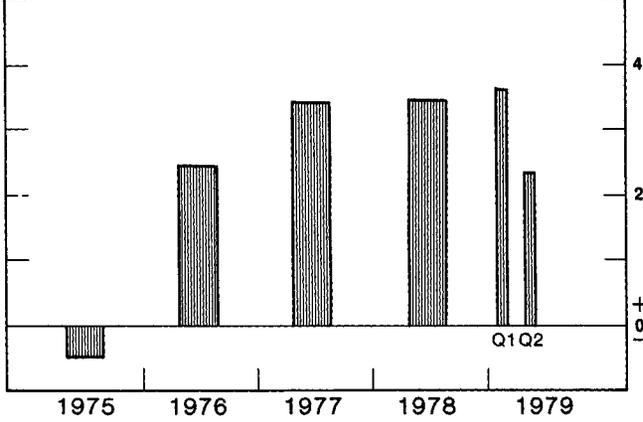
SECTION 2. EMPLOYMENT AND UNEMPLOYMENT

Almost four years of exceptionally rapid growth in employment had, by the end of 1978, given rise to considerable tautness in labor markets. Although businesses reportedly were encountering increasing difficulty in finding workers with the desired experience and skills at prevailing wage rates, the overall unemployment rate, at just under 6 percent, was well above past cyclical lows. This seeming paradox reflects in part longer-run changes in the composition of the labor force and in the output mix of the economy; in addition, the increased availability of unemployment compensation and other income maintenance programs may have altered the incentives to seek or accept employment.

Despite a leveling off in production during the first quarter of the year, monthly increases in payroll employment averaged 330,000--well above the 280,000 per month average gain during 1978. Gains in the manufacturing industry were quite large, and the average factory workweek remained at a high 40-3/4 hours. Some easing in labor demands has become perceptible since March, however, with employment gains averaging only one-third of their first quarter pace. Manufacturers have been reducing employment levels by about 35,000 per month--with the auto industry accounting for the bulk of the decline--and the average workweek has dropped to about 40 hours due to a cutback in overtime. Outside of manufacturing, hiring has continued in recent months, albeit at a reduced pace. Still, the unemployment rate has changed little since year-end, and such indicators as the average duration of unemployment and labor turnover rates have remained at levels typical of fairly tight labor markets.

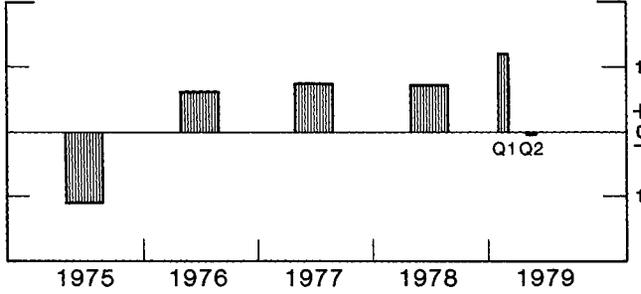
NONFARM PAYROLL EMPLOYMENT

Change from previous period, annual rate, millions



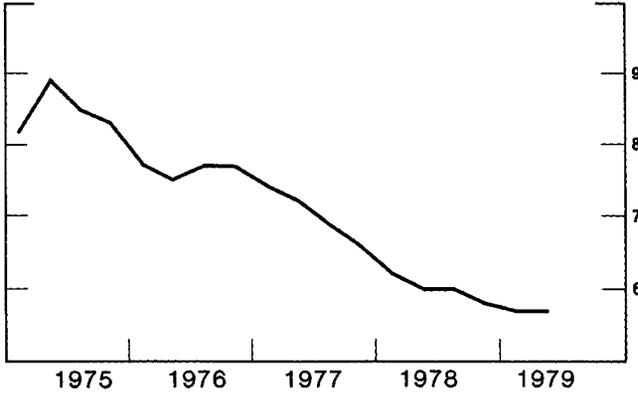
MANUFACTURING EMPLOYMENT

Change from previous period, annual rate, millions



UNEMPLOYMENT RATE

Percent

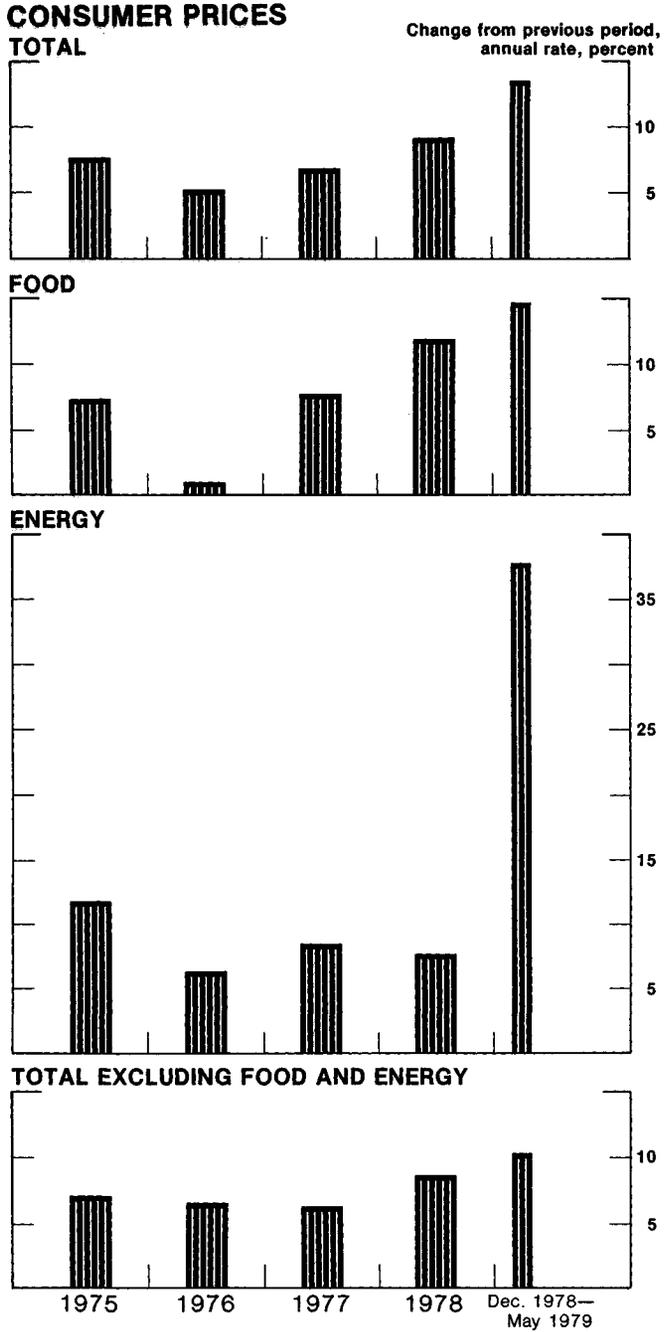


SECTION 3: WAGES, PRODUCTIVITY, AND PRICES

The pace of inflation has accelerated markedly this year. The Consumer Price Index rose at an annual rate of 13-1/2 percent through May compared with the 9 percent increase over the course of 1978. There has been a comparable stepup in the advance of prices at the producer level. Although the relatively high level of resource utilization has been a factor sustaining the momentum of inflation, supply developments specific to the food and energy sectors have accounted for much of the acceleration this year in inflation.

Food prices played a substantial role in the increase in inflation that occurred last year, and agricultural supply developments have continued to be unfavorable. In particular, beef production has remained on a down-trend, leading to sharp increases in meat prices. In addition, to rising farm prices, the rapid increase in costs of nonfarm inputs involved in processing and marketing has contributed to the acceleration of food price inflation. The further rise of the federal minimum wage, for example, was an important ingredient in the faster increase of prices for restaurant meals in the first half.

Energy prices have risen dramatically this year. Enormous increases in the prices charged by the OPEC cartel, occurring against a backdrop of significant worldwide pressures of demand on available supply, contributed to a 37 percent annual rate of increase in the energy component of the Consumer Price Index during the first five months of 1979. The rise in petroleum fuel and feedstock prices has in addition intensified cost pressures across a broad range of U.S. industries.



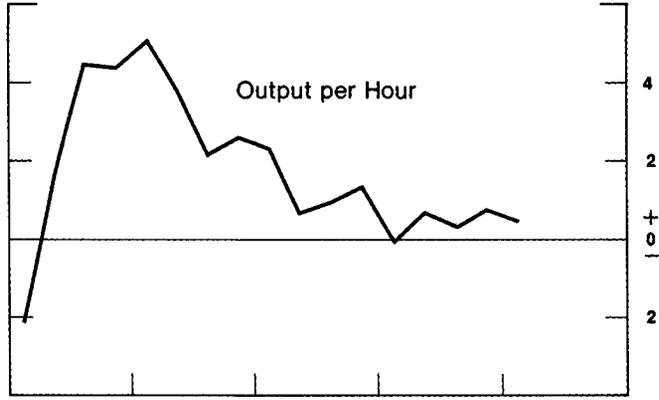
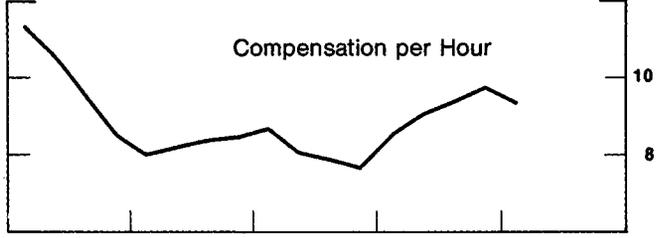
The acceleration in the rise of other prices has been less striking than that for food and energy, but it has been appreciable. Exclusive of food and energy items, the Consumer Price Index rose at an annual rate of 10 percent through May, 1-1/2 percentage points faster than the average pace throughout 1978. Pressures placed on prices of final products by rising materials costs have played some role in the broad pickup in inflation. Prices of nonferrous metals and of other actively traded nonfood commodities rose sharply early in the year when the year-end strength of the economy apparently led to some upward revision in expectations of future production levels and fears of consequent commodity shortages. In subsequent months, however, prices of many basic nonenergy commodities weakened as the slackening of economic activity became evident.

In addition to materials prices, labor costs have been a source of pressure on prices this year. The rise in wage rates generally does not appear to have accelerated, and surveys conducted by the Council on Wage and Price Stability indicate broad compliance with its wage standard, especially among large firms. However, total labor costs were boosted by enlarged employer contributions for social security and unemployment insurance, and compensation per hour (including private fringe benefits) in the nonfarm business sector rose at a 10-1/4 percent annual rate in the first quarter of the year. Meanwhile, output per hour dropped markedly in the first quarter, so that the unit labor costs of nonfarm businesses increased at an annual rate of more than 15 percent. Labor productivity apparently declined again in the second quarter, and while

UNIT COST INDICATORS

Nonfarm Business Sector

Change from year earlier,
annual rate, percent



the rise in unit labor costs likely was not quite so rapid as in the first three months of the year, it probably was fast enough to raise the first-half advance to a rate exceeded only in 1974.

SECTION 4: FINANCIAL DEVELOPMENTS

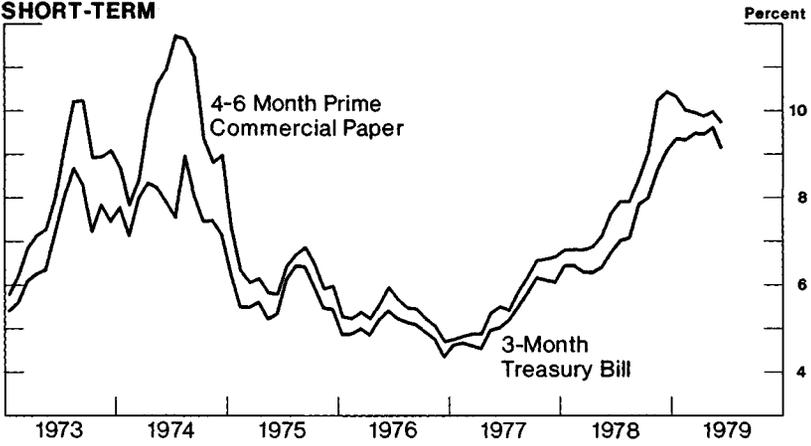
Growth of the monetary aggregates was considerably slower during the first half of 1979 than in 1978. At midyear, all of the major monetary measures--M-1, M-2, and M-3--were within the expected ranges of expansion reported by the Federal Reserve to the Congress in February. Commercial bank credit at midyear stood slightly above the path implied by its projected growth range, but the pace of overall credit expansion in the economy had moderated appreciably. Although businesses stepped up their borrowing somewhat during the first half of the year, there were more than offsetting declines in borrowing by other nonfinancial sectors.

Interest Rates

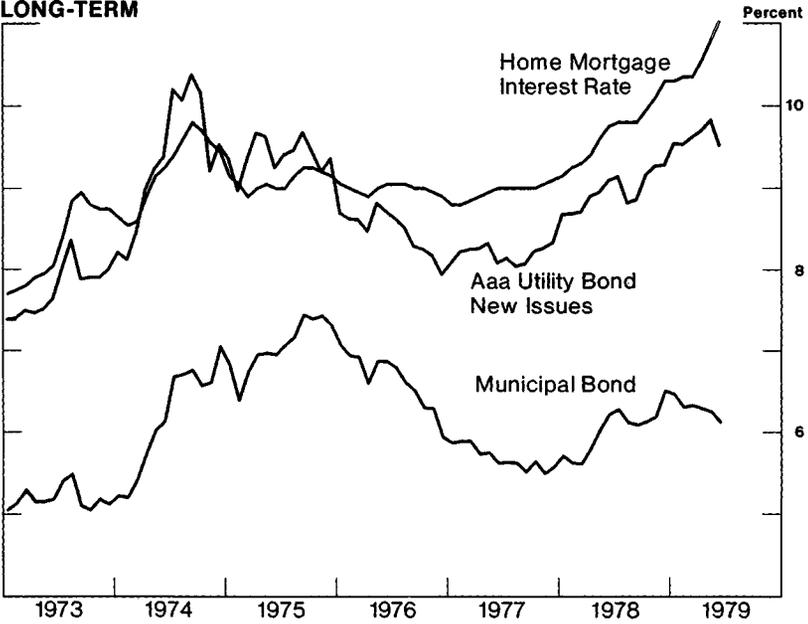
The general level of interest rates on market securities has changed relatively little since the beginning of the year after rising markedly during 1978. The federal funds rate--established in trading of immediately available funds on an overnight basis--remained around 10 percent until late April when it edged upward about one-quarter percentage point as the Federal Reserve moved to restrict bank reserve availability somewhat further in light of a surge in the monetary aggregates. Despite the small increase in the federal funds rate, other short-term market rates generally have declined somewhat on balance since December. This apparently is primarily a reflection of changing expectations about future interest rate movements as economic activity gave evidence of weakening.

In long-term securities markets, bond yields reached new cyclical highs during the first half, but retraced much of their advance in the latter

INTEREST RATES SHORT-TERM



LONG-TERM



part of the spring as many investors became convinced that the peak in money market rates had been reached. Mortgage interest rates have continued to rise, however, reaching record levels and prompting liberalization of usury ceilings in many states in order to sustain lending activity.

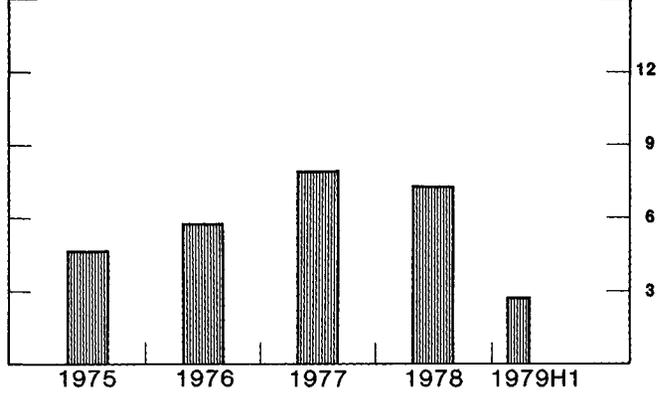
Monetary Aggregates

After expanding rapidly earlier in 1978, M-1--demand deposits and currency--leveled off in the fourth quarter and continued virtually flat through the first quarter of this year. Growth in this monetary aggregate resumed in the spring, but the rise over the first half of 1979 was at only a 2.7 percent annual rate--considerably slower than the 7.9 percent and 7.2 percent increases registered in 1977 and 1978, respectively. With nominal GNP increasing at about a 9 percent rate thus far this year, the very moderate expansion of M-1 represents a substantial shortfall from what might have been expected on the basis of historical relations among money, GNP, and interest rates.

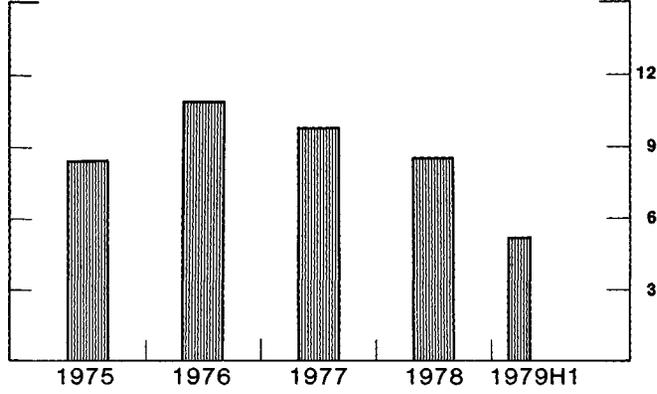
As was noted in the Board's February report to the Congress, some weakness in the public's demand for M-1 was anticipated because of the introduction last November of automatic transfer services (ATS) nationwide and of NOW accounts in New York State. The Board staff had projected that transfers from demand deposits to savings accounts associated with these innovations might reduce M-1 growth by roughly 3 percentage points over the year ending in the fourth quarter of 1979. The impact of such transfers on M-1 growth was about that much early in the year, but it apparently has dropped off in recent months. Over the past two quarters it appears that the impact of ATS and NOWs on M-1 growth has been about 2-1/4 percent, at an annual rate.

MONEY SUPPLY GROWTH

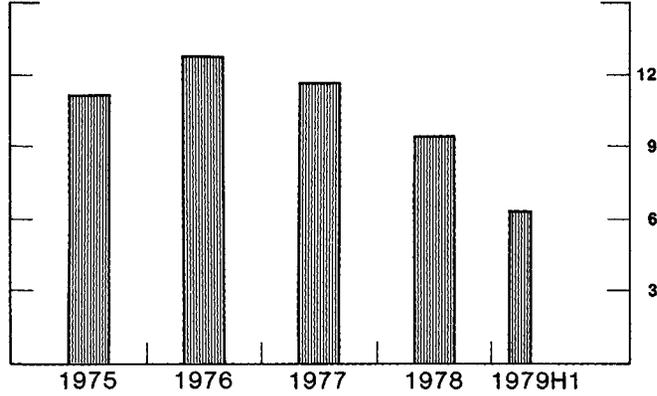
M-1 Change from previous period, annual rate, percent



M-2



M-3



Even after taking account of ATS/NOW effects, the demand for M-1 was unusually weak in the past half year, especially in the first quarter. It appears that, again as suggested in the February report, the high level of interest rates reached in late 1978 prompted greater than normal efforts to economize on non-interest-earning cash balances. Individuals evidently have shifted demand balances into a variety of interest-bearing assets, including small denomination time deposits, Treasury securities, and shares in money market mutual funds. The growth of the money market funds this year has been quite striking: over the past six months, the total assets of these funds rose from less than \$11 billion to almost \$26 billion. While these funds are an imperfect substitute for checking accounts for transactional purposes, they have provided many individuals with a high-yielding liquid asset that may be purchased in small denominations.

The relatively high level of interest rates this year has also had an appreciable impact on the interest-bearing component of M-2--that is, commercial bank time and savings deposits other than large CDs. Deposits subject to fixed interest rate ceilings have been weak since last fall. Inflows to six-month money market certificates (MMCs) provided an offset to this weakness in the fall and winter. With a change in regulations in mid-March that eliminated the one-quarter percentage point differential between MMC ceilings at thrift institutions and commercial banks when the six-month Treasury bill rate exceeds 9 percent, MMC growth at banks accelerated and provided the impetus for a pickup in the expansion of the time and savings deposit component of M-2. Over the first half as a whole, this component expanded at a 7 percent annual rate

and brought M-2 growth to a 5.2 percent rate, substantially below the 8.4 percent average rate of 1978.

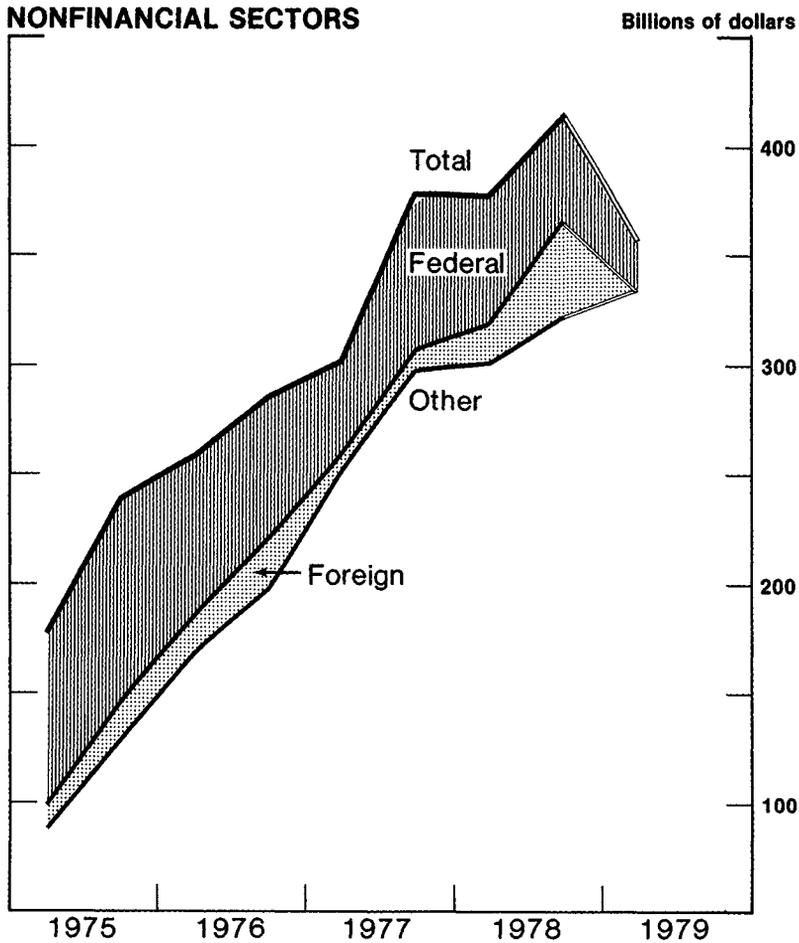
Growth of M-3 also has moderated in recent quarters, averaging 6-1/4 percent, at an annual rate, during the first half. This deceleration was partly a reflection of the slower growth of the narrower monetary aggregates, but reduced deposit inflows at nonbank thrift institutions also played a role. The slowing in thrift deposit growth was especially noticeable after mid-March when a share of the MMC market was lost to commercial banks, but inflows in the second quarter still exceeded the very low rates of past periods when high market interest rates caused serious disintermediation. Savings and loan associations made increased use of large-denomination time deposits, which are not subject to regulatory rate ceilings, to offset some of the weakness in other accounts.

Credit Flows

Net funds raised in credit markets by nonfinancial sectors of the economy during the first half totaled about \$355 billion, at an annual rate, according to preliminary estimates. This is well below the \$393 billion figure for 1978 and reflects the combined impacts of monetary restraint and a number of other factors.

One of these other factors was the diminished size of the federal budget deficit. With a very large year-end 1978 cash balance further reducing the Treasury's needs for new money during the first half, federal government borrowing fell off sharply from the 1978 pace. In contrast with the pattern in late 1978, when they effectively financed the Treasury's deficit with the proceeds of dollar-support operations, foreign central banks sold a large volume of Treasury securities in the first

**FUNDS RAISED BY
NONFINANCIAL SECTORS**



Source: Federal Reserve Flow-of-Funds Accounts.

Data for the first half of 1979 are partially estimated.

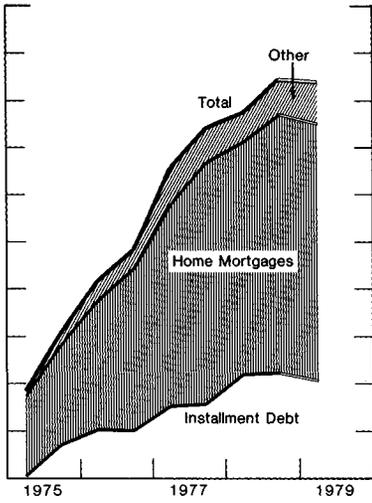
half. A part of the sizable private capital inflow to the United States during the first half was channeled through the Eurodollar market to the U.S. banking system, which acquired a substantial volume of Treasury securities. Households were important buyers of Treasury securities, as they responded to the enlarged gap between rates on such instruments and those available on deposits subject to regulatory ceilings.

State and local governments have borrowed at a reduced pace in 1979. This decline reflects the absence of advance refundings since last August when more restrictive regulations were promulgated by Internal Revenue Service. Tax-exempt bond issuance for new capital in first half was maintained at about the 1978 level, owing largely to a sharp increase in sales of revenue bonds for mortgage financing purposes; the pace of such housing-related financing slowed markedly in the second quarter, however, as a consequence of congressional proposals to curtail the use of tax-exempt bonds to fund low rate single-family mortgages. Casualty insurance companies and commercial banks have absorbed the bulk of tax-exempt bonds sold this year.

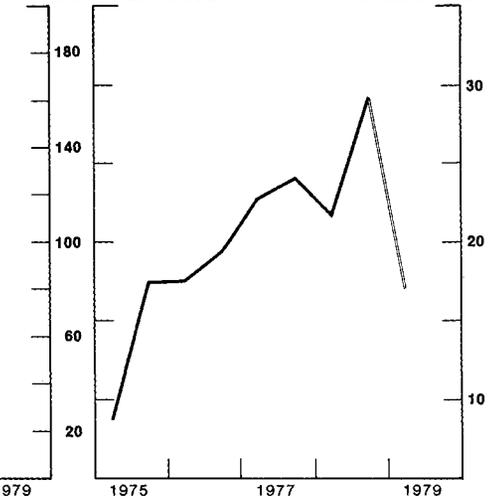
Household borrowing in the consumer installment and mortgage credit markets has leveled off this year. Although interest rates on consumer loans have risen during the past year, the moderation in growth of installment debt appears to be primarily a consequence of other factors tending to reduce consumer spending. The flattening in mortgage flows, on the other hand, does appear more directly a consequence of rising interest rates and the tightening of mortgage credit supplies.

On the demand side, households have deferred home purchase or scaled down expenditure or borrowing plans in light of the higher cost of mortgage credit. On the supply side, even where usury ceilings have

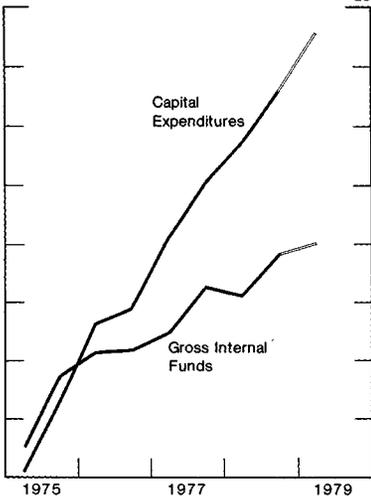
HOUSEHOLD BORROWING



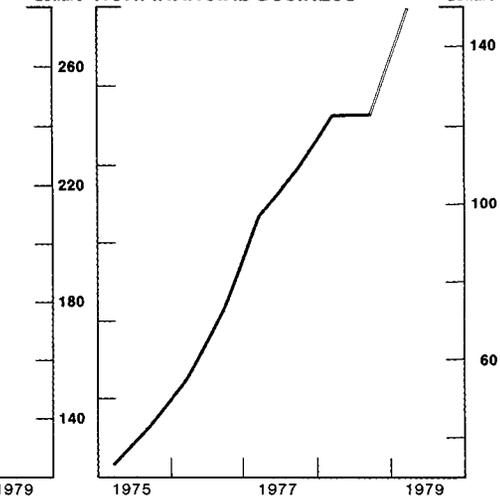
STATE AND LOCAL GOV'T. BORROWING



NONFINANCIAL BUSINESS



BORROWING BY NONFINANCIAL BUSINESS



Source: Federal Reserve Flow-of-Funds Accounts.
 Data for the first half of 1979 are partially estimated.

not been a constraint, depository institutions have pursued more cautious loan commitment policies because of concerns about current or prospective liquidity pressures. Thrift institutions have reduced their mortgage lending considerably this year as their deposit flows have diminished; although the aggregate liquidity ratio of savings and loan associations has remained well above the regulatory requirement, that liquidity cushion has shrunk somewhat and the associations have borrowed heavily from Federal Home Loan Banks and other sources. Commercial banks, too, have expanded their residential mortgage portfolios at a slower pace this year, but there have been partial offsets to reduced depository institution lending in the form of credit flows from state and local governments, life insurance companies, and federally sponsored agencies.

In the nonfinancial business sector, the growth of outlays for inventories and fixed capital has outstripped that of internally generated funds, and firms have increased their borrowing substantially. An increased share of the credit flow to businesses has been accounted for by commercial banks, as many bigger firms have preferred--at current interest rates--short- or intermediate-term bank loans to long-term bond issues with lengthy call protection. Commercial mortgage flows have remained large, however, in reflection of the strength in nonresidential construction activity. Life insurance companies have provided a large portion of these mortgage loans and, with pension funds, absorbed the bulk of a reduced volume of bond issues. Commercial paper issuance was an increased source of short-term credit for businesses in the first half, and finance company business loans continued to grow rapidly, with much of the credit being extended to automobile dealers to finance inventories.

Foreigners, who had borrowed in U.S. credit markets when the dollar was weak in 1978, apparently did not expand their debt during the first half of 1979. This change was a significant element in the overall decline in funds raised by nonfinancial sectors.

Financial sectors increased their borrowing in credit markets during the first half. Government-sponsored credit agencies stepped up security issuance to finance assistance to the residential mortgage market. Commercial banking firms and finance companies sold substantial volumes of commercial paper and of bonds, including a number of floating rate issues that offered investors a hedge against future interest rate fluctuations. Savings and loan associations, after receiving approval from the Federal Home Loan Bank Board, issued commercial paper for the first time; toward midyear there were also a number of mortgage-backed bond issues by S&Ls.

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. OUTLOOK FOR MONETARY GROWTH

In February the Federal Reserve reported to the Congress on the growth in the monetary aggregates that it expected would occur during the current calendar year. Expressed as ranges, and measured from the fourth quarter of 1978 to the fourth quarter of 1979, the increases indicated were: for M-1, 1-1/2 to 4-1/2 percent; for M-2, 5 to 8 percent; for M-3, 6 to 9 percent. The range for M-1 reflected an expectation that shifts of funds from demand deposits to newly authorized ATS and NOW accounts would reduce M-1 growth by about 3 percentage points. In addition, bank credit was projected to expand by between 7-1/2 and 10-1/2 percent.

At its most recent meeting, the Federal Open Market Committee reassessed the ranges for monetary expansion in 1979 and formulated preliminary monetary ranges for 1980. With respect to 1979, the Committee decided that it was appropriate to retain the previously established ranges for the aggregates. In reaching this decision, particular attention was focused on the uncertainties surrounding the behavior of M-1. As was noted in the preceding chapter, the estimated impact of ATS and NOW accounts on M-1 expansion has been somewhat smaller to date than had been expected when the range was initially adopted. However, the future extent of shifts to these accounts cannot be predicted with precision, especially in light of the April court decision barring ATS and certain other payments services as of January 1, 1980. Thus, while the Committee retained its original range for M-1, it expected growth to vary in relation to the range to the extent that the actual ATS/NOW impact deviates from the 3 percentage point figure projected earlier.

Even greater uncertainties faced the Committee in its consideration of monetary growth ranges for 1980. Apart from the question of possible judicial or legislative action that might affect the menu of transactions accounts available to the public, the economic circumstances and financial requirements of a period extending 18 months into the future obviously cannot be foreseen with much confidence. The Committee tentatively decided that the ranges for 1980 should be the same as those for 1979, with the understanding that adjustments might be necessary in response to legal or legislative developments affecting M-1 and, more generally, in light of emerging economic conditions. In any event, it was recognized that the current re-examination of the definitions of the monetary aggregates, which is being undertaken in light of the major institutional changes that have occurred in the payments system, might in the near future lead to a new and improved set of money stock measures.

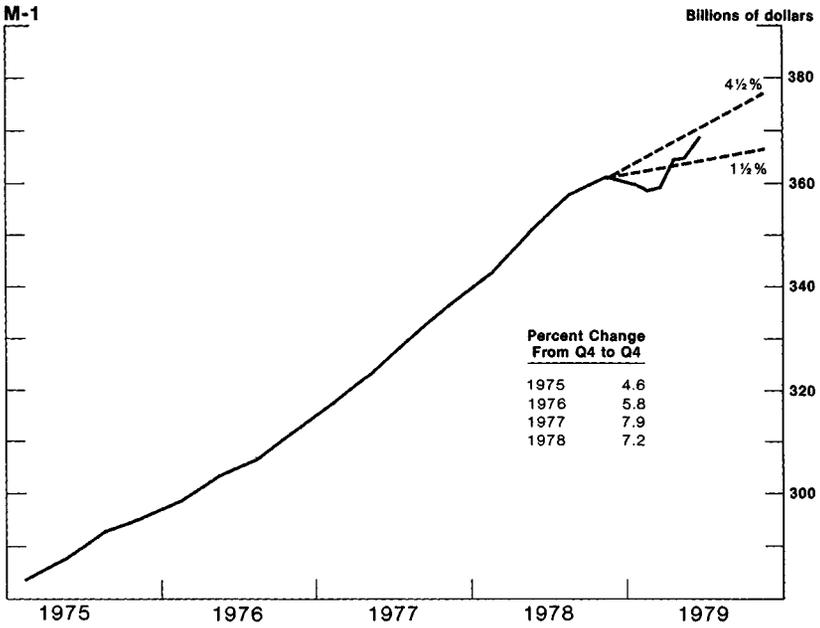
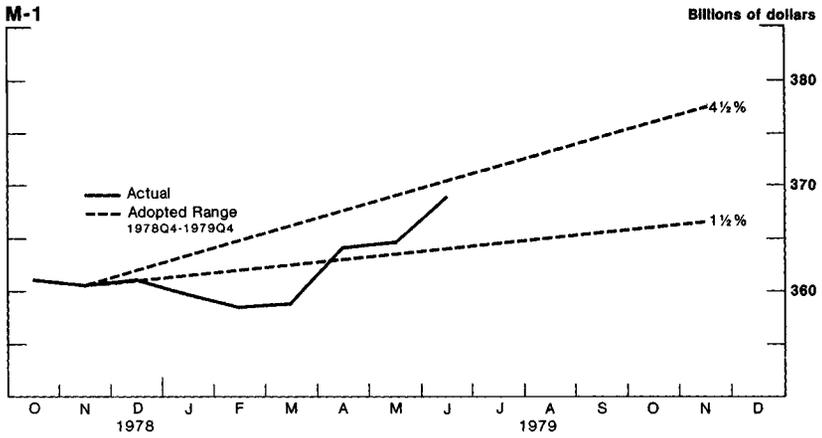
The ranges for the broader monetary aggregates, M-2 and M-3, allow for continued moderate growth of the interest-bearing components of those aggregates. In past periods of high market interest rates, inflows of deposits subject to regulatory interest rate ceilings weakened markedly. Investors "disintermediated," shifting their funds from banks and thrift institutions into higher yielding market securities. In the past year, however, inflows to such accounts--though smaller than in 1975-77--have been fairly well maintained. The six-month money market certificate, with a rate linked to Treasury bill yields, has permitted the depository institutions to compete successfully for savings against money market mutual funds and other instruments.

The growth ranges for the broader monetary aggregates imply that the depository institutions will experience adequate inflows of

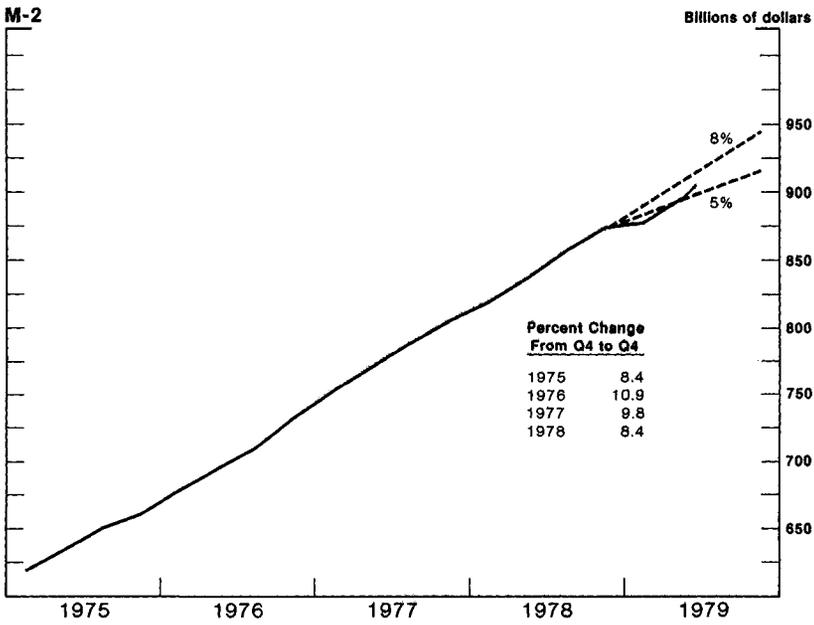
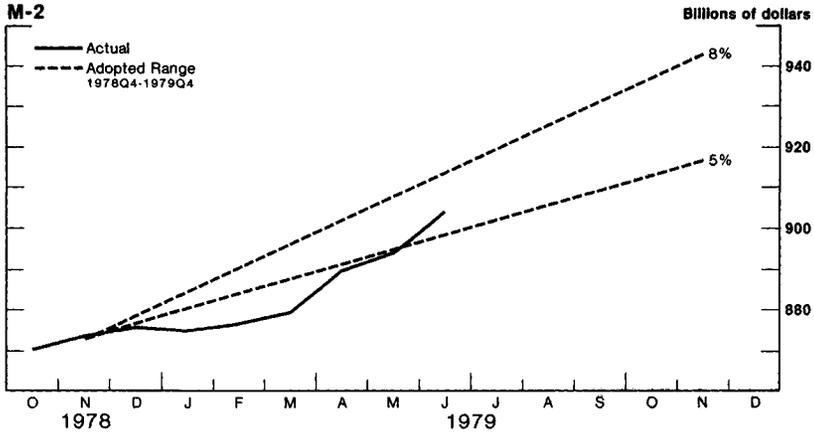
lendable funds over the remainder of 1979 and in 1980. The projections for bank credit reflect an expectation that loan demands at commercial banks will begin to moderate in the months ahead. Business loan demands, in particular, should diminish, with the corporate financing gap likely narrowing and firms probably desiring to fund short-term debts in longer-term credit markets.

The monetary ranges established by the FOMC are consistent with a policy of gradual reduction in rates of increase of the monetary aggregates in order to curb inflation. As shown in the charts on the following pages, growth in the aggregates slowed in 1978, and a further deceleration should occur this year. A further deceleration in M-1 is likely to develop even in the absence of any shifting of funds from demand deposits to ATS savings and NOW accounts. The ranges tentatively adopted for 1980 would permit continued slowing in monetary expansion. However, there is considerable variability over time in the behavior of the monetary aggregates, owing in part to financial innovations and to changes in the public's asset preferences. Since satisfactory economic performance remains the basic objective of the Federal Reserve, monetary policy, from time to time, may have to permit growth rates in the aggregates that temporarily interrupt the downward trend.

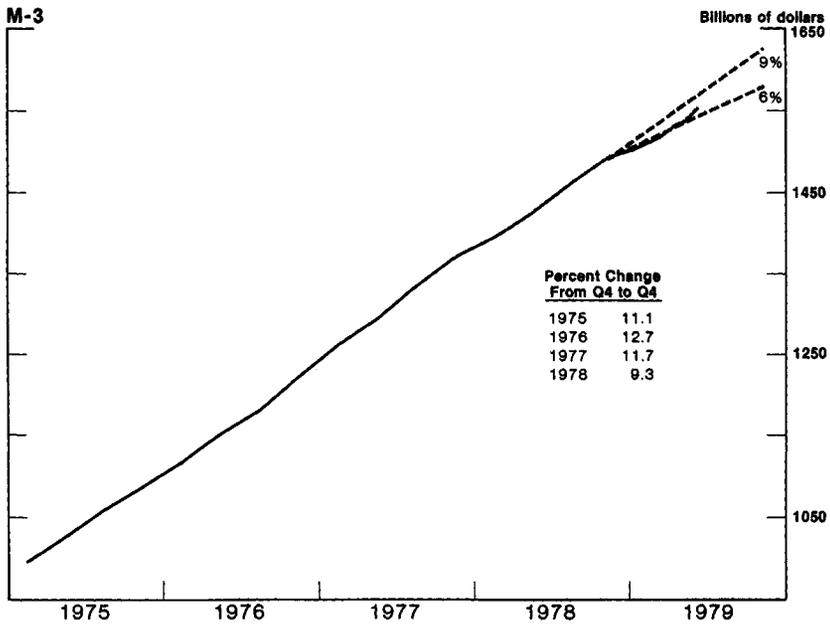
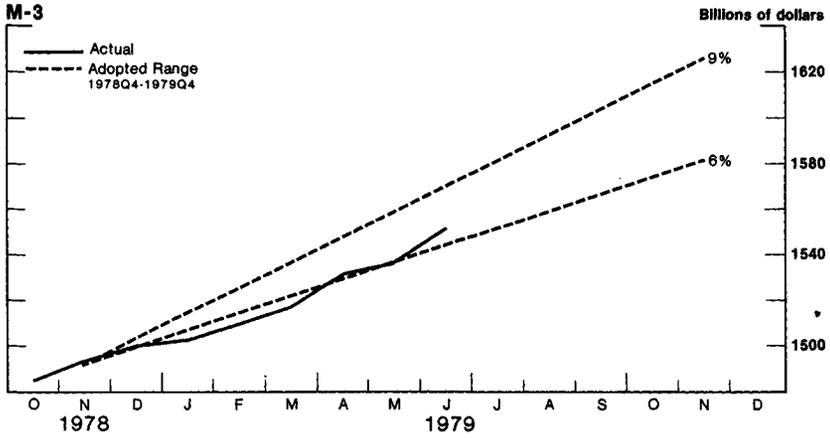
GROWTH RANGES AND ACTUAL M-1



GROWTH RANGES AND ACTUAL M-2



GROWTH RANGES AND ACTUAL M-3



SECTION 2. OUTLOOK FOR THE ECONOMY

As noted in the introduction, the economy faces a difficult adjustment to this year's oil price increases, which are aggravating inflationary pressures and intensifying forces likely to depress aggregate demand. It now appears that economic activity may well decline somewhat over the next few quarters, before turning upward in 1980.

In the near term, real disposable income is likely to show no more than modest gains, and consumers probably will spend cautiously. Business spending may decline in real terms, reflecting the correction of inventory imbalances--particularly in the auto industry--and a mild retrenchment in fixed investment occasioned by the sluggishness of consumer demand. Housing construction activity can be expected to decline somewhat further this year in response to the recent tightening of credit conditions and to the weakness in income flows. Export demand should, however, tend to support activity.

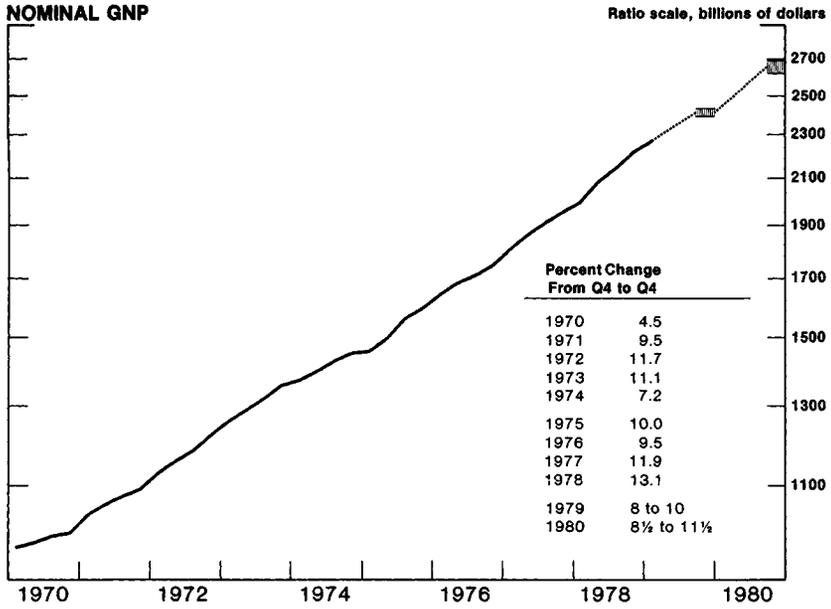
During this period, industrial production and employment are likely to edge downward. The resulting easing of demands on productive resources should help to contain inflation. Pressures on credit markets may abate and lay the groundwork for an upturn in homebuilding during 1980.

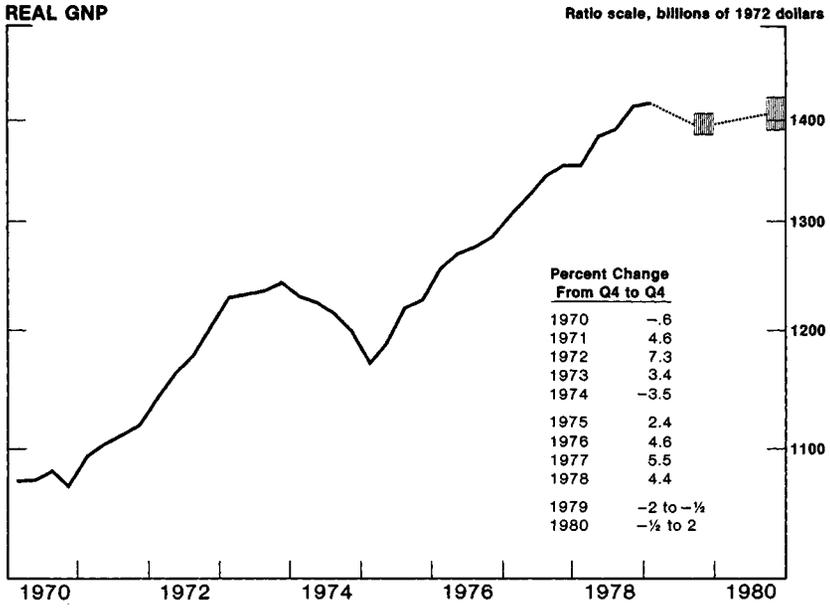
Moderate growth in real GNP should resume next year as the initial effects of the oil shock abate and consumers begin to expand their spending. The completion of the inventory correction should lead to a resumption in the growth of orders and production. Employment growth would pick up in this environment, but it seems probable

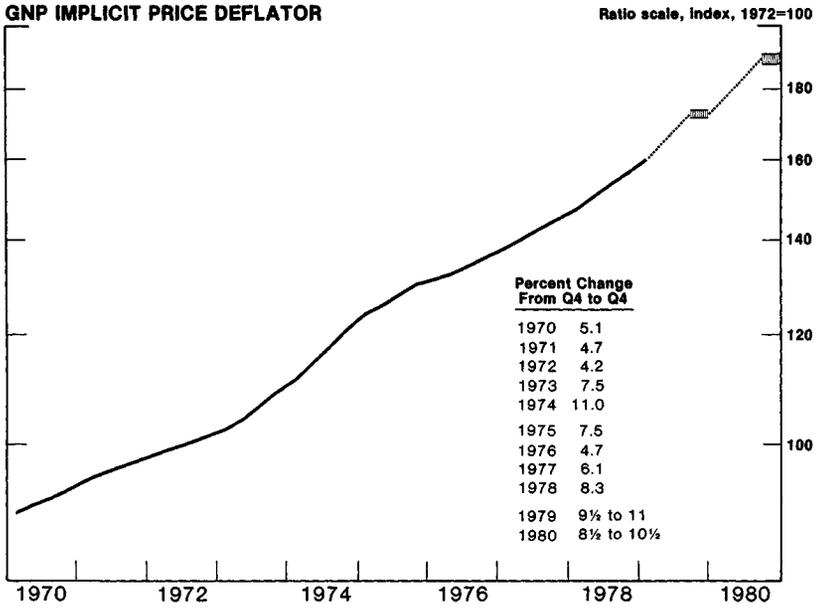
that the pace of hiring will not be strong enough to cut into unemployment. Inflation should edge lower, though progress may be quite gradual owing to the strong upward momentum of unit labor costs, the continuing relatively tight supplies of some agricultural commodities, and the further adjustment of the system to higher energy costs.

The economic outlook currently is obscured by exceptional uncertainties, and the range of possible outcomes appears quite wide. However, in order to improve understanding of the monetary objectives, an economic projection representing the consensus of the Board members at this time has been summarized in the table below and in a series of charts on the next several pages.

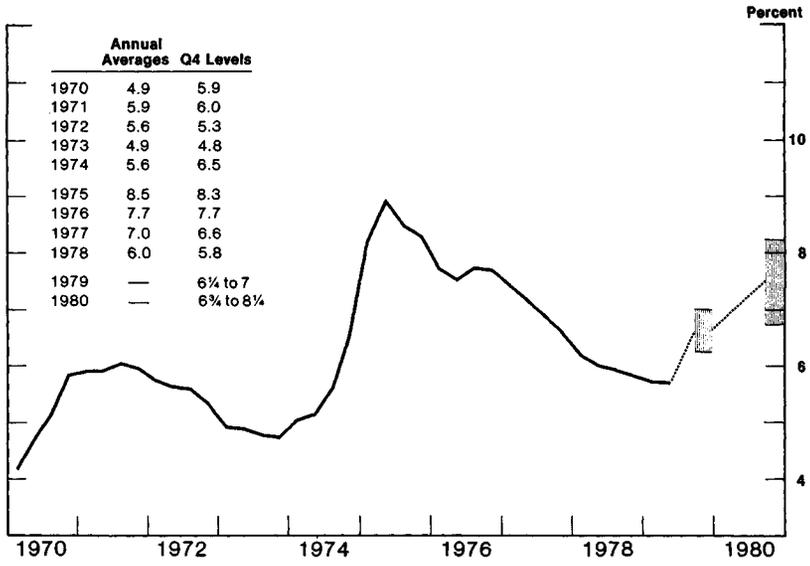
	<u>Actual</u>	<u>Projections</u>	
	1978	1979	1980.
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	13.1	8 to 10	8-1/2 to 11-1/2
Real GNP	4.4	-2 to -1/2	-1/2 to 2
Implicit price deflator	8.3	9-1/2 to 11	8-1/2 to 10-1/2
Average level in fourth quarter, percent			
Unemployment rate	5.8	6-1/4 to 7	6-3/4 to 8-1/4







UNEMPLOYMENT RATE



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 ADMINISTRATION'S SHORT-TERM GOALS

The administration has recently announced its forecast^{1/} of key economic variables in association with the midyear budget update. This forecast, which assumes no major new fiscal initiatives, contains some significant changes from the figures contained in the January Economic Report of the President. In particular, real economic growth through 1980 has been reduced and inflation has been raised.

The Administration's Forecast

	<u>1979</u>	<u>1980</u>
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	9.2	10.3
Real GNP	-0.5	2.0
Implicit price deflator	9.8	8.1
Average level in fourth quarter, percent		
Unemployment rate		

^{1/} The January Economic Report equated the 1979-1980 forecast with short-run goals.

SECTION 2. THE ADMINISTRATION'S GOALS AND THE FEDERAL RESERVE'S PLANS FOR
MONETARY GROWTH

The monetary ranges set by the Federal Reserve should be adequate to finance the amount of spending in current dollars projected by the administration. However, the administration's forecast does seem to envision a somewhat more favorable combination of real output and inflation than that suggested by the Board's consensus projection. The actual price-output mix will be determined primarily by supply conditions and by other structural or behavioral characteristics of the economy. These relationships are not known with certainty, of course, and thus many different price-output combinations must be viewed as possible for given rates of monetary growth.

Monetary growth rates are much more closely related in the short run to nominal GNP than they are to the division of nominal GNP between output and prices. The tradeoff between output and price might be improved, however, through the use of other policy tools. Governmental action to eliminate regulatory or market impediments to price competition could be helpful in tempering inflationary pressures. So, too, could a continuing program of voluntary wage-price guidelines, which may help in restraining the anticipatory actions that have made the wage-price spiral so intractable. The nation's ability to avoid an escalation of inflation over the next year or so--without serious recession--will depend in considerable degree on whether a means is found to overcome the tendency for workers and businesses to seek higher wages and prices in an effort to offset the effects of the income transfer associated with the rise in oil prices. Over the longer run, the ability of the nation to achieve sustained growth of real income will depend importantly on whether it can solve its energy problem.

The CHAIRMAN. Thank you, Mr. Miller.

We will now inquire, under the rule. You have said before this committee many times—and I take it you would say again—that in the event that action is necessary to shorten and gentle whatever recession we may be getting into, that the way you prefer doing that is by not using the fiscal approach, that is to say, large tax cuts or large increased budgetary expenditures which add to demand, but instead to provide whatever ease is needed by modest monetary ease, because that is what makes investment possible and investment produces greater productivity and greater productivity fights inflation.

As a general principle, and not in the context of today's events necessarily, but as a general principle, do you still, I hope, hold that view? And if Congress will help you set the stage by not being panicked into precipitating tax cuts or expenditure increases, will you find it easier to carry out that scenario than you would otherwise?

Mr. MILLER. Mr. Chairman, as a matter of policy preference, I would reiterate my feeling that the mix of policies for business cycles would be better achieved by use of flexible monetary policy and more stable and disciplined fiscal policy.

We must, as you point out, measure that preference in policy to the particular circumstances at any moment. One of the particular reasons that I favor that policy is that, looking at the past, our responses to business downturns quite often has been to add on another layer of Federal Government spending. This is very hard to unwind when the economy turns in another direction, so that you are caught with a constant building up of layer upon layer, just as the paint on a ship's hull keeps getting layered until the paint gets so heavy that the ship sinks. This is what we need to avoid.

The other aspect of fiscal policy—the taxing side—of course, is less subject to that criticism, because in an inflationary environment incomes move up into higher tax brackets and there is a natural draining that occurs from fiscal policy even without action. So, from time to time, it is appropriate to begin to adjust appropriate tax factors.

But I want to reiterate that my preference would be to use the more flexible monetary policy to accommodate business cycles and to adjust the direction of the economy, giving due recognition not only to the condition of the domestic economy and the position and posture of fiscal policy, but also to the way in which foreign exchange markets and the value of the dollar impact upon our domestic economy and contribute to our inflation problems.

So, I believe we are still of one mind in this. Our skills in implementation will be tested in coming months. I would like to reemphasize your view, which is that it is important that we continue to base our decisions, in the Congress, the Federal Reserve, and the administration, on facts and realities, and that we not take precipitous, premature actions about supposed concerns that have not yet appeared.

The CHAIRMAN. Thank you.

Now, both I, in my question, and you in your answer, have made reference to international matters, and, of course, anything we say about anything always ought to have that footnote and caveat in it.

I notice that as of now, for instance, the U.S. dollar in international exchange markets is down 1.2 percent against the British pound, 1

percent against the Swiss franc, and so on. And the market, as somebody once observed, will continue to fluctuate.

Having said that, however, I would ask you one other question, and that will be perhaps my last question, and it is this: It is sometimes said that in our domestic monetary policy we should be governed by the interest rate structure in this country and in other countries. It is said, for instance, that if we, to combat a recession, other things being equal, have a monetary policy which modestly lowers interest rates, that American money will then fly over to London, Frankfurt, or wherever it is going, and our international capital accounts and our exchange position of the dollar will be hurt.

I would ask you whether one doesn't need to be very careful in handling that thesis, whether it isn't true that, in fact, there are many things other than interest rate differentials which cause capital to move about, and whether it isn't true that in the recent past, in the last couple of years, in the face of quite disparate interest rate structures, short-term capital has not inevitably moved in a rush toward the higher interest rate; and ask you further whether wouldn't adherence to the policy of always adjusting our own interest rate structure to what other central banks may do, may not in the end do more inflationary and imbalance-of-payments harm than good?

Thus, in the instance, if we sought to keep here or to lure here capital from London, Frankfurt, Tokyo, or Basel by raising American interest rates, might we not end up gaining a few bucks on short-term, bank deposits and Treasury bill purchases, but lose much more by creating a deep recession which would cause stock prices to fall and foreigners to dump their equities in Wall Street?

In short, aren't there so many imponderables that a steady-as-you-go, sensible domestic monetary policy, while always one wants to take the international situation into account, is really a pretty good pole star by which to guide?

Mr. MILLER. Mr. Chairman, in the regime of floating exchange rates, it seems to me that the currency valuations are affected in the classic way: currencies go up when there are more buyers than sellers, and they go down when there are more sellers than buyers.

Therefore, it seems to me that one must look at why people buy or sell currencies. Is it to close a transaction? Is it to take a position?

To the extent that we have had some erratic markets, it has been more position-taking than covering transactions. In that regard, I think you are correct that interest rates are only one of a series of complex factors. We have had periods when interest rate differentials were narrow and the dollar was strong; and we have had periods when it was wider and the dollar was weak. You have to look at other conditions at the same time you look at relative interest rates. It is necessary to look at relative inflation rates.

It is also important to look at the direction of change. Are the trade accounts going into balance, or is there a greater surplus or a greater deficit? Our current account deficit, for example, has been quite large in recent years—last year, about \$14 billion. The direction of change in our current account deficit will bring us to about half that level this year and into surplus next year. So, that change is positive.

All of these factors, I think, have to be taken into account. I believe it would be a little unwise not to look at the interest rate matters as

they relate to the other factors, and particularly to the direction of change and the expectations of those who deal in currencies. Here again, their expectation as to our action in dealing with our domestic economy will be an important factor. If we can do a good job with our domestic economy in wringing out inflation, the dollar will be supported.

The CHAIRMAN. Thank you very much. My time is up.

Mr. Stanton?

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

Mr. Miller, I don't know whether or not—maybe I misinterpreted—I don't know if they were your prepared remarks, or your opening colloquy in regards to the subject of the rate of inflation and your prediction, but what I thought I heard you say is it was your best estimate that the rate of inflation would rise at 2 percent this year and an additional 1 percent next year.

Would you interpret that? I thought we were at 13?

Mr. MILLER. Thank you for catching that, Mr. Stanton. What I hoped I said was that the oil price shock this year will increase inflation 2 percent more than it would otherwise have been.

If we end up this year with a 10- or 11-percent inflation rate, that will be 2 percent higher than what it would have been had we not had this special effect of increased oil prices.

Recall that when I testified in February, the outlook for the year was roughly a 10-percent increase in world oil prices for the year.

Now we're talking about a 60-percent increase. It will be scaled in, so that you are talking about a 30- or 40-percent change. This is much, much higher than what we projected before the recent OPEC action and before the general shortages that developed.

I was merely pointing out the delta effect. If we had gone on what we expected in oil pricing last February, we would have X percent inflation. From what has actually happened, we will have 2 percent more than X this year from the increases.

Mr. STANTON. I just wanted to be sure on that.

Mr. MILLER. As a matter of fact, while we are doing it, I can just repeat for the record that the estimate of the Federal Reserve Board of Governors is that, using the implicit price inflator, inflation will be between 9½ and 11 percent this year.

If you subtract the 2 percentage points, then you could say that, without this oil price shock, inflation would have been between 7½ and 9 percent.

Mr. STANTON. I think it is at an annual rate now of about 13 percent.

Mr. MILLER. That is the CPI. The implicit deflator tells what is actually going on in the whole economy, not just the consumer sector. And, that rate you mention represents the CPI rate of annual change in the first 4 months, or 5 months.

We are expecting some moderation in factors such as food. And we are expecting the negative impact of energy. All of this balances out to a much higher rate than we would have expected.

Mr. STANTON. Do you see any inflationary impact on the President's proposals on energy? I was reading last night of an estimate cost of \$142 billion. Do you expect that the President's program would require in any way special treatment?

Mr. MILLER. Mr. Stanton, we don't have the details of how this will be handled, but one would suppose from the President's proposal that using the excess profits tax funds to pay for the energy development activities will not add a level of inflationary spending, but will mean a reallocating of resources. That means other sectors in the economy will have to grow less in order to provide the funds to finance energy projects.

If you took the \$140 plus billion over 10 years, and assumed that it was spread evenly and that you could start it up full-blown, you are talking about six-tenths of a percent of GNP, a figure that I would think could be handled, if it were financed properly, without exacerbating the inflation problem which is already very severe.

Mr. STANTON. Mr. Miller, you are a recognized expert in the private sector. Would you expect that the excess tax that the President is counting on will be anywhere near the cost of the energy program?

Mr. MILLER. I would suspect that what might be the ultimate outcome of this program is to use some tax funds to stimulate core projects, and that there should be a series of incentives that would bring the private sector into play with its own initiatives and investments that would supplement this.

If the program works, I would think there would be supplemental expenditures by the private sector that would finance some of the energy expansion and sources that we need.

I don't believe it should all be left to the Government. Nor do I foresee that these expenditures will be in Government operations entirely. I see the prospect that a good deal of the President's program will end up being funded in the private sector, and merely supported, or given protection by the Government against the technological risks of developing new and untried sources.

Mr. STANTON. Mr. Chairman, my time has expired.

The CHAIRMAN. Mr. Mitchell?

Mr. MITCHELL. Thank you.

Mr. Chairman, it's almost impossible to convey to you and to the members of this committee my growing sense of frustration—and sometimes I think it is going to turn to fury—over what we have done to the Full Employment and Balanced Growth Act.

It was to be a two-pronged piece of legislation. The original emphasis was to fight unemployment and the added emphasis was to fight inflation. We are now pursuing monetary and fiscal policies that are maintaining black unemployment rates across the board at a level that is absolutely unconscionable. And apparently we intend to pursue fiscal and monetary policies which will increase the rate of unemployment, some economists say, to as much as 8 percent. There is no doubt in my mind that that increase in the rate of unemployment is going to fall disproportionately on those who have already suffered enough. There is nothing I can do about it. The course has been charted.

I take this opportunity to express my growing sense of frustration that a bill which was designed to accomplish two things has been bastardized to the point that it now emphasizes only one.

That is my feeling. I want to convey it to you and to the members of this committee, and now I want to raise a question with you—unless you have some comment to make on my feelings before I ask the question.

Mr. MILLER. Chairman Mitchell, may I make some comment on that, because I don't think there is anyone who wouldn't agree with you that the levels of unemployment that we face are, from every point of view, unacceptable. And it is absolutely correct that the purpose of the Full Employment and Balanced Growth Act is to achieve full employment objectives.

The sad, unfortunate reality is, because of external events, that we cannot control yet as a Nation, we have had a tax imposed upon us; we have had a withdrawal of resources that gives us the impossible dilemma. Until we bring together all of our policies, we can neither achieve the inflation goal or the unemployment goal of the Humphrey-Hawkins bill within the timetable set by Congress, because of events outside this Nation.

Therefore, our response must not be despair, but to take every action to target in and to avoid the hardship to those who will be temporarily unemployed, and to fight the core causes, including unleashing the spirit and capacity of this Nation to get itself independent again and make its own decisions again.

Mr. MITCHELL. I am sympathetic with your position, and I obviously can't speak for all blacks or any other minorities in this country. My bone of contention is that, even prior to the time that this new crisis emerged because of the latent OPEC price increase, little or nothing had been done to reduce minority unemployment. And that is a fact. That is my concern, and I am afraid that that failure to act is being justified by this new energy crisis. And when the energy crisis diminishes I am not at all certain that we will address the problem of minority unemployment.

Mr. MILLER. I don't think it is justifiable under any circumstances. And I believe that the energy actions in 1973 and 1974, together with the actions this year ended up in a 1,000 percent increase in the price of oil, have laid an enormous burden on us.

Some of the policies, followed in the past have not been up to the task. And I think the only real thing this Nation can do is to renew and expand its commitment to shelter from harm the people you are talking about—those who are disadvantaged, black or white.

Mr. MITCHELL. May I interrupt, because I am afraid my time is going to end.

Mr. MILLER. Excuse me. I may be getting off the subject.

Mr. MITCHELL. I want to get back on the subject, too. But before I do, I want to say that I think everyone is willing to make a sacrifice. God knows, I am, and my constituents are. But the unfair part about this is the sacrifice that is now being imposed comes on top of a prior sacrifice demanded of minorities because the Government did not reduce unemployment in any significant fashion for minorities after the original OPEC price increases.

Now may I raise my question, please. You have allowed the M₁ money supply growth as part of your policy of getting to a course that you are going to pursue no matter what happens.

My concern is with the sharp rate of deceleration of M₁ adjusted for ATS accounts that has already taken place this year. The staff on the Domestic Monetary Policy Subcommittee has designed a chart, which I will share with you. That chart makes it very clear to me that each

time we have decelerated M_1 growth sharply, even adjusted for ATS accounts, that quickly we have set the stage for another recession. It is graphically clear. And my specific question is: Did not the most recent sharp deceleration—beginning last October—contribute to the recession that we are now in? And if we continue to reduce M_1 growth, will this not prolong the recession that is now just beginning?

Mr. MILLER. Mr. Mitchell, I am looking at the chart you have just mentioned. It is the first time I have seen it, but it is similar to ones I have seen before.

Mr. MITCHELL. That is a part of a study we have shared with you before—it was a part of a study done by my Subcommittee on Domestic Monetary Policy.

Mr. MILLER. You have got a dotted line here, which is apparently adjusting M_1 for ATS.

Mr. MITCHELL. That is correct.

Mr. MILLER. What you will see from that, I think, is that, on an adjusted basis, the Federal Reserve was charting a course which would be restraining but would be above the level that would trigger a recession. It was my judgment, and still is my judgment, that the monetary restraint factor would not have brought us into a recession.

The additional impact and drain-off of purchasing power by this large oil increase has brought on the recession, in my opinion. Our whole course of action in monetary policy has been to apply this restraint to dampen inflationary pressures, to control growth but not to eliminate it, and to avoid a recession.

I believe we would have succeeded but for this event that we could not control.

Mr. MITCHELL. My time has expired; however, I want to indicate that the chart of M_1 growth is adjusted for ATS accounts.

The CHAIRMAN. Mr. Wylie?

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

On page 55 of your statement, you say:

The Nation's ability to avoid an escalation of inflation over the next year or so without serious recession will depend to a degree on whether a means is found to overcome the tendency for workers and businesses to seek higher wages and prices to offset the effects of the income transfer associated with the rise in oil prices.

Mr. NEAL. We can't hear you, Mr. Wylie.

Mr. WYLIE. If we stop the rise in wages and prices in the United States, is there any reason to believe that OPEC would stop increasing their tax on Americans through the rise in price of crude oil?

Do you understand the thrust of my question?

Mr. MILLER. Yes, Mr. Wylie. We have, I think, several answers, but I think the realistic answer is that the ability and willingness of Americans to recognize the peril to their Nation from this danger of inflation and make personal sacrifices and forego some real income for a period of time in order to gain more real income in the future, that recognition, that reaction against the peril cannot guarantee us that those who control the sources outside our borders will adjust their behavior.

The only way we can bring about an adjustment of their behavior is to reduce our dependence upon their product. And as soon as we

have less demand for what they sell, that is when they will stop raising the prices; that is when they will start lowering their prices. Therefore, there is nothing more urgent for this Nation than to find a way, through a combination of policies so that we don't ride just one horse, to reduce our dependence upon petroleum as a fuel and to reduce our dependence upon imported petroleum as fast as we can.

Mr. WYLIE. Well, I couldn't agree with you more, and I agreed with the President the other night in his emphasis on the need to reduce our dependence on OPEC oil.

There are probably going to be secondary or ripple effects from the OPEC price increases. I think that if inflation is increased as it has been, and as you say it has been, because of our dependence upon OPEC oil and the fact that they are raising their prices, then the prices in the United States for other commodities are necessarily going to rise, and wages are going to rise as well.

On page 21 of your statement you have a chart which indicates the rise in the average official sales price of OPEC crude oil. Have you made any estimates on what might happen as far as the OPEC crude oil prices are concerned in the next 12 to 18 months?

And I think that is important in a prognosis as far as monetary policy is concerned and what happens as far as inflation is concerned.

Mr. MILLER. Yes; we have assumed not that we will just plateau at this number, but that we will have an OPEC price increase to roughly \$21 a barrel in mid-1979 and an increase of about \$2 a barrel additionally through 1980 on the average. That is what we have assumed. We have assumed a 60-percent increase that will be a bit stable for a while—just as the large increase in 1974 was for a while—but that then we are going to have a drift upward.

That of course is, at this moment, an assumption. If we should move more rapidly to reduce our dependence on imported oil, that might change. If we move more slowly or other events take place in the world—some interruption of oil supply, another revolution somewhere—then we could have a worse outcome.

So we are merely, at this moment, basing it on more or less the expectation and outlook based on experience.

Mr. WYLIE. Thank you.

You have a committee staff report in front of you there now, I think: Subcommittee on Domestic Monetary Policy. I think it was just supplied to you.

[The report referred to may be found in the appendix.]

Mr. MILLER. Yes.

Mr. WYLIE. Would you please refer to a chart, exhibit 4 it is called.

Mr. MILLER. Which chart?

Mr. WYLIE. Chart 4A.

Mr. MILLER. Yes.

Mr. WYLIE. You will notice there it says "year-to-year percentage change inflation as reflected by M^1 ."

The lower chart includes in M^1 repurchase agreements and Fed funds. It seems to give a more accurate appraisal of the situation as far as inflation is concerned than the upper chart. I wondered if you could comment as to the amount of inflation which might be attributed

to money growth. Is it more pronounced, or does it show up more if repos and Fed funds are included in the money supply? And why shouldn't we include them in Reserve requirements?

I think that you have that specific issue out for comment right now, and you might also at the same time indicate what the comment has been. It is appropriate, since we are talking about a Federal Reserve membership tomorrow.

Mr. MILLER. This is a very pertinent and important subject. There are several comments I would like to make.

One is, of course, that the very process of financial development of institutions, in terms of the new experience with inflation, has resulted in an incentive to create and innovate and find new techniques to economize on the source of money, and therefore to avoid the Reserve requirements.

We have seen this in terms of the development of such things as the repurchase agreement markets that you mentioned and a lot of other techniques.

At the same time, we have seen nonbank financial institutions also become active in a different way as to the nature of their deposits.

It is for this reason that we have looked upon monetary improvement and H.R. 7 not only as a need to have a legal structure, but also to make the decisions about redefining the aggregates we are tracking so that we relate to the realities of today and not to the conditions of the 1960's or the 1950's.

So, as you know, we have a project underway throughout this year to look at the definition of all the monetary aggregates, to have inputs from all those who are interested, to have experts from all walks of life comment. From this we hope to synthesize a proposal this fall, which we will then put out for further comment, so that by the first of the year we can have more perfect aggregate definitions that are related to the function of money and deposits more than to where they exist.

We don't know what those decisions will be. We have had two important seminars with outside economists and experts and congressional staff participating, and we're hoping that all of this process will help us address the kind of problem you are bringing to our attention.

Mr. WYLIE. Thank you very much. My time has expired.

The CHAIRMAN. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Mr. Miller, I am delighted to see you here. Just to follow up on the point made by Mr. Wylie, if I am reading his chart correctly and your report, on page 21, there was only a relatively slight increase in the price of oil between early 1974 and early 1979; and yet prices increased over 50 percent during that same period of time.

My point is, if this chart is right, and I am reading it correctly, I just don't think that we can blame recent increases in the rate of inflation entirely on oil prices.

Mr. MILLER. May I just comment on that particular point?

Mr. NEAL. Yes, sir.

Mr. MILLER. As you will recall, there were, in 1973 and 1974, even higher inflation rates than we are experiencing today as a result of this

same kind of oil shock. And you will recall that one of the consequences, for whatever reason, including policy actions, was that we had a severe recession, the most severe recession we have had since the Great Depression. And in that process, we did wring out some inflation, bringing it down to about a 6-percent level entering that period. Because of this worldwide recession, the demand for oil dropped and the capacity of OPEC to put in price increases abated. So we went through a period of low activity, high unemployment—9 percent unemployment—and we got inflation down somewhat. But we didn't address the fundamental policies adequately, and we came back on a reflation program. Now we have seen ourselves in a condition with a high demand for oil; we have not curtailed our appetite. The result is we are once again exposed to this market action of tight supplies and a cartel supplier who can impose price increases upon us.

Once again, whatever may have been the natural cycle as a result of the reflation, we have added another layer on top of that, just as we did in 1974.

Mr. NEAL. I couldn't argue with that. I did want to point out, though, that we did have accelerating inflation in 1977 and 1978.

Mr. MILLER. That is absolutely correct.

Mr. NEAL. And no very large increase in the price of oil. So I am just trying to point out that in my own opinion, we cannot blame that inflation on the price of oil.

Mr. MILLER. May I speak to this again?

The effect of the recent change in the price of oil is not to bring about the 8 percent inflation that we were experiencing, but to add 2 percent on top of that. We can't blame that for the 8 percent.

Mr. NEAL. Well, if I may, I want to get to two questions. It is my understanding of the way our economy works, that if the Federal Reserve creates money at a rate faster than the economy is growing, that is inflationary. And we can try to quantify that. We have tried before, and I think it is about 60 percent of the rate of inflation measured year to year, but that is really not important. It is just sort of a basic statement that, in fact, if money growth exceeds the rate of growth in the economy, that is inflationary.

In March of this year, the House Banking Committee passed a resolution, with only one dissenting voice, and that report called for a rate of growth in the money supply of about 6 percent for this year, 5 percent for the next year, 4 percent for the next year, 3 percent for the next year, and then to be essentially left at about 3 percent. And my questions are these:

No. 1: Do you agree with this general understanding I have of the way our economy works? And No. 2, if you do agree, why wouldn't it be a good idea to follow this sort of steady, moderate reduction in the rate of growth of the money supply instead of the rather erratic pattern that we have gone through recently?

Mr. MILLER. Mr. Neal, may I call your attention to the charts starting on page 44.

Mr. NEAL. What page?

Mr. MILLER. Page 44. Before we look at them, I just want to try to make one distinction. Perhaps I will oversimplify in order to make the distinction, but I will try it.

Let's divide inflation into monetary inflation and other inflation. I don't think the OPEC price increase was brought about by the change of money supply. Once you take that out and look at monetary inflation, then we certainly agree, and it has been our posture to fight inflation by bringing down the rate of growth in money and credit over time, thus wringing out the inflationary pressures while doing the least damage to the overall economy.

On page 44, you will see, in the bottom panel, that in the recession of 1974-75, money was growing at a low rate. It picked up, as the economy recovered, to a 7.9 percent in 1977.

My first testimony before this House committee was on March 9, 1978. We said then we needed to bring down the rate of growth in money. Let's look at the record. The record is 7.9 percent in 1977; 7.2 percent in 1978; and so far this year, on an adjusted basis, less than 6 percent.

If you look at M_2 , which does not have the ATS problem, you will see for 1976, 10.9 percent; 1977, 9.8 percent; 1978, 8.4 percent, and this year so far, 6 percent. Our effort is going to be to continue that process, with some adjustment for things like OPEC that we can't deal with through monetary action alone, until we win this "war."

Mr. NEAL. Well, I quite agree with what you are doing, and I am personally very happy to see that it is just under 6 percent. My question, though, was: Why go from $8\frac{1}{2}$ percent to 4 percent, in a very short period of time, and then back up to some higher percent, between 6 and 7, to arrive at that rate of growth of about 6 percent? Why not just go slow and easy?

Mr. MILLER. You may be getting on a touchy point. I have decided the best policy for me, is to have no memory of monetary policy before March 8, 1978.

Mr. NEAL. Let's see. I believe it was—in March of 1979 that the Banking Committee—

Mr. MILLER. In March 1979, 1 year after I joined the Fed, the growth rate of the monetary aggregates was slower. Even the staff is nodding.

Mr. NEAL. Mr. Miller, I have the greatest respect for you, I know you have a difficult job, and I think you are an outstanding individual. Let me just ask this, though: Would you agree that if we would follow the course of moderate, slow decline in the rate of growth of the money supply over several years, until it reaches about 3 percent, that that would be a big help in our war against both inflation and recession?

Mr. MILLER. I agree completely. And let me just restate what I hope this report says, namely: that we set these ranges at the beginning of the year for M_1 , M_2 , and M_3 ; we have been living within them after the original downward adjustment, because of the restraint we took last year; we have kept within the ranges; and those ranges contemplate the slow growth that you talk about. Tentatively, we have set the same ranges for next year, but there are so many uncertainties right now we don't know.

But that continues to allow us room to accomplish what you were saying, Mr. Neal, and I think your general philosophy is exactly the same as ours. I don't want to be defensive and I don't want to look back at past policies and be critical. All I can say is, our effort is to

accomplish just what you are talking about; to try to do it year after year, without wrenching the economy; and to change back to more of the market system in the process. You must remember that you have to look at all of this against a background that not long ago adjusted economy activity not by monetary restraint, but by closing the window on credit in housing.

From 1966, in every cycle we have shut down the window on housing; that left everybody off the hook on the monetary aggregates, because you could just shut down an important part of the economy.

In 1972, fourth quarter housing was at an annual rate of 2½ million starts. At the end of 1974, 8 quarters later, it was at a rate of 90,000. Financing was not available.

Mr. NEAL. I am very much aware of what happened. I just hope we don't do that again. That is my concern.

Mr. MILLER. We are trying to get back to a market decision. Don't shut the window; put in the restraint on money and credit and let monetary policy work uninhibited within a market economy. In such a case, I think we will accomplish what you want, and we will be more perfect in our own performance.

Mr. NEAL. Thank you, Mr. Chairman. We will recess the committee for a few minutes to record our votes.

[Brief recess.]

The CHAIRMAN. The Chair will recognize Mr. Evans.

Mr. EVANS of Delaware. Mr. Miller, in a recent regulatory interpretation, the Fed reversed itself to allow small savers to pool their funds in order to obtain money market certificate rates of return on their deposits that would be higher than what they might ordinarily receive. But member banks were prohibited from soliciting pooled deposits or from soliciting deposits on the basis that they would be pooled by the bank.

I wrote you requesting an end to this ban on soliciting pooled funds. You advised me that the lifting of the ban on soliciting pooled funds would have an adverse effect on the administration of the deposit interest rate ceiling structure.

I recognize that you may have a problem from that standpoint, but I also have some great concern, Mr. Miller in light of the first amendment provisions, as to whether or not the Fed can legally prohibit member banks from advertising this type of pooling provision.

And my caveat would be: I understand your problem, but I think there is a concern from a constitutional standpoint.

Mr. MILLER. I am not a constitutional authority, but let me describe to you what I think is the common interest we share. We all need to return to a market system where the rates paid to small savers would be competitive, and small savers would be entitled to the kind of market rates that are available to others.

Our problem is that we have built a number of major institutions, intermediary financial institutions, whose portfolios are now locked in to long-term mortgages. I am talking about thrift institutions. And the possibility of adjusting upward their average portfolio yield is a very slow process. If they suddenly were required to pay full current market rates on what have been ceiling regulated over the years they would all be in a loss position and we would threaten the finan-

cial viability of very important institutions. So we have to balance the strong equity demand of small savers against the practicality and the essential need of this society for financial intermediaries.

The money market certificates were issued as a means of turning back to the marketplace, as much as we could, without triggering that economic problem for the thrifts, and the ceiling rate was set at \$10,000 to be the same as the ceiling rate for an individual buying a Treasury bill.

Suppose an institution says "We now have \$10,000 certificates, but we will hold them here and give you pieces of them for \$100". Then small savers would take all their money to the institutions that did that, which means you would destroy money for housing or you would bankrupt the institutions who have to raise interest rates to hold their funds. We have to weigh that problem against the problem of equity and try to pursue the phasing out of regulation Q ceilings over a time that allows adjustment, as is being proposed to the Congress.

Now, on the question of "Why, then, do we permit funds to be pooled at all," the answer is simple. I don't know how to enforce a regulation that prevents you or your neighbors or your children from putting your name on an account, buying a certificate, and agreeing that you will divide it up among you. I think to put in a regulation unenforceable against individuals merely creates a public attitude of disrespect for law. They won't abide by it; therefore, they disrespect it.

So we recognize the practicalities; you really can not enforce that law upon individuals; you can't find a way to do it. It would take an enormous number of investigators, and it just isn't worth it.

This is a nationally important problem. We have to go through an adjustment process, and no one institution should try to take advantage of this and defeat the very purpose of the ceiling by breaking down this whole structure.

While I am not really aware of it, it seems to me that to allow institutions to imply that "if you come in, we will act through subterfuge to violate the law," is carrying the concept of freedom of speech too far.

Mr. EVANS of Delaware. I am not too sure, Mr. Miller, that there is any subterfuge if you do act in the open.

Mr. MILLER. The other choice, Congressman Evans, would be to prohibit all pooling, which I guess we would have to do to avoid the other extreme consequences. This includes prohibiting pooling by individuals, in which case we would have a lot of people violating the law.

Mr. EVANS of Delaware. I understand your dilemma. Mr. Chairman, if I may, just a couple of very quick questions in the interest of time, and the fact that we are here under the lights.

I listened to the gentleman from Maryland, Mr. Mitchell, speak of the unemployment problem that is attendant with a mild recession, or a mild depression, as well as the types of restraints that are necessary to combat inflation, which hurts everyone and I agree that inflation hurts the poor the most.

But I go back to a question that you answered several months ago, and that was: Isn't it a good idea to roll back the minimum wage as it

relates to teenagers, because the teenage unemployment problem in this country is so great? Wouldn't that have the effect of giving more teenagers jobs? And wouldn't a job be better than no job at all, particularly in view of the fact that if you get the first job, you can go on to a second, and so on?

Mr. MILLER. You are absolutely correct. One of the greatest problems in developing more employment opportunities for all Americans is the transition from youth to adult, transition from preparation for work to work; that transition is very difficult.

When you start with many who, for whatever reasons and whatever disadvantages, aren't well prepared and aren't skilled, the process of learning a skill and learning the world of work is extremely important to their long-term well-being. Anything that would allow them to make that step, we ought to encourage, including a youth differential, or elimination of the social security tax on young people for a certain period of time.

Any of those kinds of methods that would get them into jobs, and get them experience with work, with learning skills, learning and moving on, as they always do, to better jobs, would be very important for society; I would highly support it.

Mr. EVANS of Delaware. I thank you very much. One more question, Mr. Miller. It seems to me that we have had a rather precipitous decline in savings in America, particularly in light of the savings in the developed nations of the world; we probably have the lowest rate of capital formation of any of the industrialized nations of the world.

Would you be in favor of some type of legislation that would exempt from taxation a portion of interest gained on savings?

Mr. MILLER. Your general premise is one of a high order of importance; that is, that we have a problem of capital formation and we have a problem of investment. I have not yet brought myself to believe that the preferred action, of all the possible choices of using tax dollars, would be to shelter savings. My reasoning goes something like this: those who need to be encouraged to save, those who have small savings and don't have the opportunity to find high yields or tax shelters, are those who have the lowest income tax rates; so tax relief has the least value to those who are most needy. To those who are in the highest income tax brackets, such relief as you speak of has greatest value.

Therefore, my preference—I am not saying that yours isn't a worthwhile idea—but my preference would be for more direct action, using whatever tax dollars we can allocate for the purpose to liberalize depreciation. This relates tax expenditures directly to the capital investments we so badly need to get productivity and technology gains.

Mr. EVANS of Delaware. You still feel, Mr. Miller, that we need to accelerate depreciation, and that it would be a substantial effort?

Mr. MILLER. I don't reject others. I just think it is the most effective.

Mr. EVANS of Delaware. Thank you.

The CHAIRMAN. Mr. Blanchard?

Mr. BLANCHARD. Thank you, Mr. Chairman, and welcome, Mr. Miller. There are some economists, I think, even within the administration, that believe that we are on the verge of a more serious recession than we had in 1975. I take it you would reject that kind of prediction?

Mr. MILLER. I don't see the case for it. One of the fundamental policies we have been pursuing, one of the fundamental objectives of monetary policy and other economic policies, is to bring about restraint in the economy, to wring out inflation while maintaining balance within the economy. Serious recessions usually will have to be triggered by some sort of imbalance.

Now let's look at the economy today. Consumer spending is being retarded, both by the drain-off of income to higher prices of energy which leaves less money for other purchases, and by psychological concern about whether gasoline will be available and whether certain activities should be engaged in. But consumer spending isn't being destroyed; it still has a solid base.

If you look at business spending, you will find a slight increase in capital expenditures. There is nothing in the outlook that would cause businesses to fly from new investment in the capacity modernizations, and cost reductions they need.

One of the most volatile parts of the economy is usually the inventory sector. There, we have an extremely good position of stocks even though, as sales fall, the ratio between inventory and sales will climb up a bit. But inventories are very clean in relation to past experience, and you don't have that imbalance.

Government spending isn't showing major signs in one direction or another that would bring about this deceleration. If you look at housing, we are expecting a moderate decline, but nothing like the 60-percent decline we saw in 1973-74.

So I think, if you look at each of the components of the economy and the overall picture, you don't find a case for a serious recession.

Mr. BLANCHARD. That is good to hear. You hear beginnings of a notion that Congress might well, next year, want to enact some form of tax cut or tax change to lessen the effect of a recession everyone is talking about. I think that may be based on the assumption that the Fed will not do anything different than it has done before.

I have several questions. One: Given the fact that OPEC has inflicted upon us what you estimate to be perhaps 2 percent additional inflation, what is the Fed doing in response to that? I am not sure I read your testimony clearly.

And two: If that helps not only fan inflation but perhaps induce a recession, or guarantee it, do you think it would be wise for Congress to respond on the fiscal side? Or is there something you are going to do through the monetary policy approach to help fight a recession?

And finally, I would like to know what your feeling is on real wage insurance. I notice you indicate we need to continue to work on the price/wage problem. Congress dropped the ball on that proposal. I thought it was a good one. I am wondering how you feel about that.

Mr. MILLER. Let me take the first question, if I may. One of the things we must resist is the temptation to finance the oil price increase and thereby merely add more inflation in order to maintain final demand. The purchasing power that is pulled away from other goods and services because of the oil price increase, if put back into the economy to generate the same demand, is going to produce even more inflation. The hard reality of the situation is that the Federal Reserve should maintain firmness and continue to be diligent in its effort to maintain the growth of the monetary aggregates within the ranges

that have been established and not be tempted, prematurely, to finance this sort of increase.

That means that the difference comes out of real growth; that is why we get a recession instead of just having a slowdown; that is what all of us in the country have to pay because of this event.

Now, what happens in the future? I agree with Chairman Reuss that we should not be panicked into precipitous action. We should be prepared to see this adjustment, unpleasant as it is, and get ourselves back on the track for the renewed growth within sustainable levels that we have been attempting. That is, of course, what we see; we see a moderate recession running through this year and early next year from which, without tax cuts, we will be able to begin to grow back.

We should hold our decision on that and keep a watch. There will be a time when we may want to make tax adjustments, because inflation rates do drive people's incomes into higher tax brackets and do represent an additional drag. When we make that adjustment, I hope we will concentrate on those kinds of tax cuts for individuals—such as a reduction in payroll taxes, which directly affect prices, provided we can take action which will keep social security funding sound—that not only give them appropriate relief, but also help us fight inflation.

I also hope we will take a look at tax considerations we have just discussed that would help us with our capital formation and investment. Therefore, I would hope that we would look at individual payroll taxes and accelerated depreciation for businesses. The combination of helping individuals with payroll taxcuts and helping businesses with incentives for investment that will get us the productivity and technological improvements we need, would both be the anti-inflation kinds of actions we need.

Mr. BLANCHARD. What do you think about the real wage insurance proposal?

Mr. MILLER. I think the idea of a self-operating system that uses the tax structure has a great deal of appeal. It is very attractive.

So far, Congress has been examining it but has not been convinced that the mechanics work. Because of Congress view of it, I have tended to think of other kinds of tax reductions, and I've tended to move my thinking toward these two that I have just mentioned. I have given preference to these others over trying to solve the problems that Congress has had with the TIP-type tax.

The CHAIRMAN. The gentleman's time has expired.

Mr. Cavanaugh?

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Mr. Miller, first of all, I would like to commend you for this report. I think it is the finest that I've seen, the most explicit and comprehensive since I have been a member of this committee, and the first one from my perspective that actually complies with the aspirations of the committee and the Congress in the passage of Humphrey-Hawkins, and I thank you for that.

I particularly commend you for including, as you do on page 48, a consensus of the Board of all of the economic indicators that led to the monetary aggregates that you have presented us with here today. I think that that is a goal that this committee has had and that the Congress and indeed the country has had, to have some sort

of a broader understanding of the goals and aspirations of the Federal Reserve in setting their monetary targets.

I think that at long last we have finally arrived at that, and I think it is beneficial. The picture that you paint is an excessively gloomy one, I think, not excessively in terms of reality, but extremely depressing, at any rate.

First of all, I would like to ask a little bit about tax cuts. Last week Lyle Gramley of the Council of Economic Advisers recommended cutting corporate income taxes and allowing writeoff for plants and equipment and raising the investment tax credit as the best way to regain productivity. If the administration decides that a tax cut is necessary to combat a recession, would you favor placing emphasis on these kinds of cuts, on payroll taxes or on general income taxes?

Mr. MILLER. For the business side, for investment incentives, Mr. Cavanaugh, I would favor the accelerated depreciation. Very quickly, my view is that if you ask business what they would prefer, they would prefer a general corporate tax cut. But the trouble with that from the point of view of our national policy right now is that it would not guarantee any particular reaction.

A tax cut could merely improve cash flow. It could increase dividends. It could increase cash in the bank for the corporation. But it wouldn't necessarily go into the kind of spending and modernization that we need.

An investment tax credit is an approach that is directly related to investment and therefore is a direct incentive or an offset to the risk of investment. But because it is a forever forgiveness of tax, and because the tax reduction all happens in the first year, it is expensive from the Treasury's point of view.

Accelerated depreciation, on the other hand, does make the formula for calculation of discounted cash flow, which a corporation uses to decide the risk of its investment, more attractive. From the Treasury's point of view, it does not forgive the tax; it merely defers it. And it does spread it. So it gives a bigger bang for the buck from the Treasury point of view. It is what I prefer.

As to individual cuts, I think I would prefer something along the lines of the payroll tax reductions we just mentioned. I would think that the thing to do is to keep the retirement features of social security actuarially sound and funded with contributions. But such things as medical benefits under the social security umbrella—which is not a question of putting money aside now to pay a pension 30 years from now: they are current expenses for current illnesses—these might be funded by general revenues to allow us to take pressure off the direct payroll revenues.

That is the kind of approach that might be worth looking at.

Mr. CAVANAUGH. I agree with you particularly on the social security area.

In terms of your economic projections, you are projecting, and the consensus view of the Board of Governors seems to be, that we are entering, and will be experiencing, a worse recession than the 1973-74 period. Your real GNP projections are minus two to minus one-half for 1979 and minus one-half to plus two for 1980. In 1973-74, the GNP was minus 1.4 in 1973 and minus 1.4 in 1974 and 1.3 in 1975.

Are we in fact embarked upon a worse recession than the 1974-75 recession?

Mr. MILLER. Mr. Cavanaugh, let me get you the correct figures. I believe we have some discrepancy in our figures. The recession we are now looking at is considerably milder.

Mr. CAVANAUGH. I am on page 48 of your report.

Mr. MILLER. Look at the fourth quarter to fourth quarter on page 50; it is very important. This is the line of real GNP growth, including our range. If you look in the little inset you will see the actual figures; you will see that, fourth quarter 1973 to fourth quarter 1974, there was a minus 3.5 percent real growth. In 1979 we are expecting somewhere between a minus two and a minus one-half. Even if you took the most pessimistic view, you can see how much milder the dip would be.

There may be some discrepancy that I am not familiar with.

Mr. CAVANAUGH. The 1974-75 figures I was citing were from the economic indicators, June 1979, prepared for the Joint Economic Committee by the Council of Economic Advisers.

Mr. MILLER. The difference is looking at figures year over year or fourth quarter over fourth quarter. The difference, Mr. Cavanaugh, is between fourth quarter-fourth quarter and average for the year. If you look at our figures on the average basis, it would be even less negative.

Mr. CAVANAUGH. I understand the difference. So you are not then—

Mr. MILLER. We are looking at a milder situation. I hope that chart on page 50 shows graphically the kind of drop-down and trend toward recovery that is quite different in its characteristics from the one in 1973-75.

The CHAIRMAN. The time of the gentleman has expired.

The Chair will now recognize Mr. Kelly and ask him if he will preside for the 5 minutes of his questioning and then recess briefly, by which time I hope that Ms. Oakar and Mr. Leach and others would have returned, so we won't have to impose upon Mr. Miller much longer.

Mr. KELLY [presiding]. Mr. Chairman, for the first time, the country is now in good hands. [Laughter.]

Mr. MILLER. You better change the nameplates. It won't look good on television.

Mr. KELLY. Well, it may help my social standing. [Laughter.]

I would like to inquire of you, what kind of impact do you believe the OPEC increases have had during the portion of 1979 that has expired? What percentage or what portion of the inflation would you attribute to OPEC?

Mr. MILLER. Mr. Kelly, we are expecting that the oil price increase in 1979 will contribute 2 percent to the implicit price deflator, which we expect to be in a range of 9½ to 11 percent. Our staff points out to me that about a third of this has already impacted us. So I would say we have already received probably seven-tenths of a percent more inflation from that factor.

Early in the year, of course, the very high levels of inflation were mainly caused by two things. One is food, where the very high in-

creases have now dropped off. In the first quarter, food was more of a factor than energy. But energy was the second very big factor.

Now the biggest factor is energy, and it will increasingly be energy.

Mr. KELLY. Here is my question. It would be just a little bit less than intellectually honest to say that inflation has been caused by OPEC?

Mr. MILLER. It would be improper to say inflation has been caused by OPEC. It would be proper to say that the already severe inflation we had for the year has moved to a new plateau, about 2 percent higher, as a result of OPEC.

Mr. KELLY. Now, there is another influence in the economy that I would like to ask you about. Do we have a food shortage in the United States, as far as you know?

Mr. MILLER. There is not. There are certain kinds of food that are in short supply.

Mr. KELLY. Wheat, corn?

Mr. MILLER. No; there is a decreasing supply of beef, and that has resulted in very high beef prices.

Mr. KELLY. But as far as the subsidized commodities, the feed grains and cereal grains, there is no shortage of those?

Mr. MILLER. No. There is, however, pressure upon those commodities right now because of some worldwide tightness in supply.

Mr. KELLY. But that is something that has developed very recently.

Mr. MILLER. Very recently.

Mr. KELLY. I wonder if you have any thoughts on why it is beneficial, when we have an overabundance of a commodity, for the Government to use the taxpayers' money to stimulate the production on the one hand, and then to have a reserve program where we are encouraging the farmers not to produce, so that at the same time we are encouraging them to produce more and encouraging them not to produce quite so much. And then we move to a commodity such as energy, oil, and we are discussing now that we are going to add a new tax on the production of oil, that is, the companies that produce oil will be taxed more when we are in short supply of domestic production.

Is there some symmetry to that in economics? Or would it be better to reverse that and stop the stimulation of farm production and start stimulating the production of domestic oil?

Mr. MILLER. I think there are always analogies that can be drawn. We ought to be careful, however, in drawing an analogy between agricultural products which depend upon soil, weather, all kinds of other factors, and energy, which exists in the ground. Because of the cyclical nature of agricultural products, there is, I think, a wisdom to our policy: We have learned from biblical admonitions that we should set aside our grain stores in good harvest times because there will be famine times.

I think the idea of reserves in products that depend upon weather and climate is quite different from the question of whether we should build reserves in energy. I don't mean to duck your question, because there are certainly reasons why we should use every market incentive we can to help create conditions where we will search for, find, develop, and produce, more indigenous sources of energy.

Mr. KELLY. I have run out of time. I have to go vote. And I am going to relinquish the chair to my colleague from New York.

Mr. GREEN [presiding]. I would like to return to the question that Chairman Reuss mentioned during his opening remarks, relating to the statement on page 41 of your report that the impact of the ATS and NOW accounts on M_1 expansion has been smaller to date than expected but that the FOMC is retaining its original range for M_1 .

Does this mean in essence that the FOMC has somewhat tightened up its target for M_1 ?

Mr. MILLER. Mr. Green, our intention is to maintain the same posture. Let me try to explain using the chart on page 44; we may have to refer a little more to M_2 this time to avoid confusion. Those red lines on the top panel on page 44 represent—using the “old” basis of M_1 unadjusted for ATS— $4\frac{1}{2}$ to $7\frac{1}{2}$ percent growth. Our growth targets would be brought down toward 6 percent on average unadjusted for ATS. If you adjust for ATS—assuming 3 percent ATS effect—our midpoint is 3 percent. If we only have $1\frac{1}{2}$ percent ATS effect, then this chart could show a $4\frac{1}{2}$ percent midpoint and still be within the range for monetary control purposes.

We only ask you to bear in mind that we are within the range when you look at our performance this year. We won't know until the end of the year what the final impact of ATS is.

Mr. GREEN. If you were originally allowing 3 percent ATS effect and there has only been $1\frac{1}{2}$ percent ATS effect, then this range, instead of being a $4\frac{1}{2}$ – $7\frac{1}{2}$ range is really a 3–6 range.

Mr. MILLER. To date the ATS impact has actually been $2\frac{1}{4}$, so, therefore, you could look at this figure as being 4; it seemed to us better not to confuse you. This is a difficult problem, which I apologize for this year, caused by that technical change. Perhaps we should have shown it differently. Perhaps we should have shown $4\frac{1}{2}$ and $7\frac{1}{2}$, and then made a “phantom” change of the figures using the old basis.

But we started off on this path and we thought it best not to shift on you in midstream.

Mr. GREEN. In other words, you are saying it is three-quarters of 1 percent off?

Mr. MILLER. At the moment. We don't know what will happen for the rest of the year.

Mr. GREEN. Let me turn to this committee's report. After the February hearings, my understanding is that this committee recommended that the Fed plan on dropping its targeted rate on monetary growth slightly each year, and specifically on dropping the midpoint of the M_1 range by 1 percentage point. Yet I gather from your report that tentatively you do not plan to drop your ranges next year, but instead plan to keep them the same as this year.

Mr. MILLER. I would like to clarify that. If you look on page 44, at the bottom panel, you will see that in 1977 the fourth-quarter-to-fourth-quarter change in M_1 was 7.9 percent. We brought it down in 1978 to 7.2 percent. And if you look at today's figures, it would be less than 6 percent on a comparable basis.

Our ranges for next year have not been changed, because things are so uncertain. Our policy posture is one of continuing on that gradual decline. But we are not able at this point to identify just how that can be accomplished until we see the working through of the recent economic shocks in our economy.

If you look on page 45, you see the same sort of change in M_2 in the bottom panel; going from 10.9 percent in 1976, to 9.8 percent in 1977, to 8.4 percent in 1978, and so far this year to only about 6 percent. So we are accomplishing, in this broader aggregate, quite a sharp reduction over a number of years. This is the third year of reduction. Our hope is that we will be able to come back to you in February and tell you that we are still on that kind of a path. What degree and how far, we're not quite sure.

Mr. GREEN. I guess what troubles me is that the Humphrey-Hawkins legislation did call for setting the next year's targets at this time, and the report is rather vague on that. And your testimony now emphasizes the tentativeness with which you are talking about next year's numbers.

Mr. MILLER. Yes. In different times perhaps we could be more precise. But the last 6 weeks have brought on such interesting changes, and the President's initiatives have not been quantified yet, and our own redefinition of the aggregates is waiting this year. It is one of those times when, to be honest with you, we must tell you that we don't want to see any change in the long range objective as you have suggested and we agree with. But we are not able to quantify it at this stage, because of these events. We might, from time to time in the future, have additional midyear problems.

I hope next year, at midyear, that we will be able to come to you with a more precise outlook for 1981 and give you something a little more concrete. We are extending the same bands, which means we have room to accomplish the target you have in mind.

Mr. GREEN. Let me turn to another subject which concerns me, and that's the status of the international banking facility. As you know, for us in New York that has important economic impacts, and it is estimated 5,000 to 10,000 jobs could be involved. I appreciate the concerns you have, but I would suggest that it may be easier to regulate these activities and make sure that they are not leaping back onshore when the paperwork is available readily onshore to begin with, instead of on some obscure Caribbean islands.

I was wondering what you see as the status of that and the timing of your making a regulatory decision on that.

Mr. MILLER. Mr. Green, the Board was struggling with a series of issues. We have quite adverse comments, as you know, and a good deal of concern and opposition to the IBF concept. We think it has sufficient merit that we should not abandon it. Therefore, our decision yesterday was to not approve the present application, but to review it and reconsider it within 6 months, with the additional knowledge we gain as we carry through the International Banking Act; that act is on factor. We haven't yet implemented it.

Another factor is the pending legislation, H.R. 7, that could affect the whole area. Another possibility is what is going to happen with Edge Corporations and the rights of banks out of New York to have equal access to this facility. Another issue is the McFadden act report that is due very soon, and we don't want to fly in the face of that. Because of these considerations, it seemed better neither to reject the proposal nor to move forward with it at this point, but to let some of these changes be digested and to let us get a handle on this issue before we move ahead in any way.

I know you have a concern about this, and we want to assure you that we are not trying to kill by delay, but we are trying to be responsive to some of these broader issues which we think are getting resolved as weeks go by.

Mr. GREEN. Let me yield to Mr. Leach.

Mr. LEACH. Mr. Miller, on page 19 you present a chart showing the decline of the dollar since President Carter took office. The decline is interrupted by a plateau which has lasted from the beginning of the dollar support program last November until today.

Can you tell the committee what has been the total cost of the dollar support program? And in this regard, it is interesting to note that as of today the dollar has declined almost to the point reached before President Carter's announcement on the first of November, which at that time was intended to restore world confidence in the American economy, as well as world respect for leadership in the White House.

Mr. MILLER. Mr. Leach, as you know, the figures on this are published on a quarterly basis, and I will give you the figures through the last public report. I believe—and the staff will correct me if I am wrong—that the total cost for this whole operation in terms of the exchange rate losses suffered by the Federal Reserve were about \$10 million. This involved very large intervention activities; in relation to size of the activities, this was quite a modest cost especially in terms of importance of the contribution of that action to reducing our inflation.

The decline of the dollar—this is on page 19—from September 1977 through October 1978, contributed 1 percent to inflation last year. As it works its way through contracts and prices, we will have 1 percent more inflation this year. One percent last year, and 1 percent this year have cost consumers in America \$30 billion.

Mr. LEACH. Does the \$10 million loss include the loss of the trading value of the gold which has now reached about \$296 an ounce?

Mr. MILLER. The loss that I mentioned was to the Federal Reserve only; that was for the whole period. The Treasury has an exchange stabilization fund; I don't know what their loss, if any, was. But no, these figures do not include any effect of gold one way or the other. As to the gold sales, one has to determine at some future date whether the choice to sell gold was made at the right time and whether the intervening use of resources and savings—

Mr. LEACH. Certainly, at the present time, we can—

Mr. MILLER. The Treasury got less for gold than it could have sold it for now, but if we succeed in our anti-inflation program in 5 years the costs could be different.

Mr. LEACH. Given your new projected inflation rates, it would appear that the overall program of the Fed, of the Congress, and of the administration, has been somewhat of a failure. Having said that, I would point out that the Republican Party, through the Republican Policy Committee, came out last week with an alternative economic plan which included a \$36 billion tax cut. The plan called for an immediate and permanent personal income tax reduction of about 10 percent; the indexing of personal income taxes; the freezing of social security taxes at their present level; and the speeding up of the depreciation rates for structures, equipment, and vehicles.

Several of these points you have touched upon in answering earlier questions. However, would you support the Republican alternative, particularly in light of the fact that during the last 3 years we have seen the ineffectiveness of a higher tax program and this would be an alternative based on lower taxes.

Would you comment on the Republican alternative?

Mr. MILLER. Let me first comment on the statement that our anti-inflation program hasn't worked. I have been in Washington less than a year and a half. In that period of time, a whole array of policies has been put into effect which represents a comprehensive strategy to wage a war against inflation. I think you have not given yourself, Mr. Leach, adequate credit for the role of Congress in putting these policies together. They are important and fundamental policies; they are effective. They cannot, at this point in time, control an OPEC situation; that involves a longer term transition in terms of alternate sources of supply of energy.

But let's tick off the policies that have been put into effect in this period of time. One, a complete redirection of fiscal policy from larger deficits to smaller deficits and toward a balanced budget and a lower percent of GNP represented by Federal expenditures. I give Congress great credit for that. It was a courageous and important decision, and I would not want in any way to overlook the importance of it. I wouldn't want to reverse it; I would not want to have an \$80 billion deficit next year. We have heard from Republicans and Democrats, since I have been in Washington, of the importance of fiscal discipline to avoid repeating what was done with whatever intentions in the past. When we entered this decade, this Nation, almost 200 years old, had then built up a Federal debt of about \$375 billion. It is now over \$800 billion.

I think Congress ought to be given great credit for fiscal direction to counter that trend.

The second policy is an incomes policy—

Mr. EVANS of Delaware. Mr. Miller, if we might recess for about 7 or 8 minutes. We have to answer a call to vote.

[Brief recess.]

The CHAIRMAN [presiding]. Mr. Watkins.

Mr. WATKINS. In regard to the trade deficit, our biggest purchases have been in foreign oil, roughly around \$50 billion. Now, what, in your opinion, is the effect of our large foreign oil purchases? According to numerous reports, a lot of this money is coming back into the flow of our country's money market, increasing the supply of our dollar, creating more demand for our products, and basically having the effect of driving the cost of those products up.

Is that a significant factor, or is that a variable which you see is also playing havoc with our policy?

Mr. MILLER. The reflow of petro dollars has, of course, been a major event since the oil embargo of 1973. I would again oversimplify for a moment by saying that, if we held our economic output stable and there was the kind of change that we have recently had in OPEC prices, the effect of that would be somewhat like a tax. You pay more money for the same product; you don't change the quantity, the volume of the oil, or the amount of output of the economy as a result of that.

That money flows overseas and out of our economy and no longer represents domestic purchasing power. It goes to foreigners instead of Americans. They buy the products that Americans would have bought had we kept that money here and to that extent output is kept up. To the extent that it isn't used to buy goods and services in the United States, it becomes a financial asset, a future claim for goods and services. It may be invested here or it may be creating instability in exchange markets as it is converted to some other currency to make a demand on some other economy, either as a claim or as actual purchasing power.

The impact of that, short term, as we try to point out in the report, is to transfer real resources overseas, away from Americans, into the hands of foreigners either to purchase goods and services or to create claims on us for the future.

Mr. WATKINS. I was looking for a justification for the effect of what I have been indicating. Also, I wanted to talk to you about consumer credit and the purchasing power of the consumer. Today we have easy purchasing power for the consumer, where just a few short years ago we had to put money down to purchase an appliance, clothing, or any other depreciable item. Now it seems like we are making greater use of the credit card and the repayment period is being extended over a longer time period.

Do you foresee this as having an effect also? And do you think there is something that might be done?

Mr. MILLER. I have been concerned about the general level of debt of households—consumer and other debt—because it has risen to relatively record levels.

Recently, we have seen the amount of money required by households to service their debt rise to a record level in relation to disposable income, so that 23 percent of disposable income—the highest percent ever—has been devoted to debt service, which means that consumers are heavily burdened by debt. There has been less in the mortgage area than you would expect from the level of activity in housing; a great deal of the family debt increase has been in installment debt.

That has concerned us, and I would say to you the good news is that, even before the recent shock, our policies had already begun to dampen consumer demand and there had been a downturn in that statistic. We were moving down from that high commitment of family income to debt service and lowering it; it was already beginning to attenuate.

But I might point out, before any of us can carefully evaluate what is the right level of family debt in today's circumstances, we have a demographic factor: We have had the wave of World War II babies coming to marrying age, and at that age from 25 to 35 there is greater tendency to accumulate debt—to buy that house, buy that refrigerator, buy that first family car—than there is for people 55 to 65. When a greater percent of society is shifted into a different age bracket, you do get a pickup; that may have been a factor.

The second factor has been the movement of women into the mainstream of employment, which is a very positive factor. This has created many two-family incomes and has increased the capacity of families to incur debt. This may be a factor.

The credit card may involve an extension of credit, but many credit cards are not used for credit but merely for convenience in billing. As

you know, there are some major cards that are often referred to as credit cards that aren't credit cards at all; they're charge cards. In my case, I charge things and at the end of the month I pay for them; I haven't used any credit, but my charges show up in these consumer debt statistics.

Mr. WATKINS. Let me see if I am interpreting something correctly. You said something about family credit. Were you including mortgage payments or appreciable items, as well as consumer credit on installment payments, which is mostly depreciable items?

Mr. MILLER. We were talking of mortgages on homes; we are talking about installment credit, which will show up in automobiles, durables, and even the purchase of nondurables, and about personal loans and personal finance.

Mr. WATKINS. Some figures I saw indicated a greater ratio or movement toward consumer depreciable credit than consumer appreciable credit, which would be found in homes or apartments or things of this nature.

Mr. MILLER. It was in the installment area that we had this rapid growth, and it was of concern. I am still concerned. But I just wanted to explain to you that we were conscious of this before any recent events. Last September I spoke on this subject and pointed out that this required very careful attention because if consumers get overloaded and delinquencies move up, you have destabilization. So far, consumers have handled their payments extremely well. Delinquencies have not gone up; they have gone down.

But I still am worried, and I am delighted to see that the debt burden is beginning to come down, which I think is a good trend. Of course, now, with the recession at hand, it will come down further.

Mr. WATKINS. Very good.

That is all I have, Mr. Chairman.

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

I apologize for having to leave in the midst of your response. Let me just repeat the essence of my question.

The Republicans have proposed a four-part alternative to the current economic program. The plan specifically includes a tax reduction of 10 percent; indexation of taxes; freezing of social security taxes at the 1979 level; and speeding up of depreciation rates.

Do you support part or all of the Republican package?

Mr. MILLER. I must confess I have not studied it, but I will give you several answers.

One is that I believe an immediate tax cut to stimulate the economy would be unwise. I do not believe it is called for in these circumstances and it would get us back on the track of big deficits and stimulative demand and more of the installment debt that we just talked about—all the things we're trying to get out of.

Second, as to the components—for I believe there will be a time when we should have tax reduction, in the 1980's—I do not at this point prefer a direct income tax reduction because I believe we should keep discipline in our fiscal and monetary policy. If that is true, then whatever tax relief we can give, I think we should try to give it in the payroll tax area, where you get both a reduction of tax to the individual and a reduction of cost to business and in turn a reduction of

prices which also helps the consumer. The consumer gets two benefits from one tax cut.

On the business side, I would prefer—and I believe you mentioned it—accelerated depreciation, which I do think is a very desirable policy. I don't know just when it should be phased in, Mr. Leach, but I think we should be looking at it.

Mr. LEACH. The timing would be the issue?

Mr. MILLER. Yes.

Mr. LEACH. Thank you.

The CHAIRMAN. Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

First of all, I want to thank you for appearing before our committee once again, Mr. Miller.

I do want to ask you a question relative to the question Mr. Neal asked you, about the fact that it appears that much of the "blame" for our economic distress is laid at the doorstep of the OPEC nations. I am wondering how you feel about the large oil companies in respect to the astronomical profits that they apparently have been making and what your concerns are, if any, regarding the decontrol of oil prices?

Mr. MILLER. The tendency to look for a scapegoat, I think, would be unfortunate. The condition of inflation that we are suffering from has built up over 12 or 14 years. For whatever reason, we have pursued a course that has made us vulnerable to action by outsiders. That outside action hurts us, but we can't blame them for our becoming vulnerable.

Ms. OAKAR. Well, I am glad you said that, because, frankly, the tone of your remarks, at least in your introductory remarks and the report that I have seen, seem to suggest otherwise. So I am glad to have that for the record.

Mr. MILLER. Congresswoman Oakar, I am glad to have cleared that up, because I was trying to say there is an oil price shock. It doesn't have to result in our assessing blame so much as in our becoming much more realistic, much more aware of the peril to this Nation and how critical it is that we unite and continue on a steady and effective course to wring out inflation. There is nothing more important to this Nation. I do not believe that a political-economic-social system can survive if we go through 20 more years of this.

I don't want to assess blame. We can blame ourselves collectively. I don't believe in original sin in the sense that I am responsible for the policies of 15 years ago, but I would say we are all in this position. My feeling is that instead of pointing fingers at oil companies or at OPEC or at the Federal Reserve or at Congress, we should recognize that we are all Americans and we are all interested in a solution. Oil companies should not have a disproportionate profit. Cash flow generated from exceptional profits because of current conditions should be plowed back into the development of alternate and effective energy resources; otherwise, they should not be allowed to be retained.

But I don't think any of us gain by finger pointing. We gain more by recognizing that this is a time for mutual acceptance of restraint, mutual acceptance of belt tightening. I have a sense that Americans are prepared for that, that they are prepared to give up something if they believe it is fairly shared and that there is a direction and a solu-

tion which gives them hope for the future and for the prospects of winning this war.

I hope that this report and anything I have said can be clarified to indicate my belief that Congress has done many important things in the 1½ years of my experience; too little credit has been given to Congress. Perhaps there have been some mistakes. But this is the time to put that aside and decide where we go from here.

Ms. OAKAR. Would you care to comment on the decontrol of oil prices or would you prefer not to?

Mr. MILLER. I will probably surprise you. My personal preference, if I were the President, would be to decontrol oil prices immediately. What you do with the money or taxes that might derive from such action is something else.

The reason I think that might be a desirable policy is that although it would have a one-time bad effect on inflation, it would also mean that we would start the process of adjustment much faster and we would have lower inflation next year. While we would have a quarter of bad news, we would have many quarters of good news. I think the change of direction is so important that I would take a shock like that so as to get downstream to wipe out inflation. That would be my personal preference.

Ms. OAKAR. Mr. Miller, on page 26, you didn't indicate that the Council on Wage and Price Stability had broad compliance with the wage standard.

Do you think that their guidelines have been more effective in holding down wages than prices? And again, I get into the reports of profits, et cetera.

On page 24, you indicate that the Consumer Price Index rose at an annual rate of 13½ percent. I guess my question is: Are workers experiencing a disproportionate share of the burden? I feel strongly—

Mr. MILLER. They shouldn't.

My view is that these voluntary standards have resulted in less increases in wages and less increases in prices than would otherwise have taken place, and that our wage action has been rather commendable overall. It is quite good.

Productivity has been poor, so the unit costs have gone up. But in terms of wages, it has been a very good program. We must give credit there, too, to unions and other employee groups who have been willing to accommodate.

I think businesses have also accommodated. What I don't know is whether, in the light of events, there should have been a tighter restraint on price increases because of the volume consideration.

Price increases are related to a level of activity. When you are operating a manufacturing plant and produce 10 percent more than planned, you don't add 10 percent more total costs; you only add 10 percent more variable costs. Maybe we should have had the standard a little tighter on prices.

Ms. OAKAR. I think if you have any material in that direction for the record, that would be very important.

Mr. MILLER. I will see if I can give you something in that regard.

Ms. OAKAR. Thank you, Mr. Chairman.

[In response to the request of Congresswoman Oakar, the following information was submitted for the record by Mr. Miller:]

REPLY RECEIVED FROM MR. MILLER

When firms are operating their plants below levels of utilization which provide the lowest possible total cost per unit of output, an increase in production leads to a less than proportionate increase in total costs. As output expands, variable costs associated with the increased use of labor and materials do rise. However, overhead costs such as property taxes, and insurance and interest payments, which must be incurred regardless of the level of production, are spread over a greater amount of output. As a result, total cost per unit of output declines. This reduction in unit costs, which is based solely on efficiency considerations, could be passed on to consumers in the form of smaller price increases than otherwise would have occurred. It must be stressed that the cost of savings are only possible when output is growing and firms are operating below economic capacity.

There is little direct evidence for individual firms or industries on the operating rates that are associated with producing at the least possible unit costs. Capacity utilization rates for manufacturing industries, however, are broad indicators of business operating levels. Over the past year, capacity utilization rates in most manufacturing industries were below their peak levels experienced in 1973. This evidence is consistent with the possibility that an appreciable number of firms were operating below economic capacity and that some reduction in total unit costs could well have accompanied the rise in output levels seen last year.

The CHAIRMAN. Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

I had some questions. I am sure that I will want to submit some in writing in addition. Mr. Miller, I paid close attention to your response to my colleague from Ohio, Ms. Oakar, concerning the increase in terms of domestic prices.

Now you put an absolute percentage of the OPEC increases at 2 percent.

Is that on the absolute scale that you are talking about, or is that on the consumer price index scale?

Mr. MILLER. This is on what we call the implicit price deflator, which measures what really happens in the total economy.

Mr. VENTO. But actually, on the consumer price index, it may be considerably higher.

Mr. MILLER. It could be, yes.

Mr. VENTO. I think it is important to note that if it is 2 percent there, it could be 3 percent or 1 or 2 percent next year.

The difference is important since we are used to dealing with the consumer price index.

There was a reference to domestic decontrol or phased-in decontrol and natural gas decontrol, as well as TILT regulations and all other sorts of things in terms of energy that are not addressed in your 2 percent absolute deflator.

Is that accurate?

Mr. MILLER. That is correct.

Mr. VENTO. So those are all additional costs. For instance, natural gas is one of the more significant ones that will be reflected in terms of costs that apparently have been permitted to go into effect.

Now the only problem in terms of absolute decontrol is the fact that if we had had absolute decontrol, we would have had an immediate absolute increase in the price of old domestic oil this year, rather than a phase in.

So there really is very little control. I mean there is no free market place in that system.

That would actually add to the price and add to the number of dollars that we are putting into these particular resources and add to our inflation problem.

So I just feel compelled to point this out because it has not been discussed here.

At one point, we pegged the cost of each percentage point of inflation, or of unemployment, as costing anywhere from \$18 to \$20 billion in terms of the Federal budget.

Aren't we better off converting that into Federal spending? In other words, are we better off spending it for unemployment and other types of welfare benefits, food stamps or whatever, or are we better off spending it on job creation type programs?

In other words, targeting for specific purposes, whether it is the National Development Domestic Bank, or an EDA-type of program. Do you think that we are better off spending for that type of activity?

Mr. MILLER. We are better off spending it on targeted programs to improve the employability and skills and upward mobility of those who are disadvantaged.

Mr. VENTO. So Congress may very well confront an increase in unemployment which you are predicting with such a program. And your suggestion here would be to put it into the very specific types of programs that are targeted?

Mr. MILLER. Yes. Mr. Vento, there is, as I understand it, in your present law, an automatic countercyclical targeted program that comes into effect when unemployment reaches a certain level.

So the Congress has already built in some automatic targeted efforts, and I think that is good. I am glad that they are on the books because you won't have to redo that. That is ready to go, as I understand it.

Mr. VENTO. But the unemployment projections that you have made, those that the administration has made, I take it, assume the use of those particular policies.

In other words, that those policies would be in place and hence, that we would still have the type of unemployment picture that you are presenting here.

Is that correct?

Mr. MILLER. The Council of Economic Advisers has taken that into account. I cannot promise you that every member of the Board of Governors has taken that into account. They may have.

The CHAIRMAN. I know that you are approaching the end of your testimony and I see Mr. Ritter going and I see the lights. Did you have a question, Mr. Ritter, that you could submit to Mr. Miller for the record?

Mr. RITTER. Well, I also, like Ms. Oakar, was concerned about Mr. Miller's view of decontrol. And I was interested in his response.

And what is interesting is that, unfortunately, you are nowhere near the decisionmaking process when the situations were considered. And as we were going forward with an enormous energy plan for the future, multibillions of dollars, did it occur to you that in the recent speeches of the President, the marketplace or the normal, traditional forms and structures of the American economy were not even mentioned?

It almost seemed as if Government is nationalizing the energy industry.

Did that make you worry a little bit? This Energy Mobilization Board, the security fund, and in the meantime, the allocation system sits there and the price controls sit there.

As someone from private industry with a long tradition of backing the concepts of the American economy, did that frighten you at all?

Mr. MILLER. I must say that—

Mr. GONZALEZ. Will the gentleman yield just a minute?

Mr. RITTER. I have to go and vote.

Mr. VENTO. I think it is my time. I want Mr. Miller to respond to the question of the gentleman from Pennsylvania.

Mr. GONZALEZ. I just want a unanimous consent to submit my questions in writing.

The CHAIRMAN. Without objection, so ordered.

Chairman Miller's responses to written questions submitted by Congressman Gonzalez in connection with monetary policy hearing on July 17, 1979.

Question #1: On page 2 of your report, you state that "exogenous forces will be causing intensified inflationary pressures and downward adjustments in the demand for goods and services."

- a. Would you state what the level of inflation would have been without the latest round of OPEC increases, all other things being equal?
- b. How much deeper a recession can be expected, owing to the OPEC increases?
- c. On that same sentence, regarding the impact of outside forces, you are really saying that monetary policies--at least domestic monetary policies--are just a very short stick in a very big fight, correct?
- d. If domestic policy can only serve to moderate the impacts of outside forces, doesn't it become more important than ever to coordinate policy with other central banks? Are you undertaking to do this?

Answer: Because of the complicated, dynamic inter-relationships within the economy, it is extremely difficult to separate out the effect of a factor like OPEC price increases; a rough estimate would be that the OPEC increases to date, taking into account impacts on prices of other energy sources and some other indirect effects, will add 2 percentage points to the rise in the general price level this year and almost another percentage point in 1980.

It is my view that, had the economy not suffered the oil shock--with its effects both on inflation and on aggregate demand--we would quite likely have succeeded in avoiding a recession. Rather, there would have been a period of moderate growth during which some of the pressures on productive resources would have eased, thereby helping to slow the pace of inflation.

Monetary policy continues to be an important influence on the performance of the economy, and there are some exogenous forces whose effects it might well be able to offset. However, monetary policy cannot simultaneously offset the inflationary impulse of the rise in oil prices and the contractionary impact of the income transfer to foreign oil producers. Appropriate monetary--and fiscal--policy responses to this exogenous shock can minimize the chances that these adverse pressures would set off cumulative departures from the desired longer-range movements to full employment and price stability.

Even extensive international coordination of aggregate demand policy could not overcome the fundamental impact of the OPEC action on international terms of trade and inflationary pressures. However, the cooperative efforts of governments can help to smooth adjustments around the world, and fortunately there has been good communication at the economic summit meetings and in the various forums for discussion among financial officials.

Question #2: A few months ago the United States activated its standby facility at the IMF, to help defend the value of the dollar. Since the OPEC increases, gold has been zooming up again, but the dollar has not collapsed or been seriously attacked. Do you attribute this to intervention in the markets, to a generally stronger U.S. economy, or to what? Are we fundamentally any better off now than we were then?

Answer: The effect of OPEC's precipitous oil price increase on the economic welfare of the citizens of the United States, and the rest of the world, is unambiguously harmful. Its effect on the exchange rate of the dollar is less clear and, among other factors, will depend upon how successful we are in limiting our oil imports in the wake of those price increases.

The dollar has come under some downward pressure in exchange markets in recent weeks and the Federal Reserve and the Treasury, in cooperation with foreign central banks, have intervened to limit the dollar's decline.

The fundamental factors that ultimately determine the dollar's exchange value appear somewhat more favorable now than they were on November 1. The slowdown in economic activity in the United States relative to that abroad is expected to lead to a surplus in our current account by 1980. And we have made a start in attempting to wind down inflation in the United States and to limit oil imports. These factors are all more favorable for the dollar. In the long run, the strength of the dollar will depend mainly on our success in wringing inflation out of the economy.

Question #3: On page 8 of the report there is a set of intriguing charts. The top one shows that personal consumption expenditures actually exceeded real disposable income in three out of the last four years. The bottom one shows that in the last four years household debt repayment has increased from less than 20 per cent of income to 23 per cent or better. Does this show that people are being forced to borrow in order to sustain their usual level of living, because inflation has eaten away their real earnings? And wouldn't this higher ratio of debt actually tend to lengthen a recession and increase its hardships?

Answer: The decline in the personal saving rate and the heavy accumulation of debt may reflect in part an effort to maintain living standards by households whose budgets have been squeezed by inflation; another element in the picture is the financing of acquisitions of houses and other assets expected to rise in price. Regardless of the cause, however, it is true that the resultant debt burdens may imply some reduced resiliency on the part of the household sector in the event of an economic downturn. The Board members were mindful of this in arriving at their projections of the economic outlook.

Question #4: You hear nothing more often than the refrain that the Federal government is the prime cause of inflation. Cut spending, they say, and inflation will die. But you say that outside factors are responsible, and at page 17 you show that real purchases by the Federal government have shown modest increases since 1975, and in fact are way down for 1978 and so far this year. Isn't it a fact that the present level of Federal expenditures is providing very little stimulus to the economy, and maybe none at all?

Answer: Federal purchases are just one factor in the overall impact of the government on economic activity and inflation. They represent a direct call on real economic resources and are an important component of aggregate demand. However, the other parts of the federal budget--federal transfer payments and tax revenues--most also be considered in assessing the influence of the federal sector on the economy. If one looks back at the record of the past two decades, one is confronted with the fact that the federal budget has been in deficit in nearly every year, whether or not the economy was operating at a high level. While the past year has seen some significant progress toward budgetary restraint, there has continued to be a significant federal deficit which has tended to boost aggregate demand despite a relatively high level of resource utilization and unacceptably rapid inflation.

Question #5: After the first round of OPEC oil increases there was a recession, and you seem to think we'll have one this time too. Our balance of payments problem was compounded by the fact that Europe recovered more slowly than we did, and this contributed to the sharp fall in the value of the dollar--a decline of 15% or so in 1977 and 1978. What kind of action can you take, or do you plan to take, to try and assure that the industrial world does not fall out of "sync" again?

Answer: It is generally recognized that our balance of payments problems were intensified during the last cyclical recovery because our recovery began earlier and was stronger than the recovery abroad. An international pattern of recovery that was more synchronized would have reduced balance of payments dis-equilibria and would have been desirable for that reason. However, one should also realize that a synchronized upswing carries with it inflationary dangers as pressures are put on industrial capacity and commodity prices on a world-wide basis.

On balance, it is desirable that cyclical patterns should be roughly parallel. With this in mind, the United States and the other major industrial countries have tried to coordinate their economic policies in such forums as Summit meetings and the OECD. Relative cyclical positions and external positions were taken account of in the Concerted Action Program of the OECD. Thus, economic expansion was encouraged in those countries like Germany and Japan where the external position allowed them to enjoy faster growth, while it was recognized that it was appropriate for the United States to moderate its expansion. These attempts at coordination have had some success as witnessed by the increased growth rates of Japan and Germany, and the reduction of the current account surplus in Japan, especially.

Question #6: Don't you really think that the industrial world should take concerted action to diminish or break up the power of OPEC?

Answer: It is imperative that the industrial world take concerted action to cope with the monopoly power of OPEC. Moreover, in the longer run the industrial world must face up to the problems connected with its dependence on a large but diminishing supply of petroleum for its energy needs, as well as to the special problem that so much of the known supply is controlled by OPEC.

One line of response is to economize on the use of energy, and to start down the long road toward the development of better and more reliable energy sources. On a multilateral basis, the International Energy Agency has a role in coordinating the responses of the industrial countries to OPEC actions. Here at home, the President has just announced a series of measures to deal with the energy problem.

Another type of response is needed to resist the power of OPEC countries--or even one or two of them acting alone--to cut off abruptly the supply of oil for political reasons. To deal with that problem we need to go ahead with building a strategic stockpile, even though that will put additional upward pressure on prices while it is going on. Once the stockpiles are in place, however, their existence is likely to help moderate price increases at times of temporary shortage in the future.

Additional Question: Will you provide the Committee with your assessment of the prospects for the international dollar over the next six months? Do you anticipate a continued pegging of the Federal Funds rate in the 10 percent range, in order to keep the dollar from falling? Will international considerations significantly limit the flexibility of monetary policy in dealing with the economic slide that many private economists now foresee?

Answer: The Federal Reserve does not make official forecasts of exchange rates. In general, however, there are a number of factors which point toward a relatively stable dollar. The slowdown in economic activity in the United States relative to that abroad should lead to a significant improvement in our current account balance, which is expected to record a surplus for 1980. And the President's program for reducing oil imports will have a favorable long-run impact on the dollar's exchange value.

The Federal Reserve will continue carefully to weigh international economic conditions in the formulation of monetary policy. However, that policy will continue to be directed primarily towards the creation of an environment that will lead to a sound economy and stable prices at home. We do not anticipate pegging the Federal Funds rate at any particular level although avoiding sharp shifts in policy will allow us gradually to wind down inflation without a severe economic downturn. In the long run, if the United States is successful in bringing inflation under control, the dollar's exchange value will reflect this success.

The CHAIRMAN. You may continue, Mr. Miller.

Mr. MILLER. My hope, my advice, if asked, would be that in implementing these energy policies, that we use the private sector, which has the skills and the organizing ability to carry out these things to the greatest extent possible.

While I know that some of my business colleagues have been concerned about the aspect that you have mentioned, I also believe that the President did not foreclose anything you have said, using his energy security corporation merely as a conduit to help fund private projects.

I hope that that is what he will choose to do.

Mr. VENTO. I have yielded. I have other questions that I can ask, too, and I intend to do so.

Mr. MILLER. Perhaps I can drop you a note on that.

Mr. VENTO. One of the points, one of the major things that the Fed has in terms of its impact on this is the monetary policy, the monetary restraint, how it translates interest rate increases in the system.

Now one of the things the Council on Wage and Price Stability did propose, they pointed out three areas. One was in food, 22 percent, another was in energy, 56 percent increases in terms of cost. And of course bank profits were up 29 percent.

That is a direct factor in terms of interest rates.

Now interest rates don't suppress credit the way that they are expected to, and I would suggest there was some discussion about their being overextended, that they do result in these large profits.

And I would just call your attention to that because I continue to have a concern about the overextension of monetary policy in terms of what it can and does accomplish.

Mr. MILLER. I appreciate the comments and concerns.

Mr. VENTO. Well, I think that my time has expired.

One other question. There have been parallels drawn, Mr. Miller, between the monetary policy and the circumstances that existed in 1974 and exist today. Do you think that the Fed is paying attention to the set of circumstances in which they maintained a tight credit policy in 1974 in the context of what is happening in the economy today?

Mr. MILLER. I believe there was an article yesterday in the Wall Street Journal suggesting that, in response to the oil price shock in 1974, the Federal Reserve may have been too accommodating and then, seeing that that policy was unleashing inflation, it may have put on the brakes too fast.

I think that this is the kind of question that you are getting at. I don't know whether that analysis is true or false, but I will tell you that we will do our best to avoid overreacting, shooting from the hip, acting without facts, becoming emotional. We will continue to do our best to guide the economy on a charted course. That would be best for all of us.

Mr. VENTO. Do you think that the Federal Reserve policy today is different from what it was 5 years ago in responding to this oil price increase? Do you think it is different in terms of the posture as to where you're headed as opposed to where the Fed was headed in 1974?

Mr. MILLER. I do, because I think that we have a different attitude on fiscal policy in Congress which is far more helpful to us and more constructive. Therefore, I think that we have a much more coordinated series of policies, and therefore I think that we can avoid the sharp amplitudes of swing that were perhaps brought about by the difficulty of coping anew with this kind of problem.

Mr. VENTO. Well, that sounds like a good note on which to end, so I will adjourn the hearing with the authority of the chairman.

Thank you very much.

Mr. MILLER. Thank you. I appreciate those last words.

[The following are written questions submitted by Congressman Jerry M. Patterson of California, with attached answers from Mr. Miller.]

Responses submitted to Congressman Patterson (per his July 19 letter) in connection with Chairman Miller's testimony of July 17.

Question #1: Consumer installment debt outstanding is at a record high today--roughly \$374 billion. If the recession worsens, the impact of loan delinquencies may seriously affect our financial institutions. What can or is being done by the Fed to counsel institutions on consumer lending policies and/or general safety precautions?

Answer: The debt burden assumed by some households is a matter of some concern; it could represent somewhat of a drag on the economy should income and employment conditions deteriorate to a greater extent than anticipated. Members of the Federal Reserve Board have been calling attention to this potential problem for some time now, in Congressional testimony and elsewhere. Such statements, it is hoped, have been helpful in encouraging due caution on the parts of both borrowers and lenders--while not intruding excessively in private decision-making or creating unwarranted alarm and consequent contractive pressures.

The more direct counseling of lending institutions occurs through the regular examination process. Examiners scrutinize loan portfolios and credit policies to determine whether banks are following sound practices; where unsound practices are detected, they are specifically criticized. Substandard loans are identified, and, when appropriate, examiners may indicate that a bank should forgo promotion of lending and undertake greater collection efforts. Examiners also may require charge-off of loan losses.

Question #2: Section 3 of a June 1976 Board publication titled "Improving the Monetary Aggregates" deals with conceptual and definitional issues surrounding the various M's. I am particularly interested in the impact of credit card purchases on the money supply. Let me quote from the report at page 11:

Credit cards and the "checkless society"

An increasing volume of purchases is being made on credit cards, and direct credits of wages and salaries to bank accounts and debits to purchasers' bank accounts by sellers through computer networks will probably spread in the years ahead, perhaps moving the economy toward an increasingly "checkless society" in the foreseeable future. Insofar as credit-card purchases and the elimination of physical bank checks merely provide more convenient and efficient means of transferring demand deposits, they do not call for any redefinition of the money stock--although they may lead to a higher velocity of circulation. Insofar as they actually involve creation of new transferable money by sellers who temporarily increase the spending power of buyers, they certainly increase the volume of credit, although they do not increase M_1 as now defined or as it might be defined in response to the financial developments so far considered.

If credit cards and a checkless society largely supplant present methods of payment, it will become desirable to redefine M_1 and the other deposit totals based on it in a more fundamental way.

I would appreciate your clarification of that statement.

Also, I am interested to know whether the Board now recommends changes in the M-1 definition to take into consideration the impact of credit card purchases?

Answer: The statement quoted is part of the report of "Bach Committee," a group of eminent private economists that--at the request of the Board--examined the monetary aggregates and submitted recommendations for improvements in concepts and measurement. These recommendations are

being considered in the Board's current examination of the definitions of the monetary aggregates. Staff work is continuing and the Board has yet to arrive at any conclusions, but it appears unlikely that the growing use of credit cards per se will require changes in the definition of M-1. As the quotation suggests, credit cards facilitate the extension of credit but do not themselves represent or create money. Rather, like many other financial innovations, they increase the volume of transactions that can be conducted with a given money stock, i.e., the velocity of money. In the case of credit cards, for example, many users find them a way of better controlling the timing of their payments, so that they need not maintain large checking account balances at all times to cover unexpected outlays. Ultimately, however, a payment must be made in the form of currency or transference of checking account funds--whether that payment is made by the consumer directly to the seller or by the consumer to the credit card issuer who pays the seller. Thus credit card indebtedness or credit lines do not constitute money, but their effect on velocity must be considered in assessing the impact of monetary policy on the economy.

Question #3: President Carter, in his nationally televised speech on July 15, touched on several problem areas of the American economy. One, of course, is our productivity level. The question that interests me is what are the most effective methods by which productivity can be improved?

- What is your view about approaching the problem in part by accelerated depreciation of commercial assets?
- What advantages or disadvantages do you see in terms of adjustments for inflation by accelerated depreciation?

Answer: Investment in more modern and efficient plant and equipment is a major element in the achievement of faster productivity growth. I strongly support the liberalization of accelerated depreciation in order to encourage capital formation. Such changes in the tax laws must be made, however, with an eye to the overall fiscal policy stance of the federal government and should not hinder the achievement of a balanced budget. At the present time, with a sizable federal deficit and strong inflationary pressures, it would not be prudent to initiate a major tax cut.

With regard to the question of adjustment for inflation, accelerated depreciation would offset some of the effects of the understatement of depreciation in an environment of rising prices. Other techniques, such as replacement cost accounting, could be employed; these other approaches have their particular relative advantages or disadvantages. I believe, however, that, in terms of getting the greatest stimulus to capital formation per dollar of tax revenue reduction, accelerated depreciation has distinct advantages since only firms making new investments in plant and equipment receive the tax benefit.

Question #4: This Congress is well aware of existing budgetary constraints and the commitments we must make to national priorities including energy, housing, mass transportation, and defense, among others. A question which I and many of my colleagues share is this: The recession may necessitate a tax cut. When should such a reduction occur and what type of mix for individuals and small business relief would be most effective in your opinion?

Answer: I do not at this time foresee the need for a tax cut in order to bring the economy out of the mild recession we appear to be experiencing. However, if a tax cut becomes necessary at a future time in order to bolster the economy--or is simply made possible by the growth of tax revenues related to the rise in incomes--it would be desirable to focus attention on those changes that would yield maximum benefits in aiding progress toward price stability. Prime candidates in this regard are cuts in payroll taxes, which would have the dual benefit of easing a regressive tax and reducing labor costs, and liberalized accelerated depreciation, which would encourage productivity-increasing capital formation. These tax cuts would benefit individuals and businesses of all sizes.

APPENDIX I



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BRIEFING MATERIALS FOR MID-YEAR 1979 MONETARY POLICY OVERSIGHT

Prepared for the Committee on Banking,
Finance and Urban Affairs
United States House of Representatives

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July 16, 1979

(109)

BRIEFING MATERIALS FOR MID-YEAR 1979. MONETARY POLICY OVERSIGHT

This briefing document has been prepared to assist the House Committee on Banking, Finance and Urban Affairs in monetary policy oversight conducted pursuant to P.L. 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 Laura A. Layman, Economic Analyst; Barry Molefsky, Analyst in Econometrics; and Frances C. Klaphor, Editorial Assistant.

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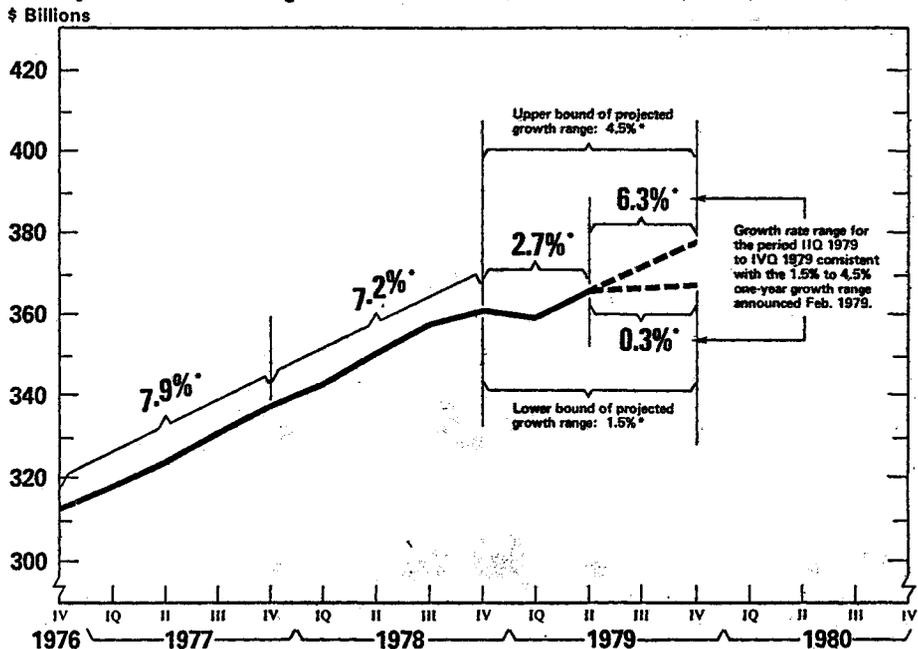
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MONEY SUPPLY (M1)

Actual Levels from Fourth Quarter 1976 and Federal Reserve
Projected Growth Range from Fourth Quarter 1978 to Fourth Quarter 1979

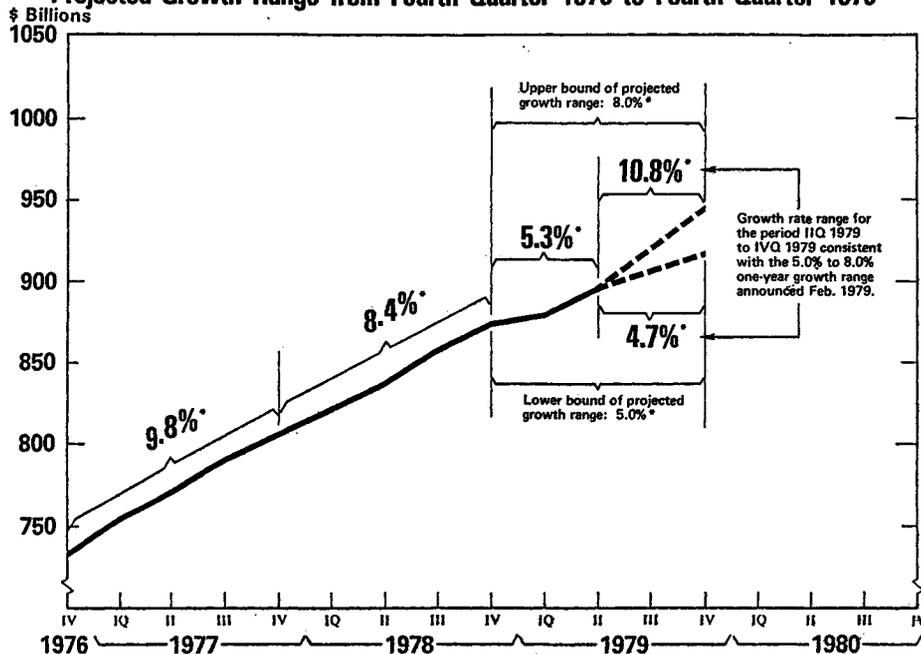


* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in May 1979.

MONEY SUPPLY (M2)

Actual Levels from Fourth Quarter 1976 and Federal Reserve
Projected Growth Range from Fourth Quarter 1978 to Fourth Quarter 1979

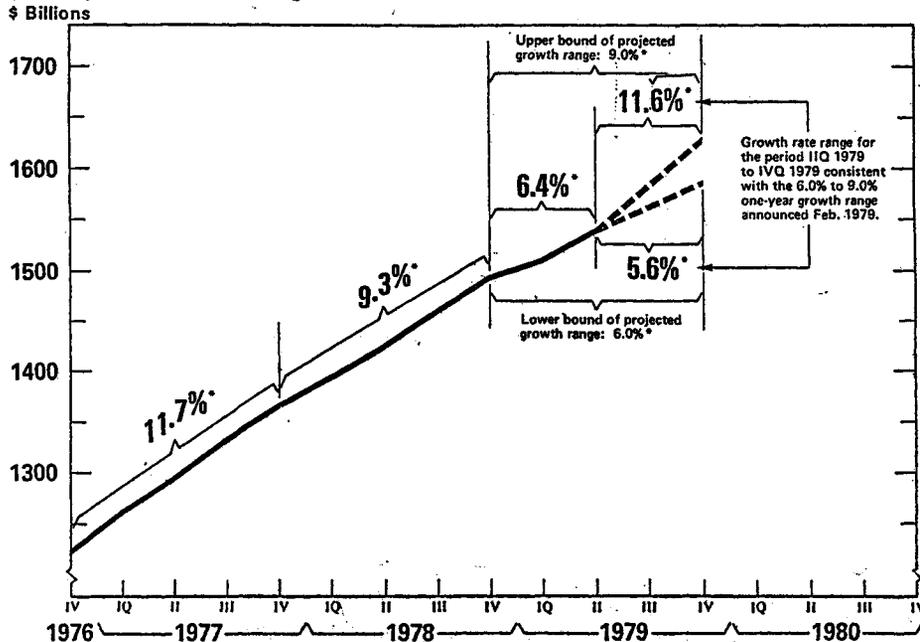


* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in May 1979.

MONEY SUPPLY (M3)

Actual Levels from Fourth Quarter 1976 and Federal Reserve
Projected Growth Range from Fourth Quarter 1978 to Fourth Quarter 1979

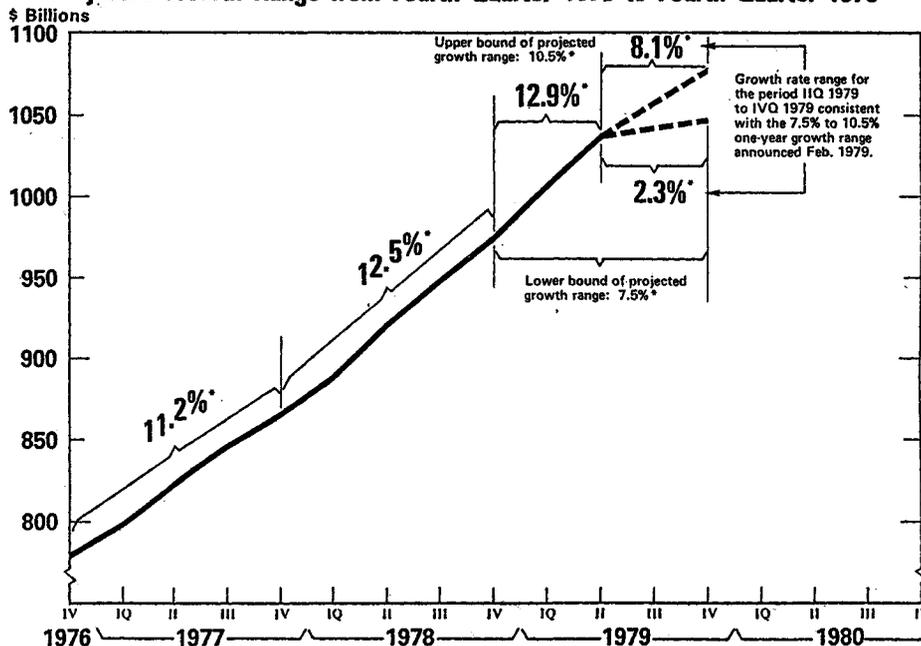


* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in May 1979.

BANK CREDIT

Actual Levels from Fourth Quarter 1976 and Federal Reserve Projected Growth Range from Fourth Quarter 1978 to Fourth Quarter 1979



* Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in May 1979.

MONETARY AND CREDIT AGGREGATES

(Seasonally adjusted compound annual rates)

	<u>1/</u>	<u>1/</u>	<u>1/</u>	<u>1/</u>	<u>1978</u>			<u>1979</u>		Federal Reserve targets: 4th quarter 1978 to 3/ 4th quarter 1979
	1975	1976	1977	1978	<u>2/</u> II	<u>2/</u> III	<u>2/</u> IV	<u>2/</u> I	<u>2/</u> II	
Monetary aggregates:										
M1	4.6	5.8	7.9	7.2	9.5	8.1	4.2	-2.1	7.8	1.5 to 4.5
M2	8.4	10.9	9.8	8.4	8.7	10.1	7.8	1.8	8.9	5.0 to 8.0
M3	11.1	12.7	11.7	9.3	8.7	10.7	9.6	4.8	8.1	6.0 to 9.0
Deposits at non- bank thrift institutions	15.7	15.6	14.5	10.6	8.8	11.5	12.2	9.2	7.0	NA
Bank credit ^{4/}	4.1	8.1	11.2	12.5	15.9	12.3	11.5	13.8	12.0	7.5 to 10.5
Adjusted monetary base (St. Louis F.R. Bank)	7.6	8.4	8.8	9.6	8.3	9.7	10.0	5.9	6.5	NA

1/ From fourth quarter of previous year to fourth quarter of year indicated.

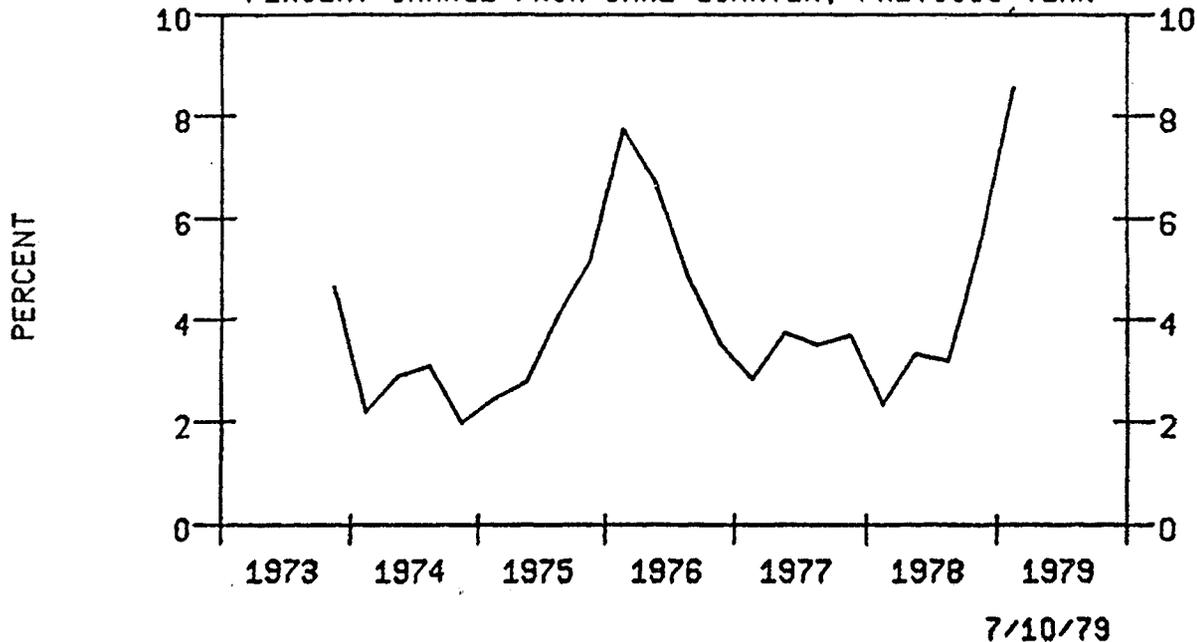
2/ From previous quarter.

3/ Federal Reserve projections as announced in Monetary Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978, February 20, 1979.

4/ Total loans and investments at commercial banks; revised May, 1979.

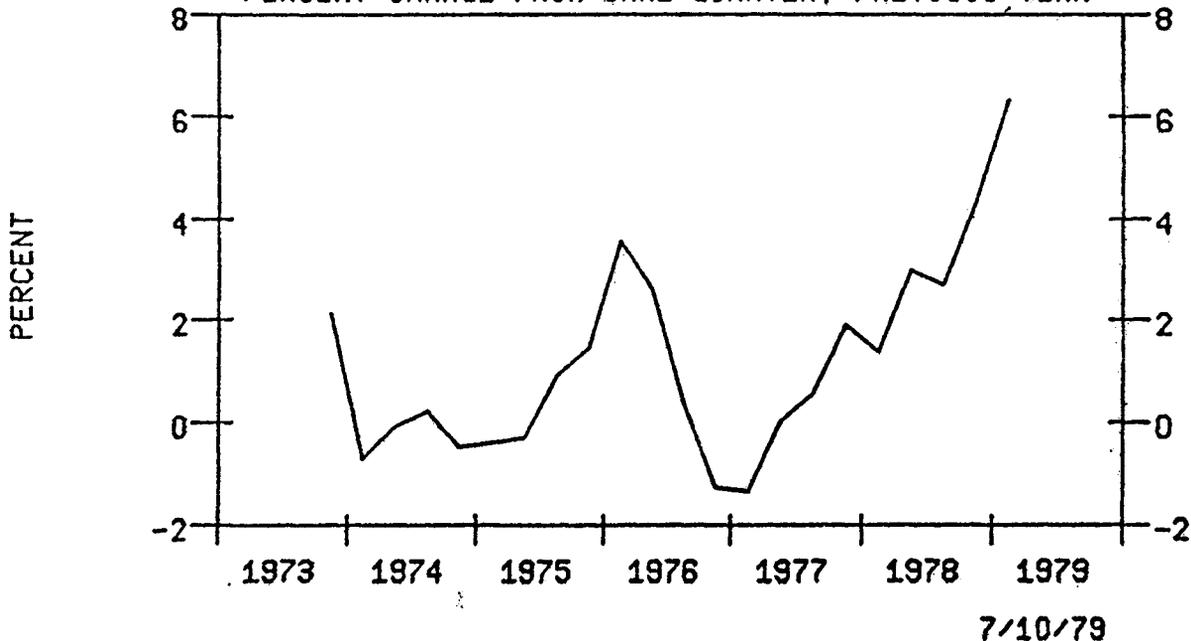
Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of St. Louis. Accessed from data files of Data Resources, Inc.

INCOME VELOCITY OF MONEY (M1)
PERCENT CHANGE FROM SAME QUARTER, PREVIOUS YEAR



SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

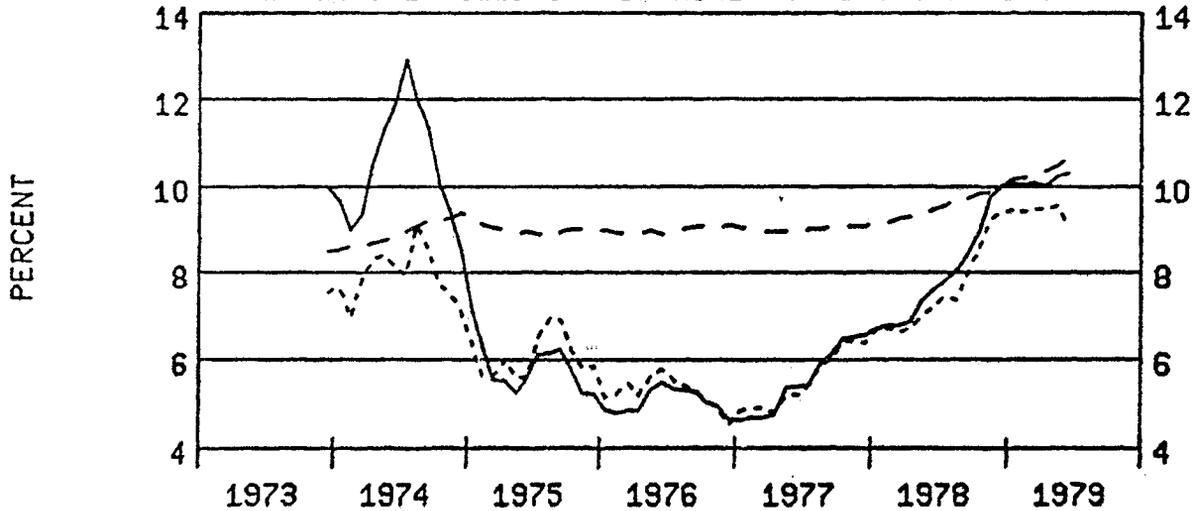
INCOME VELOCITY OF MONEY (M2)
PERCENT CHANGE FROM SAME QUARTER, PREVIOUS YEAR



7/10/79

SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
PREPARED BY CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

INTEREST RATES
FEDERAL FUNDS RATE (LINE)
AVERAGE YIELD ON 6 MONTH TREASURY BILLS (DOT)
EFFECTIVE YIELD ON NEW HOME MORTGAGES (DASH)



7/12/79

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

SELECTED INTEREST RATES, 1973-1979

	1973	1974	1975	1976	1977	1978	1st half 1979
3-mo. treasury bills (new issues)	7.03	7.87	5.82	4.99	5.26	7.22	9.37
10-yr. treasury securities (constant maturity)	6.84	7.56	7.99	7.61	7.42	8.41	9.11
Corporate Aaa bonds (Moody's)	7.44	8.57	8.83	8.43	8.02	8.73	9.34
Prime commercial paper, 4-6 mos	8.15	9.84	6.32	5.35	5.60	7.99	9.98
Prime rate charged by banks	8.02	10.80	7.86	6.84	6.82	9.06	11.75
Effective conventional mortgage rate, new homes, combined lenders	7.95	8.92	9.01	8.99	9.01	9.54	10.50
Federal Reserve discount rate (N.Y. F.R. Bank)	6.44	7.83	6.25	5.50	5.52	7.52	9.50
Federal funds rate	8.73	10.50	5.82	5.05	5.54	7.93	10.13

Sources: Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, and Moody's Investors Service. Accessed from data files of Data Resources, Inc.

FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

	1975	1976	1977	1978	1978 (II)	1978 (III)	1978 (IV)	1979 (I)
Total funds raised, by instrument:	219.8	301.7	399.4	490.8	474.4	483.6	518.5	472.4
Investment company shares	-1.1	-1.0	-1.0	-1.1	-1.9	-1.9	-1.2	-1.3
Other corporate equities	10.8	12.9	4.8	3.6	4.1	5.0	3.5	2.8
Debt instruments:	209.1	289.8	395.6	488.2	471.2	480.5	516.3	470.9
U.S. Government securities	98.2	88.1	84.3	95.2	95.8	96.3	83.7	70.6
State and local obligations	15.6	19.0	29.2	30.1	36.6	38.7	24.6	19.4
Corporate and foreign bonds	36.4	37.2	36.1	31.5	35.8	33.8	27.8	25.5
Mortgages	57.2	87.1	134.0	149.2	145.9	154.8	161.5	142.5
Consumer credit	9.4	23.6	35.0	49.9	56.4	48.5	52.8	49.8
Bank loans, n.e.c.	-13.9	6.4	32.2	53.0	32.1	56.7	59.5	35.2
Open market paper and repurchase agreements	-2.4	13.3	19.8	42.5	36.9	20.4	61.6	94.2
Other loans	8.7	15.3	25.1	36.9	31.7	31.3	44.8	33.7

Source: Board of Governors of the Federal Reserve System. 1979(I) based on incomplete data.

CRS - 11 1/
 1979 ECONOMIC FORECASTS AND ADMINISTRATION GOALS

	January 1979 Administration Goal Forecast	July 1979 Administration Forecast	CBO Current Policy Forecast 2/	Current Chase Forecast	Current DRI Forecast	Current Whart. Forec.
<u>Humphrey-Hawkins Act Goals</u>						
Level, fourth quarter 1979						
Employment (millions)	97.5		-	96.2	96.6	96.7
Unemployment rate (percent)	6.2	6.6	6.9	7.2	6.8	6.9
Percent change, fourth quarter 1978 to fourth quarter 1979						
Consumer prices	7.5	10.6 ^{3/}	10.9	10.5	10.9	12.7
Real gross national product	2.2	-0.5	-1.0	-1.5	-1.3	-0.6
Real disposable income	2.8			-0.3	0.3	-0.5
Productivity						
Total economy 4/	0.4			-		-
private business	-			-1.2		-0.2
private nonfarm	-			-2.2		
<u>Monetary Policy Variables</u>						
Money supply (M1)				3.5	2.1	4.5
Money supply (M2)				6.4	4.7	6.9
Level, fourth quarter 1979						
Federal funds rate (percent)	-	-	-	9.4	9.5	9.8
91 Day Treasury Bill Rate (percent)	8.8 ^{5/}	9.0 ^{5/}	-	8.76	8.58	8.91

1/ These forecasts are based on different systems, different models, and different policy assumptions; therefore, their comparability is limited.

2/ Mid-point of forecast range. 4/ Based on total real GNP per hour worked.

3/ Percent change, December over December. 5/ Average rate for new issues, 1979.

SOURCE: U.S. Council of Economic Advisers. Economic Report of the President. Washington, U.S. Govt. Print. Off., 1979, p. 109. Mid-Session Review of the 1980 Budget, Office of Management and Budget, July 12, 1979, p. 4. CBO Current Policy Forecast in statement by Alice M. Rivlin, Director, Congressional Budget Office, before the Committee on the Budget, United States Senate, July 12, 1979, p. 7. Chase Econometric Associates, Inc., Standard Forecast of June 21, 1979. Data Resources Incorporated, Control Forecast of June 28, 1979. Wharton Economic Forecasting Associates Inc., Control Forecast of June 28, 1979.

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1980 ECONOMIC FORECASTS AND ADMINISTRATION GOALS

	January 1979 Administration Goal Forecast	July 1979 Administration Forecast	Current CBO Policy Forecast 2/	Current Chase Forecast	Current DRI Forecast	Current Wharton Forecast
<u>Humphrey-Hawkins Act Goals</u>						
Level, fourth quarter 1980						
Employment (millions)	99.5			97.3	97.7	97.4
Unemployment rate (percent)	6.2	6.9	7.2	8.3	7.2	7.9
Percent change, fourth quarter 1979 to fourth quarter 1980						
Consumer prices	6.4	8.3 ^{3/}	8.9	7.7	7.9	10.9
Real gross national product	3.2	2.0	2.0	1.8	2.0	1.7
Real disposable income	2.3			1.0		
Productivity						
total economy 4/	1.1			-		
private business	-			2.6		
private nonfarm	-					
<u>Monetary Policy Variables</u>						
Money supply (M1)				9.0	7.2	9.0
Money supply (M2)						
Level, fourth quarter 1980						
Federal funds rate (percent)				6.9	8.8	8.1
91 Day Treasury Bill Rate (percent)	7.6 ^{5/}	8.2 ^{5/}		6.40	8.22	7.75

1/ These forecasts are based on different systems, different models, and different policy assumptions; therefore, their comparability is limited.

2/ Mid-point of forecast range.

4/ Based on total real GNP per hour worked.

3/ Percent change, December over December.

5/ Average rate for new issues, 1980.

SOURCE: See preceding table.

SUMMARY OF ADMINISTRATION'S ECONOMIC GOALS CONSISTENT WITH
THE OBJECTIVES OF THE HUMPHREY-HAWKINS ACT^{1/}

Item	YEAR				
	Goal Forecasts		Goal Requirements		
	1979	1980	1981	1982	1983
	Level, fourth quarter				
Employment (millions)	97.5	99.5	102.6	105.5	108.3
Unemployment (percent)	6.2	6.2	3.4	4.6	4.0 ^{3/}
	Percent change, fourth quarter to fourth quarter				
Consumer prices	7.5	6.4	5.2	4.1	3.0 ^{3/}
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 ^{2/}	.4	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 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. 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." 1979 Economic Report of the President. p. 108-109.

^{2/} Based on total real GNP per hour worked.

^{3/} The Humphrey-Hawkins Act puts the unemployment goal at 4% among individuals aged 16 and over in the civilian labor force by 1983 and an inflation rate of 3% as measured by the consumer price index, also by 1983.

Source: U.S. Council of Economic Advisers. Economic Report of the President. Washington, U.S. Govt. Print. Off., 1979. p. 109.

JULY 1979 SUMMARY OF ADMINISTRATION'S LONG-RANGE
 ECONOMIC GOALS AND ALTERNATIVE ECONOMIC ASSUMPTIONS^{1/}

Table 18.--LONG-RANGE ECONOMIC GOALS, 1981-1984
 (calendar years; dollar amounts in billions)

<u>Major Economic Indicators</u>	<u>Assumed for Budget Projections</u>			
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Gross national product, (percent change, 4th quarter over 4th quarter):				
Current dollars.....	11.7	10.2	7.6	6.1
Constant (1972) dollars.....	5.3	5.5	4.4	3.0
GNP deflator (percent change, 4th quarter over 4th quarter)...	6.1	4.5	3.0	3.0
Consumer Price Index (percent change, December over December)...	6.0	4.5	3.0	3.0
Unemployment rate (percent, 4th quarter).....	6.0	4.8	4.0	4.0

Table 28.--ALTERNATIVE LONG-RANGE ECONOMIC ASSUMPTIONS, 1981-1984
 (calendar years; dollar amounts in billions)

<u>Major Economic Indicators</u>	<u>Assumed for Alternative Budget Projections</u>			
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Gross national product, (percent change, 4th quarter over 4th quarter):				
Current dollars.....	11.4	10.3	9.8	9.3
Constant (1972) dollars.....	4.0	3.5	3.5	3.5
GNP deflator (percent change, 4th quarter over 4th quarter)...	7.1	6.6	6.1	5.6
Consumer Price Index (percent change, December over December)...	6.8	6.5	6.0	5.5
Unemployment rate (percent, 4th quarter).....	6.3	6.0	5.7	5.5

^{1/} As noted on pages 54 and 58 of the Mid-Session Review of the 1980 Budget:

"The long-range economic assumptions differ in nature from the short-range economic forecast presented earlier. These assumptions are not forecasts of economic events, but projections that assume progress in moving toward lower unemployment rates and greater price stability.

(Continued on page 15.)

(Continued from page 14.)

"Two sets of longer-range economic assumptions, and budget projections corresponding to each, are shown. One set, discussed in this section, assumes the achievement of the medium-term goals specified in the Full-Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). [Table 18]. These goals are highly ambitious and may be difficult to achieve. The other set of assumptions, discussed in a later section, are less ambitious."

"[Table 28] presents an alternative set of economic assumptions and a corresponding set of budget projections."

"Under the alternative assumptions presented here, the economy is assumed to grow in real terms by an average of 3.6% a year for the entire 1981-1984 period. The rate of unemployment corresponding to this growth projection is 5 1/2% at the end of calendar year 1984. The rate of inflation is assumed to drop by about half a percentage point a year after 1980, reaching 5 1/2% a year in 1984. These more conservative assumptions may be more appropriate for budget planning purposes than those of the preceding sections."

Source: Mid-Session Review of the 1980 Budget, Office of Management and Budget, July 12, 1979.
pp. 60, 72.

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)			
Third Concurrent Resolution, May 1979 ^{2/}	461.0	494.5	-33.5
Mid-session review, July 1979 ^{3/}	466.5	496.2	-29.7
1980(estimates)			
First Concurrent Resolution, May 1979 ^{4/}	509.0	532.0	-23.0
Mid-session review, July 1979 ^{3/}	513.8	542.4	-28.7
Cumulative totals first 8 months:			
Fiscal year 1978	247.5	297.2	-49.7
Fiscal year 1979	292.1	328.1	-36.0

1/ Unified budget basis.

2/ Third Concurrent Resolution on the Budget -- Fiscal Year 1979, May 24, 1979.

3/ Estimates from Mid-Session Review of the 1980 Budget, Office of Management and Budget, July 12, 1979.

4/ First Concurrent Resolution on the Budget -- Fiscal Year 1980, May 24, 1979.

Source: Economic Indicators, June 1979, and Mid-Session Review of the 1980 Budget, Office of Management and Budget, July 12, 1979.

EXPORTS, IMPORTS, TRADE BALANCE ^{1/} AND TRADE-WEIGHTED EXCHANGE
 VALUE OF THE U.S. DOLLAR ^{2/}

	1975	1976	1977	1978	1978				1979	
					I	II	III	IV	I ^P	II
(in billions of dollars; quarterly data seasonally adjusted)										
Exports	107.1	114.7	120.8	141.9	30.8	35.3	36.5	39.3	41.4	NA
Imports	98.0	124.0	151.7	176.0	42.7	43.2	44.5	45.7	47.4	NA
Trade balance	9.0	-9.4	-30.9	-34.2	-11.9	-7.9	-8.0	-6.4	-6.1	NA

Index of the weighted-average exchange value of the U.S. dollar	98.34	105.57	103.30	92.39	95.90	95.20	90.65	87.81	88.14	89.79

1/ Merchandise, excluding military, on balance of payments basis (adjusted from Census data for differences in timing and coverage).

2/ Index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries (Germany, Japan, France, United Kingdom, Canada, Italy, Netherlands, Belgium, Sweden) and Switzerland. March 1973=100. Weights are 1972-1976 global trade of each of the 10 countries.

Sources: Exports, imports, and trade balance - Economic Indicators, June 1979.
 Trade-weighted exchange value of the U.S. Dollar - Board of Governors of the Federal Reserve System.

APPENDIX II

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

BRIEFING MATERIALS
PREPARED FOR HEARINGS ON

THE CONDUCT OF MONETARY POLICY

BEFORE THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

JULY 17, 1979

(129)

CHART 1. Exhibit 1 breaks the 1954-1977 period into eight consecutive 3-year periods: 1954-1956, 1957-1959, etc. For each 3-year period, Chart 1A relates average M1 growth to the average rate of rise in the Consumer Price Index (inflation); Chart 1B relates average M1 growth to the average rate of interest on 3-month Treasury bills; 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 1C.

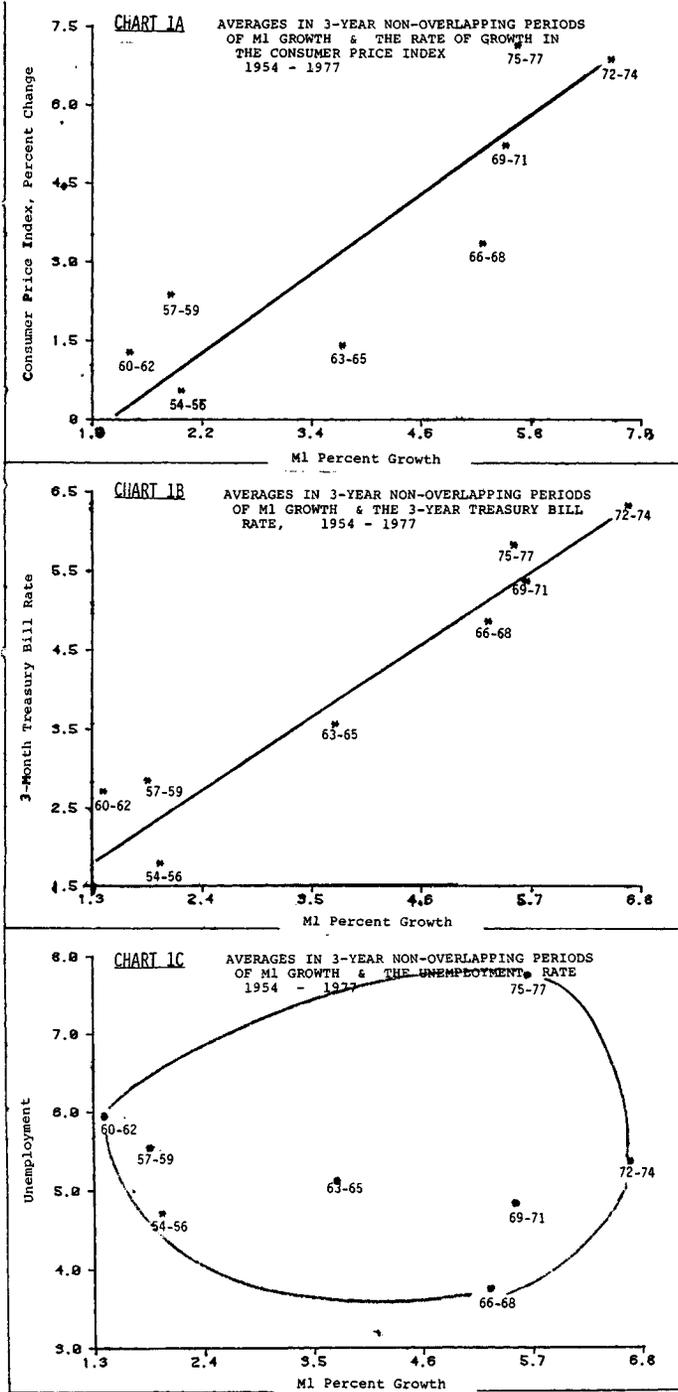


Chart 2. Last March, the Committee recommended that money growth be established at 6 percent this year, then reduced one percentage point each year until year-over-year money growth is established at 3 percent in 1982; where it would be maintained in 1983. The Committee defined money supply as M1 plus ATS and NOW accounts.

Until April 1979, the growth rate of the Committee's recommended money supply was substantially less than 6 percent per annum. As a result the outstanding volume of money fell short of the volume projected by the Committee as necessary if we are to avoid recession while unwinding inflation. In the April-June period, growth of the money soared to an annual rate of 11 percent. The upsurge in the Committee's recommended money measure soared to an annual rate of 11 percent. The upsurge in money growth in the second quarter should be regarded as a constructive correctice measure. However, it is now important to moderate money growth so as to keep it from growing more than 6 percent for 1979 as a whole.

CHART 2

ACTUAL MONEY SUPPLY

VERSUS

HOUSE BANKING COMMITTEE'S RECOMMENDATION

OF MARCH 1979

PROJECTION LINE IS BASED ON 6% GROWTH FROM NOVEMBER, 1978 THRU NOVEMBER, 1979;
AND 5% GROWTH FROM NOVEMBER, 1979 THRU NOVEMBER, 1980
BASE PERIOD IS OCTOBER, NOVEMBER, DECEMBER 1978 AVERAGE
OF M1, SA + ATS + NOWs.

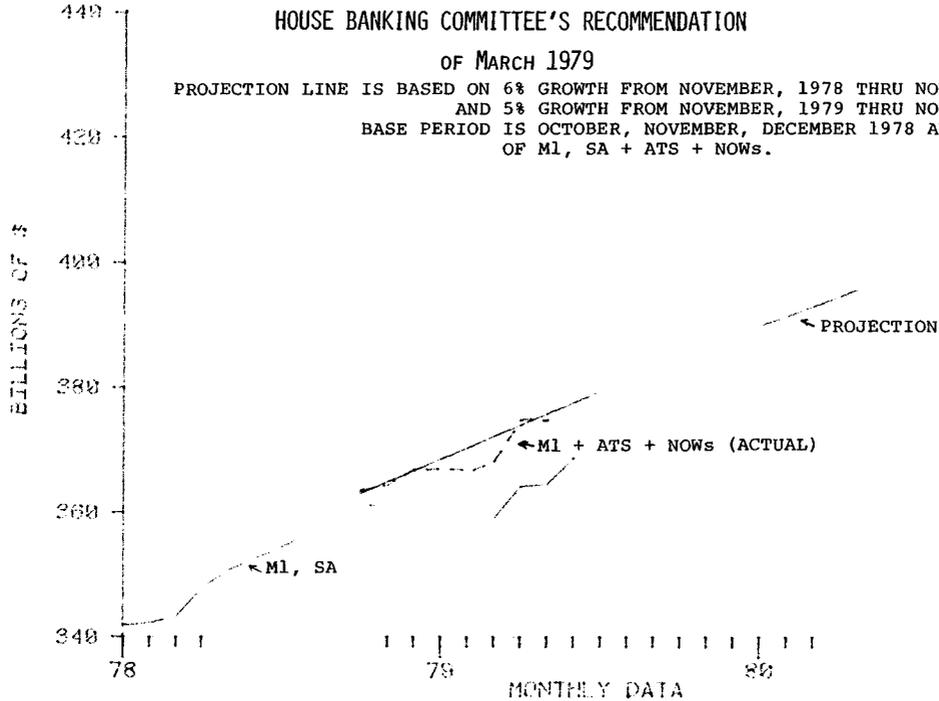


CHART 3. M1 growth, measured between the same months of adjacent years (for example, January 1947 to January 1948), cycled down and up seven times between the end of World War II and 1978; and now, after a prolonged upsurge, is headed down once more.

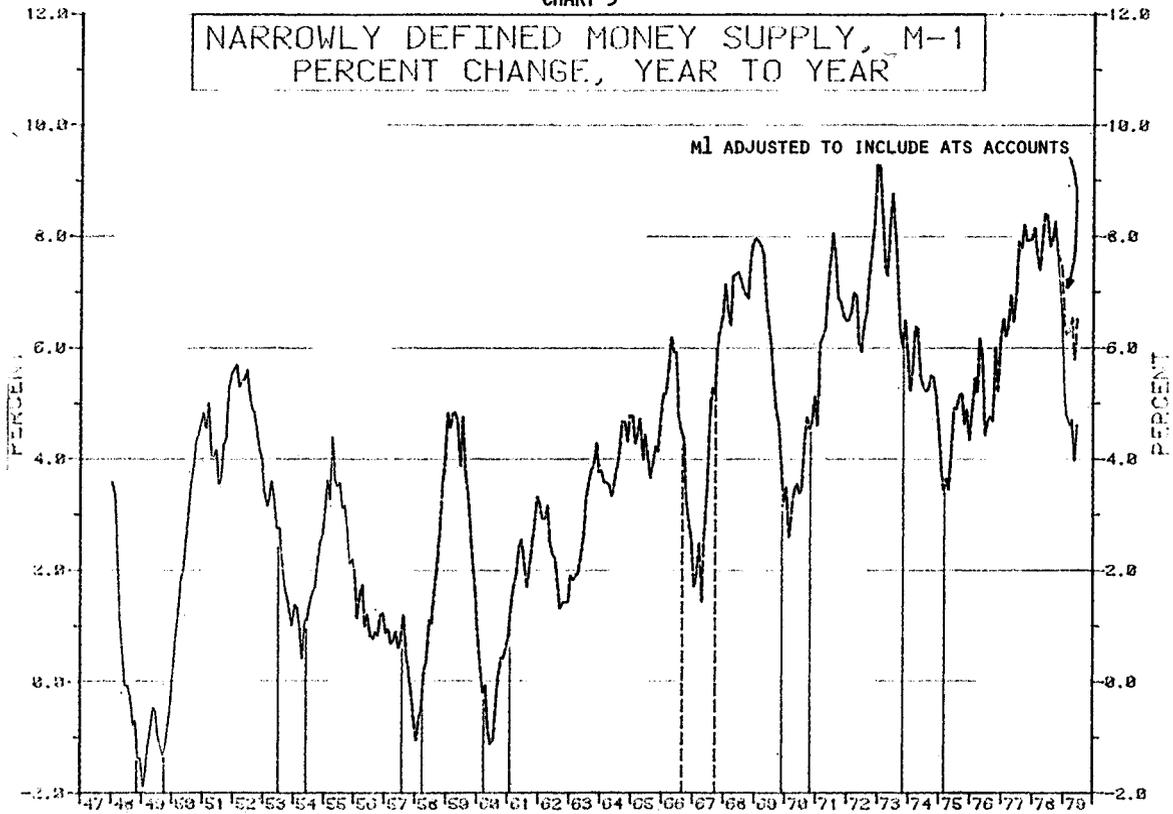
Our economy's performance in the post World War II period is mirrored in this chart of money growth. Inflation was broken after World War II and again after the Korean War by sustained low money growth. It was rekindled after 1964 by upsurges in money growth in the late 1960s, 1971-1973, and 1977-1978. 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.

Last March, based on data through February, we stated: "The chart indicates that we are now headed for another recession." It is now apparent that we were right.

How deep and long the recession becomes depends on how the Federal Reserve manages the growth of M1 (adjusted to include ATS accounts) from now on.

CHART 3

NARROWLY DEFINED MONEY SUPPLY, M-1
PERCENT CHANGE, YEAR TO YEAR



CHARTS 3.1 & 3.2. These exhibits graph year to year percentage changes in M1-plus and M2. The growth profiles of these two aggregates also warn that monetary policy again has lain the groundwork for another recession.

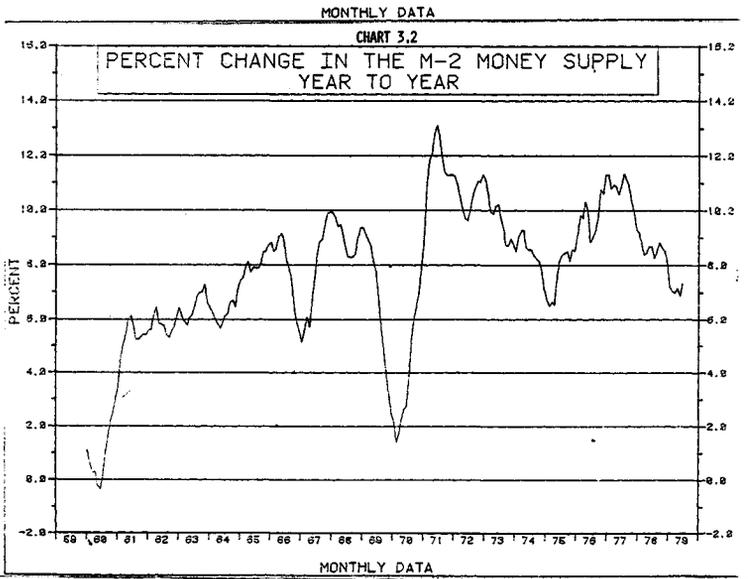
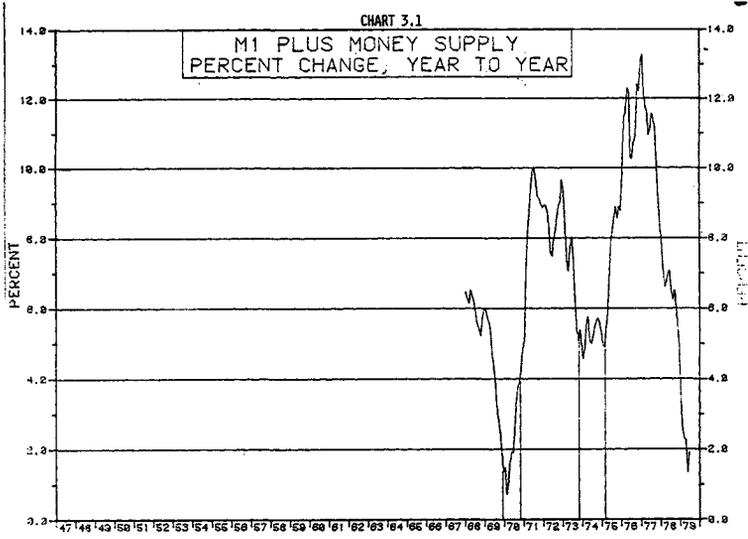


EXHIBIT 4. Exhibit 4 provides another way of looking at the relationships between money growth, inflation and interest rates. Exhibit 4A charts the percentage changes in the CPI against percentage changes in M1 (money supply) which has been lagged two years. The exhibit shows that the rate of inflation follows M1 growth two years earlier fairly closely.

Exhibit 4B charts the percentage change in the CPI against the percentage change in M1 lagged 2 years, but here adjusted to include ATS accounts and overnight repurchase agreements. The inclusion of these two adjustments picks up much of the recent inflation which cannot be explained by M1 alone.

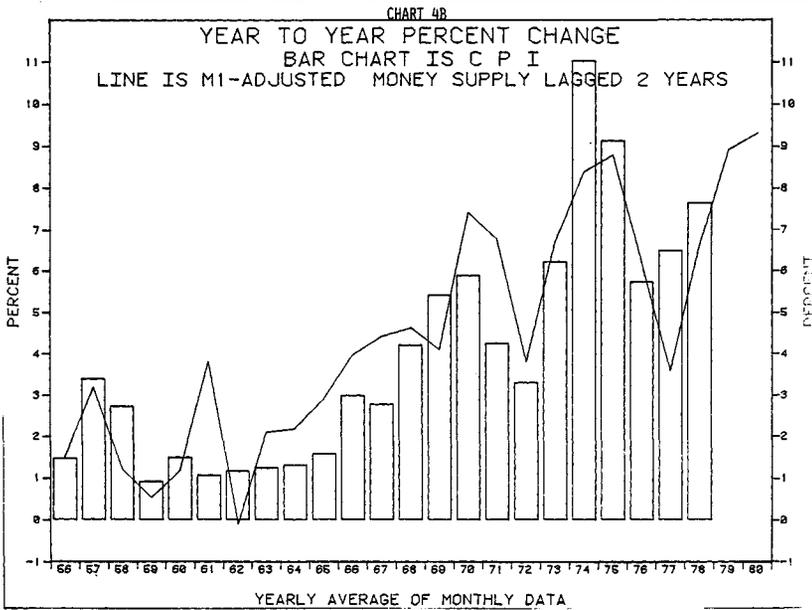
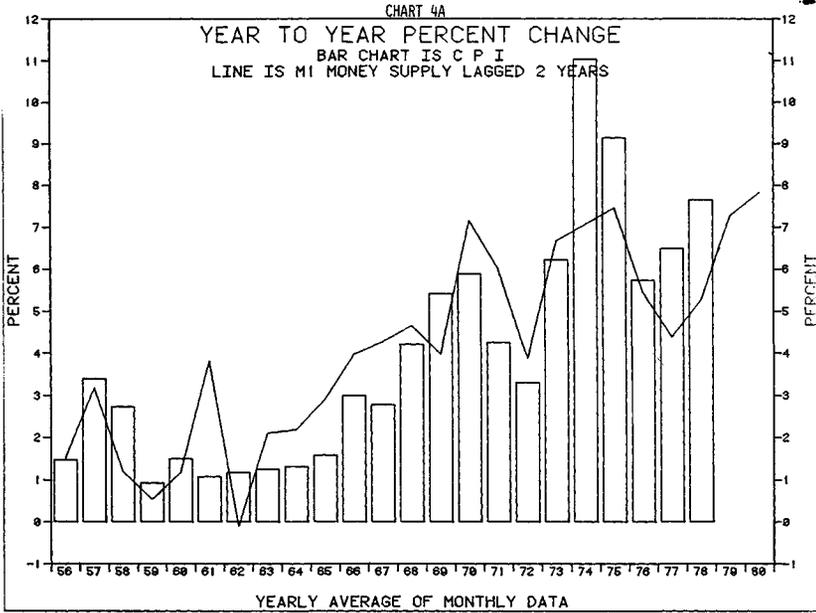


Exhibit 4C plots the percentage changes in the CPI measured between the same months from one year to the next and the Federal funds rate--the overnight inter-bank interest rate. It shows that monthly movements in the Fed funds rate occur very closely together with changes in the inflation rate measured from the same month a year ago. This indicates that even short-term interest rates are very powerfully affected by immediate past inflation.

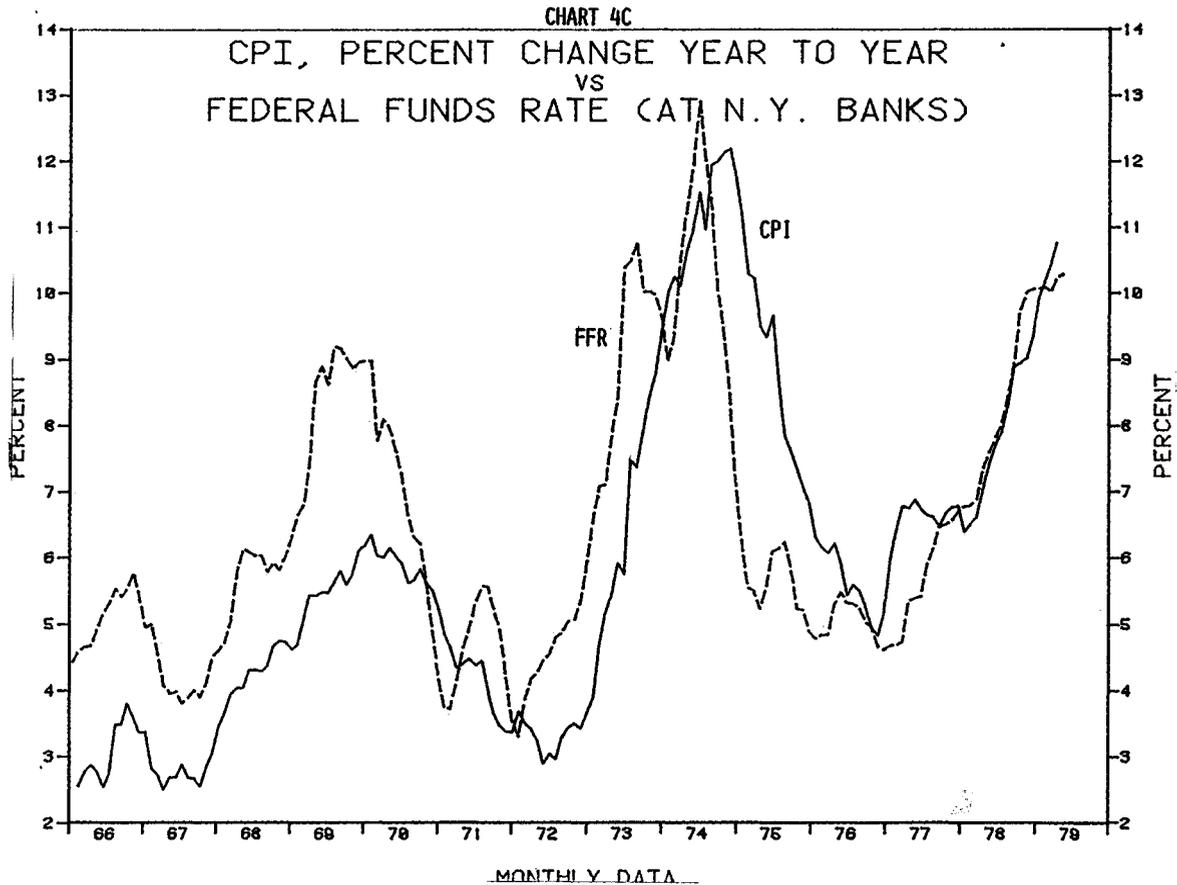


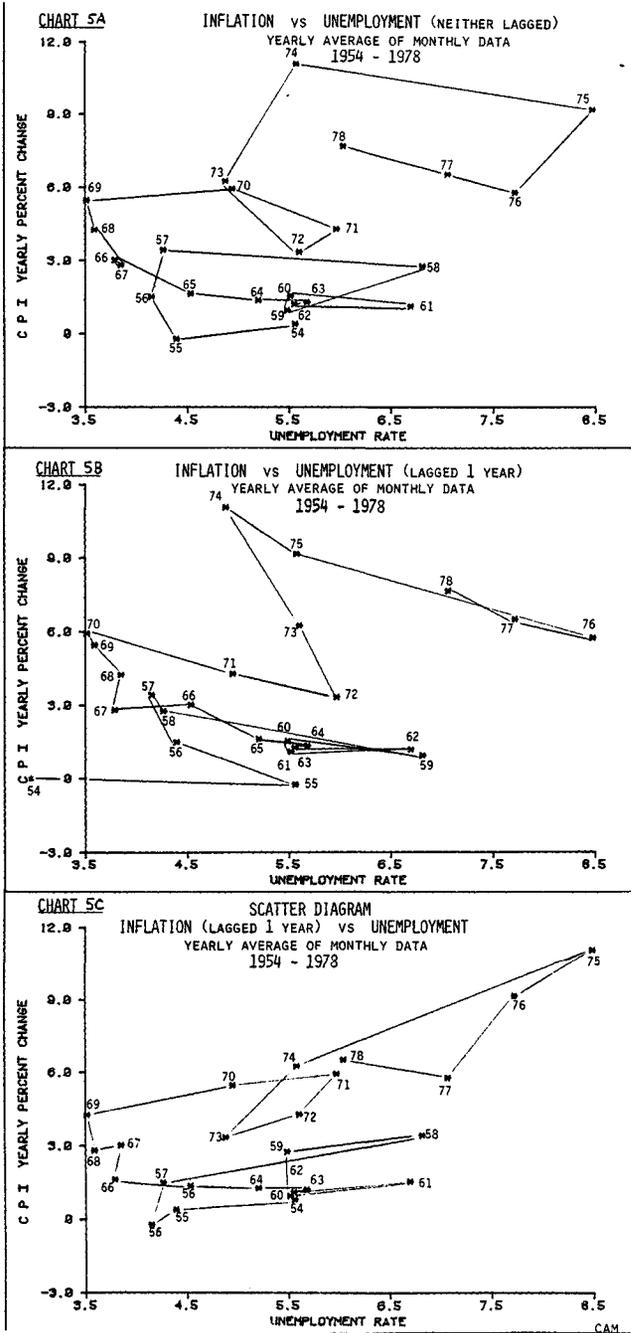
CHART 5. This chart graphs year over year inflation (vertical axis) against yearly unemployment averages (horizontal axis). The top panel graphs the two concurrently, the middle panel lags unemployment 1 year, and the bottom panel lags inflation one year.

The concurrent panel (5A) reveals that the so-called Phillips curve is unstable. On average, the trade-off was highly favorable from 1954 to 1965 but has worsened significantly since then.

The middle panel (5B) reveals much the same story. Specifically, for an arbitrarily selected unemployment rate, the rate of inflation the following year is much higher today than it was in the 1950s and early 1960s.

Finally, the evidence plotted in the lower panel (5C) reinforces this story. As indicated here, there is even some tendency for accelerating inflation to be followed by higher unemployment.

Viewed together with Chart 1, these three panels show that unemployment cannot be reduced by accelerating money growth and inflation. The result of faster money growth is higher inflation and perhaps also a rise, albeit ephemeral, in unemployment.



[Whereupon, at 5:10 p.m., the hearing was adjourned.]

