

FEDERAL RESERVE-TREASURY DRAW AUTHORITY

HEARINGS
BEFORE THE
SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
NINETY-FIFTH CONGRESS
SECOND SESSION

JUNE 27 AND 28, 1978

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FEDERAL RESERVE-TREASURY DRAW AUTHORITY

TUESDAY, JUNE 27, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
Washington, D.C.

The subcommittee met at 8:35 a.m. in room 2220 of the Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

Present: Representatives Mitchell, Barnard, and Hansen.

Chairman MITCHELL. The hearing will now come to order. We try to start our hearings early, while everyone is rested and full of vigor and, as you know, it is almost impossible to have a meeting at 10 o'clock with all the other committees meeting simultaneously.

I just want to take a moment to thank my colleague to my right, who has made every one of these early morning meetings, and I am most appreciative. I would have been rather lonely had you not shown up as often as you have, Mr. Barnard. Thank you.

This morning, the Subcommittee on Domestic Monetary Policy begins oversight hearings on the Federal Reserve-Treasury draw authority. These hearings were agreed upon during subcommittee consideration and House deliberations of House Joint Resolution 816, which would extend this authority to April 30, 1979. Under the Federal Reserve-Treasury draw authority, the Federal Reserve System is permitted to buy directly from the Treasury up to \$5 billion of public debt securities. The decision whether to use the authority resides in the Federal Reserve.

The authority has been used on 44 occasions, most recently for a period of 4 days in the amount of \$2.5 billion. Treasury argues that the authority provides a "backstop" for its cash and debt operations, in that it assures that the Treasury will be able to raise cash almost instantaneously in emergencies. However, questions have been raised both about the need for the authority and its implementation. It was agreed that the subcommittee would hold thorough oversight hearings on these questions.

In addition, the authority of the Federal Reserve to buy securities directly from the Treasury calls attention to the broader question of the impact of Treasury's financing need on Federal Reserve monetary policy. We are going to look into this question as well.

Today we are going to hear from Assistant Secretary of the Treasury Roger C. Altman and Federal Reserve Governor J. Charles Partee. We have asked them to address the need for and implementation of the draw authority.

Let me ask if my colleagues have any opening remarks to make?

Mr. BARNARD. Thank you, Mr. Chairman. I have no opening remarks.

Mr. HANSEN. Yes, and I am submitting some for the record.

[The opening remarks of Mr. Hansen follow:]

OPENING REMARKS OF THE HONORABLE GEORGE V. HANSEN

Mr. Chairman, the most important and useful result we could have from this hearing is a proposal for alternatives to the so-called Treasury draw authority. This authority is a leftover from the days of explicit Fed support for Treasury financing, when monetary policy was clearly subordinated to the Treasury's aim of cheap deficit financing. I hope we are all agreed that monetary policy should not be thus subordinated, and that we can do without the mechanisms through which the Treasury called the shots for Federal Reserve open market operations.

In recent years, the authority has been justified by appeals to the savings that could be effected by having lower Treasury operating balances. As you may remember from the dissenting views which were filed to H.J. Res. 816, Mr. Chairman, we took a careful look at those balances when the authority was in effect and when it had lapsed, and found that there was no evidence that the Treasury in fact carried lower balances when it had this backstop authority. We should face up to the fact that the reasons for this draw authority are very tenuous.

And on the other side of the books, the authority does afford scope for abuse. When the temporary debt ceiling expired last fall, this authority was used to stock up on cash to tide the Treasury over. I am not particularly pleased with that action, especially since the use of the authority, instead of recourse to the open market, will never permit us to know for sure that the authority was actually used on September 30 instead of October 1. It allows room for cutting some corners, and I don't believe that temptation should be presented to public officials.

Most importantly, the draw authority is part of the Fed's banking function, that is, it arises in consequence of the Federal Reserve acting as banker to the United States Treasury, at the same time that the Fed is the national monetary authority. Mr. Chairman, we have been subjected over the years to endless troubles rooted in deficit financing which has been rendered altogether too easy by accommodative monetary policy. I am not blaming the Fed in this regard so much as I am pointing out the impossible demands put on it. We have asked the Fed to be a good government banker and minimize debt costs at the same time that we charge it with responsibility for keeping too much money from getting into circulation. Neither the Fed nor any other institution or set of people can ride both those horses successfully. If we are going to defeat inflation, we will have to give the Fed one job and the Treasury another; the Fed should control the money supply and the Treasury should see to it that debt costs don't get out of line. Every link between monetary policy and consideration of federal debt management should be severed. This is the most important reason why we should do without the draw authority and substitute for it, if some sort of overdraft protection is needed, a mechanism which does not touch the Fed as national monetary authority.

With those points in mind, Mr. Chairman, I am glad to welcome our witnesses today. I hope they will give us the benefit of their thinking on possible alternatives to the draw authority. Thank you.

Chairman MITCHELL. We expect to focus on the relationship of monetary policy to Treasury's financing needs tomorrow morning. Of course, Governor Partee and Secretary Altman may also want to give us the benefit of their expertise on this matter.

We will proceed with the testimony and start with you, Governor Partee.

STATEMENT OF HON. J. CHARLES PARTEE, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Governor PARTEE. Thank you, Mr. Chairman

I appreciate the opportunity to present the views of the Board of Governors of the Federal Reserve System on the direct borrowing

authority of the U.S. Treasury. As the committee is aware, this authority permits the Federal Reserve to purchase obligations of the United States directly from the Treasury in amounts up to \$5 billion.

The purpose of the direct borrowing authority is to aid the Treasury in the management of its cash and debt positions. The authority provides assurance that the Treasury can meet its obligations without delay in the event of temporary need. This supplemental source of funding can be of particular value if there are large unforeseen drains on the Treasury's cash position—as when the timing of Federal receipts and expenditures is more erratic than expected—or in the event of a national emergency.

Since the establishment by Congress of the direct borrowing authority in 1942, it has been needed on 44 occasions—and only once since 1975. In every instance, the volume of funds borrowed was well under the maximum permitted by law, and was outstanding only a short time. In most cases, the amount borrowed was below \$1 billion, and in the great majority, the indebtedness was terminated in less than 10 days. The largest single borrowing amounted to \$2½ billion; and the longest duration was 28 days. Thus, the record indicates that the Treasury has utilized this borrowing authority infrequently, in limited amounts, and for very brief periods.

The principal need for the authority, historically, has arisen on the occasion of sharp declines in the Treasury's cash balance just prior to quarterly tax payment dates. Instead of going to the financial markets for funds that would be needed only temporarily, the Treasury borrowed directly from the Federal Reserve and repaid this indebtedness immediately upon receipt of the tax revenues. In recent years, however, the frequency of direct borrowing for this purpose has been reduced significantly with the introduction of short-dated cash-management bills.

The direct purchase authority has always been exercised at the initiative of the Treasury. Due to the close operational relationship between the Federal Reserve and the Treasury, a direct borrowing transaction can be accomplished quickly, even on the day it is requested. Thus, temporary accommodation of the Treasury can be achieved when needed without delay.

The terms and conditions of direct Federal Reserve purchases of Treasury obligations are established by the Federal Open Market Committee. At present, the interest rate paid by the Treasury on such obligations is one-quarter of 1 percent below the discount rate at the Federal Reserve Bank of New York. In addition, the Federal Reserve is fully aware of its responsibility to insure that the authority for direct purchases is used prudently. Thus, the FOMC's authorization for direct purchases has consistently limited the System's holdings to amounts well below the statutory maximum. At present, that limit is \$2 billion. A request for greater accommodation would be subject to review by the FOMC before it is honored.

There are other safeguards and limitations on the Treasury's direct borrowing authority, beyond the FOMC's monitoring of this activity. All direct borrowing is reported promptly in the Treasury's daily financial statement and in the weekly statements of condition of the Federal Reserve banks, all of which are available to the public. Use of the authority is also reported by the Federal Reserve in its annual report to the Congress. Also, direct borrowing is subject to the Federal debt ceiling imposed by the Congress.

In recent years, the Treasury's need to offset cash drains just before tax payment dates has been met principally by means of cash-management bills. These debt instruments can be issued with maturities of very short duration and are sold in the market in relatively large amounts on short notice. And since the cash drains experienced in recent years generally have been within the ranges expected, the Treasury has had less need to fall back on its direct borrowing authority before tax payment dates.

Nonetheless, other circumstances may require the Treasury to resort to direct borrowing to meet its debt-management and cash disbursement obligations in an orderly and timely manner. Such an episode occurred last fall when the Treasury borrowed \$2½ billion directly from the Federal Reserve to bolster its cash position in contemplation of the expiration of the temporary ceiling on the public debt. It should be emphasized that this borrowing was not undertaken to circumvent restrictions imposed by the Congress on Treasury indebtedness, but was an interim measure to assure timely discharge of the Treasury's obligations until the Congress took action on a new temporary debt ceiling.

In conclusion, the Board believes that the direct purchase authority has been effective in enabling the Treasury to meet unexpectedly large cash drains and to achieve its debt-management objectives. The assurance that the Treasury would have the option of obtaining immediate—though limited—funds outside the financial markets in times of unanticipated and temporary need is a desirable safeguard. It is analogous to the ability of member banks to turn to the Federal Reserve as a temporary source of funds through the discount window, or to the arrangement for funding temporary credit needs that the Congress has mandated for various Federal agencies with the Treasury. For these reasons the Board continues to support strongly the extension of the direct purchase authority.

[Governor Partee's prepared statement follows:]

Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

June 27, 1978

I appreciate the opportunity to present the views of the Board of Governors of the Federal Reserve System on the direct borrowing authority of the U.S. Treasury. As the Committee is aware, this authority permits the Federal Reserve to purchase obligations of the United States directly from the Treasury in amounts up to \$5 billion.

The purpose of the direct borrowing authority is to aid the Treasury in the management of its cash and debt positions. The authority provides assurance that the Treasury can meet its obligations without delay in the event of temporary need. This supplemental source of funding can be of particular value if there are large unforeseen drains on the Treasury's cash position--as when the timing of Federal receipts and expenditures is more erratic than expected--or in the event of a national emergency.

Since the establishment by Congress of the direct borrowing authority in 1942, it has been needed on 44 occasions--and only once since 1975. In every instance, the volume of funds borrowed was well under the maximum permitted by law, and was outstanding only a short time. In most cases, the amount borrowed was below \$1 billion, and in the great majority, the indebtedness was terminated in less than 10 days. The largest single borrowing amounted to \$2-1/2 billion; and the longest duration was 28 days. Thus, the record indicates that the Treasury has utilized this borrowing authority infrequently, in limited amounts, and for very brief periods.

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prior to quarterly tax payment dates. Instead of going to the financial markets for funds that would be needed only temporarily, the Treasury borrowed directly from the Federal Reserve and repaid this indebtedness immediately upon receipt of the tax revenues. In recent years, however, the frequency of direct borrowing for this purpose has been reduced significantly with the introduction of short-dated cash-management bills.

The direct purchase authority has always been exercised at the initiative of the Treasury. Due to the close operational relationship between the Federal Reserve and the Treasury, a direct borrowing transaction can be accomplished quickly, even on the day it is requested. Thus, temporary accommodation of the Treasury can be achieved when needed without delay.

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There are other safeguards and limitations on the Treasury's direct borrowing authority, beyond the FOMC's monitoring of this

activity. All direct borrowing is reported promptly in the Treasury's daily financial statement and in the weekly statements of condition of the Federal Reserve Banks, all of which are available to the public. Use of the authority is also reported by the Federal Reserve in its Annual Report to the Congress. Also, direct borrowing is subject to the Federal debt ceiling imposed by the Congress.

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Nonetheless, other circumstances may require the Treasury to resort to direct borrowing to meet its debt-management and cash disbursement obligations in an orderly and timely manner. Such an episode occurred last fall when the Treasury borrowed \$2-1/2 billion directly from the Federal Reserve to bolster its cash position in contemplation of the expiration of the temporary ceiling on the public debt. It should be emphasized that this borrowing was not undertaken to circumvent restrictions imposed by the Congress on Treasury indebtedness, but was an interim measure to assure timely discharge of the Treasury's obligations until the Congress took action on a new temporary debt ceiling.

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Chairman MITCHELL. Thank you very much, Governor. I know we have several questions. Unless you are pressed for time, I would like Secretary Altman to present his testimony now and then direct questions to both of you.

Secretary Altman, we are available to you.

STATEMENT OF HON. ROGER C. ALTMAN, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY PHILIP H. FITZPATRICK, ASSISTANT FISCAL ASSISTANT SECRETARY (FINANCING)

Secretary ALTMAN. Thank you, Mr. Chairman,

With your permission, I would like my statement submitted in full for the record, and I would just summarize it briefly here.

I appreciate the opportunity to assist in your oversight of the Fed's authority to purchase directly from the Treasury up to \$5 billion of public debt obligations. The purpose of this authority is simply to facilitate the efficient management of the public debt.

As you know, it was first granted in its present form in 1942, and it has been renewed for temporary periods on a series of occasions.

It has lapsed on five occasions in recent years, and those are detailed in my statement.

As Governor Partee said, borrowings from the Federal Reserve System under this authority have been for very short periods. The average length being from 2 to 7 days. Only twice in the past 35 years has the Treasury had to draw funds in this manner for periods exceeding 13 consecutive days—and I have included a table which lists the instances of actual use.

Borrowings under the authority are subject to the public debt limit, and they are reported in the daily Treasury statement, the weekly Federal Reserve statement, and in the Federal Reserve Board's annual report to the Congress.

Mr. Chairman, the existence of this direct purchase authority provides us with a margin of safety which permits us to let our cash balance fall to otherwise unacceptably low levels in advance of seasonally heavy revenues.

This, in turn, results in balances that are not as high as they otherwise would be during the periods of high revenues which follow. In turn, this permits the public debt to be kept to a minimum, and the Government's interests costs to be minimized.

In addition, an advantage of this direct purchase authority is to hedge against the possibility that unforeseen swings in our cash flows could suddenly deplete our cash balance and require sudden borrowing.

The purchase authority is available, of course, to provide an immediate source of funds for temporary financing in the event of a national emergency on a broader scale. Fortunately, that has never happened, but it is conceivable, of course, that financial markets could be disrupted just at a time when large amounts of cash had to be raised to maintain governmental functions and to meet the emergency.

Consequently, the direct purchase authority has, for many years, been a key element in the Treasury's financial planning for a national emergency.

Let me emphasize that the direct purchase authority is viewed by the Treasury only as a temporary accommodation to be used under unusual circumstances. We fully agree that our debt obligations should be floated in the market, and that purchases of Treasury securities by the Federal Reserve System should normally be made through that same public market.

We also agree fully that this authority should not be considered a means by which the Treasury may independently influence credit conditions by usurping the authority of the Federal Reserve to engage in open-market operations in Government securities.

In that connection, it is important to emphasize, as Governor Partee did, that any recourse by the Treasury to Federal Reserve credit under this authority is subject to the full discretion and control of the Federal Reserve itself.

This concludes my prepared remarks, Mr. Chairman, and of course I will be happy to answer any questions that you have.

[Secretary Altman's prepared statement follows:]

STATEMENT BY THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY FOR DOMESTIC FINANCE
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

I welcome this opportunity to assist in your oversight of the authority of Federal Reserve Banks to purchase directly from the Treasury up to \$5 billion of public debt obligations. As you know, the most recent extension of this authority expired on April 30, 1978. On April 19, 1978 this Subcommittee favorably reported House Joint Resolution 816, to extend this authority to April 30, 1979. The Resolution was adopted by the House of Representatives on May 1, but the Senate has not yet acted.

The purpose of the direct-purchase authority is to facilitate the efficient management of the public debt. It was first granted in its present form in 1942, and it has been renewed for temporary periods on a number of occasions. The authority has lapsed, however, on five occasions in recent years -- from July 1 until August 14, 1973; from November 1, 1973 until October 28, 1974; from November 1 to November 12, 1975; from October 1 until November 7, 1977 and the current period.

Borrowings from the Federal Reserve System under this authority have been for very short periods, the average length being from 2 to 7 days. Only twice in the past 35 years has the Treasury had to draw funds in this manner

for periods exceeding 13 consecutive days. I have appended a table which lists the instances of actual use. Borrowings under the authority are subject to the public debt limit, and its use is reported in the Daily Treasury Statement, the weekly Federal Reserve Statement, and in the Federal Reserve Board's Annual Report to the Congress.

The existence of the direct purchase authority provides us with a margin of safety which permits us to let our cash balance fall to otherwise unacceptably low levels preceding periods of seasonally heavy revenues. This, in turn, results in balances that are not as high as they otherwise would be during the periods of high revenues that follow, allowing the public debt to be kept to a minimum and thus reducing interest costs to the Government. Moreover, there is always the possibility that unforeseen swings in our cash flows may suddenly deplete our cash balance and require a sudden borrowing.

The direct-purchase authority is available to provide an immediate source of funds for temporary financing in the event of a national emergency on a broader scale. While this has never happened, it is conceivable that financial markets could be disrupted at a time when large amounts of cash had to be raised to maintain governmental functions and meet the emergency. Consequently, the direct-purchase authority has for many years been a key element in the Treasury's financial planning for a national emergency.

I want to emphasize that the direct-purchase authority is viewed by the Treasury as a temporary accommodation to be used only under unusual circumstances. The Treasury fully agrees with the general principle that our debt obligations should be floated in the market and that purchases of Treasury obligations by the central bank should normally be made through that same public market. The Treasury agrees also that the direct-purchase authority should not be considered a means by which the Treasury may independently attempt to influence credit conditions by usurping the authority of the Federal Reserve to engage in open market operations in Government securities. In that connection, it is important to emphasize that any direct recourse by the Treasury to Federal Reserve credit under this authority is subject to the discretion and control of the Federal Reserve itself.

This concludes my prepared statement, Mr. Chairman. I will be happy to respond to any questions.

Attachment

DIRECT BORROWING FROM FEDERAL RESERVE BANKS
1942 TO DATE

<u>Calendar Year</u>	<u>Days Used</u>	<u>Maximum Amount At Any Time (Millions)</u>	<u>Number of Separate Times Used</u>	<u>Maximum Number Of Days Used At Any One Time</u>
1942	19	\$ 422	4	6
1943	48	1,302	4	28
1944	none	--	-	-
1945	9	484	2	7
1946	none	--	-	-
1947	none	--	-	-
1948	none	--	-	-
1949	2	220	1	2
1950	2	180	2	1
1951	4	320	2	2
1952	30	811	4	9
1953	29	1,172	2	20
1954	15	424	2	13
1955	none	--	-	-
1956	none	--	-	-
1957	none	--	-	-
1958	2	207	1	2
1959	none	--	-	-
1960	none	--	-	-
1961	none	--	-	-
1962	none	--	-	-
1963	none	--	-	-
1964	none	--	-	-
1965	none	--	-	-
1966	3	169	1	3
1967	7	153	3	3
1968	8	596	3	6
1969	21	1,102	2	12
1970	none	--	-	-
1971	9	610	1	7
1972	1	38	1	1
1973	10	485	3	6
1974	1	131	1	1
1975	16	1,042	4	7
1976	none	--	-	-
1977	4	2,500	1	4

Note: Federal Reserve direct purchase authority expired
on April 30, 1978.

Office of the Assistant Secretary
(Domestic Finance)

June 23, 1978

Chairman MITCHELL. Thank you very much. Both of your statements will be submitted in their entirety for the record.

Congressman BARNARD?

Mr. BARNARD. Thank you, Mr. Chairman.

I recall, in the last hearings we had on this subject on the temporary extension of the direct borrowing authority, one of the main criticisms was the question as to whether or not this did exceed the debt limit prescribed by Congress.

And Governor, I noticed in your statement you said that direct borrowing is subject to the Federal debt ceilings imposed by the Congress. And so, therefore, it—at no time would cause the amount to exceed the ceiling?

Governor PARTEE. That is my understanding.

Secretary ALTMAN. That is correct; it is subject to the debt limit, as are all other Treasury securities.

Mr. BARNARD. I have what may be an obvious question. Last fall we took advantage of this program of authorized borrowing, \$2½ billion for 4 days according to your table. Was the length of time the reason you did not go into the open market to satisfy this need?

Secretary ALTMAN. Essentially, Mr. Barnard, that September use of the authority represents a good example of why we think we need it. By borrowing from the Federal Reserve, we were able to wait until the very last minute and see precisely what amount of debt capacity remained under the public debt limit between the amount of debt then outstanding and the \$700 billion ceiling, and borrow precisely that amount—namely \$2½ billion, on the shortest possible notice—which would then put us in the best possible position to go through the subsequent period during which the debt ceiling had reverted to \$400 billion. And yet, we were in a position where we had to do our best to be sure that interest and principal payments on the Government's debt were maintained.

So in other words, the short-notice aspect of the borrowing authority from the Federal Reserve was the principal advantage to us, then.

Governor PARTEE. You could not be sure of when Congress would act, either. It might have been 3 days, or 5 days, or 7, or 9 days. An so this provided the credit for just whatever length of time it was needed.

Mr. BARNARD. For the record, are you familiar with the figures at that particular time? The debt ceiling was what?

Secretary ALTMAN. \$700 billion.

Mr. BARNARD. And there was a request for \$780 billion I believe, wasn't it?

Secretary ALTMAN. That is approximately correct.

Mr. BARNARD. Then we settled back down to the figure of \$750 billion.

Secretary ALTMAN. That is right, \$752 billion.

Mr. BARNARD. So you were waiting for the determination of Congress on the \$750 billion before you then issued other debt instruments?

Secretary ALTMAN. Well, of course it wasn't just a question of waiting to see exactly what number the Congress gave us; it was more a problem of not being able to undertake new borrowings during that period between October 1, or September 30 when the temporary debt limit expired, and between passage of a new resolution extending it.

So it was more a question of our not having authority to borrow during that period between the expiration of the temporary debt limit and passage of a new law extending it, rather than exactly what number it was.

And as you all know, it is the obligation of the Secretary of the Treasury to do everything he can to be sure that there is not a default on Government obligations. So he took steps, in the 24 hours preceding October 1, to maximize our cash balance and thus permit us to go through the maximum number of days during which we would have no borrowing authority, but during which we obviously had to make payments on existing debt.

Mr. BARNARD. You have no borrowing authority, but you borrowed from the Federal Reserve?

Secretary ALTMAN. We borrowed from the Federal Reserve during the last 24 hours before the expiration of the temporary debt ceiling. We borrowed up to the maximum \$700 billion which pertained through September 30. But on October 1, that temporary debt ceiling expired—the permanent debt ceiling of \$400 billion governed. And so we borrowed in those last few remaining hours to give us a maximum cash balance.

Mr. BARNARD. I know this is a technicality, but I am wondering why you were not in violation at that particular time when it expired and you were borrowing from the Fed.

I mean, it did expire? Right?

Secretary ALTMAN. It expired on September 30.

Mr. BARNARD. And it was then \$400 billion. So far a period of time, then, the borrowings did exceed the \$400 billion?

Secretary ALTMAN. The debt outstanding exceeded, yes.

Mr. BARNARD. What happens in a situation like that?

Secretary ALTMAN. You can't issue new debt.

Mr. BARNARD. Well, let me ask Governor Partee a question. Has there ever been a situation when the Treasury requested the authority to borrow directly from the Federal Reserve, and the Fed denied that request?

Governor PARTEE. Not to my knowledge, no.

Mr. BARNARD. Mr. Chairman, I have no further questions at this time. I would like to reserve the right to ask some more, later.

Chairman MITCHELL. Certainly.

There is a mood in the House of Representatives that says: Get rid of congressional committees that don't serve any real function; get rid of all of the old things that have just been hanging around for a long period of time and are used infrequently. This is one of the contexts in which we want to review this draw authority. There is certainly a group of Members of the House of Representatives who feel very strongly that it is not just not needed. We have used it on 44 occasions. It has lapsed on several occasions. The economic world did not collapse. I believe the thinking behind some of the Members who oppose continuing this draw authority is that if there is good cash management practices, you really don't need the draw authority. And I would further assume that some of those Members who oppose it would say: Well, it might be needed in cases of a national emergency such as you alluded to, and if that is true why not just rework the language so that the draw authority would only apply to cases of true national emergency? Could I get your reaction to that—in the context that the authority has only been used 44 times and has lapsed 5 times?

Secretary ALTMAN. Mr. Chairman, you are in a much better position than I am to judge the mood of the Congress, but it seems to me that another facet of that mood is to at least reduce the rate of growth in Government spending.

Certainly there is an antispending movement afoot in the country. And the basic advantage of this direct purchase authority, beyond the national emergency considerations, is it enables us to carry lower cash balances, and thus borrow less, and thus cost the taxpayers less in interest than if we didn't have it.

So I would think it would be inconsistent with the mood of the Congress not to give us this authority and require us to carry somewhat higher cash balances and pay more interest on the public debt as a result.

Chairman MITCHELL. That is interesting, because I was going into that area, next.

In your testimony, you indicated that the draw authority enables the Treasury to maintain lower cash balances than otherwise you would be allowed to do. One of our colleagues, Congressman Rousselot from California, discussed this during the House debate on May 1. He pointed out that, during the period November 1, 1973, to October 31, 1974, when the authority lapsed, average daily balances were lower than during the following 12-month period. How do you account for that kind of a discrepancy? I assume he is accurate.

Secretary ALTMAN. Well, I think he was referring to average balances with the Federal Reserve banks—the Treasury's average balance with the Federal Reserve banks. And the reason that those balances were higher, or have increased since 1974, Mr. Chairman, really has nothing to do with this direct purchase authority.

Essentially, Treasury reported to the Congress in mid-1974 that our basic system of maintaining tax and loan account balances at commercial banks around the country was costing the Government more money than the value of the services which those banks were rendering. And as a result, in the fall of 1974, the Treasury took steps to reduce its tax and loan account balances at banks around the country, and correspondingly increase them at the Federal Reserve banks.

The reason we did that was: The Treasury earns money on its balances at the Fed, because those are invested. And of course the profits of the Federal Reserve System are paid into the Treasury.

So we took steps to increase our balances at the Fed by pulling them down at commercial banks as a way of earning more money on those balances. And that is the reason why those balances have risen.

Now I think you know that legislation permitting the Treasury to actually earn explicit interest on tax and loan account balances was passed by the Congress last October, and will be implemented as soon as Treasury receives an appropriation to provide for fees which will pay for banking services.

And when the tax and loan accounts begin to generate earnings for the Treasury, we will then go back to the practice of leaving the bulk of our operating funds in tax and loan accounts at commercial banks.

So the reason that the balances are higher at the Fed banks has nothing to do with the direct purchase authority.

Chairman MITCHELL. Let me try to continue to play the devil's advocate role here in terms of limiting this authority only to the emergency situations. If we would limit it just to a true national

emergency, I would assume that the \$5 billion would be a totally inadequate amount of money. Would that be your assumption in the face of a true national emergency? It depends on how I define "true," I suppose?

Secretary ALTMAN. I would really like to think about that, Mr. Chairman, and answer you for the record. I am not an expert on the Treasury's emergency preparedness procedures.

And while our present plans are built around the \$5 billion figure, I am not prepared to say this morning that that is wholly inadequate, because I would like to have a chance to review the other aspects of those plans.

Mr. BARNARD. Mr. Chairman, would you yield?

Chairman MITCHELL. Surely.

Mr. BARNARD. In regards to that, I notice from 1971 through 1975 seemed to be the period when there was the most frequent use of this authority. It is obvious that that had no relationship to the Vietnam war.

Secretary ALTMAN. Not to my knowledge.

Governor PARTEE. I think that reflected the style of the debt managers that the Treasury had at the time. They were doing their utmost to minimize cash balances because of this problem of not receiving interest on balances that were out with commercial banks, and therefore they tended to run closer to the margin. And at times, when the receipts weren't quite what they were expected to be, there were sudden needs as well. But it was more a matter of style than the war.

Chairman MITCHELL. The Emergency Bank Regulation Act affords the Treasury the power to freeze bank accounts. Now, wouldn't that make the draw authority absolutely unnecessary or superfluous, if we had a broad national emergency such as you indicated in your testimony? You already have the power to put a freeze on.

Secretary ALTMAN. Really, again, I am not an expert in emergency preparedness, Mr. Chairman, but I would think that the freeze authority is an inadequate substitute for our ability to draw directly from the Federal Reserve.

There are so many unforeseeable aspects to a true national emergency, which we usually define as a nuclear attack, that the ability to borrow from the Federal Reserve where we have this intimate working relationship and where procedures for lending to us on an hour's notice are in place, I think that that is necessary and it is not an authority that is adequately offset by just our ability to freeze bank accounts around the country.

If we had a true holocaust in this country, I don't think it is clear that we could get our hands on moneys that are maintained in banks in various parts of the country in the amount of time we would need, as compared to the short amount of time we could do so with the Fed.

Governor PARTEE. I think, Mr. Chairman, the problem is the definition of national emergency.

I assume that no one in this room would like to put the Government in the position where it can't pay its bills. And it seems to me that it is conceivable that one might have a national emergency in a political sense—in the sense that, for a time, people would not be prepared to buy Government securities because of some political happening. One could have it in an economic sense, because, let us say, a very major

bank failed in the United States, and people started to take their money out of banks. If they went into currency, there might not be much of a market for Government securities at the time all of this money was flowing out of the banks and into people's hands. Or it could be a military emergency of either lesser or greater extent, as a nuclear attack. I think the problem of pinning down just exactly what constitutes the emergency is the difficulty of limiting the authority to that kind of a case.

Now, as far as the \$5 billion limit is concerned, I think our presumption would be that what we need would be to have authority to provide some funds to the Treasury only until Congress could get together, and that might be difficult for Congress to do. And there would have to be estimates of how long in these various kinds of emergencies it would take the Congress to act. One might assume that it could be within a couple of weeks. Within a couple of weeks Congress could extend the authority or increase the authority. And so my feeling is the \$5 billion today is a lot different than \$5 billion was in 1942. It is a much, much smaller amount of money, in relative terms.

But still my feeling is that it is adequate on the presumption that Congress could act in about 2 weeks' time. That would take care of Treasury's funding; it would give the Treasury a cash balance for that period.

Chairman MITCHELL. Well, assuming that Congress could get itself together that effectively within 2 weeks, it would still seem to me to be an inadequate amount. We are spending \$3 billion a day now, aren't we?

Governor PARTEE. Yes; we are really comparing the \$5 billion with the deficit, which is on the order of \$50 or \$60 billion, because the revenues would presumably still be coming in from tax collections and that kind of thing.

So as I say, I think this is enough for awhile.

Chairman MITCHELL. Would you comment, Secretary Altman?

Secretary ALTMAN. Well, I simply wanted to say that I have no real difference of view with Governor ParTEE's estimate, but it is very hard to know, because in a period of very heavy maturities of Government securities \$5 billion might not carry us anything like 2 weeks; in a period of light maturities, seasonally light maturities, it might be adequate for more than that. So it is quite hard to know.

Chairman MITCHELL. Well, I am not going to try to pin you down to a hard answer this morning, but it seems to me in talking about a true national emergency that that \$5 billion is going to be totally inadequate. Your political and your economic system is at least temporarily disrupted, and it is my own feeling, and I don't know how my colleague feels about this, that \$5 billion would be a totally inadequate sum for such a situation.

Earlier I indicated that I assumed there was prudent cash management. I have to assume that. We now have the new tax and loan procedures, which are about to go into effect. Why would you need this draw authority from the standpoint of cash management once those new procedures go into effect?

Secretary ALTMAN. Mr. Chairman, again, without the Federal Reserve direct purchase authority, we run slightly higher balances at

our seasonal low points than we otherwise would do, because we don't have the ultimate flexibility represented by our ability to borrow from the Federal Reserve on what amounts to 2 hours' notice.

And that flexibility, that type of ultimate flexibility is not provided by the tax and loan account system. Our ability to earn interest on those balances is a major improvement from the standpoint of Federal cash management.

But what we are talking about here is short-term borrowing abilities, which is different from overall cash management.

And it simply will be the case that we will run slightly higher balances, to be sure that we are not suddenly caught short if we don't have this direct purchase authority, than if the Congress extends it.

Chairman MITCHELL. Is this true despite the fact that you draw interest on your balances?

Secretary ALTMAN. Yes; it is, because even though we draw interest on those balances—let me step back—the only major difference between our approach to our tax and loan account system, now that we have authority to earn interest as compared to when we didn't, is the fact that we will earn interest and that therefore that system will be more profitable, if you want to use that word, to the Government.

But that will not change our ability to obtain funds on very short notice. The same amounts of money will be in the tax and loan account system as were there before. It is just that we will be able to earn interest on it, whereas before they were idle, essentially.

But our ability to get money on short notice is not going to be changed.

Mr. BARNARD. Would the chairman yield?

Chairman MITCHELL. I would.

Mr. BARNARD. Secretary Altman, wouldn't you say that actually what the Treasury is doing, which is common practice for business big or small, is maximizing their cash balance? Instead of putting aside large cash balances, which are earning no interest, you are reducing your cash balances down to the very minimum needs required.

As a result you are maximizing the use of these cash balances.

Mr. ALTMAN. That's right.

Mr. BARNARD. And then it is like business, Mr. Chairman, that would do the same thing but on a certain day they would have an excessive need of cash, which they would run down to the bank and borrow for a few days and then pay it back.

Experience shows that this does maximize and permit you to utilize small balances. I am surprised that the Treasury has not used this more often.

It seems to me that if you had the rate of interest that the Fed charges you, that you would save even more money as far as the tax-payers are concerned. But, of course, the Fed may increase your interest rates a little bit on what they charge you.

May I have one further question on your time, Mr. Chairman?

Chairman MITCHELL. Certainly.

Mr. BARNARD. Governor Partee, we talked about this minutes' notice. Now, that bothers me a little bit. Is it just a telephone call and you say, great, let us go?

What procedure does the Fed go through with on this?

Governor PARTEE. Well, if the Treasury's direct borrowing is within the authorization limit, which is currently \$2 billion, there

would be a discussion simply between the Manager of the System's Open Market Account and the Treasury representatives.

Mr. BARNARD. Do you talk about the maturity at all?

Governor PARTEE. That generally would not be an issue, because the loan would probably be for just 2 or 3 days. If the Treasury requested a larger amount—say they want to go above the \$2 to \$3 billion, \$4 billion, even to \$5 billion—that would be large enough so that the maturity might be of some concern.

And when borrowing requested exceeds the authorization, telephone conference call or a wire (telegraph) notification to Federal Open Market Committee members and a vote by the committee as to whether this should be approved or not is required. For direct borrowing over the \$2 billion authorization, that would take half a day, perhaps, to get done. But under \$2 billion can be managed, I would say, in a matter of minutes. As a matter of fact, with a discussion between Treasury and the FOMC Account Manager in New York, Alan Holmes, and probably a call to the Chairman of the Board, the transaction would be completed very quickly.

I would agree with you, Mr. Barnard. Since the Treasury keeps its checking account with the Federal Reserve, the place that it is going to run out of money, if it has cut it too fine, is at the Federal Reserve, because its checks are going to be in excess of those balances. So that is where you need to put the money when it is required. It is very similar to an overdraft capacity or a backup line of credit arrangement that a commercial bank would have for its customers.

Mr. BARNARD. It still means though that when they make this draw you have not exhausted all your balances with the banks and savings and loans across the country?

Secretary ALTMAN. No.

Mr. BARNARD. You still have your balances there, but on paper you are down to zero balances. You are not talking about a zero balance situation, are you?

Secretary ALTMAN. Why don't I let Mr. Fitzpatrick answer that question.

Mr. FITZPATRICK. Typically we draw the balances down as close to zero as we can in the case of the large banks, what we call the C category banks, which would be the Bank of America, Citibank, and so forth. We could draw them down to exactly zero.

In the case of the medium size banks of which there are about 2,000 we could typically get at them to a zero balance also if we have sufficient notice or sufficient perception of the need. In the case of about 10,000 small banks, it is more difficult, so the practice has been, since I have been involved with it, to reach for all the large and intermediate bank balances and to the extent possible to get to the small banks.

Mr. BARNARD. Well, I think what you have done is understandable. It is the only practical way you can do it.

Mr. FITZPATRICK. Well, in the case of the small banks, we have a difficult time getting in touch with them. With the C banks it is a matter of a telephone call or a wire, but with the small banks, you have to depend upon the post office.

Mr. BARNARD. Thank you, Mr. Chairman.

Chairman MITCHELL. Mr. Hansen.

Mr. HANSEN. Thank you, Mr. Chairman.

I apologize for missing your statements, gentlemen, but I am familiar with them. I have a statement, Mr. Chairman, that have been prepared somewhat in concert with the anticipated statements which I would like inserted, perhaps after your own remarks, at the opening, if it would be your desire.

Chairman MITCHELL. Without objection they will be at the opening of the hearing.

Mr. HANSEN. I have a few questions I would like to propound. One is perhaps basically philosophical. If we are going to defeat inflation, I think we are going to have to be sure that the Fed and Treasury are somewhat separate, that the Fed controls the money supply and the Treasury, of course, needs to stay in line.

Do you agree with this type of analogy?

Governor PARTEE. Yes; I have testified to that fact.

Mr. HANSEN. Then perhaps this is the most important reason why we should do without the draw authority and substitute for it some sort of overdraft protection, some sort of a mechanism which does not touch the Fed as a national monetary authority.

I would like your reaction to that.

Governor PARTEE. Well, Mr. Hansen, I consider the direct borrowing authority to be essentially an overdraft arrangement. You see it is so limited relative to the total magnitude of funds that flow in the credit market, or the size of the GNP, or the size of Federal spending, that it seems to me that even if under duress the Federal Reserve put out the whole \$5 billion—and the FOMC would have to agree to this—and left it out for a considerable period of time—which would be a public event, noted in the statements, as we said, of the Federal Reserve and the Treasury, and undoubtedly would receive press comment and possibly a special ad hoc hearing of this committee—why even in that event, it would not significantly affect the situation with regard to money and credit in the country.

Indeed, what we would typically do, even with a small credit extension to the Treasury, is offset it by other open market operations so that the effect would be zero on bank reserves. That is to say, as we were lending the Treasury money, we might well be selling securities into the market and thus absorbing the reserves that we provided by having loaned the Treasury money.

So I don't think it is a significant kind of an entry into the central bank finance ministry association that concerns you and would concern me also.

Mr. HANSEN. Can you tell me why the FOMAC is involved with something that is basically a banking function?

Governor PARTEE. Because the specific authority is in a section of the Federal Reserve Act having to do with purchases and sales of securities. The purchases and sales of securities for the account of the Federal Reserve banks is a matter handled by the Federal Open Market Committee. Although I refer to them functionally as overdraft privileges, these transactions technically involve the purchases of securities directly from the Treasury by the System's Federal Open Market Account.

Mr. HANSEN. Well, is there any reason we should not move it out of there and into the Board of Governors?

Governor PARTEE. Well, that could be done, Mr. Hansen, but I don't think there would be any particular advantage.

Mr. HANSEN. How long has the \$2 billion limit been in effect and what has been the limit at other times?

Governor PARTEE. I am sorry, I don't have a full record on that. The \$2 billion has extended for quite awhile back, and I can't tell you when it was put on. The subject comes up very, very infrequently in the Federal Open Market Committee, because the facility is not used often.

And as I say, it is almost always used within that \$2 billion limit, and therefore it just seldom has come up. The last major entry we can find in the record of the Federal Open Market Committee was 1957.

Mr. HANSEN. In the September 30 entry, was there any special meeting at that time when you went to \$2½ billion.

Governor PARTEE. There was a wire communication from the Chairman of the Board to the members of the Federal Open Market Committee indicating what the problem was and the recommendation of the Manager of the Open Market Account desk and of the Chairman of the Board that the limit be raised to \$2½ billion, and there had to be affirmative responses by a majority of the Committee before that could be activated.

Mr. HANSEN. Then you are saying that you essentially followed the format that you were laying for Mr. Barnard a moment ago. Could you tell me when you got those responses?

Governor PARTEE. I don't have the record, sir. Since a majority of the FOMC is the Board of Governors right on the scene in Washington and since we have prompt attention to such wires by the presidents of Reserve banks who are members of the Committee, my assumption is that we would have had all but one or two before the end of the day.

Mr. HANSEN. In last fall's draw, how many persons at the Fed were involved in arranging this financing? And can you give their names and positions?

Governor PARTEE. Well, it would require the attention and concurrence of every member of the Federal Open Market Committee, which would be the seven members of the Board and the five voting Reserve bank presidents on the Committee at that time.

It also would have involved several people at the desk in New York: undoubtedly Alan Holmes, the manager for the special open market account, and probably Peter Sternlight, the deputy. And it would have involved in Washington several senior staff members: probably Stephen Axilrod and maybe Peter Keir, and probably one of our operations people in the division that has to do with Federal Reserve bank activities. And that is about the list.

Mr. HANSEN. Secretary Altman, could you give me the same answers as they pertain to the Treasury?

Secretary ALTMAN. Well, among those involved in the Treasury in this were the Under Secretary for Monetary Affairs, Tony Solomon, myself, the Special Assistant to the Secretary for Debt Management, and several senior members of the Treasury debt management staff, including Mr. Snyder, Mr. Cook, Mr. Cavanaugh, and I think that would be the list of senior Treasury people.

Mr. HANSEN. Can you gentlemen tell me what alternative overdraft arrangements you might suggest, instead of the draw authority?

Secretary ALTMAN. Mr. Hansen, I would say, frankly, I don't see any advantage at all to replacing the draw authority with some other approach. If your intention is to provide us with an overdraft capacity, as Governor Partee said, this is an overdraft facility. It is a tiny amount, \$5 billion, in comparison to total Federal outlays, the size of the money supply and other measures of overall comparison. I might point out in 1942 when this was first granted, it was granted at \$5 billion. I think the total Federal outlays then were about—well, they were less than 10 percent of the current level of outlays; the total money supply was probably also less than 10 percent of its total.

The \$5 billion, in other words, in percentage terms shrunk dramatically over the years as any potential influence on monetary policy, on total credit, or on anything else.

And I just don't think there would be anything served by changing the form of direct purchase authority, if you agree that we need one, that we need an overdraft capacity.

Mr. HANSEN. Do you agree, Governor Partee?

Governor PARTEE. One of the difficulties that I would have procedurally with an overdraft facility is that it would have to be specified at one of the Federal Reserve banks, presumably the Federal Reserve Bank of New York.

Technically the direct purchases are made by a joint account for the 12 Federal Reserve banks. We prefer not to have individual Reserve banks with individual landing authority, because of the precedential value that that might have in the possible use of such facilities for other purposes. We haven't raised this question, but I would think that probably the Board and the FOMC would take the position of preferring the current arrangement to a standard overdraft arrangement of the kind that commercial banks have.

Mr. HANSEN. Mr. Chairman, I have just one little parting shot. I would like to ask the gentlemen as a last rejoinder, and maybe Governor Partee would like to be involved in this; if you had an emergency cash flow problem now that you don't have this authority, what would you do?

Secretary ALTMAN. Using last September as an example, we would have been able to borrow somewhat less than \$2½ billion probably, to be sure that we did not pierce the debt limit, because we need more advance notice to borrow in the open market on a cash management basis than we do with the Fed.

We would have borrowed less than \$2½ billion from the public, and if the Congress had not passed a statute extending and expanding the temporary debt limit, then the amount of days during which we could have continued to make payments on all the bases the Federal Government has to make payments would have been shorter, and we would have run out of money sooner.

Theoretically, we would have run out of money sooner.

Governor PARTEE. As the holder of the Treasury's checking account, I would have to say that if it didn't have the money on deposit at the Reserve banks to clear the checks, we would have to bounce them. The Treasury checks would be returned for insufficient funds. But that would be a very difficult decision to make.

Chairman MITCHELL. As we work House Joint Resolution 816 through the coming year, it is my intention as of now to put in a bill to the effect that if the President declares a national emergency, the

Federal Reserve Board of Governors would have the authority to waive the \$5 billion ceiling. What is your reaction to that? Would that constitute any monumental problems for you, Secretary Altman?

Secretary **ALTMAN**. Mr. Chairman, I can't foresee any monumental objections. I think we would like to check it in relation to the existing emergency planning procedures.

For example, it is possible that that is already in there. I can't tell you that it isn't right now.

Chairman **MITCHELL**. I don't think that it is.

Secretary **ALTMAN**. But, in general, that concept would pose us no insurmountable problem.

Chairman **MITCHELL**. Governor Partee.

Governor **PARTEE**. I can't see any problem with it, but again I would like to check it. If it is a discrete event—that is, if you have a definition of national emergency that is declared by the President—then I think it can be done.

Chairman **MITCHELL**. Would you check and submit to us an evaluation of that?

[Governor Partee and Secretary Altman subsequently submitted the following letters for the record:]



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

J. CHARLES PARTEE
MEMBER OF THE BOARD

July 13, 1978

The Honorable Parren J. Mitchell
Chairman
Subcommittee on Domestic
Monetary Policy
Committee on Banking, Finance
and Urban Affairs
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman"

At your Committee's June 27th hearing on the Treasury's direct borrowing authority, you asked that I submit for the record my views on the desirability of an amendment to the Federal Reserve Act that would provide the Federal Reserve authority to waive the \$5 billion limit on direct Treasury borrowing in the event of a national emergency declared by the President.

I have checked into this matter, and it is my understanding that under existing emergency preparedness plans, upon the determination of a state of emergency by the President, suspension of the limit on direct purchases of U. S. Treasury obligations by the Federal Reserve is adequately handled.

Since suspension of the \$5 billion limit is provided for in the structure of emergency planning now in place, it would not appear that standby authority is required, since this would tend to single out this one aspect of emergency planning for special treatment.

Sincerely,



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 24, 1978

Dear Mr. Chairman:

At the June 27 hearings you asked for my views as to the need for legislation to provide for waiver of the \$5 billion limit on Federal Reserve direct purchases of Treasury obligations in the event of a national emergency declared by the President.

Our current emergency preparedness plans contemplate a number of amendments to existing law to deal with certain restrictions, including the \$5 billion limit. After reviewing these plans we have concluded that such amendments should be considered as a package in the context of overall emergency planning and that there is no need for special legislation at this time to waive the \$5 billion direct purchase limitation.

Please let me know if I can be of further assistance.

Sincerely yours,

Roger C. Altman

The Honorable
Parren J. Mitchell
Chairman, Subcommittee on
Domestic Monetary Policy
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Mr. BARNARD. Mr. Chairman, I would like to remark on the overdraft thing for just one moment. It seems to me that this is better than an overdraft system. This takes an overtaxing of Treasury and an overtaxing of the Federal Reserve. You could have a preauthorized overdraft like this.

But, it does seem to me that every time this was needed, it ought to come to the attention of somebody rather than just be automatic.

Mr. HANSEN. Will the gentleman yield?

Mr. BARNARD. Yes.

Mr. HANSEN. Did you get out of the colloquy a minute ago some idea that maybe there would be more careful money management practices if they did not have this little slopover possibility?

Mr. BARNARD. No, I think it ties in.

Mr. HANSEN. I was interested in Secretary Altman's remarks about how much more carefully things might be done under the circumstances.

Secretary ALTMAN. Well, if I could comment, Mr. Hansen.

You weren't here earlier when we had a conversation on this. It is not at all a question of more careful management. It is a question, in fact, or less careful management, because the direct purchase authority permits us to run smaller cash balances and thus borrow less and cost the taxpayers less in terms of interest. It saves the taxpayers money, because we can run a lesser cash balance.

So with it, we are able, in my judgment, to more efficiently manage the cash and the public debt, not the reverse.

Mr. BARNARD. I want to say I appreciate these gentlemen coming this morning as you do. The discussion has been very enlightening, and I think you have brought a lot of good information to us as far as this legislation is concerned. And I want to extend you my welcome.

Chairman MITCHELL. I too am grateful that you took the time to come before us this morning and my two colleagues for joining me.

And with that very, very elegant statement, the meeting is now adjourned until tomorrow morning, when we will continue our hearings and look at the relationship between monetary policy and the Treasury's financing needs.

[Whereupon, at 9:30 a.m., the hearing was adjourned, to reconvene at 8:30 a.m., Wednesday, June 28, 1978.]

FEDERAL RESERVE-TREASURY DRAW AUTHORITY

WEDNESDAY, JUNE 28, 1978

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The subcommittee met at 8:35 a.m. in room 2220 of the Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

Present: Representatives Mitchell, Barnard, and Hansen.

Chairman MITCHELL. The hearing will come to order.

If you listened to WTOP this morning, you heard a summary of what is going on on the Hill today. All committees are meeting simultaneously, and therefore, we are on a rather tight schedule.

This morning the subcommittee will conclude our hearings on the need for perpetuating the Federal Reserve Treasury draw authority; the administration and the implementation of the authority; and the broader related question of how the Treasury's financing needs in general affect the Federal Reserve's conduct of monetary policy and its control of our monetary policy.

Our focus today will be on the broader issue to which I referred, the matter of the Fed's conduct of monetary policy and its control of the money supply.

Our witnesses this morning are Prof. William Poole, professor of economics, of Brown University; Lawrence Kudlow, vice president and money market analyst, of Paine, Webber, Jackson & Curtis, and John Altee, president, Institute for Economic Analysis.

Gentlemen, first of all, I want to welcome you and thank you for taking the time out to be with us.

What I would like to do is take the testimony from all of you and then we will question you simultaneously.

We, of course, have copies of your written statements which will be submitted for the record. What I would like, if you could try to keep your oral presentation to 10 or 12 minutes, that would be tremendously helpful in light of the terrible timetable that we have today.

The distinguished ranking minority member, Mr. Hansen, has joined us. Do you have an opening statement, Mr. Hansen?

Mr. HANSEN. No; I think I will pass, in order to move the hearing along, Mr. Chairman.

Chairman MITCHELL. Fine. Thank you. Mr. Poole, will you lead off for us.

Mr. POOLE. Thank you.

**STATEMENT OF WILLIAM POOLE, PROFESSOR OF ECONOMICS,
BROWN UNIVERSITY**

Mr. POOLE. I am very pleased to be here this morning to provide my views on the Federal Reserve-Treasury draw authority which permits the Treasury to borrow up to \$5 billion directly from the Federal Reserve System. My discussion of this matter is divided into two parts. First, I will examine the functions of the draw authority and second, I will discuss some more general issues of monetary control raised by the existence of this authority.

FUNCTIONS OF TREASURY DRAW AUTHORITY

The Treasury draw authority should be viewed in two distinct contexts. First, in the case of a national military emergency it would certainly be possible that the financial markets would be closed due to physical destruction or other causes. In such an event it would obviously be impossible for the Treasury to sell securities to the general public in order to raise the cash necessary to carry on the everyday operations of the Government. In a national emergency the continuing functioning of the Government would, of course, be highly important and so it is sensible to plan for the remote possibility of such an event.

In a national emergency, however, a Treasury draw authority limited to \$5 billion—the magnitude of the authority that now exists—would probably be too small. After all, the Federal Government is now spending an average of almost \$3 billion per business day. My recommendation would be for a larger emergency Treasury draw authority—perhaps \$10 to \$15 billion to be utilized only in the event that a military emergency physically closes down the financial markets and makes the sale of Treasury debt impossible.

A second and quite unrelated function of the draw authority is to permit the Treasury to meet temporary cash needs that may arise under normal circumstances due to the inevitable planning mistakes and miscalculations that occur from time to time. There needs to be some mechanism to handle temporary Treasury cash needs in excess of those provided for by current tax receipts and regularly scheduled sales of Treasury securities. For the most part, of course, temporary cash needs can be met out of existing Treasury cash balances at the Federal Reserve. Precisely because it cannot forecast its cash needs with perfect accuracy, the Treasury has a longstanding practice of maintaining cash balances that provide for some cushion against contingencies.

Nevertheless, there may be times when the Treasury balances at the Fed cannot satisfy the Treasury cash needs. In some cases it will be possible for the Treasury to market additional securities on short notice, but in other cases selling extra securities might be quite costly. The existing draw authority provides a way for the Treasury to handle such a situation conveniently and at little cost.

It is my recommendation, however, that the Treasury not be permitted to borrow funds directly from the Federal Reserve but rather that the Treasury be permitted to borrow Government securities from the Federal Reserve's portfolio. The borrowed securities could then be sold by the Treasury on the open market to raise the needed cash.

This proposal has little practical difference from the existing arrangement. When the Treasury borrows directly from the Federal Reserve and then spends the borrowed funds, there is an immediate increase in the reserves of the banking system. To neutralize the monetary impact of this reserve increase, the Federal Reserve typically sells securities from its portfolio in order to drain the newly created reserves from the banking system. My recommendation would involve no practical difference, because instead of the Federal Reserve lending cash to the Treasury and then selling securities from its portfolio, the Treasury would borrow the securities and sell them.

Although my proposal involves no practical difference it has the advantage of providing a clear congressional statement that the Treasury is not to have a claim on newly created Federal Reserve money. This statement of principle is extremely important in reducing the possibility at some future time of excessive money creation due to Treasury borrowing from the Federal Reserve not offset by Federal Reserve sales of securities.

My recommendation, therefore, is that in the absence of a national emergency the Treasury be permitted only to borrow Government securities from the Federal Reserve, with the size of the borrowing limited to securities aggregating \$5 billion in market value. The precise security issues to be borrowed would be determined through Treasury-Federal Reserve consultations.

GENERAL MONETARY CONTROL ISSUES

The Treasury draw authority, like most other individual pieces of legislation related to monetary and banking regulation, is a minor element of a very much larger matter concerning monetary control. Although it would be highly desirable to have a thorough reform of our monetary legislation and Federal Reserve regulatory practice in order to make monetary control more exact, until such a reform is put in place it is necessary to proceed on a case-by-case and bit-by-bit basis, insuring that new legislation moves in the correct direction rather than in the wrong direction. To provide a framework in which to view the current legislation, a few general money control issues will now be examined.

That there is a monetary control problem can be seen clearly from the charts at the end of my statement. These charts show that money growth has consistently slowed at the time of business cycle recessions and has speeded up during business cycle expansions. Consider the chart on page 12.

The sharp deceleration of money growth before the onset of the 1969-70 recession—the beginning of the recession is indicated by the vertical line marked "P" for "business cycle peak"—shows up clearly. Or, examine page 13 for a clear picture of the monetary deceleration during the last recession. However, lest there be excessive concentration on monetary decelerations and recessions, note also that monetary accelerations have preceded inflationary business booms, such as the 1967-69 and 1972-73 booms.

The long standing highly procyclical pattern to money growth has contributed to the business cycle recessions and inflations that we have experienced over the years. At your leisure, I urge you to examine my

charts for the entire period since 1908 in order to see just how procyclical money growth has been, and to see how regular and consistent the pattern has been.

Monetary instability is due to a variety of factors, none of which should be permitted to continue. The basic problem is that the legislation controlling the Federal Reserve, Federal Reserve regulations, and Federal Reserve practices have all consistently ignored monetary control issues. As a result we have a very poor monetary control system.

Our monetary system has two basic features that make for sloppy monetary control. First, the normal flows of reserves into and out of the banking system as a whole produce short run monetary disturbances that the banks themselves cannot offset due to the nature of our banking regulations. Consider, for example, the effect of lagged reserve requirements regulation, in force since 1968.

When, for example, the Treasury draws down its cash balances at the Fed, new reserves are pumped directly into the banking system as the balances spent by the Treasury are transferred on the books of the Federal Reserve to the member bank reserve accounts. The member banks, therefore, have larger reserve balances. However, their required reserves are based, since 1968, on their deposits 2 weeks earlier, and so the new reserve balances are entirely in excess of the requirements since reserve flows 1 week obviously cannot affect deposits 2 weeks earlier. The banks, wanting to invest these extra balance at interest, put the balances up for lending on the Federal funds market. But since banks in general have excess reserves, the demand for Federal funds is low and so the interest rate on Federal funds is bid down to very low levels. The Federal Reserve, not wanting to see interest rates bid to low levels, comes into the market to absorb the excess reserves and to prop up the interest rate.

The process, of course, works exactly in reverse when the balances flow from the banks into the Treasury as, for example, when taxes are paid or payments are made for newly sold Treasury securities. In this case, banks experience reserve shortages and bid up interest rates. Since the regulations provide no way for the banks to meet a temporary reserve shortage, the Federal Reserve feels compelled to enter the market to supply additional reserves to hold interest rates within targeted bounds.

The second feature of our monetary system that makes for poor monetary control is that reserve disturbances—which the banks cannot manage very well—are far larger than they need to be. The Federal Reserve should be pushed to reform its reserve regulations so that banking disturbances can be handled more easily, but until these reforms are put into place every effort should be made to avoid adding to the sources of disturbances in reserve flows. My recommendation on the Treasury draw authority is designed with this objective in mind. If the Treasury borrows securities from the Federal Reserve to meet current cash needs, then banking disturbances are minimized. The purchasers of the securities sold by the Treasury pay funds into the Treasury and the Treasury pays those funds back out as it writes checks. In contrast, if the Treasury borrows funds directly from the Federal Reserve, then the Federal Reserve is required to take action to neutralize the monetary impact of the Treasury spending the newly created reserve balances.

Now, just a couple concluding comments.

As should be clear from my discussion, the legislation at hand is a minor part of a very important subject; but if total reform is not at hand, let us at least insure that we move in the correct direction on each minor matter.

The issue at hand—the broader issue—is clearly of enormous importance. Everyone recognizes that extreme neglect of monetary control has led to extreme consequences. No one who lived through the great German inflation in the early twenties will dispute this contention. In that experience it is clear that printing press money was directly responsible for the hyperinflation.

Less well known, but equally clear, is the fact that monetary instability caused the Great Depression. Failure of the Federal Reserve to prevent the 1929–33 monetary collapse that shows up so clearly on the chart on page 10 turned what might have been a minor recession into the Great Depression. The great German inflation and the Great Depression were both avoidable, but were not in fact avoided because of the lack of attention paid to monetary stability.

While conjuring up visions of hyperinflation and the Great Depression is probably going a bit far in the context of the legislation at hand, there is no need to rely on such extreme cases to understand the importance of the issue at hand. Examine the charts for the period since World War II and note the clear tendency of money growth to slacken during recessions and to rise during booms. This pattern of money growth has exacerbated our business cycles and may in fact be the root cause of even relatively small business cycle movements. The matter is of immediate and compelling importance. The acceleration of inflation today has certainly not been helped by the acceleration of money growth in 1976 and 1977. The deceleration of money growth now underway, if pushed too far, will surely produce a recession starting next year. The patterns are all too regular and all too obvious to be ignored.

Thank you, Mr. Chairman.

Chairman MITCHELL. Thank you, Mr. Poole. Your entire statement will be inserted in the record at this point.

[Mr. Poole's prepared statement follows.]

Statement by William Poole
Professor of Economics, Brown University
Before the Subcommittee on Domestic Monetary Policy
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
June 28, 1978

I am very pleased to be here this morning to provide my views on the Federal Reserve--Treasury draw authority which permits the Treasury to borrow up to 5 billion dollars directly from the Federal Reserve System. My discussion of this matter is divided into two parts. First, I will examine the functions of the draw authority and, second, I will discuss some more general issues of monetary control raised by the existence of this authority.

Functions of Treasury Draw Authority

The Treasury draw authority should be viewed in two distinct contexts. First, in the case of a national military emergency it would certainly be possible that the financial markets would be closed due to physical destruction or other causes. In such an event it would be obviously impossible for the Treasury to sell securities to the general public in order to raise the cash necessary to carry on the every-day operations of the government. In a national emergency the continuing functioning of the government would, of course, be highly important and so it is sensible to plan for the remote possibility of such an event.

In a national emergency, however, a Treasury draw authority limited to 5 billion dollars--the magnitude of the authority that now exists--would probably be too small. After all, the Federal Government is now spending an average of almost 3 billion dollars per business day. My

recommendation would be for a larger emergency Treasury draw authority--perhaps \$10-15 billion to be utilized only in the event that a military emergency physically closes down the financial markets and makes the sale of Treasury debt impossible.

A second and quite unrelated function of the draw authority is to permit the Treasury to meet temporary cash needs that may arise under normal circumstances due to the inevitable planning mistakes and miscalculations that occur from time to time. There needs to be some mechanism to handle temporary Treasury cash needs in excess of those provided for by current tax receipts and regularly-scheduled sales of Treasury securities. For the most part, of course, temporary cash needs can be met out of existing Treasury cash balances at the Federal Reserve. Precisely because it cannot forecast its cash needs with perfect accuracy, the Treasury has a long-standing practice of maintaining cash balances that provide for some cushion against contingencies.

Nevertheless, there may be times when the Treasury balances at the Fed cannot satisfy the Treasury cash needs. In some cases it will be possible for the Treasury to market additional securities on short notice, but in other cases selling extra securities might be quite costly. The existing draw authority provides a way for the Treasury to handle such a situation conveniently and at little cost.

It is my recommendation, however, that the Treasury not be permitted to borrow funds directly from the Federal Reserve but rather that the Treasury be permitted to borrow government securities from the Federal Reserve's

portfolio.¹ The borrowed securities could then be sold by the Treasury on the open market to raise the needed cash.

This proposal has little practical difference from the existing arrangement. When the Treasury borrows directly from the Federal Reserve and then spends the borrowed funds there is an immediate increase in the reserves of the banking system. To neutralize the monetary impact of this reserve increase the Federal Reserve typically sells securities from its portfolio in order to drain the newly created reserves from the banking system. My recommendation would involve no practical difference because instead of the Federal Reserve lending cash to the Treasury and then selling securities from its portfolio, the Treasury would borrow the securities and sell them.

Although my proposal involves no practical difference it has the advantage of providing a clear congressional statement that the Treasury is not to have a claim on newly created Federal Reserve money. This statement of principle is extremely important in reducing the possibility at some future time of excessive money creation due to Treasury borrowing from the Federal Reserve not offset by Federal Reserve sales of securities.

My recommendation, therefore, is that in the absence of a national emergency the Treasury be permitted only to borrow government securities from the Federal Reserve, with the size of the borrowing limited to securities aggregating \$5 billion in market value. The precise security issues

¹The face value of any securities borrowed from the Federal Reserve should be added to the debt total to which the debt limit applies. Otherwise, the Treasury could evade the congressionally-determined debt limit by borrowing and selling securities rather than by borrowing funds directly.

to be borrowed would be determined through Treasury-Federal Reserve consultations.

General Monetary Control Issues

The Treasury draw authority, like most other individual pieces of legislation related to monetary and banking regulation, is a minor element of a very much larger matter concerning monetary control. Although it would be highly desirable to have a thorough-going reform of our monetary legislation and Federal Reserve regulatory practice in order to make monetary control more exact, until such a reform is put in place it is necessary to proceed on a case-by-case and bit-by-bit basis, insuring that new legislation moves in the correct direction rather than in the wrong direction. To provide a framework in which to view the current legislation a few general money control issues will now be examined.

That there is a monetary control problem can be seen clearly from the charts at the end of my statement. These charts show that money growth has consistently slowed at the time of business cycle recessions and has speeded up during business cycle expansions. Consider the chart on page 12. The sharp deceleration of money growth before the onset of the 1969-70 recession--the beginning of the recession is indicated by the vertical line marked "P" for "business cycle peak"--shows up clearly. Or, examine page 13 for a clear picture of the monetary deceleration during the last recession. However, lest there be excessive concentration on monetary decelerations and recessions note also that monetary accelerations have preceded inflationary business booms, such as 1967-69 and 1972-73.

The long-standing highly procyclical pattern to money growth has contributed to the business cycle recessions and inflations that we have experienced over the years. At your leisure I urge you to examine my charts for the entire period since 1908 in order to see just how procyclical money growth has been, and how regular and consistent the pattern has been.

Monetary instability is due to a variety of factors, none of which should be permitted to continue. The basic problem is that the legislation controlling the Federal Reserve, and Federal Reserve regulations, and Federal Reserve practices have all consistently ignored monetary control issues. As a result we have a very poor monetary control system.

Our monetary system has two basic features that make for sloppy monetary control. First, the normal flows of reserves into and out of the banking system as a whole produce short-run monetary disturbances that the banks themselves cannot offset due to the nature of our banking regulations. Consider, for example, the lagged reserve requirements regulation in force since 1968. When, for example, the Treasury draws down its cash balances at the Fed new reserves are pumped directly into the banking system as the balances spent by the Treasury are transferred on the books of the Federal Reserve to the member bank reserve accounts. The member banks, therefore, have larger reserve balances. However, their required reserves are based, since 1968, on their deposits two weeks earlier, and so the new reserve balances are entirely in excess of the requirements since reserve flows one week obviously cannot affect deposits two weeks earlier. The banks, wanting to invest these extra balance at interest, put the balances up for lending on the federal funds market.

But since banks in general have excess reserves the demand for federal funds is low and so the interest rate on federal funds is bid down to very low levels. The Federal Reserve, not wanting to see interest rates bid to low levels, comes into the market to absorb the excess reserves and to prop up the interest rate.

The process, of course, works exactly in reverse when balances flow from the banks into the Treasury as, for example, when taxes are paid or payments are made for newly sold Treasury securities. In this case banks experience reserve shortages and bid up interest rates. Since the regulations provide no way for the banks to meet a temporary reserve shortage, the Federal Reserve feels compelled to enter the market to supply additional reserves to hold interest rates within targeted bounds.

The second feature of our monetary system that makes for poor monetary control is that reserve disturbances--which the banks cannot manage very well--are far larger than they need to be. The Federal Reserve should be pushed to reform its reserve regulations so that banking disturbances can be handled more easily, but until these reforms are put into place every effort should be made to avoid adding to the sources of disturbances in reserve flows. My recommendation on the Treasury draw authority is designed with this objective in mind. If the Treasury borrows securities from the Federal Reserve and sells the securities as needed to obtain the funds to meet current cash needs, then banking disturbances are minimized. The purchasers of the securities sold by the Treasury pay funds into the Treasury and the Treasury pays those funds back out as it writes checks. In contrast, if the Treasury borrows funds directly from the

Federal Reserve, then the Federal Reserve is required to take action to neutralize the monetary impact of the Treasury spending the newly created reserve balances.

Concluding Comments

As should be clear from my discussion the legislation at hand is a minor part of a very important subject; but if total reform is not at hand let us at least ensure that we move in the correct direction on each minor matter.

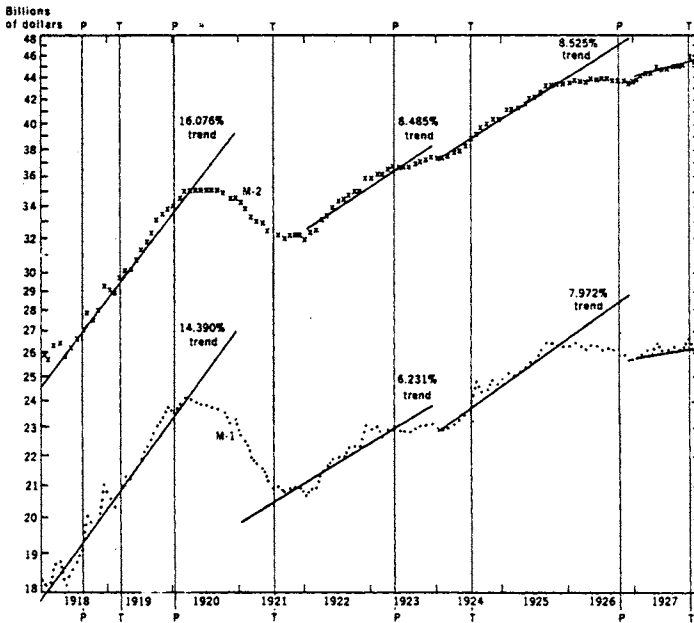
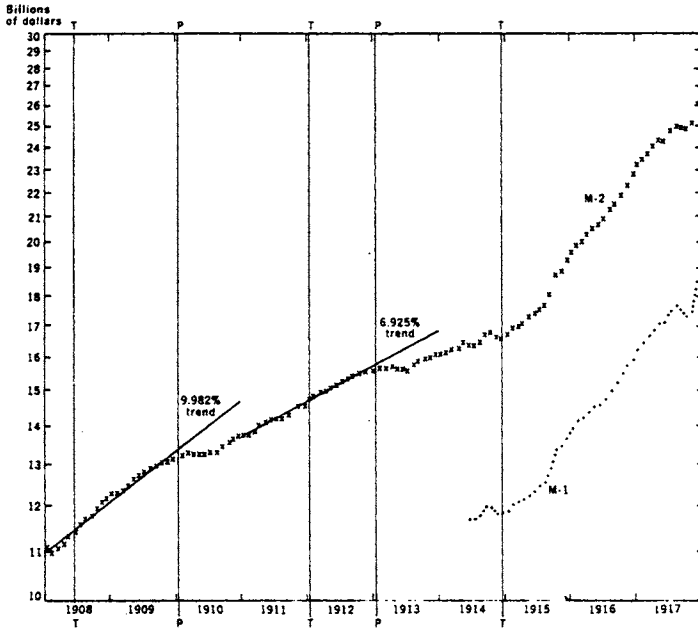
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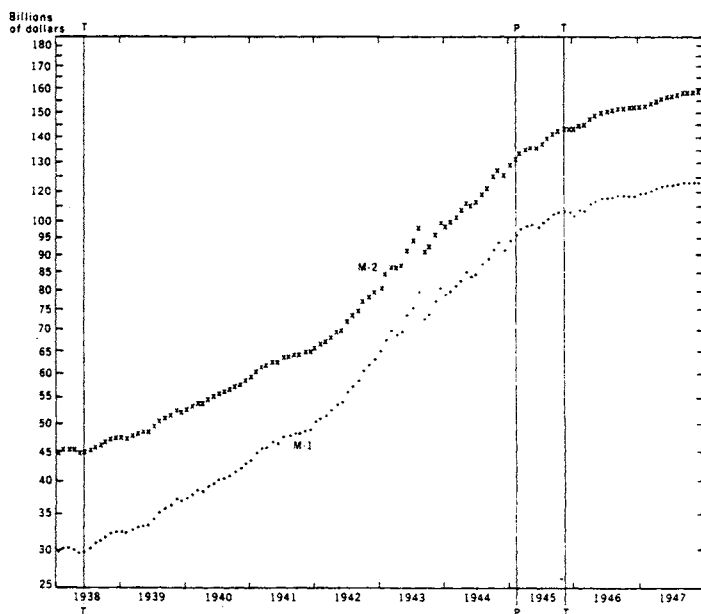
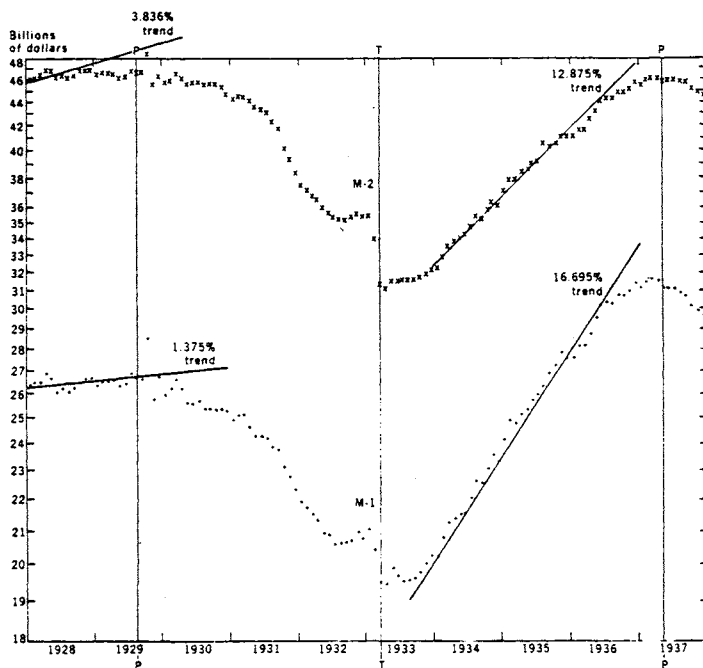
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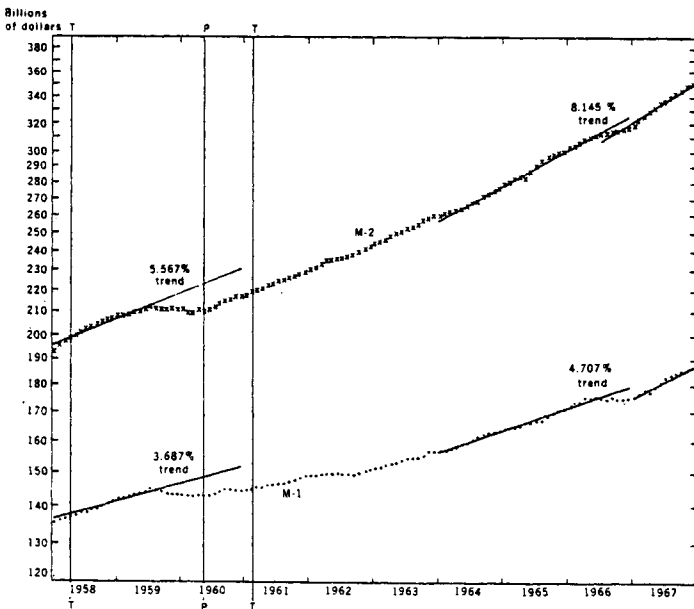
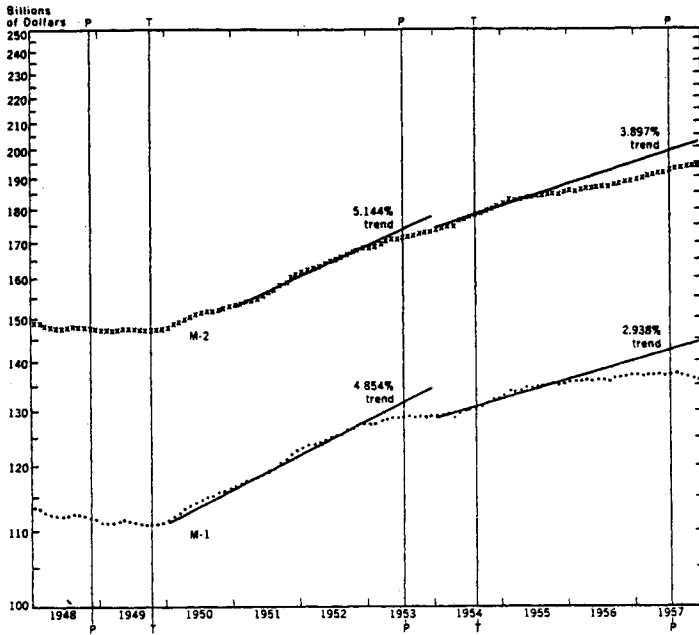
While conjuring up visions of hyperinflation and great depression is probably going a bit far in the context of the legislation at hand, there is no need to rely on such extreme cases to understand the importance of the issue at hand. Examine the charts for the period since World War II and note the clear tendency of money growth

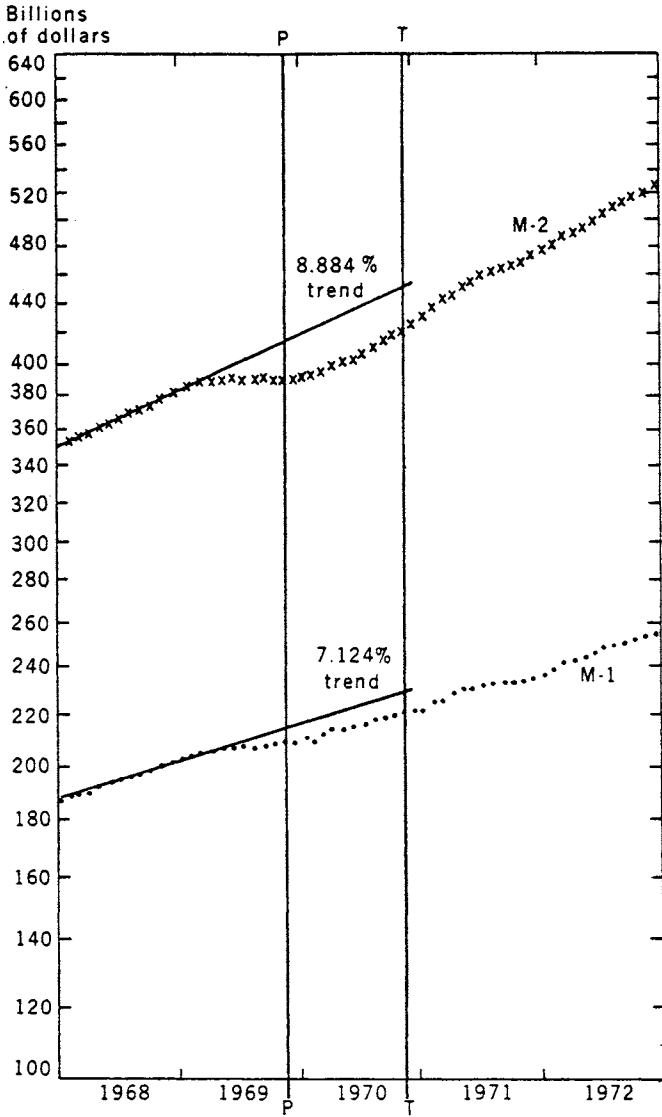
to slacken during recessions and to rise during booms. This pattern of money growth has exacerbated our business cycle and may in fact be the root cause of even relatively small business cycle movements. The matter is of immediate and compelling importance. The acceleration of inflation today has certainly not been helped by the acceleration of money growth in 1976 and 1977. The deceleration of money growth now underway, if pushed too far, will surely produce a recession starting next year. The patterns are all too regular and all too obvious to be ignored.

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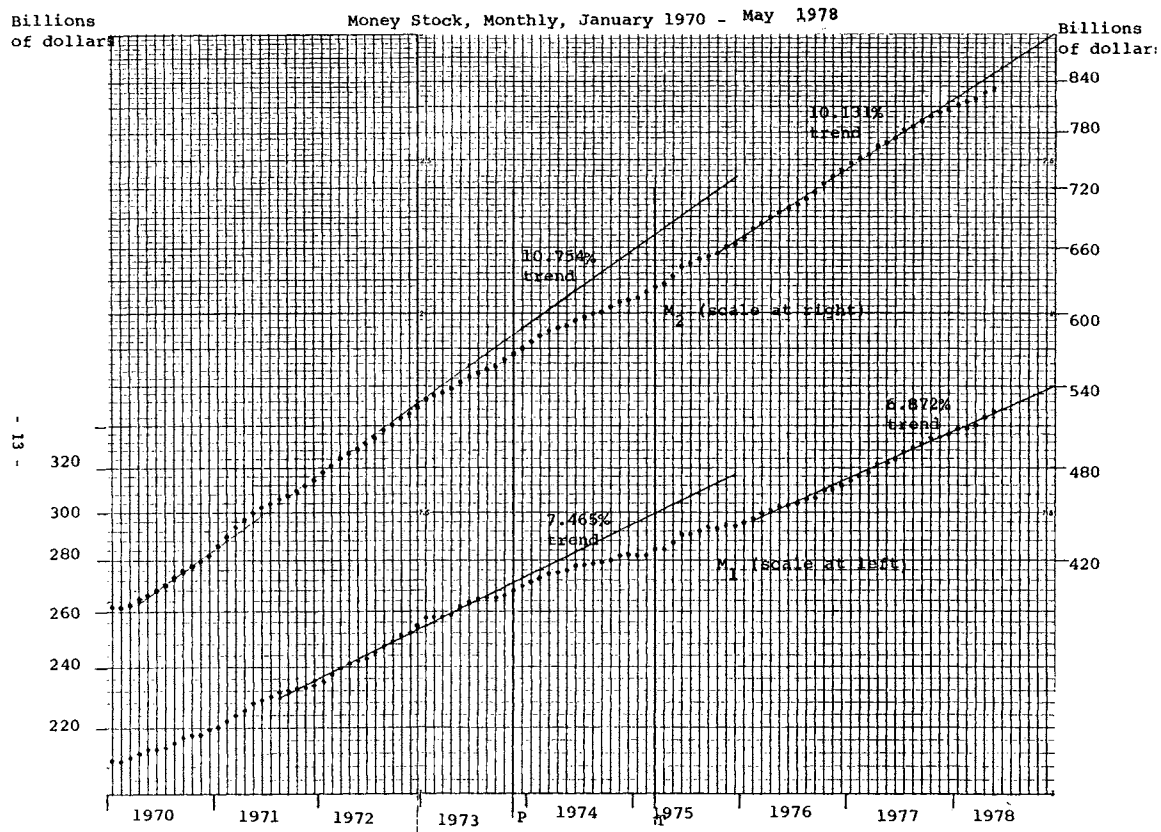








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Notes on the figures:

- 1) The NBER business cycle peaks and troughs are indicated by the vertical lines marked "P" and "T".
- 2) The money growth trends were determined by fitting moving least squares time trends to the logarithms of the monthly money stock data over 25-month intervals. The highest time trend over a 25-month interval is identified as the trend rate of money growth characterizing the expansion phase of the business cycle. The figures show these trends for every business cycle expansion since 1908 with the exceptions of the expansions during the two World Wars and the 1945-48 expansion.
- 3) The charts on pp. 9-12 were taken from William Poole, "The Relationship of Monetary Decelerations to Business Cycle Peaks: Another Look at the Evidence," Journal of Finance, 30 (June, 1975), 697-712. The monetary data have been revised slightly since these charts were drawn.

Chairman MITCHELL. Mr. Atlee?

STATEMENT OF JOHN S. ATLEE, PRESIDENT, INSTITUTE FOR ECONOMIC ANALYSIS

Mr. ATLEE. Today there are widespread fears that we are heading into another tight money recession, as Mr. Poole said—even before we have fully recovered from the last one. I especially appreciate the opportunity to testify before this subcommittee because I believe that this subcommittee has a mandate which could play a key role in preventing such a disaster.

It is now fashionable to say that the idea of economic fine tuning has proved a failure. However, the main reason it has failed in the past is that we do not yet have even the most basic policy tools which would be needed to make it work effectively.

The main thrust of my testimony is to explain how more systematic and precise coordination between our monetary and fiscal policy could provide the main key to achieving stable full employment growth without inflation, and to describe briefly the main new policy tools which are needed to make such coordination possible.

For continued stable recovery toward full employment, there are three basic policy requirements:

First, a firm and credible recovery target. We had hoped that the present administration would provide this, but it has not; second, money growth keyed explicitly and solely to supplying the money stock needed to service the growth of income and spending along the prescribed recovery path—as shown, for example, in the IEA chart panel 2A, which is attached as the next-to-the-last page of my statement; and third, formula flexibility of fiscal policy explicitly keyed to maintaining a stable balance between the total supply and demand for credit, with stable interest rates.

Part A below discusses these requirements briefly, with primary emphasis on the functional relationships between monetary and fiscal policy, and the way in which credit-related stabilization tax adjustments could facilitate precise coordination between them.

Part B discusses in some detail the specific requirements for an appropriate rate of money growth.

Part C discusses briefly several means of achieving more precise measurement and control of the money supply.

NO. 1: FIRM RECOVERY TARGET

Perhaps the most basic requirement for more effective economic policy is the adoption of a firm and credible Government commitment to maintain a stable rate of recovery until we reach genuine full employment—and then to maintain stable full employment as the basic operating condition of our economy. I wish that such a commitment could be included in the final version of the Humphrey-Hawkins Full Employment and Balanced Growth Act.

NO. 2: ECONOMICALLY APPROPRIATE MONEY GROWTH

To actually achieve stable recovery toward full employment, monetary policy should have but one purpose: to supply the economy

with the precise amount of money stock which is needed to maintain that stable recovery.

However, in our present policy framework, the Federal Reserve is expected to control not only the money supply, but also the level of interest rates and the supply of credit. This is a flagrant case of responsibility without corresponding authority. In actual fact, the growth of the money supply normally provides only about 10 percent of the total supply of credit. Thus, the Federal Reserve has only marginal and indirect control over interest rates and the total supply of credit.

For both accurate analysis and sound policy, it is necessary to make a clear distinction between "tight money" and "tight credit." The potential for economic disruption which is inherent in the Fed's traditional conflicting responsibilities was again demonstrated during the past year.

The sharp increase in interest rates during the second and third quarters of 1977 has usually been blamed on a Federal Reserve "tight money" policy. In fact, as chart panel 2A shows, the growth of the money stock during that period remained very close to the precise amount needed to maintain the Carter administration's apparent policy target of 5 percent real growth. The formula used for the "money needed" line is explained in part B, below. Thus, the real culprit was not "tight money" but "tight credit" caused by excessive borrowing. Because of the large increase in mortgage borrowing and business borrowing—augmented by an untimely increase in the Federal deficit—the Fed could not have prevented the increase in interest rates without allowing an excessive increase in the money supply. What was needed was not more money but less borrowing.

During the first quarter of this year, however, there was exactly the opposite kind of imbalance. In this case, "monetary" policy was apparently determined not by the economy's need for money, but by the Fed's desire to maintain a 6½ percent Federal funds interest rate, in the belief that this would prevent further decline of the dollar exchange rate. Because of the sharp decline in mortgage borrowing and other demands for credit—which was undoubtedly partly due to the bad weather and coal strike—the Fed could keep the funds rate up to 6½ percent only by allowing a sharp decline in the rate of money growth. The Fed could have achieved both its interest-rate target and adequate money growth only if there had been a temporary "compensatory" increase in Federal borrowing to offset the decline in private borrowing.

Although complete data on total borrowing during the second quarter of this year are not yet available, the phenomenal spurt of consumer installment borrowing and the rebound of housing starts, together with the sharp rise in interest rates, suggest that this quarter is repeating the "tight credit" imbalance which occurred during the second and third quarters of last year. Although second-quarter money growth has not been fast enough to make up for this large first-quarter shortfall, it would probably be wrong to call this "tight money."

NO. 3: FLEXIBLE FISCAL POLICY

During the past few months Congress and the Carter administration have spent much effort trying to decide—and to agree on—how much to cut taxes, and when. Also, on how large the federal deficit

should be next year, and the year after. The fact is that no one can now know with certainty how much tax cut will actually be needed next fall or winter, or how much deficit will really be appropriate next year or the year after. What is needed is the fiscal machinery for flexible adjustment of fiscal policy to the current needs of the economy.

It has often been suggested that the President could be given discretionary authority to make needed temporary adjustments in tax rates. I believe that Congress has been right in refusing this authority because of the possibility that it could be misused for partisan political purposes.

"Formula flexibility."—Seventeen years ago the prestigious Commission on Money and Credit recommended serious consideration of what it called "formula flexibility"—that is, "provision for automatic changes in the level of certain tax rates whenever prescribed economic indicators change by specified amounts." "At first glance," said the CMC, "such a proposal may seem radical. Actually, however, it would do little more than make explicit what is now implicit in the conventional type of automatic stabilizers"—mainly the "automatic" effect of recessions on Federal tax receipts and "depression relief" expenditures.

The main reason that this idea has received so little attention has been the failure to devise suitable "indicators" on which to base the formula.

However, the current increased interest in more systematic coordination of monetary and fiscal policy suggests a highly appropriate basis for such a formula—the size of the Federal deficit should be varied in such a way as to maintain a stable balance between the total supply and demand for credit, with stable interest rates.

Thus, when interest rates are tending to rise because of excessive private borrowing—or insufficient financial saving—the Federal deficit should be reduced by means of a small temporary increase in withholding taxes. On the other hand, when private borrowing is weak, but it is considered desirable—for foreign exchange or other reasons—to maintain a particular interest rate, the Federal deficit should be increased by means of a small reduction in withholding taxes—rather than reducing the money supply and causing recession.

Administratively, such a "stabilization tax adjustment" would be relatively simple. Most large payrolls are today compiled by computer. I have been told by one of the large firms which performs this service that the required adjustment could be carried out very simply by a single additional instruction to their computer.

The withholding tax rate would clearly be the simplest means of effecting the required adjustment in the first instance. However, other taxpayers would make a similar adjustment in their quarterly or annual returns. Moreover, as the experience of the past year shows, the adjustments in different quarters might largely cancel out for the year as a whole.

One of the greatest advantages of this approach to economic stabilization is the very high degree of precision and flexibility which it could provide. Because the adjustments could be made as often as needed—once a quarter or even oftener—they would tend to be quite small—particularly after the economy has been actually stabilized for long enough to correct the massive structural distortions caused

by past recessions and "booms." There is a close analogy here to driving a car: on a winding road the driver must make continuous large adjustments of the steering wheel; on a straight road he may make almost as many adjustments, but they will be much smaller.

On the model T Ford, to use another automotive analogy, there were two levers beside the steering wheel—one to adjust the spark, the other to adjust the gasoline/air mixture. Modern cars make both these adjustments automatically. I believe it is time that we similarly modernized our present "Model T" approach to coordination of monetary and fiscal policy.

Formula flexibility would provide more effective congressional control of the Federal budget.—The present large deficit was not decided by Congress, but mainly by the fact that the economy is still operating so far below capacity. Congressional budget discussions are now based largely on unreliable "forecasts" of future economic and credit conditions. With "automatic" formula control of the economic stabilization aspect, Congress would have much more effective control over the basic structure of spending and taxes, as expressed in the high-employment budget, and would not have to devote so much fruitless time and effort to the shortrun implications of its actions, over which it has so little effective control. Moreover, the stabilization adjustment would automatically compensate for faulty estimation of the effect of new taxes—for example, the crudeoil tax or turnover tax—large changes in tax rates—for example, the social security tax—or new expenditure programs—for example, medicaid/medicare, job programs—and shortfalls of actual spending below budgeted amounts.

I would now like to list several things which the Federal Reserve should include in its quarterly report to Congress.

Chairman MITCHELL. Page 12?

Mr. ATLEE. Page 12; right.

First, detailed data for the key factors related to monetary velocity, which is one of the two key factors in the formula for appropriate monetary growth.

Second, state in explicit, quantitative terms, its forecast or policy target for total monetary stimulus, which is the sum of the growth of the money supply and the trend of velocity change.

Third, cease reporting of a quarterly target range for the growth of M_1 .

Fourth, cease setting any policy targets for M_2 , M_3 , and all the other confusing "money and credit aggregates" which the Fed has added in recent years.

I would also like to list several specific measures which would help to achieve precise measurement and control of the supply.

First, eliminate all reserve requirements on time and savings deposits and have uniform reserve requirements for all classes of demand deposits.

Second, require all banks to become members of the Federal Reserve System.

Third, pay interest on members banks' reserve deposits.

Fourth, require 100 percent reserves against all demand deposits. That sounds like a radical proposal, but it would be relatively simple and undisturbing, I believe, if we did it the right way.

Fifth, float the discount rate—tie it to the Federal funds rate.

A final note: It is likely that a number of the proposals and analytical aspects discussed in this statement lie outside the official mandate of this subcommittee.

However, I believe it is also true that some of the key aspects relating to the coordination of monetary and fiscal policy do not fit very neatly within the traditional mandate of any existing congressional committee.

Therefore, I hope that this subcommittee will give consideration to this problem, and perhaps make some recommendation to Congress as to how these matters could most effectively be dealt with by Congress.

Thank you, Chairman Mitchell.

Chairman MITCHELL. Thank you very much. Your entire statement will be inserted in the record at this point.

[Mr. Atlee's prepared statement follows:]

PREPARED STATEMENT OF
JOHN S. ATLEE
(President, Insitute for Economic Analysis)
FOR PRESENTATION TO
THE HOUSE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
June 28, 1978

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Today there are widespread fears that we are heading for another "tight money" recession -- even before we have fully recovered from the last one. I especially appreciate the opportunity to testify before this committee because I believe that this committee has a mandate which could play a key role in preventing such a disaster.

It is now fashionable to say that the idea of economic "fine tuning" has proved a failure. However, the main reason it has failed in the past is that we do not yet have even the most basic policy tools which would be needed to make it work effectively.

The main thrust of my testimony is to explain how more systematic and precise coordination between our monetary and fiscal policy could provide the main key to achieving stable full employment growth without inflation, and to describe briefly the main new policy tools which are needed to make such coordination possible.

For continued stable recovery towards full employment, there are three basic policy requirements:

- (1) a firm and credible recovery target;
- (2) money growth keyed explicitly and solely to supplying the money stock needed to service the growth of income and spending along the recovery path; and
- (3) "formula flexibility" of fiscal policy explicitly keyed to maintaining a stable balance between the total supply and demand for credit, with stable interest rates.

Part A, below, discusses these requirements briefly, with primary emphasis on the functional relationships between monetary and fiscal policy, and the way in which credit-related "stabilization tax adjustments" could facilitate precise coordination between them. Part B discusses in some detail the specific requirements for an appropriate rate of money growth. Part C discusses briefly several means of achieving more precise measurement and control of the money supply.

A. BASIC POLICY REQUIREMENTS FOR STABLE RECOVERY

1. FIRM RECOVERY TARGET

One of the most basic requirements for more effective economic policy is the adoption of a firm -- and credible -- government commitment to maintain a stable rate of recovery until we reach genuine full employment -- and to maintain stable full employment as the basic operating condition of our economy. I hope that this commitment will be included in the final version of the Humphrey Hawkins Full Employment and Balanced Growth Act.

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In order for businessmen to plan ahead with confidence and to invest in the additional capacity and cost-saving equipment which the economy needs, they must have confidence that the government will not permit -- and will not induce -- another recession every few years. Such a full-employment commitment would also make a major contribution towards faster reduction of our so-called "structural" unemployment, and even towards reducing many inflationary costs which have become embedded in our economy as a result of its traditional roller-coaster performance.

2. ECONOMICALLY APPROPRIATE MONEY GROWTH

To actually achieve stable recovery towards full employment, the most important requirement is a monetary policy which has but one purpose: to supply the economy with the precise amount of money stock which is needed to maintain that stable recovery.

In our present economic policy framework, the Federal Reserve is expected to control not only the money supply, but also the level of interest rates and the supply of credit. This is a flagrant case of responsibility without corresponding authority. In actual fact, the growth of the money supply normally provides only about 10% of the total supply of credit. Thus, the Federal Reserve has only marginal and indirect control over interest rates and the total supply of credit.

"Tight money" vs. "tight credit." -- The potential for economic disruption which is inherent in the Fed's traditional conflicting responsibilities was again demonstrated during the past year. The sharp increase in interest rates during the 2nd and 3rd quarters of 1977 has usually been blamed on a Federal Reserve "tight money" policy. In fact, as the accompanying Chart Panel 2A shows, the growth of the money stock during that period remained very close to the precise amount needed to maintain the Carter Administration's apparent policy target of 5% real growth. The real culprit was not "tight money" but "tight credit" caused by excessive borrowing. Because of the large increase in mortgage borrowing and business borrowing -- augmented by an untimely increase in the federal deficit -- the Fed could not have prevented the increase in interest rates without allowing an excessive increase in the money supply. What was needed was not more money but less borrowing.

During the first quarter of this year, however, there was exactly the opposite kind of imbalance. In this case, "monetary" policy was apparently determined not by the economy's need for money, but by the Fed's desire to

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maintain a 6-3/4% federal funds interest rate, in the belief that this would prevent further decline of the dollar exchange rate. Because of the sharp decline in mortgage borrowing and other demands for credit -- which was undoubtedly partly due to the bad weather and coal strike -- the Fed could keep the funds rate up to 6-3/4% only by allowing a sharp decline in the rate of money growth. The Fed could have achieved both its interest-rate target and adequate money growth only if there had been a temporary "compensatory" increase in federal borrowing to offset the decline in private borrowing.

Although complete data on total borrowing during the 2nd quarter of this year are not yet available, the phenomenal spurt of consumer instalment borrowing and the rebound of housing starts, together with the sharp rise in interest rates, suggest that this quarter is repeating the "tight credit" imbalance which occurred during the 2nd and 3rd quarters of last year. Although 2nd quarter money growth has not been fast enough to make up for this large first-quarter shortfall, it would probably be wrong to call this "tight money."

3. FLEXIBLE FISCAL POLICY

During the past few months Congress and the Carter Administration have spent much effort trying to decide (and to agree on) how much to cut taxes, and when. Also, on how large the federal deficit should be next year, and the year after. The fact is that no one can now know with certainty how much tax cut will actually be needed next fall or winter, or how much deficit will really be appropriate next year or the year after. What is needed is the ~~fiscal~~ machinery for flexible adjustment of fiscal policy to the current needs of the economy.

It has often been suggested that the President could be given discretionary authority to make needed temporary adjustments in tax rates. I believe that Congress has been right in refusing this authority because of the possibility that it could be misused for partisan political purposes.

"Formula flexibility." -- Seventeen years ago the prestigious Commission on Money and Credit recommended serious consideration of what it called "formula flexibility" -- i.e. "provision for automatic changes in the level of certain tax rates whenever prescribed economic indicators change by

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specified amounts." "At first glance," said the CMC, "such a proposal may seem radical. Actually, however, it would do little more than make explicit what is now implicit in the conventional type of automatic stabilizers" -- mainly the "automatic" effect of recessions on federal tax receipts and "depression relief" expenditures.

The main reason that this idea has received so little attention has been the failure to devise suitable "indicators" on which to base the formula.

However, the current increased interest in more systematic coordination of monetary and fiscal policy suggests a highly appropriate basis for such a formula -- the size of the federal deficit should be varied in such a way as to maintain a stable balance between the total supply and demand for credit, with stable interest rates.

Thus, when interest rates are tending to rise because of excessive private borrowing (or insufficient financial saving), the federal deficit should be reduced by a small temporary increase in withholding taxes. On the other hand, when private borrowing is weak, but it is considered desirable (for foreign exchange or other reasons) to maintain a particular interest rate, the federal deficit should be increased by a small reduction in withholding taxes -- rather than reducing the money supply and causing recession.

Administratively, such a "stabilization tax adjustment" would be relatively simple. Most large payrolls are today compiled by computer. I have been told by one of the large firms which performs this service that the required adjustment could be carried out very simply by a single additional instruction to their computer.

The withholding tax rate would clearly be the simplest means of effecting the required adjustment in the first instance. However, other taxpayers would make a similar adjustment in their quarterly or annual returns. Moreover, as the experience of the past year shows, the adjustments in different quarters might largely cancel out for the year as a whole.

One of the greatest advantages of this approach to economic stabilization is the very high degree of precision and flexibility which it could provide. Because the adjustments could be made as often as needed (once a quarter or even oftener), they would tend to be quite small -- particularly after the economy has been actually stabilized for long enough to correct the massive structural distortions caused by past recessions and "booms." There is a close analogy

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here to driving a car: on a winding road the driver must make continuous large adjustments of the steering wheel; on a straight road he may make almost as many adjustments, but they will be relatively small.

On the Model T Ford, to use another automotive analogy, there were two levers beside the steering wheel -- one to adjust the spark, the other to adjust the gasoline/air mixture. Modern cars make both these adjustments automatically. I believe it is time that we similarly modernized our present "Model T" approach to coordination of monetary and fiscal policy.

More effective Congressional control of the federal budget. -- It has been argued that Congress would object to such an automatic, formula-controlled stabilization tax adjustment because it would mean giving up some of its constitutional budgetary authority. In actual fact, it would have quite the opposite effect. The present large deficit was not decided by Congress, but mainly by the fact that the economy is still operating so far below capacity. And Congressional budget discussions are now based largely on unreliable "forecasts" of future economic and credit conditions. With "automatic" formula control of the economic stabilization aspect, Congress would have much more effective control over the basic structure of spending and taxes, as expressed in the high-employment budget, and would not have to devote so much fruitless time and effort to the short-run implications of its actions, over which it has so little effective control. Moreover, the stabilization adjustment would automatically compensate for faulty estimation of the effect of new taxes (e.g. the crude oil tax or turnover tax), large changes in tax rates (e.g. the social security tax), or new expenditure programs (e.g. medicaid/medicare, job programs) and for shortfalls of actual spending below budgeted amounts.

Stabilization and reduction of interest rates. -- This approach to economic stabilization, and to coordination of monetary and fiscal policy, would not only tend to stabilize interest rates, but would have the significant "side effect" of making it possible for Congress to actually decide the basic level at which they would be stabilized. The balance between the total supply and demand for credit could be maintained, through free-market mechanisms, at whatever level Congress sets. Although Congress's practical range of discretion in this regard would of course be limited by international economic conditions and various other factors, it would undoubtedly be wide enough to permit a significant influence over the long run. Reducing the level of interest rates would significantly reduce the competitive cost of capital-intensive solar energy equipment and energy-saving techniques of construction and industrial production.

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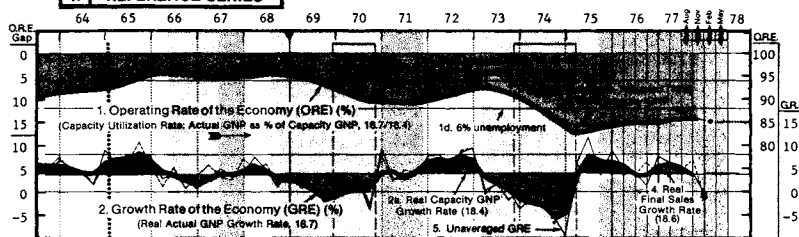
May-June, 1978¹

IEA CHARTS

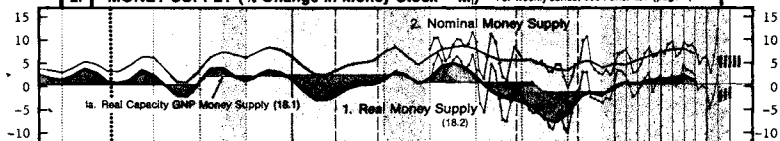
Key Indicators of Economic
Performance and Relationships

(Key to Chart Symbols on page 7)

1. REFERENCE SERIES

2. MONEY SUPPLY (% Change in Money Stock — M_t)

For weekly series, see Panel 2A (page 7)

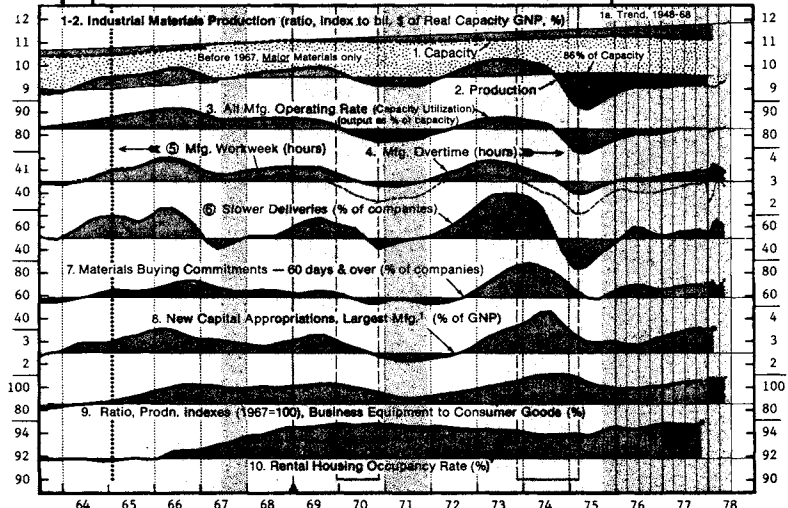


3. UNEMPLOYMENT RATES (%)

Foreign rates adjusted to U.S. definitions



4. KEY INDICATORS OF INFLATIONARY SHORTAGES OF SUPPLY



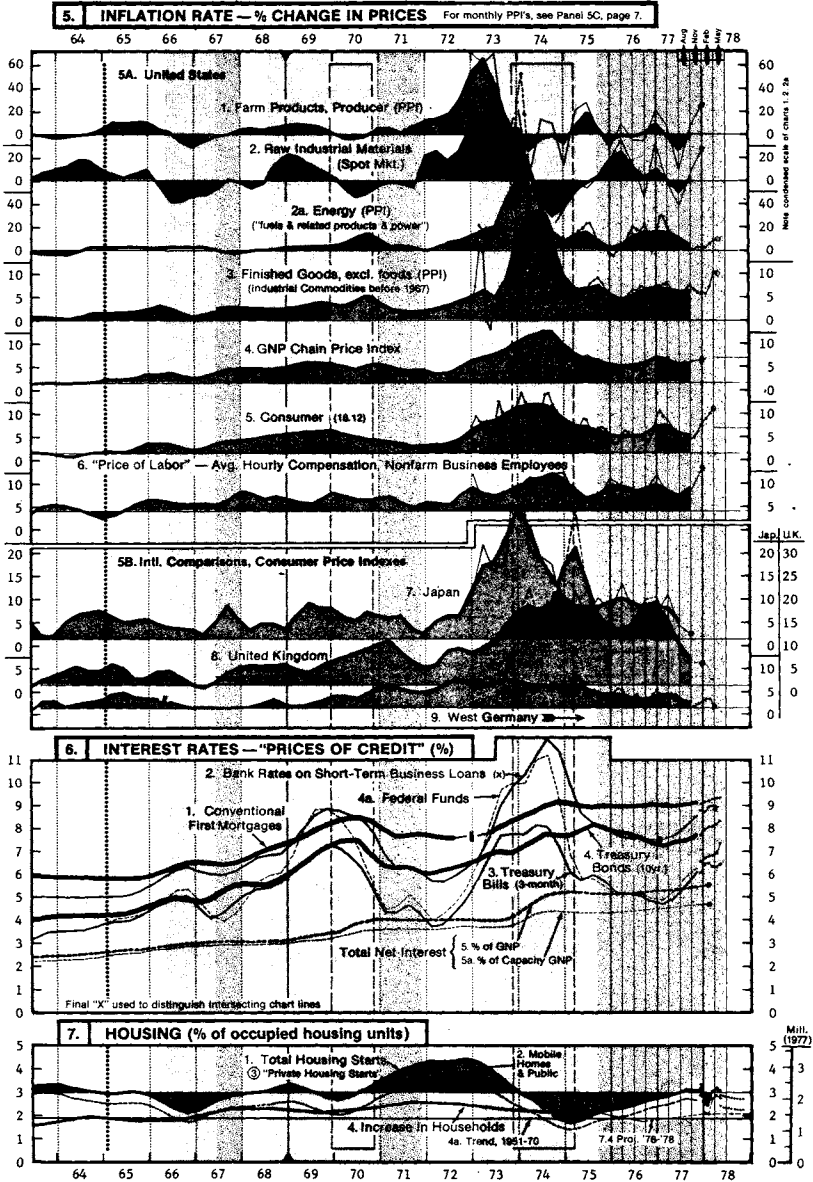
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*Includes all data available through: June 16

May-June, 1978

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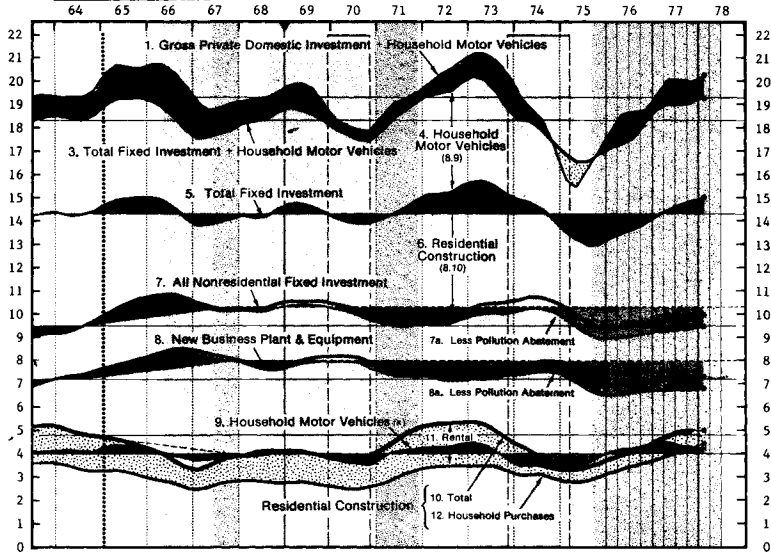
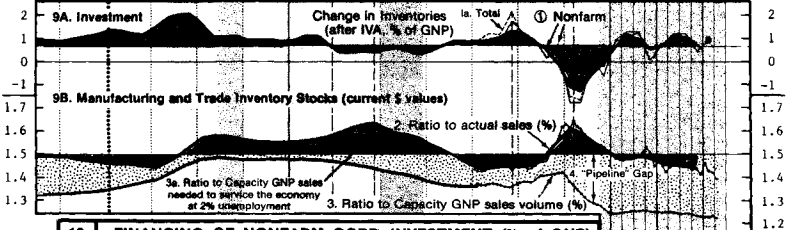
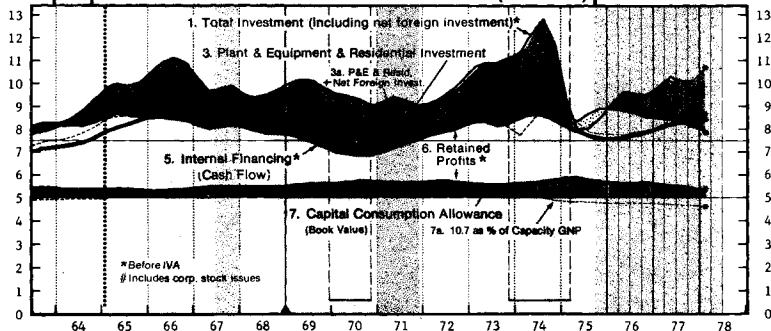
Indicators of Economic
Performance and Relationships

2

2

May-June, 1978

IEA CHARTS

Key Indicators of Economic
Performance and Relationships**8. INVESTMENT (% of GNP)****9. BUSINESS INVENTORY INVESTMENT AND STOCK/FLOW RATIOS****10. FINANCING OF NONFARM CORP. INVESTMENT (% of GNP)**

3

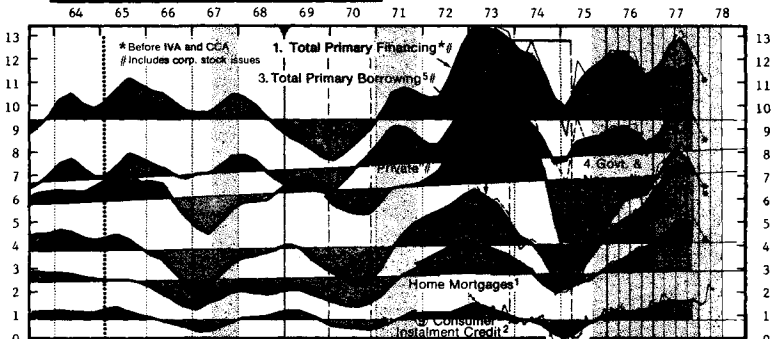
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May-June, 1978

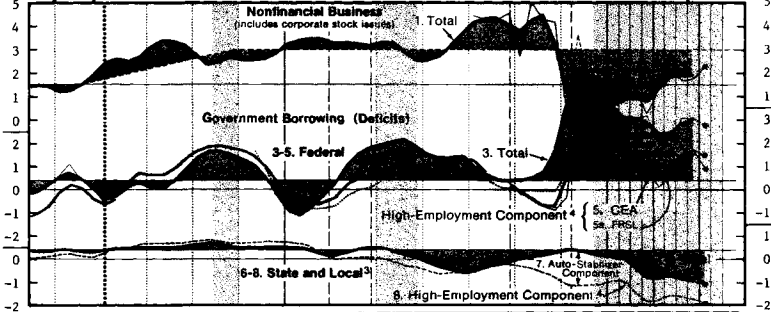
IEA CHARTS

Indicators of Economic
Performance and Relationships

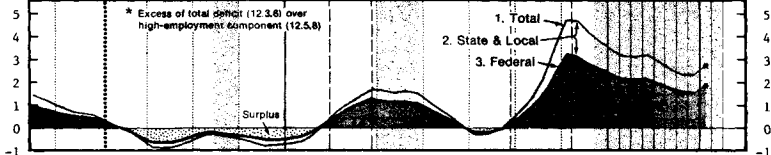
11. PRIMARY FINANCING (% of GNP)



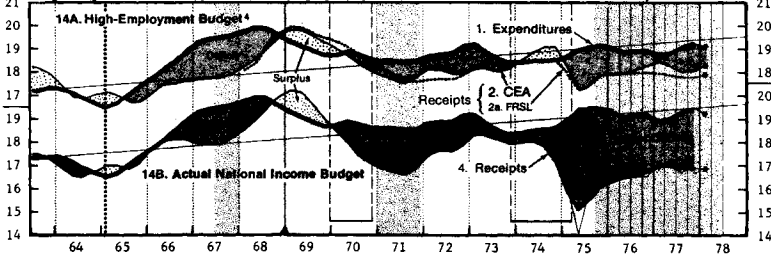
12. PRIMARY MARKET FINANCING—BUSINESS & GOVERNMENT (% of GNP)



13. AUTOMATIC STABILIZER COMPONENT OF GOVERNMENT DEFICIT* (% of GNP)



14. FEDERAL BUDGETS—KEY ASPECTS (N.I. Basis; % of Capacity GNP)



1. Incl. mobile homes credit from 71.4.

2. Excl. mobile homes credit from 71.4.

3. F/F Basis—Includes government retirement credits to households.

4. 4% unemployment definition, adjusted to 1965 demographics (includes supplementary & special unemployment benefits).

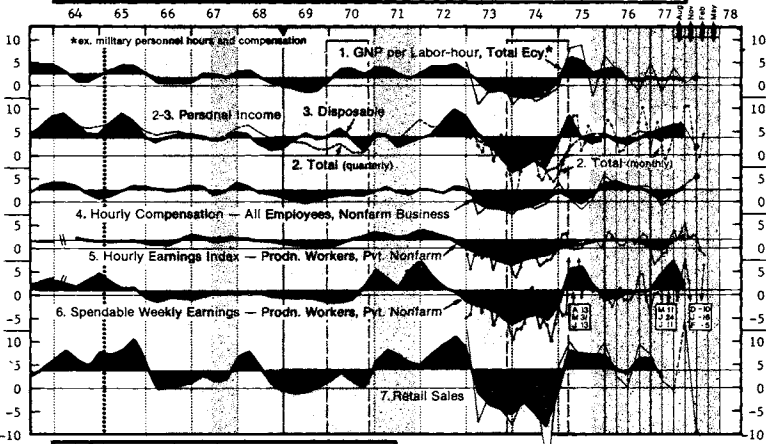
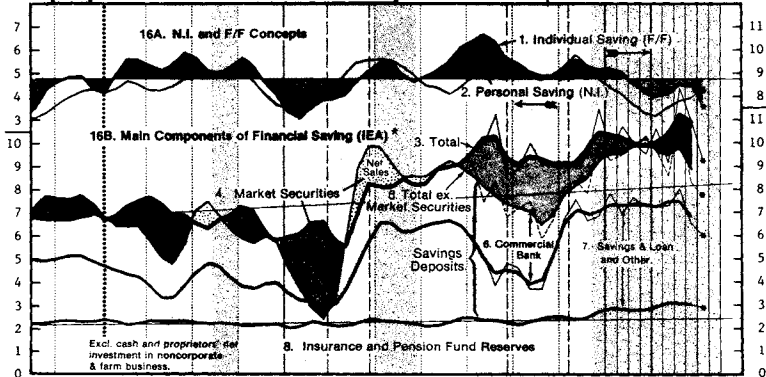
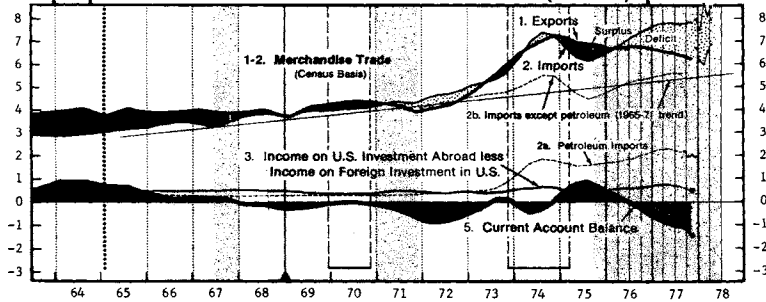
5. PRIMARY BORROWING IS NET borrowing which finances GNP expenditure.

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May-June, 1978

IEA CHARTS

Key Indicators of Economic
Performance and Relationships**15. REAL OUTPUT, INCOME, RETAIL SALES (Growth Rates, %)**For monthly series,
see Panel 15A, p.7**16. HOUSEHOLD SAVING (% of GNP)****17. U.S. INTERNATIONAL TRANSACTIONS — KEY ASPECTS (% of GNP)**

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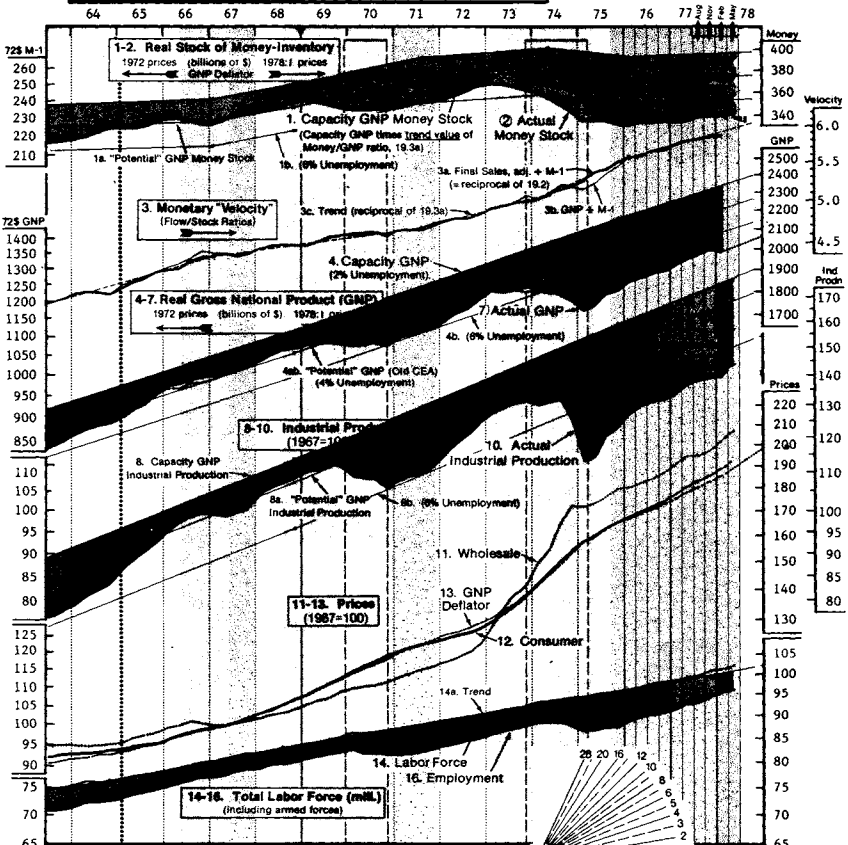
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May-June, 1978

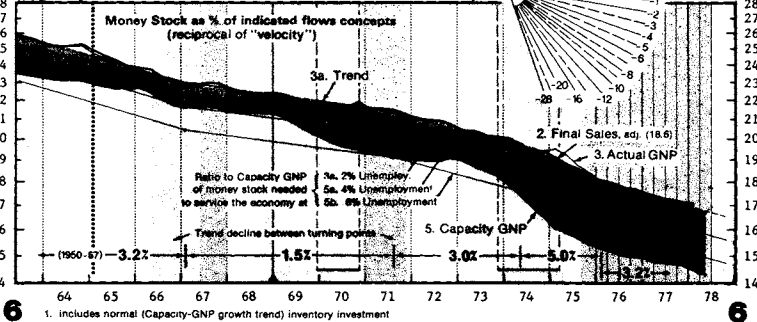
IEA CHARTS

Key Indicators of Economic
Performance and Relationships

18. GROWTH SERIES—ABSOLUTE VALUES (Ratio Scale)



19. MONEY STOCK/FLOW RATIOS (% Ratio Scale)



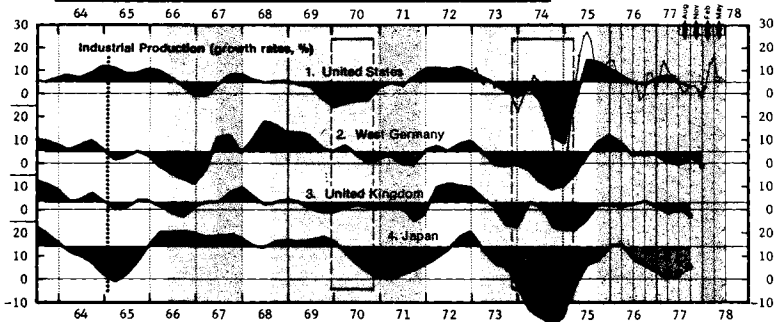
1. includes normal (Capacity-GNP growth trend) inventory investment

May-June, 1978

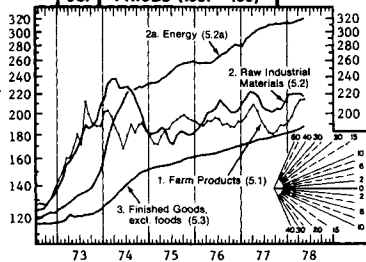
IEA CHARTS

Key Indicators of Economic
Performance and Relationships

20. INTERNATIONAL COMPARISONS: Industrial Production

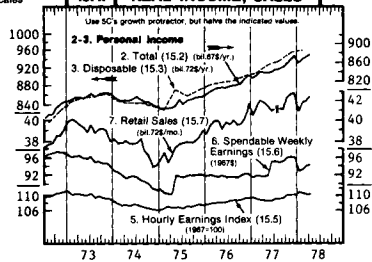
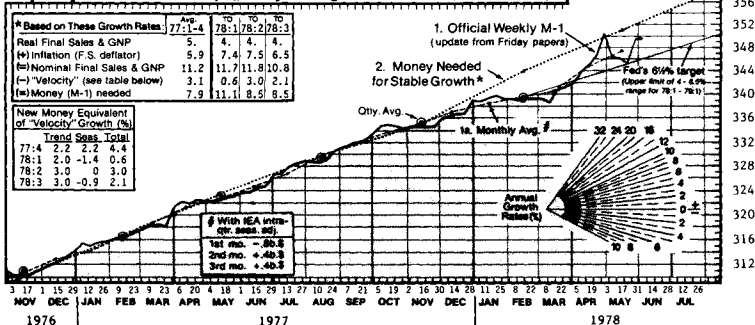


5C. PRICES (1967 = 100)



Ratio Scales

15A. REAL INCOME, SALES

2A. MONEY STOCK (M₁; Daily Averages; billions of \$; Ratio Scale)

IEA CHART CONVENTIONS

Most "normal" lines for individual series are estimates of "balanced growth" values.

Vertical dashed lines denote recessions of the ORE - when the 2-qr. average of the GRE (1.2) is significantly below norm for more than one quarter.

Vertical dashed lines delimit NBER contractions - coincide roughly with declines of Real GNP (GRE below zero). (11/73 and 5/75 tentative.)

Vertical striped areas denote periods of relative stagnation - when the GRE (1.2) is clearly inadequate in relation to the ORE GAP (1.1a).

Vertical dotted line marks the beginning of large-scale direct U.S. military involvement in Vietnam and Korea.

Circle around chart number indicates basic data are the same as, or comparable to, and NBER "leading indicator."

Main chart lines are 2-quarter centered (1-2-1 weighted) moving averages except for annual data. Charts 4.1 and 7.4, and Panels 18 and 19.

Recent-data line lines: Quarterly series (finals) - unaveraged data.

In ratio-scale panels 18 and 19, final quarterly data are extended by unaveraged monthly data.

Monthly series - Growth rate series (Panels 2, 5, 15, 20) are 2-month centered (1-2-1 weighted) moving averages. Final "o" denotes unaveraged value, which has limited analytical significance. All other monthly series are unaveraged.

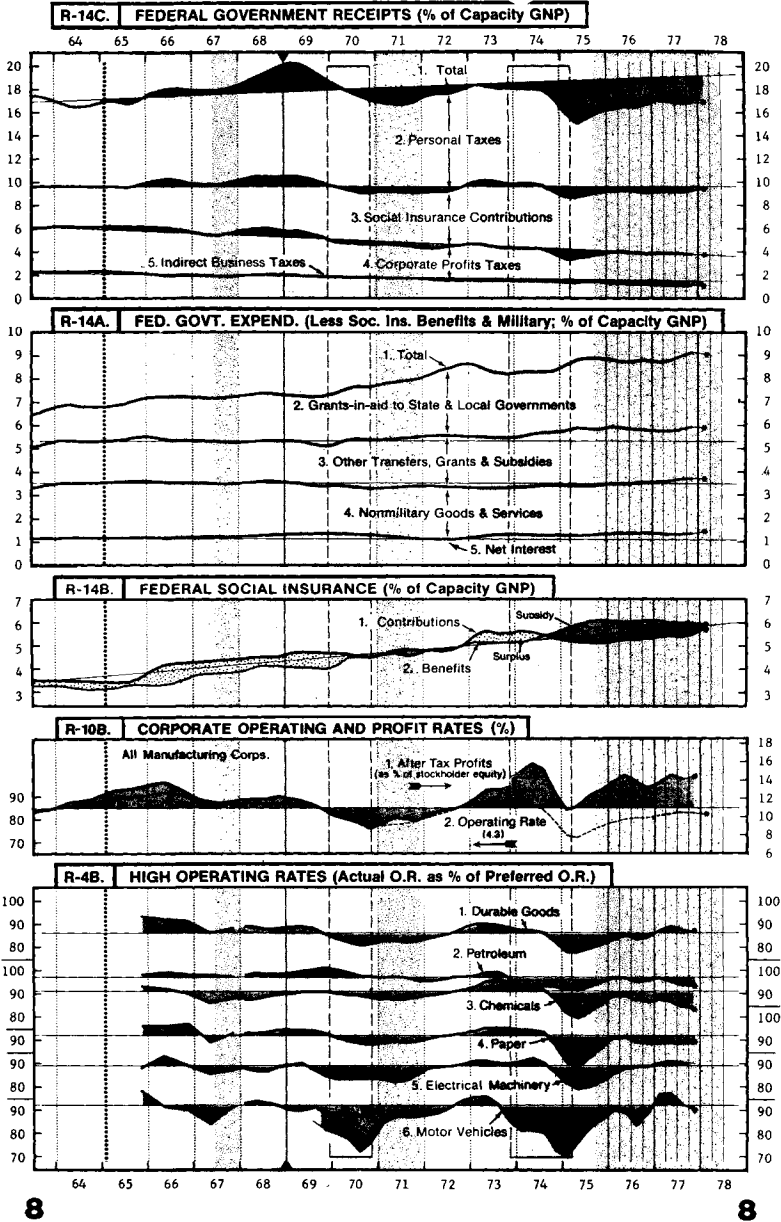
Government and other original source projections - Specific Value: _____ Range of Values: _____ Growth Rate Value: _____

7

7

May-June, 1978

IEA CHARTS

Key Indicators of Economic
Performance and Relationships

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Role of the Federal Reserve. -- Under the present system, the Federal Reserve tries to control "money and credit" by buying and selling Treasury securities. When it buys, this supplies additional reserves to the banking system, permitting the banks to expand their loans and checking deposits (which constitute the bulk of the money supply). When the Fed sells, this drains reserves out of the banking system, forcing the banks to reduce their loans and the money supply.

However, as noted above, this often involves a "trade-off." With any given total demand for credit, the Fed can reduce the growth of the money supply only by permitting an increase in interest rates, and vice versa. With the stabilization tax adjustment, the Fed would still occasionally be faced with the same "trade-off" in the interval between tax adjustments: when the demand for credit is "too high" this would cause an increase in either interest rates or money stock or both. Although this aspect needs further study, it would probably be better for the Fed to hold the money supply as close as possible to the most appropriate growth rate and allow temporary fluctuation of interest rates.

The Fed would send the Treasury at least monthly its estimate of the amount of tax adjustment needed, to return interest rates to the desired level. With provision for frequent adjustments, trial-and-error precision would be adequate, but greater precision would come with experience.

B. HOW MUCH MONEY DOES THE ECONOMY NEED?

Growth of the money supply is the main factor which determines the growth of total spending (GNP) and total employment, because additions to the money stock are "created out of thin air" (or "printed") in the process of bank lending, and thus constitute a net additional source of purchasing power which was not previously saved from anyone's income and spending. Thus, too much money tends to cause inflation, while too little money tends to cause recession and unemployment.

If the stabilization tax adjustment were to facilitate the growth of the money supply at always precisely the most appropriate rate, how would that rate be determined?

The "formula" for appropriate money growth contains three basic factors:

- (1) the appropriate rate of real economic growth;
- (2) the current trend value of the "demand" for money
(as expressed in the "velocity" ratio); and
- (3) the rate of inflation.

1. THE APPROPRIATE RATE OF REAL ECONOMIC GROWTH

The long-run growth trend of "potential" GNP is determined by the long-run trends of the labor force and "productivity." These are basic economic factors over which current public policy has very little control. But the growth rate of "potential" GNP is the same as the growth rate of actual GNP consistent with a stable unemployment rate. Before the OPEC "oil tax" this generally was estimated at about 4%. Since then, estimates vary somewhat, from 3.9% by George Perry at Brookings down to 3½% by Fed Chairman Miller. But this is still a fairly narrow range.

Thus, the real controversy today is concerned not with the basic trend but with the most appropriate rate and extent of recovery towards the full-employment potential.

The problem of retarded capacity. -- Here a key problem is that long years of sub-capacity operation of the economy have tended to reduce the immediately available capacity to much below the long-run trend of "potential" output. Low operating rates have reduced business investment in additional plant and equipment capacity. High unemployment rates have left many young workers without adequate job experience and have kept many others in occupations far below their potential skill and experience. As a result, there is a tendency to run into inflationary "bottleneck" shortages of industrial capacity and skilled labor long before there is full employment of the total labor force.

The basic choice: fast or slow recovery. -- There are two ways of facing this problem. One way is to continue a relatively rapid rate of recovery while taking difficult but really effective measures to reduce inflation and solve the other structural problems caused by the depression. The other option is to reduce the rate of recovery so as to temporarily avoid these difficult decisions.

The slow-recovery option implicitly accepts the continuation of high unemployment (with the associated high rate of street crime and family disruption), high federal deficits (due to continued low tax receipts and high unemployment benefits and other "depression-relief" expenditures), and lower industrial productivity (due to slower introduction of technologically more efficient equipment).

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The rate-of-recovery decision is essentially political. Therefore, it should be decided openly and explicitly by the elected representatives of the American public -- i.e. by the President and by Congress -- not by the Federal Reserve, which effectively makes the final decision under the present arrangements.

There are indications that both the Fed and the Carter Administration are now choosing the slow-recovery option. Under the present division of responsibility between the Administration, Congress and the Fed, Congress has no direct and certain way of affecting that decision -- and would not even under Humphrey/Hawkins.

2. THE CURRENT TREND OF THE "DEMAND" FOR MONEY

Money as an inventory stock. -- Because our present monetary system permits money to be created in the process of bank lending, there has been a traditional confusion between money and credit. This confusion can be reduced if we think of credit as borrowed purchasing power and money as an "inventory stock" of the medium of exchange.

The *Wall Street Journal* article which reports the weekly money supply data usually explains that the M-1 measure -- checking deposits and currency -- "is considered an important economic determinant" because it "represents funds readily available for spending." Newly created money (i.e. a net addition to the existing money stock) is of course "available for spending" because the money is created in the process of bank lending, and money is usually borrowed only for the purpose of spending it. However, in terms of the average quantity over a period of a month or so, our checking account balances are no more "available for spending" than the grocer's inventory stock is "available for selling." Money "flows through" the account (as income or expense), just as goods "flow through" the grocer's inventory stock. But the average level which each household and business firm considers necessary and/or desirable for carrying on normal operations is essentially "locked in" and unavailable for spending.

The "demand" for money, and the stock/flow ratio. -- One of the key concepts in business management is the inventory/sales ratio. This stock/flow relationship is also used in its inverse form as the inventory "turnover" ratio. The stock/flow ratio of the economy's money inventory is just as important to

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sound monetary management as the inventory/sales ratio is to business management.

The monetary equivalent of the storekeeper's inventory "turnover" ratio is called "velocity." Unfortunately, this concept is so poorly understood by the public that it is often referred to as "esoteric" or "arcane" even in the business press. Undoubtedly one of the reasons is that the term "velocity" is itself anomalous and functionally meaningless. The relationship is much easier to understand in its inverse (inventory/sales ratio) form, which expresses directly the economy's current need for money-inventory stock, in relation to any given rate of income and spending.

Thus, it is useful to think of the primary goal of monetary policy as supplying the economy's need for money-inventory (indicated by the current trend value of the stock/flow ratio) as the economy grows along the prescribed recovery path. In this perspective, the additional purchasing power which finances the growth of the economy is merely an automatic by-product of providing the growing stock of money-inventory.

Page 6 of the attached IEA CHARTS shows both the "velocity" form of this ratio (Panel 18, chart 3a) and the stock/flow form (Panel 19, chart 2).

Note that these charts relate the money stock to "final sales adjusted" rather than to GNP. IEA study of these relationships has shown that using final sales (total GNP minus its volatile inventory investment component) makes the ratios both more stable and more functionally significant. However, to make the general level of these ratios approximate the traditional GNP ratios, we developed the concept of "final sales adjusted." This concept could be described either as "final sales plus normal inventory investment" or as "GNP minus abnormal inventory fluctuations." It is shown as Chart 6 in Panel 18.

The "new money equivalent" of the declining stock/flow ratio. -- Whereas the business inventory sales ratio has remained relatively constant since World War II, the monetary stock/flow ratio has been declining at a fairly stable rate of about 3% a year. This decline has been caused partly by business firms' increasingly efficient cash-management, and partly by rising interest rates, which make everyone try to minimize their non-interest-bearing checking account balances.

Since a decline in the monetary stock/flow ratio tends to "unlock" existing cash balances and make them available for spending (e.g. when banks

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reduce the minimum balances needed to avoid service charges), the effect is similar to a proportionate increase in "new money."

Thus, the total "monetary stimulus" -- which determines the growth of nominal final sales (and GNP) -- has two components:

- (1) actual money growth and
- (2) the "NEW MONEY EQUIVALENT" of the trend decline in the "demand" for money (as indicated by the rate of decline in the stock/flow ratio or the rise in its inverse form, the "velocity" ratio).

Estimates for both of these components should be included in the Fed's quarterly reports to Congress, as explained below (p. 12).

3. TAKING ACCOUNT OF THE INFLATION RATE

The economy's money-inventory stock has another similarity to business physical inventory stocks: during inflation the nominal (current-dollar) value of the stock has to keep up with the rate of inflation or the stock is unable to perform its functional role effectively.

The 1973-74 "wheat and oil" inflation is a case in point. To have expected businesses and households to carry on a normal "real" volume of transactions with the 1972 dollar amount of money stock (as implicitly required by Fed policy during that period) was about as realistic as expecting business firms to carry on their normal physical volume of business with their 1972 dollar value of inventory stocks.

Thus, any workable systematic "formula" for determining an appropriate rate of money growth must reflect the current inflation rate. In actual practice, it may be advisable to do this in a way which will systematically "lean against the wind" -- such as using the lower of the most recent three months' rate or the previous year's average. But it is the growth of the real money stock that primarily determines the growth of real GNP.

This is illustrated dramatically in IEA's chart of the "Real Stock of Money Inventory" (IEA CHARTS, page 6, Panel 18, chart 2), which shows how sharply the 1973-74 inflation reduced the actual working value of the economy's money stock -- and how this decline was closely followed by the decline in GNP (chart 7). This same relationship is shown in growth-rate terms in Panels 1 and 2 on page 1 of IEA CHARTS.

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The "money-causes-inflation" myth. -- The fear that money-growth causes inflation is based primarily on unique wartime experiences -- and peacetime cases of weak government -- where excessive monetary expansion was used to finance huge government deficits. The idea that the present inflation was (and is) caused by excessive money growth is based on a gross misreading of economic history and functional relationships. The fourfold increase in the price of oil was not caused by excessive monetary expansion. Nor was the large 1972-73 increase in the price of wheat. There was no way that slower money growth alone could have prevented those price increases from increasing the general inflation rate. In an economy where a large portion of industrial prices are set "administratively" on a cost-plus basis, where major wage contracts are set for three years on the basis of union bargaining strength, and where many other prices and wages are automatically escalated with the rate of inflation, slowing the rate of real money growth while the economy is well below capacity can cause recession but will have little effect on the longer-run rate of inflation.

Some economists have found an apparent correlation between the inflation rate and the growth of the money supply two years or so earlier. Although IEA has not yet undertaken a systematic review of their data, our preliminary study found no systematic and inherent relationship between money growth and inflation. We suspect that there would be very little residual relationship if separate prior account were taken of the relationship between the economy's growth rate and the level of the operating rate. It is quite likely that the rapid rate of real economic growth induced by the rapid growth of the real money stock during 1972 was somewhat too fast considering the already high operating rate. But a few cases of such mismanagement should not be interpreted as a general relationship.

The inflationary effect of inadequate money growth. -- If the monetary growth rate does not take adequate account of the inflation rate, it shifts the inflation forward in time -- as the lower rate of real growth increases non-productive federal "depression deficits," reduces business investment in more productive equipment and increased capacity, and prevents unemployed workers from obtaining the productive skills and experience which will prevent future skilled labor shortages. It is like keeping the bill collector from the door by borrowing from the money-lender.

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NEED FOR NEW FED REPORTING REQUIREMENTS

The requirement that the Fed report to Congress every quarter has undoubtedly helped to increase Congressional and public understanding of monetary policy. But the present framework of these reports tends to be misleading in several respects. I believe that the following changes in the content of these reports would facilitate Congressional understanding of, and influence on, monetary policy:

1) Present detailed data for the key factors related to monetary "velocity", including:

- a) actual and seasonally adjusted ratios to GNP and to final sales,
- b) an estimate of the current basic trend value of these ratios,
- c) an analysis of the trend in the seasonal factors of these ratios, and the factors which cause this seasonal pattern,
- d) detailed information on special factors which have affected the "demand" for money (i.e. short-run fluctuations in the seasonally adjusted "velocity" ratio) during the previous period, and those which are expected to affect it during the upcoming period. In this statement, the Fed should distinguish between those factors which have already been fully taken into account in the seasonally adjusted M-1 series, and those which have not yet been "adjusted out".

2) State in explicit quantitative terms its forecast (or policy target) for "total monetary stimulus" -- i.e. the sum of monetary growth and the "new money equivalent" of the increase in "velocity" -- in much the same form that these are presented in lines 1-3 of the table for IEA's "Monetary Forecast of Economic Growth" (attached herewith). Since this is the quantity which actually determines the growth of nominal final sales and GNP, the Fed's forecast for this sum would implicitly indicate its target for the growth of nominal GNP (or final sales). If the Fed is also required to state an explicit estimate of the inflation rate, this will also indicate the Fed's forecast or policy goal for real economic growth.

3) Cease reporting a quarterly target-range for the growth of M-1. -- There are several reasons why the Fed would tend to prefer a "range" rather than a single figure: (a) uncertainty regarding the trend of "velocity" (which is the other component of total monetary stimulus), (b) uncertainty regarding the rate of inflation, (c) uncertainty regarding the overall balance

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between the supply and demand for credit, and the fact that the Fed is supposed to manage interest and credit as well as money growth, and (d) the possibility that, if inflation increases, the Fed may decide to induce a tight-money recession to "fight inflation."

In actual practice, the lower limit of the Fed's target range has in every case been so unrealistic as to constitute a mere "window dressing" for the benefit of those who look on monetary restriction as the key to fighting inflation. The upper limit has usually also been unrealistic, and since the base for calculating it has shifted each quarter, that limit also has been more confusing than helpful. It would be far more helpful to Congress and the public if the Fed were to specify separately the various factors which have gone into calculating its own money growth policy target.

4) Cease setting any policy targets for M-2, M-3 and all the other "money and credit aggregates" except M-1. -- In actual fact, the Fed's management of bank reserves has a significant direct effect only on checking deposits. Moreover, it is only the growth of M-1 that is causally related to real economic growth. Thus, the reporting of growth rates and setting of policy targets for other "money and credit aggregates" is only confusing.

C. ADDITIONAL MEASURES TO ACHIEVE MORE PRECISE MEASUREMENT AND CONTROL OF THE MONEY SUPPLY

There are several main sources of imprecision in the measurement and control of the money supply in addition to its basic linkage with interest rates and credit:

- a) the high "reserve leverage" of the present fractional reserve system, under which a change of \$1 in reserves supplied by the Fed to the banking system results in a corresponding change of about \$6 in the money stock. This correspondingly magnifies the effect of changes in float, inadequate reporting, and policy errors.
- b) the fact that many banks are not members of the Federal Reserve System, do not keep their reserves on deposit at the Fed, and submit their statistical reports only infrequently.
- c) the Fed's inadequate information on demand deposit ownership, which limits the Fed's analysis of the factors which actually influence the "demand for money" (i.e. the actual cash-management attitudes and practices) of different categories of depositors.

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Below is a brief annotated listing of some of the measures which would help to reduce these sources of imprecision.

1) Eliminate all reserve requirements on time and savings deposits and have uniform reserve requirements for all classes of demand deposits. --

Having to make allowances for the proportion of total reserves allocated to deposits with different reserve requirements is at times a significant potential source of error.

2) Require all banks to become members of the Federal Reserve System. --

There are frequent and relatively large revisions of the money stock data caused by the fact that the Fed does not get regular weekly reports from non-member banks, and the fact that non-member banks are not required to keep their reserves on deposit at the Fed.

3) Pay interest on member banks' reserve deposits, as a means of reducing non-member resistance to joining the Fed. While it is quite true that there is a certain anomalous aspect to the Fed paying interest on reserves which it has itself created, this is no more anomalous than permitting the banks to earn interest on loans that they make with money that they themselves create. But there is an overriding public interest in having much more precise measurement and control of the money supply.

4) Require 100% reserves against all demand deposits. -- This would eliminate the "reserve leverage" of statistical and policy errors. If the Fed pays interest on the reserve deposits, there should be little bank opposition to this reform. In essence, putting this into effect would require the Fed to buy enough additional Treasury securities from banks and non-bank investors to provide the banks with the necessary additional reserves. The Fed would use the interest it earns on these Treasury securities to pay interest to the banks on their reserve deposits. The non-bank investors who sell Treasuries to the Fed would presumably use the funds to purchase some of the private securities which the banks would be selling to obtain funds to meet the increased reserve requirements.

5) Floating discount rate. -- In early May, when the Fed allowed a gap of 3/4% to develop between the discount rate and the federal funds rate, the discount rate became a "bargain" source of funds, and there was a surge of bank borrowing from the Fed, accompanied by a surge in the weekly money stock measure -- which upset Wall Street and provided an excuse for a further increase

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in the funds rate. Apparently a similar gap has been allowed to develop during the past week, and will probably be followed by a similar surge of the money stock.

Since the development of the federal funds market, the Fed carries out its control of reserves almost entirely through open-market operations, and the discount rate has lost its former significance as an indicator of monetary policy. If the discount rate were allowed to "float" with the federal funds rate, it would no longer be a source of disruption in the "money market" but would still serve as a "last resort" source of funds for banks in trouble.

6) Demand deposit ownership survey. -- The Fed is currently considering the abandonment of the demand deposit ownership survey which it has conducted since 1970. Instead of abandoning it, the Fed should expand this survey to include separate data on a number of significant sub-groups which have significantly different cash-management attitudes and practices. This would provide a much-needed empirical basis for more precise analysis of the "demand" for money.

FINAL NOTE

It is likely that a number of the proposals and analytical aspects discussed in this statement lie outside the official mandate of this committee. But I believe it is also true that some of the key aspects relating to the coordination of monetary and fiscal policy do not fit very neatly within the traditional mandate of any existing Congressional committee.

Therefore, I hope that this Committee will give some consideration to this problem, and perhaps make some recommendation to Congress as to how these matters could be most effectively dealt with by Congress.

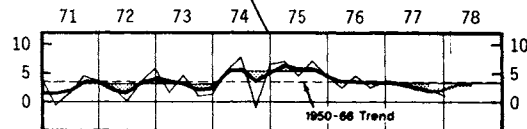
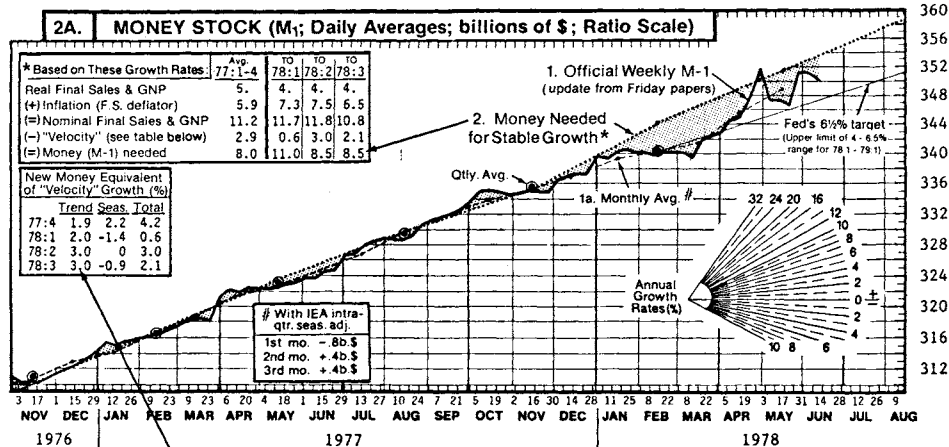


Fig. 1. NEW MONEY EQUIVALENT OF "VELOCITY" GROWTH

This chart is the annual growth rate of the ratio of M-1 to final sales, seasonally adjusted by IEA. The heavy line is a two-quarter-centered (1-2-1 weighted) moving average. This average is used as the short-run trend for past periods in computing the "money needed" line in Chart Panel 2A. The dotted-line projection of this heavy line is IEA's estimate of the future movement of this trend.

"MONETARY FORECAST" OF ECONOMIC GROWTH*

GROWTH RATE OF: (% change, annual rate)	Actual			Fore- cast ¹
	77:3	77:4	78:1	78:2
1 NOMINAL MONEY STOCK (M_1)	8.3	7.7	5.7	10.0
2 NEW-MONEY EQUIVALENT OF "VELOCITY" CHANGE ²				
2a Trend + Seasonal Factor ^{3,5}	1.7	4.2	0.6	3.0
2b Actual and Forecast ⁴	1.4	4.3	-0.2	-
3 TOTAL NOMINAL MONETARY STIMULUS (1 + 2) ⁵ (= NOMINAL FINAL SALES)				
3a Formula (1 + 2a) ⁵	10.1	12.2	6.3	13.4
3b Actual (Forecast = 1 + 2b) ⁵	9.9	12.4	5.5	-
INFLATION INDEXES ⁶				
4 Consumer Price Index	5.0	4.7	7.8	8.0
5 Final Sales fixed-weight	4.9	6.2	6.5	7.0
6 FINAL SALES DEFLATOR	5.3	6.0	7.3	7.5
7 GNP deflator	4.8	5.9	7.0	7.2
8 "REAL" MONEY STOCK (1 - 6) ⁷	3.0	1.7	-1.5	2.4
9 TOTAL "REAL" MONETARY STIMULUS (8 + 2 or 3 - 6) ⁵ (= REAL FINAL SALES)				
9a Formula (8 + 2a) ⁵	4.7	5.9	-1.0	5.5
9b Actual (Forecast = 8 + 2b) ⁵	4.4	6.1	-1.7	-
"REAL" GNP				
10 Change in rate of inven- tory investment (% GNP) ⁸	0.7	-2.1	1.8	0.5
11 Real GNP (Forecast = 9a + 10)	5.1	3.8	0.0	6.0
CORRESPONDING OPERATING RATES ⁹				
12 Final Sales (see line 9b)	85.5	86.0	84.8	85.2
13 GNP (see line 11)	85.8	85.8	85.1	85.5

* *General note on using this box.* -- The title uses quotation marks to indicate that this is not a conventional type of forecast. It is designed primarily to present the key macro-economic factors which determine the economy's growth rate in a systematic arrangement according to their basic functional relationships, and thus, inferentially, to provide an integrated framework for evaluating the government's current monetary, anti-inflationary and recovery policies.

The "forecast" column(s) in the monthly *Review and Prospect* have a twofold purpose: (1) to provide subscribers with IEA's "best guess" regarding the immediate future values of lines 1, 2b, 4-7 and 10 which will result from current and prospective policy actions, and (2) to provide subscribers with a framework in which they can easily modify IEA's "forecasts" according to their own assumptions or predictions -- or with later data.

Note: The relationships in this box do not imply any lag between change in the money supply growth rate and in the growth of nominal (current \$) spending. IEA research indicates that there has been no significant lag since 1973, and also that there is no consistent or inherent relationship between money growth and the inflation rate.

1. Values are entered in the "forecast" section of rows 2b, 3b and 9b only when there is good reason to believe that the actual change in "velocity" during the quarter will be significantly different from the normal trend rate (plus normal seasonal factor). Otherwise, the "formula" and "forecast" values are identical.

2. To simplify the formula for precise estimation of total monetary stimulus, the growth rate of the traditional *flow/stock* "velocity" ratio is used here rather than the reciprocal *stock/flow* ratio of IEA CHARTS Panel 19. Note that the *positive* rate-of-increase values of "velocity" are slightly higher than the corresponding *negative* rate-of-decline values for the stock/flow ratio in Panel 19 (e.g. 90 is 10% below 100, but 100 is 11.1% above 90).

see over for notes 3 - 9

NOTES TO "MONETARY FORECAST" OF ECONOMIC GROWTH continued

3. Line 2a.	<u>77.3</u>	<u>77.4</u>	<u>78.1</u>	<u>78.2</u>
Trend	2.5	1.8	2.0	3.0
Seasonal Factor	-0.4	2.2	-1.4	0.0
total	1.7	4.2	0.6	3.0

(For derivation, see IEA SPECIAL REPORT #2. These are still preliminary estimates. Their further improvement will be a key aspect of IEA's continuing research.)

4. Line 2b. -- The difference between lines 2a and 2b (i.e. between trend-plus-"normal"-seasonal-factor and the actually realized "velocity" change) reflects all of the statistical estimating errors, "technical" factors, and functionally significant "random" factors affecting the relationship between monetary growth and the growth of nominal final sales, including:

- any estimating error, abnormal seasonal factor, or other special ("random") factor affecting the seasonally adjusted money supply and/or final sales (later revisions of both series are sometimes relatively large);
- any error in the calculated seasonal factors of the "velocity" ratio;
- any "technical" distortion of the normal "monetary multiplier" process by sharp changes in the amount or timing of "new money" flows, especially when associated with shifts between federal government and private checking deposits;
- any as-yet-unrecognized change in the basic trend of the stock/flow ratio;
- any short-run functionally significant fluctuations in the stock/flow ratio (i.e. fluctuations in the basic "demand" for money-inventory) such as those caused by speculative "hoarding" of either goods or money, or by "beat-the-price-increase" spending;
- changes in the conceptual and statistical definition of M_1 (such as the legislation permitting check payments to be made from interest-bearing savings accounts, but continued exclusion of such accounts from the official M_1 measure of the money supply), and changes in the rate of public response to such changes;
- any other "random" or special short-run factors affecting the stock/flow ratio;
- any systematic relationship which there may be between changes in the stock/flow ratio and the growth-rate or operating rate of the economy.

In IEA's initial experiment with "monetary forecasting" (see SPECIAL REPORT #2), the forecast value missed the actual value by 2% or more in 25% of the quarters during 1970-76. But the 2-quarter moving average was accurate within 1% in all but 11% of the quarters. This suggests that an abnormal deviation from trend in one quarter tends to be offset by an opposite deviation in the next.

5. The formula combination of growth rates is expressed in the parentheses as simple addition ($x+y$) or subtraction ($x-y$). This simple "rule-of-thumb" calculation is accurate enough for many purposes -- usually within $\frac{1}{2}\%$ of the true value of the combination. But the true multiplicative value can be calculated by the simple procedure below:

TO "ADD" GROWTH RATES "X" AND "Y":

- convert each growth rate from percent to ratio form, thus:
 - divide the % rate by 100 (move decimal 2 places to left) and
 - add 1.0 to the result (which makes negative growth rates less than 1.0, but positive in sign -- see example 2 below);
- multiply the two results;
- reconvert the result to percent, thus:
 - subtract 1.0 (result may be negative)
 - multiply by 100 (decimal 2 places to right).

TO "SUBTRACT" GROWTH RATE "Y" FROM GROWTH RATE "X":

Follow the above procedure, except that in step 2 "x" is divided by "y" (see example 3 below).

Three examples:

	① "X + Y"	② "X + Y" (y is negative)	③ "X - Y"
	4.5% + 10.0%	3.5% + (-8.5%)	3.5% - 8.5%
(1)a.	0.045, 0.100	0.035, -0.085	0.035, 0.065
b.	1.045, 1.100	1.035, 0.935	1.035, 1.065
(2)	1.045 x 1.100	1.035 x 0.935	1.035 ÷ 1.065
	= 1.1495	= 0.9677	= 0.9718
(3)a.	0.1495	-0.0323	-0.0282
b.	15.0% (vs 14.5%)	-3.2% (vs -3.0%)	-2.8% (vs -3.0%)

Corresponding "rule-of-thumb" values are shown (in parentheses) for comparison.

6. Various measures of the inflation rate are shown here to indicate the extent to which reported "real" growth rates may depend on the particular price index used -- and the extent of quarter-to-quarter variability. Implicit suggestion: evaluate short-run growth rates with a grain of salt!

7. Line 3. -- For this purpose, the money stock is deflated by the final sales deflator, in order that the computed formula-real-final-sales (line 9a) will be consistent with officially-reported real final sales (line 9b). Thus, line 8 differs slightly from the growth of the real money stock in IEA CHARTS 2.1 and 18.2, which uses the GNP deflator. (It also differs from the real money stock series in *Business Conditions Digest* and the Commerce Dept.'s "Composite Index of Leading Indicators," which uses the CPI.)

8. Line 10. -- These values are computed as the difference in inventory investment in 72% values, divided by 72% GNP, and multiplied by 4 to approximate the annual-rate values. When the inflation rate is relatively low, these values approximate four times the changes shown in Chart 9.1a. (Because of the complex relationships involved, the "rule-of-thumb"-computed values in line 10 are usually not precisely the same as the actual difference between the final sales and GNP growth rates.)

9. As a rough forecasting "rule-of-thumb," the change in the operating rate = the recovery component of the growth rate (i.e. approximately the total growth rate minus 4%) divided by 4 (to approximate the quarterly effect of the indicated annual-rate growth rate).

Chairman MITCHELL. Might I comment. When we attempt to deal with a rather narrow area of consideration, the draw authority, it is very difficult to keep within that scope, and not go into all of the broader implications of the Fed's monetary policy.

I would like to suggest that at some time in the near future we will examine the Federal Reserve's monetary policy practices in detail. And certainly, your statement here will be entirely applicable.

Mr. BARNARD. Mr. Chairman, if you would yield?

Chairman MITCHELL. Yes.

Mr. BARNARD. First of all, let me say at the outset that I have enjoyed both the testimonies that have been offered so far. They have been very enlightening. And they certainly address some problems that really need to be addressed. I know that this subcommittee was planning to undertake a study of monetary policy, and I thought maybe you had gotten into it without—

Chairman MITCHELL. No; I certainly had not. I understand perfectly why both of the witnesses had gotten into the broad, related issues, because it is impossible to talk about the draw authority without touching on monetary policy, too.

However, you are quite right; there is going to be a series of hearings on the entire larger question.

Mr. BARNARD. We have had the first installment.

Chairman MITCHELL. Yes; you have been the precursors for the hearings that will be coming.

Mr. BARNARD. It has been very interesting.

Chairman MITCHELL. Mr. Kudlow? Don't apologize, Mr. Kudlow, for being late. Most of us were late or nearly late because of power outages.

Mr. KUDLOW. Good. That makes me feel a little better. This was an airplane outage, as it turns out.

Chairman MITCHELL. I advised the other witness that we are under rather tight time constraints because so many hearings are going on this morning.

We have your entire statement, which will be submitted for the record. We would appreciate it if you would capsulize it in 10 or 15 minutes.

STATEMENT OF LAWRENCE A. KUDLOW, VICE PRESIDENT AND MONEY MARKET ANALYST, PAINE, WEBBER, JACKSON & CURTIS, INC.

Mr. KUDLOW. Yes; I would be glad to. At Dr. Weintraub's request, essentially, this is a discussion of some problems of implementation of monetary policy. It does not go into the issue of the Treasury's new cash management practices and the like.

My concern is with the failure of the monetary agency to contain money supply growth rates within the targets they themselves have set in recent years.

As the chart indicates after page 4, you can see that the Fed has not been able to achieve its own goals, since the early part of 1977, and moreover, looking ahead, taking account of current trends, it further appears that the Fed will be unable to achieve its goals well into the year 1979.

The disappointing aspect of this for me, of course, apart from the inflationary implications of this rather generous money supply growth rate of the past 1½ to 2 years, is that there are very few people in Congress who have undertaken a serious evaluation of one of the principal stumbling blocks to controlling the money supply; that is, the Fed's own policies of execution or implementation.

In fact, I noted in the testimony that—I have been sitting in on hearings for House and Senate banking committees and subcommittees for about 3 years since I left the Federal Reserve and came to the private sector—I don't recall any instance, frankly, of a detailed examination of the Fed's implementation and execution policies.

There is lots of talk about interest rates and lots of talk about the money supply, but not much about what actually happens each day at the Federal Reserve bank, the New York trading desk, which in my opinion, is of fundamental importance.

What I try to bring out in the testimony is a brief, by no means exhaustive, but I think germane study, of these execution policies.

The Federal Reserve targets money supply, as you know, over the intermediate run. Since 1970, and specifically, 1975, the Fed has sought to achieve its goal of noninflationary economic growth and foreign exchange stabilization by means of setting moderate, agreed upon, goals of money supply growth.

As I said at the outset, the Fed has not been able to achieve this. And I would argue, in large measure, the reason for the Fed's failure to achieve their own goals is the outdated, indeed obsolete means, of controlling the money supply.

Each day, the Fed seeks to control interest rates, mainly the Fed funds rate, with which you are quite familiar. This is done through the New York Fed trading desk.

And there is an inherent contradiction here between interest rate control and monetary control. Let me illustrate this quite briefly, in effect, by reiterating some awfully good testimony, I thought, given to this subcommittee in the summer of 1976, by Fed Governor Charles Partee, who used to run the research department at the Federal Reserve Board.

Governor Partee testified that to achieve money supply growth rate targets required great attention to the bank reserves supply which the Fed controls, rather than some short term interest rate target like the Fed funds rate.

And Governor Partee argued—and again I think quite correctly—that trying to control interest rates might achieve some stability in the short run on the part of rates, but would result in substantial instability in the intermediate and long run with respect to the economy.

That is, during periods of rising demand, for example, the Federal Reserve might try and keep a Fed funds rate stable, shall we say, 7.5 percent. But with demand pressures rising, unless the Fed intervened to add reserves to the banking system, that Fed funds rate will rise to 7.75, 8, or 8.5 percent. That is roughly what is taking place today.

Unfortunately, by stabilizing that Fed funds rate in the short run, the central bank merely achieves a substantial additional increase in bank reserves supply, which is the raw material of money supply growth.

Thus, this notion of controlling rates by buying U.S. Treasury bills and adding to the reserve base, simply works to pump up the money supply. Inflation expectations in the general economy are worsened. As individual investors and businessmen, and indeed labor union leaders for that matter, observe this expansive monetary course, they assume inflation will get worse in the next year or so and they demand inflation premiums.

It might take the form of higher wage contracts. It might take the form of higher product pricing. In the financial markets, ironically, inflation premiums take the form of higher interest rates. That is, the Fed can only succeed in controlling rates in the very short run.

Ultimately, inflation expectations and other economic forces will work to subvert these policies. What is left is an additional growth in the reserve supply and additional growth in the money supply. I am prepared to argue that it is axiomatic that higher inflation is a destabilizer in the economy. It is a disincentive to invest. It is a disincentive to employ. Capital formation is reduced. And, of course, interest rates wind up rising, perhaps by a greater degree than might have otherwise been the case, thereby throwing the economy ultimately into a period of recession. This is the traditional Fed operation of stop-and-go monetary policy. We are right in the middle of that cycle right now. Many forecasters, myself included, have come to fear that we will reach a recession sometime in 1979 or 1980.

So to briefly review: Although the Fed in a way has come a long way the last 10 or so years, rather than explicitly targeting interest rates, they moved toward targeting the money supply. The Fed has recognized publicly, as so many economists have before, that there is a clear relationship between money growth and future price growth, and also between money growth and future income growth. Unfortunately, the means by which the Fed attempts to control money supply is an obsolete approach which is a throwback to the earlier period when interest rate targets dominated Fed thinking.

We have the New York trading desk on the one hand, trying to control that Fed funds rate every day, and we have the Open Market Committee and the Board of Governors of Washington on the other, talking about targeting the money supply.

These two approaches are essentially incompatible, and they work toward economic instability, rather than stability. And indeed, as I argue, even with respect to the notion of interest rate stability, efforts by the Fed to prevent the normal business cycle increase in rates, a phenomenon that has always taken place during business cycles, are ultimately subverted by inflation expectations that result from over-rapid bank reserve and money supply growth.

In response to this dilemma; that is, the utter failure to achieve the very goals set by the Fed, with a sharp reduction in credibility, it is no coincidence that we experience substantial turbulence in dollar exchange markets abroad as foreign investors watch the Fed fail to grapple with monetary control and fail to grapple with containing inflation. As we observe these economic difficulties at home and abroad, I propose that as problematic and as troublesome as these events are, there is nonetheless a fairly clear set of alternative approaches which might be utilized. In any case, I think alternative approaches deserve the attention of this subcommittee and perhaps

other congressional bodies as well. I am not talking in terms of broad policy goals. I am talking about the execution of the policy; the day-to-day implementation.

I would argue first of all, the Fed ought to clear up what its own goals are with respect to the money stock. Let us have a clearly defined money supply growth rate and then shoot for it. For M_1 , I would suggest something in the magnitude of 2 to 4 percent—which is roughly in line with the long-term growth trend of the U.S. economy. The real output potentially grows at 3 to 3.5 percent. That is all money growth should seek.

Second, turning back to this matter of the execution problems, I would argue that the Fed should relinquish its intention of efforts to control rates, and instead should focus its emphasis on efforts to control the raw material of money supply, which is bank reserves.

The Fed is well in control of the reserve base. The Fed knows each day what the so-called operating factors are. These include Treasury deposits, float, currency, and the like.

Of course, it is the Fed, and only the Fed, that can buy and sell Treasury bills and other Government securities which add or absorb reserves. Some data analysis we did to bring your attention to this problem is exhibited on the table after page 12. I know statistics can be very dry. I know the time of the Congressmen is short. However, some economists occasionally use data to provide a basis for their arguments.

Briefly, what we have illustrated through some very straightforward regression analysis is a substantial relationship between a measure of bank reserves, in this case the monetary base, and a measure of the money supply, in this case M_1 . I want to bring to the subcommittee's attention that as we move over longer periods of time, particularly 3-, 6-, and 12-month periods, that the statistical relationship improves substantially. The R^2 —the R^2 is a statistical indicator that shows there is a high relationship between the base and M_1 . The R^2 is 0.7 over a 12-month period. That is a very close statistical fit, and suggests that there is indeed a clear linear relationship between the monetary base and the money supply, in turn implying that if the Fed were to control the monetary base, it would have a better handle, a leg up, if you will, in controlling the money supply.

Looking back to page 9 in the testimony, we observe an insignificant relationship between the Fed funds rate and the money supply. The Fed tries to control the Federal funds rate. As I indicated, this is the key rate for daily operations conducted at the New York trading desk. Here, over 1-, 2-, 3-, 6-, and 12-month periods, low R^2 indicate the absence of any significant statistical relationship. My point here is, for years, bound mostly by tradition and habit, the U.S. central bank has pursued policies presumably with an eye toward controlling the money stock, which have no basis in fact, no statistical foundation.

There has never been a mandate from business economists or from academic economists or, indeed, from elected or appointed officials, to suggest that the business of controlling rates as a way of controlling the money supply is a useful or effective approach. In a way, put quite plainly, in my view the Fed has gotten away with mayhem over the years, particularly the last 5 or 10 years, because, although in response to congressional initiatives the Federal Reserve has changed its

intermediate target to a money supply target, it has not changed the method by which it operates each day in the financial markets. And, as long as the Fed keeps trying to control interest rates, it is doomed to fail in controlling the money supply.

Looking again toward the back of my prepared statement, after page 12 you will see a series of graphs. These are relationships between the monetary base and M_1 . I have run three graphs. All I have done here is to take the monetary base versus M_1 , and I am looking at the spread—the growth in M_1 minus the growth in the monetary base.

I argue here that, since the Fed controls the base each day—that is, the volume of bank reserves plus currency—essentially, in doing so, they would have a much better chance of controlling the money stock. The standard error, describes over long periods the width of the spread between M_1 and base growth rates. If the spread were particularly wide, it would be almost futile to attempt this approach. Sometimes it is 5 percentage points. That is simply not good enough. They are doing that as it is.

However, looking at the 6- and 12-month periods, the standard deviation is reduced to only 1.3 percent. Thus, were the New York Fed to target monetary base growth of around 3 percent year over year, statistical tests indicate that the Fed would achieve money supply growth within about 1.5 percentage points on either side, perhaps as low as 1.5 percent or perhaps as high as 4.5 percent. This would reflect a substantial narrowing from the error range the Fed currently permits.

Against this background, my first suggestion proposes that the Fed relinquish its efforts to control rates and should instead focus its efforts on controlling the monetary base. In so doing, they would better control their intermediate targets, that is, the money supply, over 6- and 12-month periods. In this regard, I encourage the Fed to end attention to 1-week or 1-month or 2-month movements in the money supply. There is too much hysteria among financial market participants over these short-term data. I include the banks and the nonbank dealers in this. Much of this is caused by the Fed itself. Weekly numbers and monthly money supply numbers have no economic meaning at all. They are mostly a function of statistical noise and seasonal adjustments.

What matters with respect to influencing income and inflation is monetary growth rates over periods of 3, 6, or 12 months, or considerably longer. This then, becomes our second proposal.

I believe, through the use of statistical techniques, that the Fed would be better advised to look at the monetary base as a means of controlling the money supply. If this control were undertaken over longer periods of time, it would enable the Fed to keep M_1 growth in a noninflationary range.

This is essentially the message; I am going to stop there. The testimony covers a bit more ground, but due to the constraints of time and the like, I think I will end it right there. Thank you.

[Mr. Kudlow's prepared statement follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

Mr. Chairman, it is a pleasure to meet with this Subcommittee today to present my views on the conduct and implementation of U.S. monetary policy. It almost goes without saying that the execution of monetary policy has a profound effect

on the course of actual money supply growth and, in consequence, on the movement of key economic variables such as output, employment, inflation, and interest rates. Even so, it remains generally true that matters pertaining to the execution of day-to-day Fed operations, administered by the Trading Desk at the Federal Reserve Bank of New York and directed under FOMC instructions by the System Account Manager and the Deputy System Account Manager, receive little Congressional notice and even less evaluation.

In three years of attendance at House and Senate Banking Committee hearings for monetary oversight, I cannot recall a single instance where the Fed's daily implementation procedures were critically assessed. This I believe is most unfortunate, for it is my firm view that the disappointing monetary performance of the current business cycle, as in the case of past business cycles, can be directly linked to faulty and obsolete methods of monetary control rooted in the deeply held Fed conviction that interest rate stabilization through control of the Fed funds rate is the proper short-run monetary policy lever. And, let me add at the outset of this testimony, it is my view that the continued use of this procedure implies a commitment toward a condition of permanently high inflation in the domestic economy, along with continued turbulence in dollar exchange markets around the world.

The Fed's commitment toward some form of interest rate control dates back to the very inception of the U.S. central bank. In earlier times the principal rate lever was the measurement of member bank borrowings, and this gradually gave way to the setting of targets for free reserves. The free reserve doctrine is essentially an interest rate—member bank borrowing approach, as the level of borrowing (as influenced by the discount rate) is the dominant element in the free reserve identity.

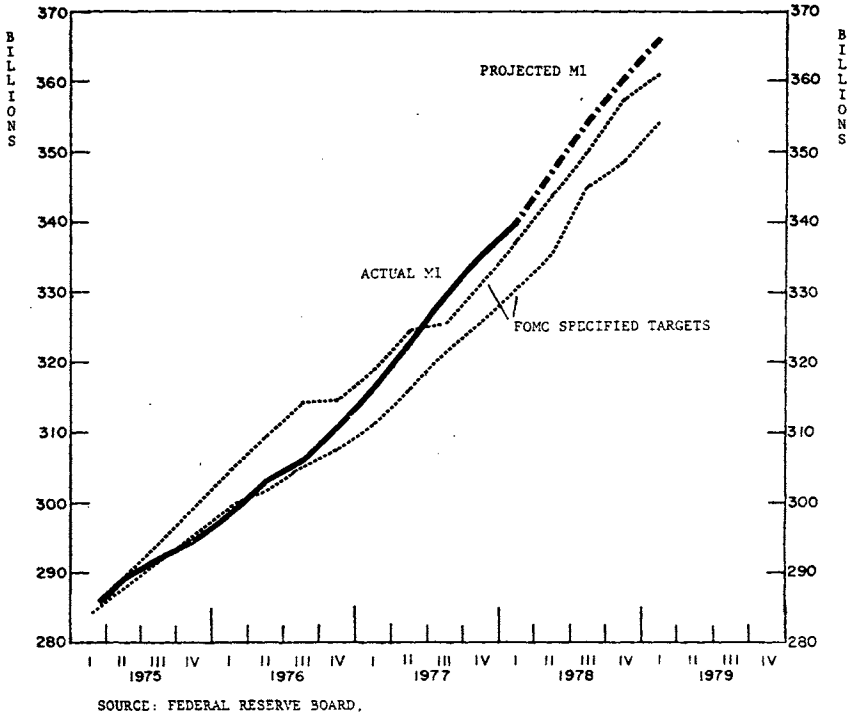
Traditional reliance on an interest rate control rule may have come about due to the long held notion that the proper intermediate-term monetary policy goal ought to be the supply of credit, and thus it was thought that shifts in the price of credit would bring about desired changes in credit supply and demand. Additionally, it does not seem unreasonable to presume that the Fed's preoccupation with maintaining orderly financial markets stems in part from fears of banking panics, panics which occurred with almost cyclical regularity during the nineteenth century and the early part of the twentieth. Such fears were buttressed during the depression (1933), and these fears were to some extent revived during recent crises over Penn Central (1970) and the Franklin National Bank (1974).

By 1970, however, the authorities tilted policy toward a monetary control rule. This approach, long advocated by economists who recognized that money supply changes exert a major influence on output and inflation, then became the dominant intermediate-term objective. Starting in early 1974, the FOMC began specifying quantitative ranges of tolerance over short-run intervals. By the spring of 1975, after passage of Concurrent Resolution 133, the Fed began reporting year-over-year monetary targets in regularly scheduled sessions before the House and Senate Banking Committees. This reform was widely heralded as a major step in the direction of a more rational monetary policy that might help the Fed realize its long term objective of steady, noninflationary economic expansion accompanied by dollar exchange market stability. At the same time, various Fed spokesmen pledged central bank determination to gradually decelerate money supply growth rates as an important means of dampening inflation expectations and reducing actual inflation rates.

Now, three years after the passage of Resolution 133, monetary performance has turned out as disappointing as in any time during the past. Not only has the Fed failed to achieve its own money supply growth rate targets, but the inflation rate has accelerated in an all too familiar pattern. Moreover, with the sharp rise in inflation and rates of interest the U.S. economy is again faced with the increasing probability of a substantial recession during 1979 or 1980. Thus, the more things change, the more they remain the same.

As the accompanying charts indicate, the Reserve has not achieved monetary growth rates (M1) within specified ranges since the spring quarter of 1977, a year ago. Further, evidence suggests that the monetary overrun pattern will continue well into 1979. Partly in response to this failure, the Fed has not lowered the M1 target over the last year, thus undermining its commitment to seek slower monetary growth consistent with diminished rates of inflation. In assessing these failures, the principal culprit appears to be the Fed's determination to cling to short-run implementation procedures of interest rate control, despite the shift toward an intermediate-term goal of money supply control. And, without question, the two are inconsistent and incompatible. In these circumstances we observe a

Fed dilemma which is now nearly ten years old: how to balance the goal of monetary stability with the goal of interest rate stability. With more evidence from the next series of charts, it is clear that the Fed has generally opted to resolve this dilemma through the control of rates rather than money.



<u>Year Ending</u>	<u>FOMC Specification for M1</u>	<u>Actual M1 Growth</u>
1976 March	5 1/2 - 7 1/2 (6 1/2)	5.0
2Q	5 - 7 1/2 (6 1/4)	5.2
3Q	4 1/2 - 7 1/2 (6)	4.6
4Q	4 1/2 - 7 (5 3/4)	5.7
1977 1Q	4 1/2 - 7 (5 3/4)	6.3
2Q	4 1/2 - 7 (5 3/4)	6.6
3Q	4 1/2 - 6 1/2 (5 1/2)	7.8
4Q	4 1/2 - 6 1/2 (5 1/2)	7.9
1978 1Q	4 1/2 - 6 1/2 (5 1/2)	7.5
2Q	4 - 6 1/2 (5 1/4)	7.9e
3Q	4 - 6 1/2 (5 1/4)	7.7e
4Q	4 - 6 1/2 (5 1/4)	7.5e
1979 1Q	4 - 6 1/2 (5 1/4)	7.9e

e -- based on PWJC estimates

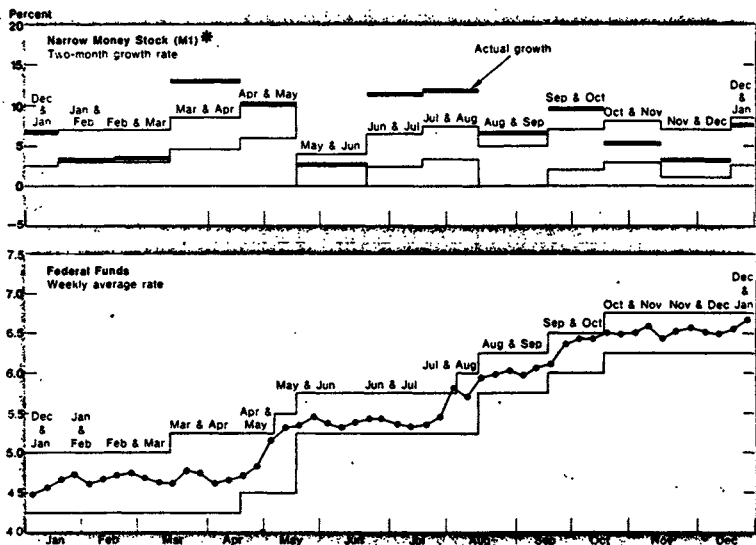
Against the background of a policy of interest rate control, it is not surprising that actual money supply growth is well above targeted ranges. During a prolonged period of rising fiscal demand, such as the current recovery, the authorities are forced to add to the bank reserve supply in increasingly generous fashion in order to prevent normal private market forces from driving rates higher. That is, to offset rate pressures stemming from increases in the demand for reserves, the

Fed works to expand the reserve supply. However, this growth in the reserve base provides the raw material for a subsequent strengthening in monetary aggregates.

By choosing to control interest rates, or by working to temper or moderate normal rate pressures released by the forces of an expanding private economy, the Fed finds itself again and again in a vicious circle of rapid bank reserve growth, leading to excessive monetary growth, with the effect of fueling demand pressures and aggravating inflation expectations. And, the ultimate result of this progression of events is a renewal of interest rate pressures that prompts the Fed to supply even more reserves, thus beginning the circle anew.

Chart 4

FOMC Ranges for Short-run Monetary Growth and for the Federal Funds Rate, 1977



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, September 1977. The FOMC's target ranges for monetary growth and the federal funds rate are shown in the shaded areas. The actual growth rates for the narrow money stock and the federal funds rate are shown in the line graphs.

In this fashion, as the authorities seek to control the Fed funds rate, monetary policy becomes procyclical rather than counter-cyclical. The growth in reserve and money aggregates creates new demand pressures at that point in the business cycle when policy should be geared to demand restraint. Conversely, if demand is falling, the Fed is apt to absorb reserves, thereby reducing money growth and creating an even steeper decline in activity. In this way monetary policy works to deepen the influence of recessionary forces at a point in the economic cycle when demand stimulus is more appropriate. In summary, a policy in pursuit of interest rate stability inevitably leads to substantial economic instability.

In testimony before this Subcommittee two years ago, Federal Reserve Board member J. Charles Partee demonstrated a clear understanding of the interest rate-bank reserve dilemma. At a key point in his prepared text, Governor Partee stated:

If the Federal Reserve did nevertheless attempt to maintain selected interest rates at some predetermined level, the effort could well lead to inappropriate rates of growth in bank reserves and the money stock. If interest rates came under pressure because of rising demands for funds, for example, System efforts to prevent interest rate increases would inevitably generate more rapid monetary expansion, thereby feeding new inflation pressures. If, on the other hand, interest rates came under downward pressure because of slackening business activity and

declining demands for funds, System efforts to prevent the decline in rates would inevitably retard monetary growth rates and quite possibly exacerbate the recessionary problem.

Thus, any serious effort to specify monetary policy aims in terms of interest rate intentions or expectations could well prove inconsistent with stated objectives for growth rates in the monetary aggregates. . . . Needless to say, these effects would be quite perverse from the standpoint of economic stabilization.

Needless to say, as the Fed has moved to in traditional moderate interest rate increases during the past two years, the perverse and destabilizing effects of rising rates and inflation have gradually come to dominate the economy. Even more perversely, although interest rates have increased substantially during the past 18 months, so too has the growth in bank reserves, thus fueling a series of inflationary money supply impulses. In Congressional testimony last winter, Chairman Miller stated: "... as relatively rapid monetary expansion continued, the Federal Reserve gradually exerted increasing restraint in the provision of bank reserves. . ." Yet, a careful look at the data reveals that money market conditions underwent substantial firming, but bank reserve conditions during the period actually became more accommodative.

Month	Total reserve growth (over 12- mo intervals, seasonally adjusted)	Federal funds rate (effective average rates)
1977:		
January	1.1	4.61
February9	4.68
March	1.0	4.69
April	1.8	4.73
May	1.6	5.35
June	1.8	5.39
July	2.8	5.42
August	3.3	5.90
September	3.8	6.14
October	3.9	6.47
November	3.5	6.51
December	3.5	6.56
1978:		
January	5.9	6.70
February	6.9	6.78
March	6.2	6.79
April	6.3	6.89
May	7.1	7.36
June	18.3	17.52

¹ Estimates.

Thus it appears that the Fed is again caught in an inflationary cycle that is sustained by procedures of interest rate control implementation that not only serve to destabilize business conditions with the threat of an inflation induced recession, but also serve to drive interest rates higher and for a longer period of time than might otherwise be the case if private market forces were left unfettered. What's more, despite frequent intervention to control the funds rate, the authorities have utterly failed in their effort to contain monetary growth within targeted ranges. Indeed, this interest rate orientation is a highly suspect tool of monetary control. In fact, even more than suspect, there is no evidence to support the Fed funds-money supply relationship alleged by the Federal Reserve. The connection between interest rate changes and money supply changes has proven to be unreliable and highly volatile. This non-relationship is documented by the accompanying statistical tests. Measured over intervals spanning from one to 12 months, the exceedingly low R^2 's indicate that the interest rate-money relationship has no statistical significance.

Moreover, there has never been an clear mandate from either business or academic economists, or from members of Congress, or from the White House, that controlling interest rates is an effective policy instrument to control the money stock. Down through the years the Fed has always utilized this approach, but the fact remains that the approach itself has never been substantiated. Even worse, Fed intervention in open market operations to stabilize the funds rate has increased substantially in recent years. And, with this in mind, the reasons behind the persistent problem of generally disappointing economic growth, accompanied by an unrelenting inflation, become a good deal less mysterious than many analysts would have us believe.

The short-term operating approach of rate stabilization has during the past decade tended to steepen the slope of business and credit cycle movement. Monetary policy has entered a consistent and predictable pattern of stop and go. bBt inflation expectations during the period have worsened, so much so that prices continue to rise even during periods of output decline. The process of enforced rate control, really a policy of price controls, interferes with the important allocating function of interest rates. Rising rates serve to dampen plans for production and spending, and thus help to prevent conditions of excessive demand that are likely to yield more rapid inflation.

STATISTICAL ANALYSIS

(based on monthly data, January 1960 - May 1978)

Relationship between 1 month growth in M1 and 1 month percent change in the Federal Funds Rate (FFR)

$$1 \text{ month } \% \text{ change in M1} = 5.04 - .00002 (1 \text{ month } \% \text{ change in FFR})$$

$$(17.24) \quad (0.52)$$

$$R^2 \text{ adj.} = .003$$

Relationship between 2 month growth in M1 and 2 month percent change in the Federal Funds Rate (FFR)

$$2 \text{ month } \% \text{ change in M1} = 4.94 + .0007 (2 \text{ month } \% \text{ change in FFR})$$

$$(20.87) \quad (0.45)$$

$$R^2 \text{ adj.} = -.004$$

Relationship between 3 month growth in M1 and 3 month percent change in the Federal Funds Rate (FFR)

$$3 \text{ month } \% \text{ change in M1} = 4.86 + .002 (3 \text{ month } \% \text{ change in FFR})$$

$$(23.91) \quad (1.26)$$

$$R^2 \text{ adj.} = .003$$

Relationship between 6 month growth in M1 and 6 month percent change in the Federal Funds Rate (FFR)

$$6 \text{ month } \% \text{ change in M1} = 4.71 + .008 (6 \text{ month } \% \text{ change in FFR})$$

$$(26.60) \quad (2.59)$$

$$R^2 \text{ adj.} = .03$$

Relationship between 12 month growth in M1 and 12 month percent change in the Federal Funds Rate (FFR)

$$12 \text{ month } \% \text{ change in M1} = 4.61 + .013 (12 \text{ month } \% \text{ change in FFR})$$

$$(30.40) \quad (3.44)$$

$$R^2 \text{ adj.} = .05$$

Note: "t" statistics are provided in parenthesis.

R^2 adj. is a measure of goodness of fit. An R^2 adj. of .70 means that 70 percent of the variation in M1 growth is explained by variations in monetary base growth.

But, under the conditions of stop and go monetary policy, with an uninterrupted rise in the secular inflation rate, business and financial planning has become next to impossible. The increase in risk and uncertainty serves as a disincentive for capital formation, with a resultant drag on output and employment trends. With government authorities announcing policy targets that are never achieved, credibility is substantially reduced and economic agents come to expect that the rules of the game will be changed arbitrarily. This of course enhances risk and uncertainty even more, thereby further reducing incentives for longer-term investment.

Finally, the alleged government anti-inflation commitment is discarded in the minds of rational agents who dismiss such promises as meaningless political rhetoric. Monetary policy failures cannot take all the blame for fostering this

unattractive economic and investment climate; inappropriate fiscal and regulatory policies have contributed mightily. However, an analysis of the fiscal-regulatory climate goes beyond the scope of this paper, however, and will have to serve as grist for another mill.

To substantially improve monetary performance, and at the same time rebuild government credibility on the anti-inflation front, the Federal Reserve must completely overhaul its implementation procedures. Toward this end I recommend the following steps: First, the agency must decide on the most appropriate longer term trend growth rate of the money stock. I would recommend a range of 2 to 4 percent, roughly in line with the rate of change of real potential output (3-3½ percent).

Second, to more effectively contain the growth of the money stock and bring performance closer to objectives, the agency must abandon the discredited interest rate control approach and instead seek to control the growth rate of the bank reserve supply. The System Account Manager has daily knowledge of all the so-called operating factors (Treasury deposits, float, etc.) and thus can easily control the monetary base, in my view the broadest measure of Fed open market operations. The accompanying statistical analysis indicates a clear relationship between rates of base change and rates of money stock change. Importantly, measured over 3, 6, and 12 month periods, the high R^2 's indicate a significant and rising correlation between the two growth rates. Moreover, the graphs associated with the regression analysis clearly show the relatively stable relationship between the base and the money stock over longer periods.

In contrast, short-run movements of the money stock are dominated by statistical noise and seasonal adjustment factors and, as such, have no economic meaning. In consequence, the Fed should end its preoccupation with attempts at fine-tuning 1 and 2 month M1 growth patterns. The Fed should also admit that its short run money forecasts are as unreliable as those of the private sector. Weekly money supply changes should be assigned the obscurity they so richly deserve. And, laid to rest in the same grave, next to the weekly projections, should be the 1 & 2 monthly corpses as well.

Instead, the Fed must actively campaign to emphasize the importance of 3, 6, and 12 month monetary trends, for it is these trends that influence income growth and inflation patterns. I believe the most valuable indicator would prove to be M1 changes over 12 month intervals, adjusted each month. For example, if base growth were maintained around 2.5 percent per year, statistical tests indicate that M1 growth might fluctuate in a relatively narrow 1.2 to 3.8 percent range. With the aid of advanced statistical techniques, particularly recent improvements in the Box-Jenkins approach, improved money multiplier forecasts could be used to narrow the 12 month M1 range even further. In these circumstances data received each month would be viewed not as a highly volatile and unsettling benchmark, but instead as part of a gradually evolving adjustment process to maintain steady money stock growth rates on a year-over-year basis.

STATISTICAL ANALYSIS

(based on monthly data, January 1960 - May 1978)

Relationship between 1 month growth in M1 and 1 month growth in the monetary base (MB)

$$1 \text{ month } \% \text{ change in M1} = 3.35 + .26 (1 \text{ month } \% \text{ change in MB})$$

$$(7.93) (5.19)$$

$$R^2 \text{ adj.} = .11$$

Relationship between 2 month growth in M1 and 2 month growth in the monetary base (MB)

$$2 \text{ month } \% \text{ change in M1} = 1.67 + .52 (2 \text{ month } \% \text{ change in MB})$$

$$(4.16) (9.36)$$

$$R^2 \text{ adj.} = .28$$

Relationship between 3 month growth in M1 and 3 month growth in the monetary base (MB)

$$3 \text{ month } \% \text{ change in M1} = .49 + .71 (3 \text{ month } \% \text{ change in MB})$$

$$(1.37) (13.38)$$

$$R^2 \text{ adj.} = .45$$

Relationship between 6 month growth in M1 and 6 month growth in the monetary base (MB)

$$6 \text{ month } \% \text{ change in M1} = -.15 + .80 (6 \text{ month } \% \text{ change in MB})$$

$$(0.50) (18.54)$$

$$R^2 \text{ adj.} = .61$$

Relationship between 12 month growth in M1 and 12 month growth in the monetary base (MB)

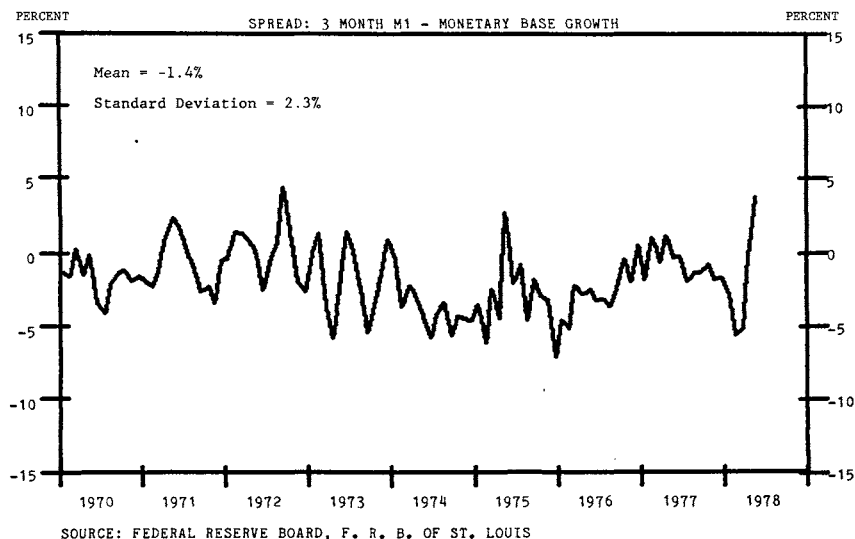
$$12 \text{ month } \% \text{ change in M1} = -.09 + .80 (12 \text{ month } \% \text{ change in MB})$$

$$(0.38) (22.90)$$

$$R^2 \text{ adj.} = .70$$

Note: "t" statistics are provided in parenthesis.

$R^2 \text{ adj.}$ is a measure of goodness of fit. An $R^2 \text{ adj.}$ of .70 means that 70 percent of the variation in M1 growth is explained by variations in monetary base growth.





Third, the Reserve, in addition to announcing the first two proposals, must also announce in the clearest of words that it recognizes that stable interest rates, short rates as well as long rates, can only come about through stable and non-inflationary monetary growth rates that will provide the foundation for similarly stable rates of inflation. This includes short rates as well as long rates. Such an approach toward constant and modest money growth rates would be implemented on a gradual basis, perhaps a 1 to 1.5 percent yearly decline in M^1 growth over a four year period. Some decline in output growth would take place, but this mild shock would be fully anticipated and therefore short-lived. More importantly, the restoration of Fed credibility would quickly lead to a significant and sustainable decline in long-term rates, soon to be followed by a similar decline in short rates. As a result, assuming restrained fiscal policies (tax-rate cuts and more moderate government spending growth), the climate for long-term capital investment

would be greatly improved, thereby stimulating both output growth and employment. Of critical importance, however, is the announcement effect of a clear statement backed by steady performance. These positive signals would dampen inflation anticipations and greatly smooth the transition process.

Fourth, to smooth the transition process in the money market, the Fed must reform required reserve regulations and reserve carry-over regulations. This will enhance the ability of the money market to relax transitory disturbances to short-term rates. Here too, the authorities must clearly announce their intention, in this case to allow the Fed funds rate to freely float.

The Fed expends too much effort intervening to cushion financial sector disturbances that would more effectively be resolved by an ongoing market mechanism. In my view the frequency of Fed intervention has actually increased trading volatility by creating a massive (and counterproductive) guessing game over every jiggle in the Fed funds rate. The losers in this game have skills that are no worse than any one else's, they simply have worse luck. On the whole, nearly all dealers have suffered substantial trading losses in efforts to outguess the Fed. This hapless approach is partly fostered by the ever growing and now enormous volume of Fed interventions, a trend which appears well related to the increase in market volatility.

Last, the Fed should implement the recommendations of the Bach Commission, particularly the suggestions for improved accounting of nonmember bank deposits and more reliable seasonal adjustment techniques.

The monetary excesses of the past two years have given rise to a variety of rather well-founded fears that a new recession looms just over the horizon. A number of respected analysts now argue that substantial further increases in rates of interest and inflation must inevitably result from overly stimulative demand policies that have already released forces that cannot be checked short of such a recession.

My own view of the interest rate—economic outlook for the next year is admittedly rather pessimistic, but I would nevertheless argue that any time is appropriate for constructive changes in policy. The new administration of Fed Chairman G. William Miller has hardly begun. The mistakes of past years weigh very little on his shoulders, at this point his slate is still relatively clean. Thus, from the important standpoint of bureaucratic politics there is no need to defend past policies and there exists every incentive to embark on a new course.

Congress can play a major role in this hoped for movement toward monetary reform. Through vigorous analysis and examination, along with the kind of constructive prodding that clearly falls within the realm of Congressional oversight of the making of monetary policy, much progress appears possible. Clearly the vast majority of American voters, and voters are after all tax payers as well as bond and stockholders, are opposed to inflation. Inasmuch as inflation can never be curbed without greatly diminished money supply growth, the political climate at present appears more conducive to substantive changes in the formulation and implementation of monetary policy than has been the case in many years. In this spirit, while the foregoing suggestions are neither exhaustive nor without some analytic imperfection, it is nonetheless hoped that they will spur additional inquiry into what has up to now been an almost sacrosanct domain.

Chairman MITCHELL, Thank you very much. This is fascinating testimony. I don't claim to be a leading statistician, but to achieve the kind of standard deviation that you have found, 1.3 percent, is remarkable for a 6-month to a 12-month period.

Mr. KUDLOW. It is very small.

Chairman MITCHELL. It is an infinitesimal deviation. Obviously, it speaks to the soundness of your thesis.

Mr. KUDLOW. The few times that Fed officials have been asked to address themselves to the issue of monetary implementation they have argued that the effect on M_1 on interest rates is the same as the effect on M_1 on some measure of reserves like the monetary base over 1-month periods of time.

I don't disagree with that thesis. My point is: Who cares about 1-month periods of time? There is too much statistical noise there. Over 6- and 12-month periods of time, however, the interest rate-money relationship breaks down, but the monetary base-money

relationship holds up. That is really the only point I am trying to make here.

Chairman MITCHELL. I want to pursue this if I can, but first I want to get back to the Treasury draw authority. This is a fascinating thing that I hope to have time to discuss. It seems to me what Mr. Atlee has suggested is that in actuality the Fed really has an impact only on about 10 percent of the interest rates. This seems to be at variance with the position you have taken.

Let us go back to the draw authority first, and then perhaps we can spend sometime on other arguments. I am going to suggest, perhaps submit, an amendment to the legislation on the draw authority which would, in effect, waive the \$5 billion ceiling which is now in effect if the President should actually declare a national emergency. May I have your reactions to that possible amendment which the Chair intends to propose?

I think you have indicated, Mr. Poole, that it is obvious \$5 billion would be inadequate in a real emergency: I would assume, therefore, that you would favor waiving the \$5 billion ceiling in a true emergency. Is that correct?

Mr. POOLE. Yes.

Chairman MITCHELL. Do you other gentlemen have any reaction to this?

Mr. ATLEE. It is alright with me.

Mr. KUDLOW. I would be inclined to agree, but I am not that familiar with the issue.

Chairman MITCHELL. A second question for all three of you is: Would you favor giving the Treasury the option of borrowing securities as well as borrowing cash from the Federal Reserve? What I mean is, keeping the cash draw authority and adding onto it a securities draw option with some sort of limit on it. Am I making my question clear? May I have a response?

Mr. ATLEE. I don't see the point of it. I was interested in Mr. Poole's mention of that, but I don't really understand the point of it.

Chairman MITCHELL. Mr. Poole?

Mr. POOLE. I would not have both. It seems to me that there is no need to have both. My major purpose in making the suggestion that the Treasury borrow securities is to provide a clear statement that the Congress does not want the Government to be financed by printing press money; that the securities the Treasury would borrow would have to be sold to raise the cash.

In that case, you would not have monetary creation financing Government activities. I would have one substitute for the other. The practical import, as I tried to emphasize, is minor, provided that the Federal Reserve, in fact, neutralizes the impact of the cash draw by the Treasury.

Do you understand what I am saying or am I being confusing?

Chairman MITCHELL. I missed the last part of your statement.

Mr. POOLE. When the Treasury borrows money directly from the Fed reserves are pumped out into the banking system. When the Treasury spends that newly created money, ordinarily the Federal Reserve does not permit that new spending to remain in the banking system, but sells Government securities to absorb those reserves.

My point is simply that we ought to be telling the Federal Reserve, or the Government as a whole, that we don't want activities financed

by printing press money. By changing the borrowing authority, the draw authority, so that it is a draw on securities rather than on cash, we would be making a clear statement that we are not to finance Government activities by printing press money.

Chairman MITCHELL. Wouldn't that present some problems to the Treasury in terms of immediate access to cash?

Mr. POOLE. No; because the Treasury would sell the securities. The Treasury would borrow the securities and sell them on Wall Street to raise the funds.

Chairman MITCHELL. Within the context of the issue we are considering, the draw authority, if it exists primarily for situations which have to take place very, very quickly—

Mr. POOLE. But this is exactly what already happens, except that now the Federal Reserve sells the securities.

Chairman MITCHELL. I guess my point is, could the Treasury sell securities fast enough, say, in a 48-hour period?

Mr. POOLE. They can sell them in 10 minutes.

Chairman MITCHELL. To accomplish the same effect as the draw?

Mr. POOLE. Absolutely. They can sell the securities in 10 minutes, with one phone call.

Mr. KUDLOW. And often do, in practice. It happens all the time.

Mr. POOLE. The main problem is, it would be awkward to issue a new set of Treasury bills on a Friday afternoon or something like that, because there are regular issues scheduled every week. But to sell an existing issue is an entirely different matter.

Mr. KUDLOW. I think it is important that the Treasury not have an unlimited, unconstrained power essentially to create new money—although it is an indirect process through the Federal Reserve that has gone too far at this point. We should be imposing constraints, rather than suggesting fewer limits.

Chairman MITCHELL. Can I infer from that that to the extent to which we allow this to happen, it sets the stage for poor management within both the Treasury and the Fed?

Mr. KUDLOW. Absolutely. I think it is important to remember that the Treasury has access to substantial amounts of cash, and that at any time the Treasury can call on a variety of accounts sitting in different places in the Government—some at the Federal Reserve, some of them elsewhere, some in the commercial banking system as well, through the T. & L. accounts. So the notion that the Treasury would have any kind of substantial cash shortfall for more than a few minutes is a notion which I find to be hardly realistic.

Chairman MITCHELL. Mr. Hansen?

Mr. HANSEN. I think we are about out of time, Mr. Chairman. I do feel that we need some imagination. I appreciate the statements that have been presented this morning by you gentlemen, because I think we need some imagination in our management of monetary policy.

I think too often we have delegated it to independent agencies, and the Congress has abdicated its responsibility and authority. I think that, really, if we are ever going to get this monstrosity under control that we have created, the Congress is going to have to reclaim some authority and set some more responsible and reasonable guidelines so that, as you say, you don't have the willy-nilly cleaning up of the printing presses.

I do have some questions I would like to submit to some of you which Dr. Weintraub can give to you afterward, if it is all right. I won't take the time now, but I would like some answers, and I would like to explore what you have gone into a little bit further.

I think it does present some alternatives, and some viable alternatives.

Mr. Chairman, thank you very much.

[Congressman Hansen subsequently sent a letter containing questions to Mr. Poole. The letter along with Mr. Poole's response letter follows:]

FARREN J. MITCHELL, MD., CHAIRMAN

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U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-FIFTH CONGRESS

WASHINGTON, D.C. 20515

July 10, 1978

Professor William Poole
Department of Economics
Brown University
Providence, Rhode Island

Dear Professor Poole:

At the hearing in front of the Subcommittee on Domestic Monetary Policy on June 27, 1978, you suggested that the Treasury "draw" authority could be replaced with some mechanism by which the Treasury could borrow securities from the Federal Reserve System Open Market Account Portfolio, sell them to raise cash, then repay the Fed when adequate cash was again available.

As we agreed at that meeting, I am submitting the following additional questions to you, and will appreciate any further comments or explanation they might suggest to you.

1. How would the Treasury repay the Fed? Would it use something like repurchase agreements in selling the securities in the market?
2. Am I correct in my understanding that the only charge the Fed would make would be a relatively small administrative or handling charge, since the earnings on the securities would still accrue to the Fed (the Treasury would make up what was lost by selling the securities)?
3. What drawbacks are there to your proposal?
4. Does it matter where the securities are borrowed from? As a technical matter, couldn't Treasury borrow securities from the portfolios of Government securities dealers?

Many thanks in advance for taking the time to answer these additional questions. And again, special thanks for your appearance before the Subcommittee. Your testimony has been of great value and most enlightening.

Yours for individual liberty,

GEORGE HANSEN
Member of Congress



BROWN UNIVERSITY *Providence, Rhode Island • 02912*

July 20, 1978

The Honorable George Hansen
U.S. House of Representatives
Subcommittee on Domestic Monetary
Policy of the
Committee on Banking, Finance
and Urban Affairs
Ninety-Fifth Congress
Washington, DC 20515

Dear Congressman Hansen:

I am writing in response to your letter of July 10, 1978 concerning the Treasury "draw" authority. My answers to your questions are as follows:

1. The Treasury would repay the Federal Reserve by returning the exact securities that it had borrowed. Thus, when the Treasury borrowed securities from the Fed and sold them in the open market to raise cash, it would later go back into the market to repurchase securities of the same issue and return those securities to the Federal Reserve.

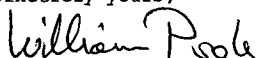
2. It is correct that the only charge the Fed would make would be a small administrative or handling charge since the Treasury would return the identical securities to the Fed. The Treasury would be expected to reimburse the Fed for any interest coupons the Fed might have lost during the period over which the Treasury had borrowed the securities. But, in practice, the Treasury would no doubt borrow securities for such a short time that they would not in fact have to be concerned about the interest coupons.

3. As far as I can tell there are no drawbacks to my proposal. In fact, just yesterday I discovered that the Federal Reserve has, or at least had, standard procedures for lending securities from its portfolio to Government securities dealers for the purpose of improving the efficiency of open market operations. (See Minutes of Federal Open Market Committee 1970, pp. 256-62). I am sure the Federal Reserve would be willing to provide you with the details on their procedures for lending securities to dealers.

4. It does not in fact matter where the securities are borrowed. There is no reason why the Treasury could not borrow securities from a private firm, such as a Government securities dealer, instead of from the Federal Reserve. I see no reason not to give the Treasury the authority to borrow securities from private firms as well as from the Federal Reserve, provided that the value of the securities borrowed under any such arrangement is counted in the total of Treasury borrowing subject to the debt ceiling.

I hope I have answered your questions; should you have any further questions please feel free to write to me.

Sincerely yours,

A handwritten signature in cursive script that reads "William Poole".

William Poole
Professor of Economics

Chairman MITCHELL. Thank you.

The Chair is going to ask an unusual request of the witnesses. There are some theories and approaches that have been presented this morning which represent rather radical departures from the normal way of proceeding.

As I indicated earlier, we are planning an indepth hearing on monetary policy, and certainly we would include its implementation at that time. If we can work it out, I really would like you gentlemen to come back, not for a formal hearing, but for a seminar with the members, where we can pursue, in depth, your approaches and some of your ideas which are fascinatingly radical, and therefore, very fascinating to me. If we can work it out, in terms of your schedules and travel expenses and that kind of thing, would you be amenable to it?

Mr. POOLE. Yes.

Mr. ATLEE. Yes.

Mr. KUDLOW. Yes.

Chairman MITCHELL. The members could block out 3 hours one evening for a seminar.

Mr. KUDLOW. As I said before, I think the utility of this approach is enormous. As I have observed in recent years, when you get Government officials, Fed officials, before this subcommittee as well as the parent committee, in many cases it strikes me that you all have been overwhelmed in many respects. You are being bamboozled because you are not as familiar with the minutiae and the nuances that the Fed officials are. It doesn't mean that their judgment is any better; it just means that they are better versed in these day-to-day affairs, and that they have a better understanding of the nomenclature. If we could get beyond those superficialities and attack the issues directly, I think it would be much more productive, not only from the standpoint of this subcommittee, but from the entire congressional oversight of monetary policy.

Chairman MITCHELL. I agree with you, except that I would not use the word "bamboozled." [Laughter.]

It appears that, very often, members become traumatized. [Laughter.]

Mr. KUDLOW. I stand corrected.

Mr. HANSEN. Mr. Chairman, I think sometimes we have a tendency to take what we are and what we do for granted. I think that, since we are relegated to an 8:30 hour in the morning, we sometimes wonder if we are being set aside for other things. But, Mr. Chairman, I think you chair one of the most important subcommittees in the Congress. Certainly, everybody has to deal with money. The value of that money and the availability of it is probably the most important thing to the people in this country today.

I am not sure that, sometimes in the helter-skelter—I think that what Mr. Kudlow is referring to is: We have so many things coming across here, it is hard for us to zero in on one thing and really do justice to it.

I think what you are saying, Mr. Chairman, is vital. I commend you for taking this step. I really feel, if the country is going to solve its problems, part of the responsibility rests right here.

Chairman MITCHELL. Precisely. We need the education that would come to us as a result of such a seminar, when we are not under pressure to make another meeting.

I have one last comment, or question, on the draw authority: The Treasury argues that in the event of a national emergency, they would fear a communications breakdown, or banking crisis, and therefore, the authority would be absolutely essential to them under those kinds of conditions. That is their argument; and I think that they have made a somewhat persuasive argument for it, which has caused me to lean toward the continuation of the draw.

Any reaction, Mr. Kudlow?

MR. KUDLOW. I am prepared to be persuaded of that, but only in the most reluctant terms, frankly.

Chairman MITCHELL. Mr. Atlee?

MR. ATLEE. Yes; I suppose so. I would think that it might have a risk of giving the Government authority to get into national emergencies.

I am not sure just how significant that would be in facilitating getting into a national emergency. That would be my only concern on that.

One thing that happened some years ago that was possibly relevant: I had noticed—I should say, someone else who was dealing with the data—noticed a large increase of currency in circulation. After some investigation, it was discovered that this was from the Federal Reserve Bank in San Francisco, and it happened to have been drawn out by the CIA for operations in Asia.

Now if the Treasury could get the funds directly from the Federal Reserve—that is, additional funds, not just currency—that kind of thing could be enlarged. I don't know, but that would be my only concern with it.

Chairman MITCHELL. Mr. Poole?

MR. POOLE. I think an important consideration here is how the words "national emergency" are interpreted. I do not know what that term means. I am not a lawyer. I do not know what the practice is.

My preference would be to have that term interpreted clearly to mean "in the event of physical destruction, communications breakdown, and so forth"; rather than a situation where the President might announce that there is a "national economic emergency," for example, in peacetime, in which case we would have the danger of printing-press money being used to finance our activities.

I would emphasize "national military emergency," or some kind of qualifying phrase that would make clear exactly the kind of thing that we are talking about—communications failures, and so forth.

Chairman MITCHELL. Gentlemen, it has been fascinating. I would hope that we could try to work with Dr. Weintraub and get a seminar set up sometime after we return from this—what do they call it—"work period"? [Laughter.] Our "July 4th District Work Period." [Laughter.] Let us shoot for the end of July, depending upon your vacation schedules and so forth.

Thank you again. It has really been remarkably interesting testimony.

[Whereupon, at 9:43 a.m., the hearing was adjourned, subject to the call of the Chair.]

